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Over the cliff with Morgan Stanley

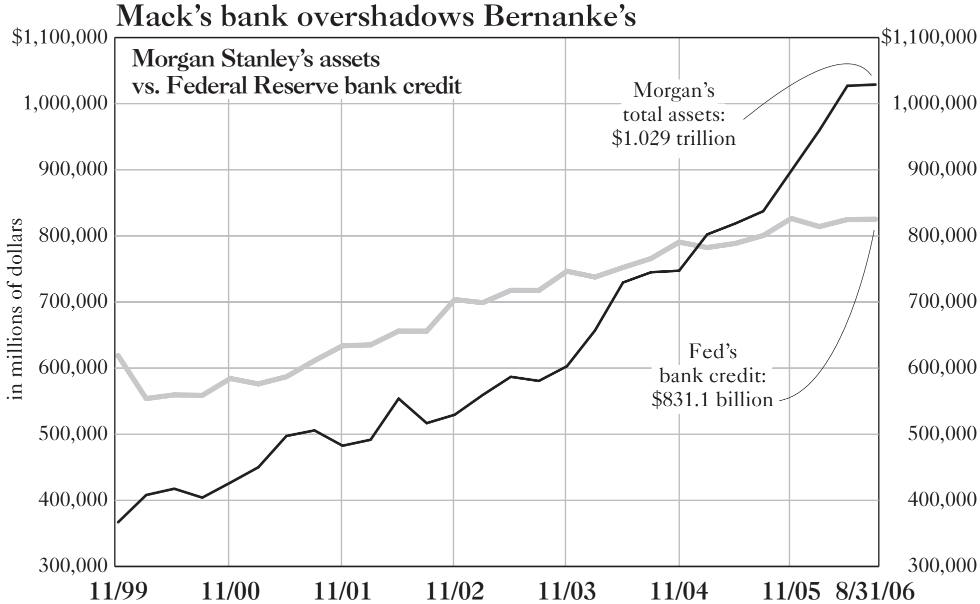
Alone among the Wall Street financial-services providers that used to style themselves, simply, as "brokerage houses," or—with a little more tone—"investment banks," Morgan Stanley is the owner of a $1 trillion balance sheet. It cleared the 13-figure mark on the May 31 statement date. The former white-shoe partnership has expanded its footings at the rate of 21.5% per annum since 2003. It has left Goldman Sachs in the dust, size-wise. And while no lawful, tax-paying, privately operated financial institution in the world can match the Fed's gross margins, Morgan Stanley today deploys more assets than the house of Ben S. Bernanke.

It would be well for Morgan if Bernanke et al. delivered a nice, safe, soft landing in any future macroeconomic descent. Wall Street is heavily exposed to credit risk, and Morgan Stanley is especially heavily exposed. For one thing, Morgan itself is highly leveraged. For another, its corporate clientele is increasingly highly leveraged. And, for a third, its Discover Card customers and mortgage borrowers are—many of them—presumably highly leveraged. Morgan Stanley is, in fact, a dealer in, and user of, financial leverage on a huge and growing scale.

Without reference to price, "risk" is an uninformative word, and the bearish indictment we are about to hand up against Morgan Stanley is not that the firm is shouldering lots of risk. Our complaint is, rather, that the firm and its stockholders are not being properly paid for their trouble. How could they be, given the compression of credit spreads, the flatness of the yield curve, the Street-wide stampede to facilitate private-equity promotions (now under the glare of the Justice Department), the late-cycle relaxation of lending standards and the widely credited myth that the Federal Reserve will pull the market's chestnuts out of the fire before they're even so much as singed? Admittedly, this might seem a hard point to carry in the wake of a quarter in which Morgan's earnings from continuing operations jumped by 61% and its return on equity totaled 23%. We reason, however, that whether or not this is the top of the credit cycle, it certainly isn't the bottom, and to generate the returns it does, Morgan Stanley is traipsing through minefields. In the asymmetry between what it earns and the chances it takes to earn it, Morgan reminds us of the mutual funds that racked up triple-digit profits in the 1990s, only to give them back, with interest, in the 2000s.

No doubt, Morgan Stanley's top managers would think long and hard before jumping off a bridge with a length of elastic rope tied to their ankles or making a dash across Sixth Avenue against the traffic. But John Mack did not return triumphantly to the chief executive's chair in 2005 to err on the side of caution. His remit is to run the ball down the field and into the end zone, "end zone" being an undefined term but perhaps taking the form of a merger with a giant commercial bank. In the wake of its protracted executive-suite soap opera, Morgan is probably the least likely firm on Wall Street to beat a tactical retreat from risk

Mack's bank overshadows Bernanke's



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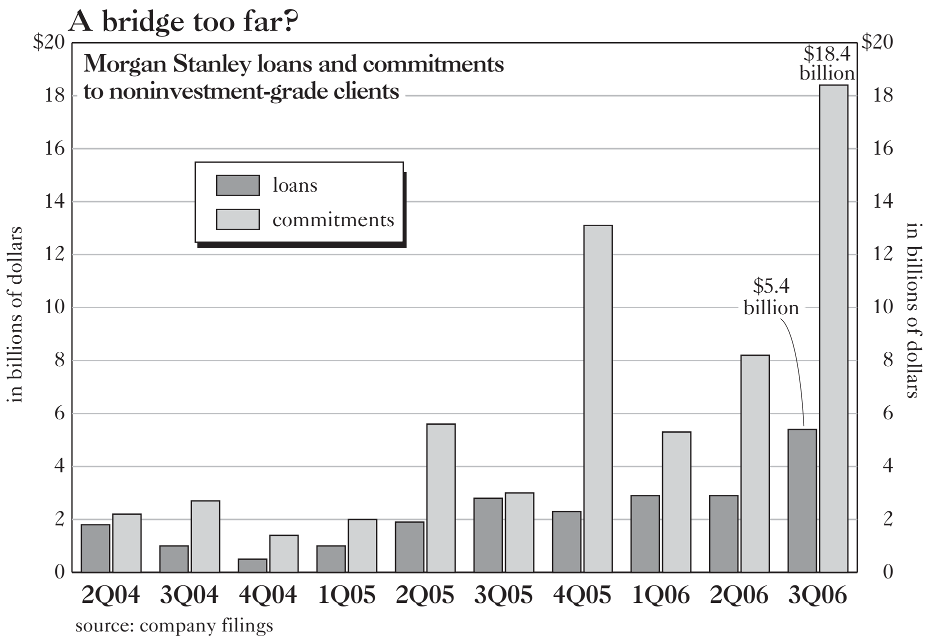

on account of the dangers that a turn in the credit cycle may present on some indeterminate future date (which date this publication expected long before now). The regenerated Morgan Stanley seems determined to make money while the making's good.

We say that the making's not so good as it seems—indeed, that the markets Morgan Stanley is just now getting around to entering would be better candidates for a timely exit. We have in mind, specifically, nonprime residential mortgage lending, which Morgan belatedly entered with its August acquisition of Saxon Capital (a transaction that "provides Morgan Stanley with new origination capabilities in the non-prime market, which we can build upon to provide access to high-quality product flow across all market cycles," the Morgan announcement said in part). And we have in mind private equity, which the firm is reentering after a two-year absence, and hedge funds, a couple of which the firm has been rumored to be scooping up. As for Morgan's acquisition last Friday of Chicago's Downtown Public Parking System, for $563 million, "the first purchase by the bank's infrastructure investment group," as Bloomberg reported, we only note the headline on page 24 of Tuesday's *Financial Times*: "Fingers could get burned as hot money floods infrastructure."

But the business we would fly fastest from, not toward, if we were in the Morgan driver's seat, is the business of making bridge loans to speculative-grade borrowers. Typically, these are companies undergoing a leveraged buyout. The bridge lender extends credit pending the close of the anticipated transaction, at which time the new entity is expected to fund itself in the capital markets. Mack and we seem to disagree on the advisability of jumping in now with both feet. Morgan's commitments to lend leapt by $10.2 billion in the latest quarter alone—to $18.4 billion in August from $8.2 billion in May. And as the firm readily admits, the credit of low-rated companies is difficult or impossible to hedge. "Maybe just help us, how do we think about that risk?" an analyst asked Morgan Stanley's chief financial officer, David Sidwell, on the September conference call. "Because I know it looks a lot more dangerous than it is, and it's actually a great business."

Yes, indeed, Sidwell replied, it *is* a great business. And what makes it great is that Morgan Stanley's niche is origination and distribution. Not if it can help it does Morgan hold a loan beyond the few months it takes for the borrower to secure permanent financing in the junk-bond or the leveraged-loan markets. Morgan not only knows its credits cold, Sidwell went on, but it is also careful to keep its options open. It retains the right to charge a higher interest rate or to back out of the loan altogether if the borrower runs into sudden financial problems. Of course, he added, if the credit markets collapsed, a lender could get caught in spite of these safeguards. It happened in 1989-90.

First Boston then achieved the inglorious distinction of owning more than $1 billion in "hung" bridge loans, a.k.a. bridges to nowhere or, more pithily, "piers." The bridges became piers when the junk market suddenly shut down in the fall of 1989. Bridge-loan promoters noted that most of First Boston's bridge loans, even some of the most speculative, worked out eventually—out of 25, only five went sour. Unfortunately, as with real bridges, an 80% success rate was inadequate. Except for the costly and reluctantly tendered support of its parent, CS Holdings, First Boston could very well have been a goner.

"I think we remember 1989, you remember 1989, and I think a lot of the managements remember 1989," Peter E. Nerby, a Moody's vice president, tells colleague Dan Gertner. "And we think that risk management at securities firms actually works pretty well. So we think a more likely scenario is the market just slows down, the inventory runs off, it gets syndicated. But you're right, there's always a risk that something turns quickly. That can happen."

In the debt markets these days, risk seems a cloud no bigger than the size of a man's hand. Through last month, just six high-yield companies had defaulted in 2006, which puts the junk-bond market on the road to the fewest defaults in a quarter-century. At Discover, Morgan Stanley's credit card subsidiary, delinquencies and charge-off rates are near their cyclical lows. But no financial sky is forever blue, and thunderheads are forming in credit—from mortgages to speculative-grade debt to the "structured" bits and pieces of junior debt that trade at 200 basis points over Libor but, come the deluge, will almost certainly trade at 1,000 over. In one corner of its immense corporate skull, Morgan seems to agree. *The Wall Street Journal* reported the other day that the firm is in talks to acquire 20% of Avenue Capital Group, a hedge fund specializing in distressed debt. "Players like Avenue's founder, Marc Lasry, have been amassing war chests in the last few months in anticipation of credit problems among lower-rated companies after several years of easy money," the *Journal* said. "At a recent conference, Mr. Lasry told investors he expects that to come in the next three to nine months."

Morgan Stanley, in fact, has been hiring distressed-debt talent on both sides of the Atlantic. "Deals done in 2006 have been at historically high valuations and leverage multiples, so there is very little room for slippage," Pat Lynch, the head of Morgan's distressed-debt team in Europe was quoted as saying in London's *Daily Telegraph* last month. Lynch went on to venture that the cyclical chasm will not open immediately: "We think it's going to take time through 2007 for the fundamentals to really deteriorate," he said, "but we're ready for business if it does."

Nobody can know. Nor can anybody know which market will blow, come the turn in the cycle. But what we all can and should know is that the post-2002 credit expansion has been one of the all-time least discriminating. Whether in residential mortgages, tradable bank debt, speculative-grade bonds or so-called structured credit, few borrowers have been left behind. It follows that, come the next crack-up, both peril and opportunity will be unsurpassed. Martin Fridson's analysis again comes to mind (see the prior issue of *Grant's*). Given the dodgy ratings mix of current junk-bond issuance, he points out, a recession no more severe than the meek and mild 1990-91 downturn could produce a default rate "not observed since shortly after the bottom of the Great Depression, in 1933."

Whether Morgan Stanley's investment in distressed-debt is a timely hedge or a case of cognitive dissonance is a matter for speculation. On balance, certainly, the firm is hugely exposed to the adverse consequences of the boom from which—now that Mack is back—it's riding for all it's worth. Goldman and, indeed, the rest of Wall Street are riding hard, too. All, for now, are the happy heirs to the low interest rates and tight credit spreads that the Fed helped to instigate in the name of fighting "deflation" back in 2002-03. We pick on Morgan not only because, among all the brokers, it has the biggest balance sheet and, arguably, the most motivated CEO, but also because its bridge-lending disclosure is so forthright. And it is expanding as if—literally—there were no cyclical tomorrow.

Morgan Stanley vs. the field
(in $ millions)

	last 12 mos. to 8/31/06	2005	2004	2003
Morgan Stanley				
Total assets	$1,028,872	$898,523	$747,334	$602,843
Total debt/total assets	78.3%	79.9%	76.4%	74.7%
Equity/total assets	3.2	3.3	3.8	4.1
Value at risk (VaR)*	$79	$85	$73	$55
Goldman Sachs				
Total assets	$798,309	$706,804	$531,379	$403,799
Total debt/total assets	64.9%	68.9%	64.5%	66.5%
Equity/total assets	3.8	3.7	4.7	5.4
Value at risk (VaR)*	$130	$99	$95	$82
Bear Stearns				
Total assets	$334,760	$292,635	$255,950	$212,168
Total debt/total assets	63.7%	64.9%	63.2%	62.3%
Equity/total assets	3.4	3.6	3.3	3.3
Value at risk (VaR) *	$41	$29	$22	$22
Lehman Brothers				
Total assets	$473,737	$410,063	$357,168	$312,061
Total debt/total assets	81.5%	81.7%	82.3%	83.5%
Equity/total assets	3.7	3.8	3.8	3.9
Value at risk (VaR)*	$54	$55	$38	$31

*minimum loss expected in one out of 100 trading days, as calculated by Fitch
sources: Bloomberg, Fitch Ratings

Last week, Bloomberg broke the news that, following a two-year absence from the private equity market, Morgan Stanley is making its return with a takeover fund totaling as much as $5 billion. As with hedge funds, bridge lending, infrastructure investment and nonprime residential mortgage origination, Morgan does not exactly have the field to itself. According to Dealogic, in 2005 the private-equity maw absorbed 951 U.S. companies worth $163.3 billion. In only the first nine months of 2006, it has swallowed 813 U.S. companies worth $245.8 billion, more than twice the pace of a year ago.

"At stake is Chief Executive Officer John Mack's mandate to reverse a slide that began under predecessor Philip Purcell and restore Morgan Stanley to the stature of its late 1990s heyday, when it was the envy of the securities industry and earned 75% more than Goldman," Bloomberg said. "The focus on LBOs once again puts the New York-based company in competition with the biggest buyout firms, including the Blackstone Group LP. . . ."

Of all the times not to have to compete with Blackstone, we would put the autumn of 2006 at the top of the list. It's not that Stephen Schwarzman, the Blackstone CEO, doesn't sound reasonable. Rhetorically, he's unanswerable. "As the economic cycle lengthens, prices tend to get higher and the prospects for earnings growth tend to get a little weaker, so it's a time where one needs to exercise caution," he told Reuters recently. So much for words. As for deeds, Blackstone is leading the $17.6 billion leveraged acquisition of Freescale Semiconductor, a deal that the great and knowledgeable Fred Hickey, editor of *The High-Tech Strategist*, calls "insane." Hickey and Gertner and your editor are as one on that point. But, crazy or sane, the Freescale transaction is emblematic. It is what passes for good business in 2006. Let us look at the numbers.

If the recent buyout of Philips Semiconductors (now NXP Semiconductors) is any guide, Freescale will be paying an interest rate of 8% on its projected $10.45 billion of debt, implying annual interest charges of $836 million. Yet, between 2001 and 2005, the prospective borrower generated that much EBITDA in only two years, 2004 and 2005. In 2001, the cyclically vulnerable chip maker produced cash flow of all of $22 million, an impressive $814 million less than the projected post-deal interest charge. Naturally, it being the twilight of the private equity feast, Freescale is going to be very highly leveraged. "The ratio of debt to EBITDA is eight times," Gertner points out. "Yet Morgan Stanley is building up its European distressed team to capitalize on the opportunities that leverage ratios of a mere six times are likely to produce."

In defense of the alleged profligacy of the GOP-controlled 51st Congress (1889-91), which its detractors dubbed the "Billion Dollar Congress," Republicans of the day proudly countered, "It's a Billion Dollar Country!" No doubt the overseers of the first trillion-dollar balance sheet in the U.S. stock-brokerage industry reason that these are trillion-dollar markets. So they are, not least in leverage.

After cycles turn, chastened investors look back in amazement at the things they credulously believed. The more introspective reexamine the transactions and news headlines that—as they can see so clearly after the fact—provided the tip-off that markets had gone too far in one direction or the other. Looking back on the upswing of the mid-2000s, posterity may emit low whistles at the news (broken by Bloomberg on October 2) that Morgan Stanley intends to provide its highly paid employees with $2 in margin debt for every $1 of bonus money they contribute to the firm's hedge funds and LBO funds. If the investments earn more than the interest rate charged, the employee must repay the loan, with interest. If the investment is a loser, however, the loan and the loan service are forgiven.

As a compensation and retention scheme, the bruited Morgan Stanley heads-you-win, tails-we-lose idea may or may not secure the loyalty of the firm's rainmakers. And it may or may not be unique on Wall Street (supposedly, other firms also dispense two-to-one nonrecourse margin debt to favored employees). In any case, to us, it's symbolic of the new, exquisitely ill-timed Morgan Stanley push for growth and greatness. We admit that ours is a minority opinion. Gertner's survey of the rating agencies turned up no substantive criticism of the firm or its risk-management procedures. Yes, Morgan's so-called value-at-risk is going up, the analysts say, but so, too, is its equity. As to the profitable (and non-transparent) prime brokerage business, says Fitch, "We believe the number of new entrants into the prime brokerage business is pressuring profit margins for Morgan Stanley but that risk appetite has not materially altered."

For our part, we believe that risk appetite throughout the credit markets is ravenous, and that the proof of just how precariously balanced these markets have become is how few people appear concerned. Spreads on five-year credit-default swaps for the major Wall Street firms (e.g., Morgan, Goldman, Lehman, Bear Stearns, Merrill Lynch) are quoted between 20 and 34 basis points, at or near historical lows.

The non-crisis attending the collapse of Amaranth Advisors last month has further steadied Wall Street's nerves (not that they needed it). If a $6 billion hedge-fund collapse does no systemic damage, what event could? But the tranquilizer dispensers overlook that Amaranth dealt in exchange-cleared markets. Credit is an uncleared, over-the-counter market. No clearinghouse insists on scrupulous daily marks to market, with the appropriate rebalancing of collateral. In credit, it's mark as you please, leverage as you can. Never before have hedge funds taken such an active role as lenders. And in no cycle prior to this one have the terms and conditions of lending been so free and easy across so many markets. Observing these facts, we doubt that anybody's risk models are properly tuned and calibrated.

Thus, Gertner wryly observes, the new Morgan Stanley wins plaudits from the stock market. "It's a great time to expand into the nonprime residential mortgage business—despite the now apparent housing slowdown," he winds up. "It's a great time to reenter the private equity business—despite the high multiples being paid for previously off-limit industries. It's a great time to expand your hedge-fund business—despite the blowup of Amaranth (in which Morgan happened to get caught). And it's a great time to expand into bridge lending because, to quote one of the rating-agency analysts with whom I spoke, 'These firms are very good at managing these risks.'"

It's a great time, in fact, to buy some disaster protection—puts or, for the institutionally equipped, CDS, on Morgan Stanley (MS on the New York Stock Exchange). Insurance is cheap at the price.

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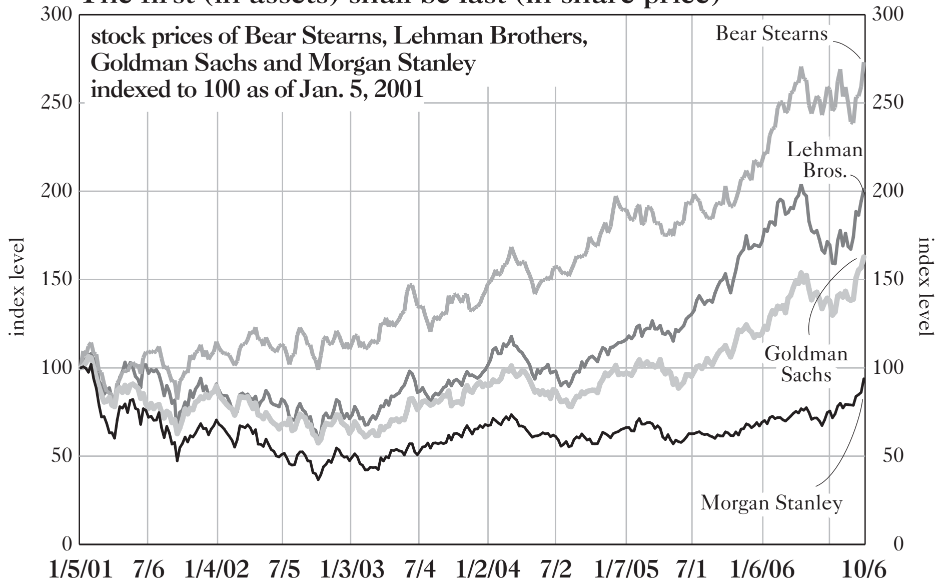
The first (in assets) shall be last (in share price)



source: The Bloomberg