ARGUS
MEDIENBEOBACHTUNG

THE WALL STREET JOURNAL EUROPE.

1200 Brussels
Auflage 5 x wöchentlich 100'216

1077237 / 229.28 / 146'343 mm2 / Farben: 0 Seite 16 29.05.2007

Comeback plan: 'Mack the Knife' plays catch-up at Morgan Stanley

To regain securities firm's perch, CEO pushes big bets and big deals; 'direct access to me'

By Anita Raghavan

WHEN JOHN J. MACK became chief executive of **Morgan Stanley** in 2005, he was disquieted by what had become of the big securities firm he had left four years earlier. The firm wasn't wagering much of its own money with big trades and investments, missing Wall Street's latest gold mine. Its bankers were losing out on far too much mergers-and-acquisitions work.

"He didn't recognize the place, how lumbering we had become," says Paul J. Taubman, head of global mergers and acquisitions. Last June, after Morgan Stanley bankers watched the $67 billion purchase of **BellSouth** Corp. by **AT&T** Inc. from the sidelines, Mr. Mack slipped into a meeting of 100 investment bankers and delivered a blunt, impromptu speech suited for a losing team.

"It bothers me the way we interact with a number of our clients," he said in his North Carolina drawl, his unmistakable anger captured in an internal Webcast. "It bothers me that we take no and walk away....There are people in this room embarrassing the firm. This is a great firm," he said, his voice rising. "You've lost your swagger....When we miss business, I want it to ruin your day, because it ruins my day."

A former bond salesman nicknamed "Mack the Knife" for his cost-cutting tendencies, Mr. Mack, 62 years old, is two years into his campaign to raise Morgan Stanley's metabolism. He wants to restore the firm's reputation as a top merger adviser, to make a lot more financial wagers with the firm's own money, and to discard some remnants of its ill-fated merger with Dean Witter, Discover & Co.

Already, he has jettisoned 2,000 Dean Witter brokers and steered the remaining force to richer clients. He plans to spin off the Discover credit-card business. And he is pushing the firm to get into the private-equity business by teaming up with big investors to buy entire companies, with the intention of reaping big profits by selling them or taking them public. Buoyed by trading gains and more merger-advisory work, Morgan Stanley earned a record $2.67 billion in the fiscal first quarter, up 70% from the year-earlier period.

His effort underscores a major shift in how money is being made on Wall Street. When Mr. Mack helped orchestrate Morgan Stanley's 1997 merger with brokerage giant Dean Witter, large securities firms were infatuated with the small investors plowing oodles of money into stocks. That love affair with the "little guy" soured when the stock market nose-dived in 2000, leaving many small investors saddled with losses and gunshy about further trading.

Meanwhile, tens of billions of dollars were flowing into hedge funds and private-equity funds, private investment vehicles for institutions and the wealthy. Competitors such as **Goldman Sachs Group** Inc. and **Lehman Brothers Holdings** wasted little time going after these new big fish. They targeted the investment funds for business, and began behaving like hedge funds themselves, notching huge profits wagering their own capital on everything from stocks to the price of oil. But Morgan Stanley, which was once a pioneer in investing in buyout deals, was slow to respond, and now lags behind arch-rival Goldman. Mr. Mack's big challenge is to catch up.

For most of its 72-year history, Morgan Stanley had been a leader on Wall Street. It traces its roots to banking titan J.P. Morgan & Co., the famed "House of Morgan." When the Glass-Steagall Act of 1933 erected a wall

NEWS IN DEPTH
Comeback plan: 'Mack the Knife' plays catch-up at Morgan Stanley

ARGUS MEDIENBEOBACHTUNG ARGUS der Presse AG Streulistrasse 19 CH-8032 Zürich
Telefon 044 388 82 00 Fax 044 388 82 01 www.argus.ch

between commercial banking and investment banking, the company split in two. The investment bank, which can issue securities but can't take deposits, took the name Morgan Stanley, and it was investment banker to such blue-chip companies as International Business Machines Corp. and General Motors Corp.

The theory behind its $10.2 billion merger with Dean Witter was that Dean Witter's army of retail brokers would sell stocks and other products for Morgan Stanley bankers. Dean Witter chief Philip Purcell became chairman and chief executive, with Mr. Mack his No. 2. Before long, it became clear to Mr. Mack that he wouldn't get the top job anytime soon, and he left in January 2001, after 29 years at the firm. Later, his son gave him a custom Monopoly board with a "Chance" card that reads: "A struggle with Phil Purcell finds you in a dilemma at MSDW. Should you stay or should you Go? You choose Go."

It was a troubled merger. The brokerage businesses were never effectively integrated. Mr. Purcell showed little interest in investment banking and blocked proposals to use Morgan Stanley's money to make financial bets or to invest in private-equity deals, current and former Morgan Stanley executives complain. Morgan Stanley's market valuation slipped to about $57 billion in June 2005 from about $94 billion in January 2001, a bigger drop than its main competitors. As discontent from shareholders and employees mounted, Mr. Purcell stepped down that June. He declined through a representative to comment.

Mr. Mack grew up in Mooresville, North Carolina, the son of a Lebanese grocer. He attended Duke University on a football scholarship, but a neck injury ended his years on the defensive line and his financial aid. To raise tuition money, he took a job at a local brokerage firm.

In his years away from Morgan Stanley, Mr. Mack ran rival financial firm Credit Suisse Group, but was ousted over his support for pursuing a big merger. A registered Republican, he supported George W. Bush in the 2004 presidential election, although he recently threw his support behind Democratic presidential candidate Hillary Clinton. In mid-2005, after a short stint as chairman of Pequot Capital Management Inc., a hedge fund, he returned to Morgan Stanley to take the top job.

"I don't think you get too many second chances" in life, says Mr. Taubman, the mergers-and-acquisitions chief: "This was an opportunity to come back to a place desperately in need of leadership."

When he arrived for work, one of the first things Mr. Mack discovered was that Morgan Stanley had missed the private-equity boat. It hadn't done much advising, lending to, or investing alongside buyout firms like Blackstone Group, which can generate big fees and profits. Nor had it raised a U.S. buyout fund of its own, a lucrative business for competitors like Goldman.

He asked Alan Jones, then head of corporate finance, what had happened. Mr. Jones pushed a stack of papers toward his new boss. "Here are five years' worth of business plans I wasn't allowed to execute," Mr. Jones said, according to people familiar with the conversation.

"Just go do it," Mr. Mack responded, according to these people.

It hasn't been easy. Morgan Stanley investment bankers, wary of competing with their own clients to buy companies, questioned the move. Some wondered if Morgan Stanley was getting into the private-equity game too late. And they worried about risk. Investment banks have always put their own money on the line by buying stocks and bonds from clients and by extending short-term loans. But the modern private-equity business, where deal sizes run to many billions of dollars, involves taking much bigger risks—bigger loans to clients and bigger direct investments.

Mr. Mack argued that the move is essential to the firm. The potential fees and investment profits were too big to ignore, he said.

Recently, he gave employees an example: Merrill Lynch & Co. is teaming up with buyout funds on a $21 billion leveraged buyout of hospital company HCA Inc. Morgan Stanley is advising HCA's board, a traditional investment-banking role. Merrill will make eight to 10 times as much money as Morgan Stanley, he said.

Playing catch-up has been costly. Morgan Stanley lured Stephen Trevor from Goldman to run the new business, which cost the firm more than $30 million, mostly to buy out Mr. Trevor's Goldman stock and private-equity interests, according to two people familiar with the pact. Morgan Stanley is now raising a buyout fund projected to be $6 billion, and now has about $8 billion in private-equity investments. By comparison, Goldman has a $20 billion fund and has $28 billion in investments.

To get a role in some private-equity

deals, Morgan Stanley has extended risky short-term loans to help buyout firms fund large transactions. This exposes it to the risk that the borrower won't be able to find longer-term financing, potentially leaving Morgan Stanley with a piece of the target company.

During his first 100 days on the job, Mr. Mack asked his lieutenants to draw up proposals for boosting Morgan Stanley's profits. Among their ideas: investing in the financial-derivatives business, getting more involved in residential-mortgage finance, and taking more risk by trading with the firm's own capital.

One of his first difficult decisions was what to do about the firm's Discover credit-card operation, which had been criticized as a slower-growth business than the firm's core ones. Mr. Purcell had decided to spin off the operation to shareholders. Mr. Mack reversed course, arguing that Discover provided diversification and cash flow.

At an internal Morgan Stanley meeting in the fall of 2005, Henry McVey, the firm's chief strategist, told Mr. Mack that Discover's growth prospects were keeping a lid on the firm's stock price. During a business trip to China in early 2006, people familiar with the matter recall, Mr. Mack told Mr. McVey: "We don't need a quick fix."

Last summer, a group of the firm's top bankers, known as the chairman's council, gave Mr. Mack an earful during a meeting in the firm's corporate dining room, several attendees recall. Mr. Taubman, the mergers chief, argued that Discover was of no strategic importance, these people say. Ruth Porat, a senior banker, questioned whether Morgan Stanley would be better off if management focused on the firm's core banking and other businesses, they say.

"Everybody was on me for Discover," says Mr. Mack, including eight former executives who two years earlier had waged a public campaign to unseat Mr. Purcell.

In the end, Mr. Mack was persuaded. In December, he proposed that the firm spin off Discover, which is set to take place in this year's third quarter.

Critics were also after Mr. Mack to sell Morgan Stanley's brokerage operations for individual investors. Many of the former Dean Witter brokers weren't as productive as their counterparts elsewhere on Wall Street. In 2004, the unit posted a profit margin of just 8%, far below the 19% at Merrill and 22% at Citigroup Inc.

In August 2005, Mr. Mack recruited Merrill's brokerage head, James Gorman, to run the business. His challenge: to change the perception that it caters to small clients. In reality, he says, less than 5% of the individual-investor clients have assets of $100,000 or less. "We aren't opening small offices in small towns," he says. "In fact, we are closing them."

Mr. Mack was particularly concerned about Morgan Stanley's investment-banking franchise, which had been stung by defections and was in turmoil. Last July, one month after criticizing his investment bankers for poor salesmanship, he showed them how to go after business aggressively.

When it appeared that Morgan Stanley would be left without any advisory role on the $21 billion HCA buyout, he phoned Fred Gluck, then an HCA director. He recommended Morgan Stanley's top merger bankers, and offered Mr. Gluck "direct access to me."

HCA tapped Morgan Stanley and Credit Suisse as advisers to the hospital company's board. "We wanted a second point of view," Mr. Gluck says. Morgan Stanley earned $17 million in advisory fees, according to Thomson Financial.

Mr. Mack prodded his lieutenants to stop rewarding laggards. Late last fall, he complained to managers that proposed pay packages were "all up, up, up. Nobody is down," two people familiar with the conversation recall. Walid Chammah, who runs Morgan Stanley's global investment-banking business, spent Thanksgiving weekend in November in the office with his deputy, slashing paychecks for poor performers, these people say.

Morgan Stanley's share of advising on world-wide merger deals has risen this year to 29.6%, from 17% during Mr. Purcell's last full year, 2004. It recently won a plum assignment as co-lead underwriter of Blackstone's $4.75 billion initial public offering. Profit margins in its brokerage business have rebounded from 8% to 15%. Since Mr. Mack's return, Morgan Stanley's stock has risen 60%, to Friday's close of $84.26 on the New York Stock Exchange. But that lagged behind the 66% gain over that period in the Dow Jones U.S. Select Investment Services index of brokerage firms and exchanges.

Earlier this year, it appeared that Morgan Stanley had lost out on a bid to advise private-equity firm Apax Partners on the $1.8 billion acquisition of Chicago insurance broker Hub International Ltd. Mr. Chammah and a team of senior bankers

that included U.S. insurance banking chief Eric Bischof showed up at Apax to pitch the business once again. They offered to invest alongside Apax, ultimately agreeing to put in as much as $250 million.

"If you turn back the clock a year," Ms. Porat, a senior banker who mobilized the team, told associates, "there is a good chance we may have missed a deal like this."

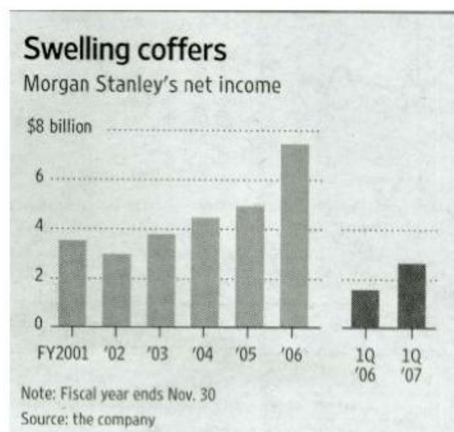
To get a role in some private-equity deals, Morgan Stanley has extended risky short-term loans to help buyout firms fund large transactions.

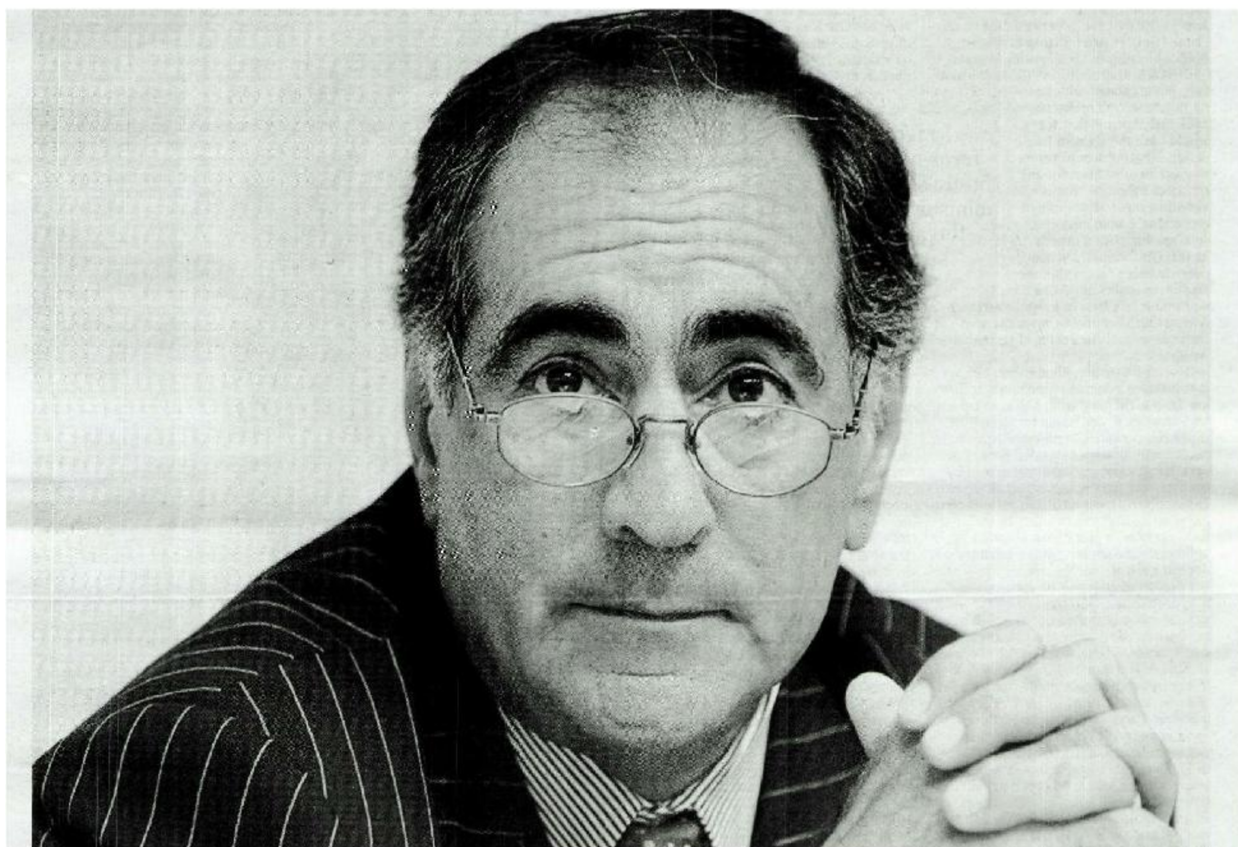
Second chance

◆ **The situation:** CEO John Mack is trying to restore Morgan Stanley's reputation as a top merger adviser and to wager more of its own money.

◆ **The background:** When he returned in 2005 after a four-year absence, Mr. Mack was bothered by the firm's direction.

◆ **What's next:** Financial results have improved, but it's too early to know whether the firm will make big money on private-equity investments.





Reuters

Morgan Stanley CEO John J. Mack, who took the top job after a four-year absence, is two years into his campaign to raise the securities firm's metabolism.