MORGAN STANLEY (NYSE: MS)

Capital Markets & Financial Services

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From Headwinds to Tailwinds: An Optimistic Trajectory

OUTLOOK

We are positive on both the near-term and mid/long-term outlook of Morgan Stanley. Although we emphasize caution on exposure to Investment Banking and Capital Markets due to underlying uncertainty in the Federal Reserve's interest rate calendar, we believe that improving market sentiment and a seemingly resilient macroeconomic backdrop support a constructive growth narrative.

INDUSTRY ANALYSIS

Downturn in Investment Banking revenues in light of corporate deal drought. The broader financial services industry has faced continuous headwinds in the past two years due to an uncertain macroeconomic environment and heightened regulatory scrutiny. Following 2021, the Federal Reserve's battle with post-pandemic inflation, and the following surge in financing costs resulted in an average 35% YoY decline in total M&A deal value to 2023.

Net interest margins squeezed due to a prolonged high-rate environment. The Federal Reserve's higher-for-longer rate policy has, in aggregate, adversely impacted net interest margins (NIM) for the past two years, in-turn depressing net interest income (NII) across the banking sector. NIM compression is expected to continue into the next fiscal year, with Morgan Stanley, JPMorgan Chase (NYSE: JPM), and Goldman Sachs Group (NYSE: GS) anticipating YoY NIM decreases of 3.7%, 4.6%, and 8.8% respectively.

Depressed Equity and Fixed Income issuance continues to impact underwriting revenues. Between 2021 and 2022, sharp increases in cost of capital caused new US Fixed Income and Equity issuances to fall by 34% and 77% respectively. Broader issuance activity recovered fractionally in 2023, however the underwriting environment remains largely depressed, and is expected to remain as such until markets begin to see a decline in capital costs, reliant on the onset of easing from the Federal Reserve.

Wealth Management revenues stagnate as earnings on increasing assets-under-management (AUM) are offset by changes in client preferences with respect to product mix. Although average AUM in the Wealth Management sector have increased between 2021 and 2023, revenues on new asset inflows have generally been offset by a shift in client product preference; particularly, asset mix has shifted away from higher-fee asset classes/products (namely equities) towards lower-fee asset classes/products (namely fixed income and cash management services). If the current rate-environment is maintained, it is expected that we will continue to see Wealth Management revenues be adversely impacted.

INDUSTRY UPSIDE FACTORS

Financial sponsor exit opportunities and dry powder stockpiles provide optimism in a macroeconomic easing scenario. Private equity (PE) firms have accumulated a record $2.5tn in cash reserves, which, given a reduced financing cost scenario is positioned to provide a surge of activity in the M&A environment. Additionally, given the multi-year PE liquidation cycle, heightened investment activity in light of 2021's low financing costs should result in a resurgence of equity issuance as PE allocations reach maturity ahead of 2027.

Supply chain disruptions due to global conflict resulting in heightened systemic risk tolerance among corporate clients. Ongoing supply chain challenges amid seemingly long-term global conflict are expected to prove beneficial to the M&A environment as corporate clients attempt to front run a tightening supply backdrop. Corporate near shoring may also accelerate in light of an improving macroeconomic outlook, as the soft-landing narrative for the US economy comes into focus.

MARKET DATA

Current Price	$98.97
52-Week Range	$69.42-$103.25
Market Cap	$160.8
Enterprise Value	$547.0
Dividend Yield	3.4%
EPS	$5.24

KEY FINANCIAL METRICS

	2022A	2023A	2024E
Revenue	$53.7	$54.1	$57.8
% Growth	*-9%*	*0.7%*	*7%*
Net Income	$11.2	$9.2	$10.9
% Growth	*-27%*	*-23%*	*28%*
Net Interest	$9.3	$8.2	$9.2
% Growth	*16%*	*-12%*	*12%*
Net Margin	21%	17%	19%
% Change	*-16%*	*-19%*	*12%*

KEY MULTIPLES

VALUATION	
P/E	18.03x
EV/Sales	5.48x
P/BV	1.71x
PEG	1.52x
LIQUIDITY	
Current Ratio	1.40x
Cash Ratio	0.02x
CET1 Ratio	15.0%
LEVERAGE	
Debt/Assets	31.3%
Debt/Capital	79.5%
Debt/FFO	24.13x
EFFICIENCY	
Total Asset Turnover	0.08x
Return on Equity	9.5%
Efficiency Ratio	71%

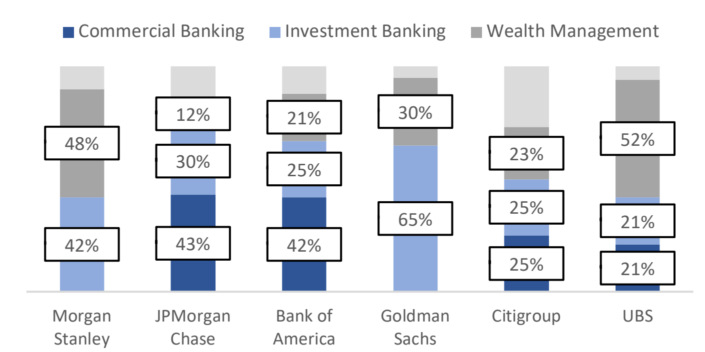
Source(s): FactSet, Morgan Stanley Company Filings
All figures in billions of $USD except per share values.
Data as of February 28, 2024.

Morgan Stanley's Unique Position as a Leading Wealth Manager

LOSSES IN INVESTMENT BANKING OFFSET BY GAINS IN WEALTH MANAGEMENT

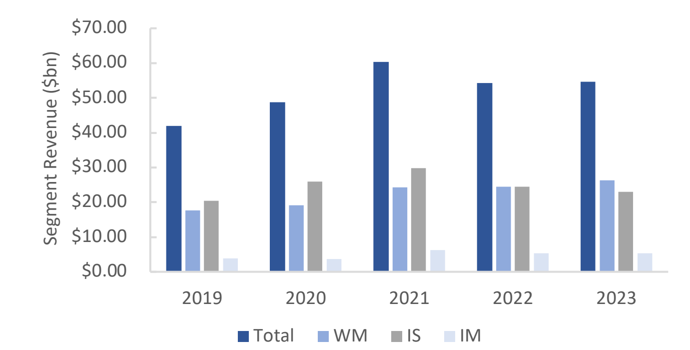
Morgan Stanley is the sixth largest wealth manager in the world, providing the firm with disproportionate exposure to asset management-based revenues in comparison to its direct peers (Exhibit 1). Morgan Stanley's unique, nearly equal revenue division between Wealth Management and Institutional Securities (Morgan Stanley's Investment Banking segment) has provided the firm with a cushion against downturns in the Investment Banking business, as higher market levels have supported the inflow of fee-based assets contributing to positive fee-based flows in the Wealth Management segment. Morgan Stanley's Wealth Management revenues increased 7.5% from $24.42bn in 2022 to $26.27bn in 2023, offsetting a $1.33bn loss in Institutional Securities revenues over the same period (Exhibit 2).

Exhibit 1: Morgan Stanley Among Highest Exposure to Wealth Management Among Peers



Source(s): FactSet

Exhibit 2: Morgan Stanley's Decreasing Revenues Are Attributable to Weaknesses in Institutional Securities



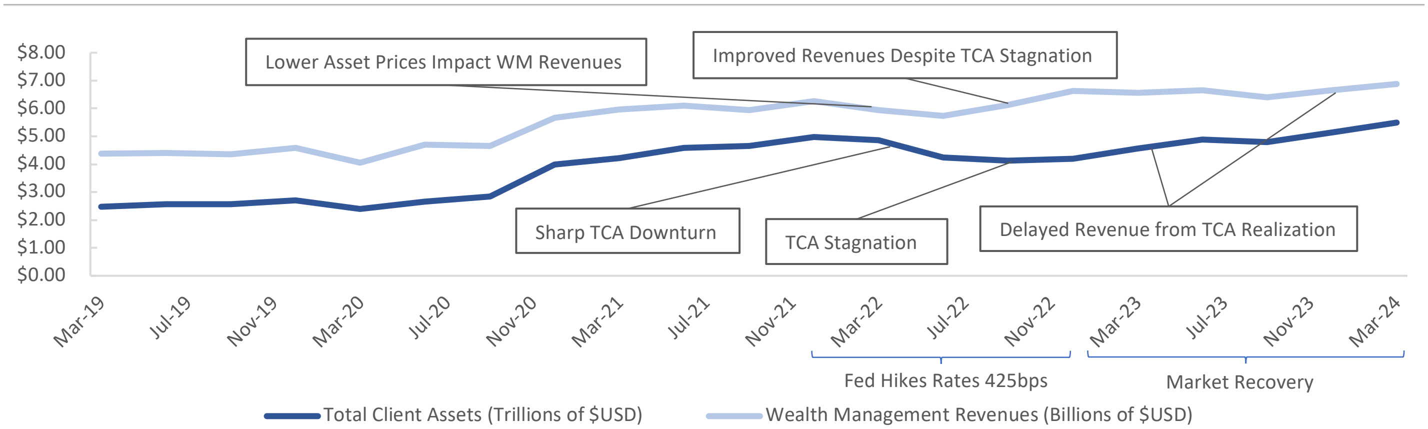
Source(s): FactSet

WEALTH MANAGEMENT SEGMENT PROVIDES SHORT TERM RESILIENCE WHILE POSITIONING FOR LONG TERM GROWTH

Morgan Stanley's multi-year client conversion cycle within their Wealth Management segment sees the gradual transition of client assets from low-fee product offerings (namely cash management and separately managed accounts) to advisor and portfolio manager-led accounts. This product pipeline has shown to be effective in times of stagnated/decreasing total client AUM (Exhibit 3), as Wealth Management revenues can be propped-up through the conversion of old client assets to higher-fee products.

Additionally, improvements in broader equity markets, particularly in light of lower Federal Reserve policy rates, have historically caused a shift in client preference of asset mix towards shorter-term equity investments, as fixed income and long-term asset management offerings become less attractive due to a decrease in relative return opportunities. This supports a narrative of strong revenue improvements in a lower rate environment as equities are Morgan Stanley's highest-fee asset class, at 71bps as compared to fixed income at 35bps and long-term AUM at 44bps. Morgan Stanley's client conversion approach has proven to be most effective in periods of improving market outlook as client appetite for higher fee products increases.

Exhibit 3: Despite Decreasing Total Client Assets, Wealth Management Revenues Remain Consistent



Source(s): Morgan Stanley Company Filings, FactSet

MORGAN STANLEY'S TRADE OFF BETWEEN EXPOSURE TO GAINS IN INVESTMENT BANKING AND NEAR-TERM MARKET OPTIMISM

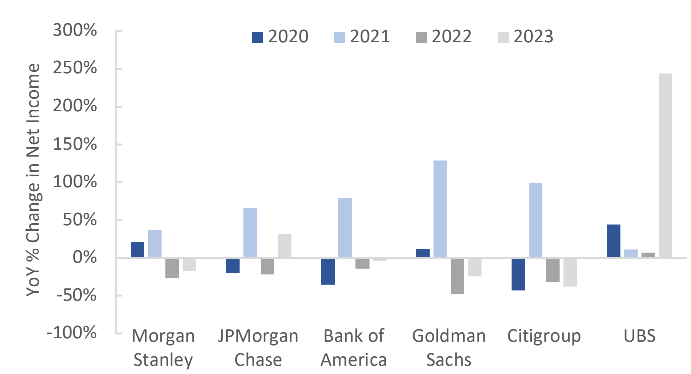
Although heightened exposure to Wealth Management has helped Morgan Stanley avert major losses from a downturn in Investment Banking activity (as can be seen with Goldman Sachs, which has the largest Investment Banking segment proportion of Morgan Stanley's competitors), the silver lining of this stablility is limited exposure to gains. In 2021, Morgan Stanley experienced the second lowest increase in Net Income across its competitors, at 37%, while Goldman Sachs experienced a landslide 129% increase (Exhibit 4). The lowest increase in Net Income was attributable to UBS, which carriest the highest-in-class exposure to Wealth Management, posting only an 11% YoY increase in 2021.

Additionally, exposure to the Commercial Banking business has helped competitors JPMorgan Chase and Bank of America mitigate losses in recent years, as consumer dry-powder has built up and deposit yields have become more attractive. In recent years, forward-looking valuations have placed earnings with higher exposure to alternative financial services sectors at a higher value (Exhibit 5), with Morgan Stanley having consistently remained in the upper range of NTM P/E multiples within its competitors.

We are not optimistic on the outlook of rate cuts in 2024, however we do believe that asset levels will continue to trend upwards supported by an increased emergence of the soft landing narrative for the US economy. Therefore, we believe that Wealth Management revenues will continue to push upwards supported by positive fee-based flows of client assets in 2024, providing Morgan Stanley with a unique growth opportunity while M&A and underwriting calendars continue to remain dry througout the year.

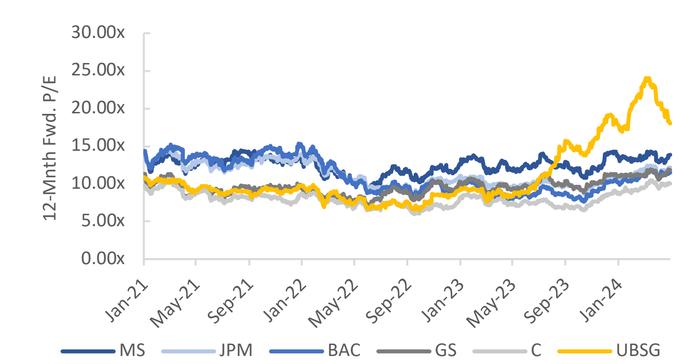
Looking ahead to 2025, we believe that we are in the early innings of a multi-year M&A cycle, with a positive outlook on activity from both financial sponsors and the corporate community. Looming PE exit opportunities, record stockpiles of cash from financial sponsors, restricting supply chains, and the ever-increasing importance of integrating new & highly specialized technologies (including machine learning applications) have led us to take the stance that with the onset of Federal Reserve rate cuts, we will see a surge in Investment Banking activity. Although Morgan Stanley's exposure to this revival of activity will be limited relative to competitors like Goldman Sachs, it is our belief that the company remains well positioned to mitigate near-mid term uncertainties, and take advantage of long term growth prospects within the broader financial services industry.

Exhibit 4: Wealth Management & Commercial Banking Exposure Mitigates Impact of Investment Banking Downturn



Source(s): FactSet, Company Filings

Exhibit 5: Forward-Valuations Have Favoured Higher Wealth Management Exposure in Recent Years



Source(s): FactSet

Lagging Efficiency Due to Heightened Expenses Amidst E*TRADE Acquisition & Legal Headwinds

EXPENSES MOUNT AS LEGAL & REGULATORY CHALLENGES ARISE

Morgan Stanley's Efficiency Ratio has generally outpaced competitors in recent years, a growth partially attributable to a costly special assessment by the Federal Deposit Insurance Corporation (FDIC) in reaction to several high-profile treasury yield related bank collapses/bankruptcies in early 2023. In conjunction with this special assessment, Morgan Stanley was charged a $286mn one-time fee in an effort to assist with the replenishment of the FDIC's deposit insurance fund. This charge, however, was not unique to Morgan Stanley, with JPMorgan Chase, Bank of America, Citigroup, and Goldman Sachs, among other banks, being charged $2.9bn, $2.1bn, $1.8bn, and $529mn respectively.

Additionally, Morgan Stanley suffered a $249mn settlement cost as the result of an SEC investigation which found that at least one employee had committed a multi-year fraud involving the disclosure of confidential information regarding ongoing/upcoming block trades; this investigation pegged Morgan Stanley as having failed to enforce its policies concerning the misuse of material non-public information. The firm has since taken action to prevent further regulatory breaches & oversights.

We believe that these one-time costs hold no meaningful impact on the near-term prospects of Morgan Stanley; with systemic banking issues, both within the firm and in the broader financial services sector having been largely resolved, these expenses do not impact our forward guidance.

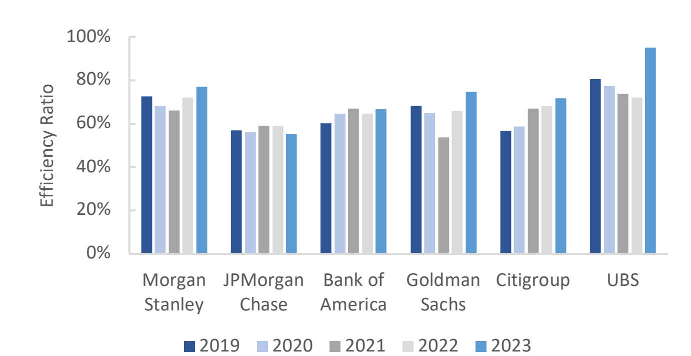
E*TRADE INTEGRATION COSTS WEIGH ON OPERATING EXPENSES

Morgan Stanley agreed to acquire E*TRADE Financial Corporation, a leading electronic trading platform, in an all stock deal definitively announced in February 2020. This transaction carried a value of approximately $13bn, representing a per share consideration of $58.74, and a migration of over 5.2mn client accounts with over $360bn of retail client assets to Morgan Stanley's Wealth Management business. The acquisition of E*TRADE marked a significant stepping stone for Morgan Stanley's Wealth Management business, transitioning away from what had previously been a full-service advisor led model towards a direct-to-consumer transactional channel. Although the acquisition poses numerous long term benefits, including an improved Common Equity Tier 1 Capital Ratio (CET1), a push towards pre-tax profit margins of 30% in the Wealth Management business, and a significant increase in technological efficiency for the firm's sizeable corporate and retail client base, the near-term integration costs of the new system have weighed on Morgan Stanley's operating expenses, propelling an increase in Efficiency Ratio. With the integration of E*TRADE having been fully completed in 2023, we hold a positive outlook on Morgan Stanley's operating metrics in the coming years, as the firm moves to fully realize tailwinds from the acquisition.

OPTIMISTIC EXPENSE OUTLOOK SUGGESTS IMPENDING IMPROVEMENTS IN EFFICIENCY

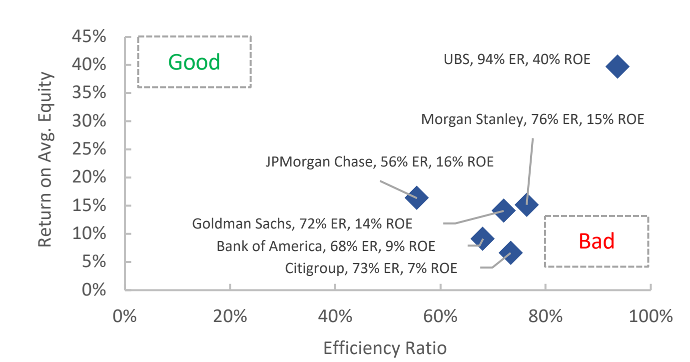
We believe that although Morgan Stanley is currently lagging peers in efficiency (Exhibit 6), with a second worst-in-class efficiency ratio of 76%, a forward-looking absence of prior inefficiency factors provides an optimistic outlook for the firm as the financial services industry moves towards an improving macroeconomic backdrop. Additionally, we emphasize the importance of the firm's competitive return on equity (ROE), which, coupled with a clearly stated long-term ROE target of 20% provides a clear path forward for the company, particularly as returns in Wealth Management continue to improve through the inflow of new client assets, and the conversion of existing client assets to higher-fee products (Exhibit 7).

Exhibit 6: Morgan Stanley's Efficiency Ratio Lags Behind Peers…



Source(s): FactSet

Exhibit 7: …But Remains Competitive Considering Returns



Source(s): FactSet

Conclusion

Ultimately, we believe that Morgan Stanley is well positioned to withstand near-term uncertainty in the interest rate environment, while taking advantage of improving market sentiment through its Wealth Management business. Although the firm's exposure to a recovery in the Investment Banking business is underpronounced when compared to peers like Goldman Sachs and JPMorgan Chase, we emphasize the importance of stability in the near term as turbulent markets continue to impact corporate activity and broader movements in capital markets.

Looking ahead, it is our stance that Morgan Stanley's efficiency metrics will continue to improve, which, in combination with the firm's effective revenue cushion through its Wealth Management transition pipeline support its current valuation relative to competitors. Our constructive outlook on the M&A calendar heading into 2025 further leads us to believe that Morgan Stanley is justified as a leading player in Financial Services & Capital Markets, with both positive near-term, and long-term prospects.

Please read disclosures/risk and liability information beginning on page 5, including Analyst information on page 6.

COMPANY DESCRIPTION

Morgan Stanley is a global financial services firm that offers a wide range of investment banking products and services to corporations, governments, financial institutions, and individuals. The company operates through three main segments: Institutional Securities, Wealth Management, and Investment Management. The Institutional Securities segment delivers financial advisory services, capital-raising solutions, and related financing services tailored for institutional investors. The Wealth Management segment provides a comprehensive suite of brokerage and investment advisory services. These services encompass various investment types, including equities, options, futures, foreign currencies, precious metals, fixed-income securities, mutual funds, structured products, alternative investments, unit investment trusts, managed futures, separately managed accounts, and mutual fund asset allocation programs. The Investment Management segment offers diverse investment strategies across equity, fixed income, alternative investments, real estate, and merchant banking. Founded by Harold Stanley and Henry S. Morgan in 1924, Morgan Stanley is headquartered in New York, NY, and continues to play a pivotal role in the global financial landscape.

Important Disclosures

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