

Combining Valuation and Balance Sheet Strength

A NEW MARKET NEUTRAL STRATEGY

The choice between value and growth investing can depend on where we are in the economic cycle. At present, investors may start looking for value opportunities. However, are there other factors to consider? For example, if a stock's balance sheet is weak, the valuation multiple may be less relevant to stock price movements than, for example, concerns about the balance sheet or a higher cost of capital as lenders respond to higher perceived risk. Even for tactically bullish investors, balance sheet strength could be a consideration.

Morgan Stanley's European Equity Strategy team¹ have therefore introduced a new market neutral strategy identifying stocks that are strong for both valuation and balance sheet properties. The strategy combines both our existing Greenblatt-inspired valuation and Piotroski-inspired financial health strategies. The rationale of the 'combo' strategy is to identify cheap (or expensive) stocks with strong (or weak) balance sheets as potential long (or short) ideas, using a combination of the two methodologies.

SELECTION METHODOLOGY

The strategy uses three metrics to assess stocks:

• RETURN ON CAPITAL EMPLOYED (ROCE)

ROCE is a measure of quality and efficiency: is the company making good use of its capital to generate revenue? A high ROCE indicates high quality, and vice-versa.

• ENTERPRISE VALUE / EARNINGS BEFORE INTEREST, TAXES, DEPRECIATION AND AMORTISATION (EV/EBITDA)

This valuation metric is often seen as analogous to Price / Earnings, but at the broader operating level. It measures the overall worth of a company (including debt) relative to its ability to generate cash. A low EV/EBITDA indicates that a company could be undervalued, and vice-versa.

• PIOTROSKI SCORE

This score assesses stocks based on nine criteria, all intended to measure the financial strength of a company. The higher the score, the stronger and more profitable the company. Please see the end of this document for more information on how the score is calculated.

¹ Source: Morgan Stanley Research, "A New "Magic Formula" – a 'Combo' Strategy Inspired by Greenblatt & Piotroski" (April 14, 2009, Edmund Ng). For additional information, research reports and important disclosures, see <https://secure.ms.com>.

LONG / SHORT CERTIFICATES

Investors can access this strategy via 6-month certificates. The certificates offer a return linked to the relative performance of two baskets, selected using the 'combo' strategy proposed by Morgan Stanley's European Equity Strategy Team.

- **Long Basket:** stocks with a high ROCE, low EV/EBITDA and Piotroski score above 5
- **Short Basket:** stocks with a low ROCE, high EV/EBITDA and Piotroski score below 5

The stocks are screened on the basis of market capitalisation and liquidity, and, for the short basket, for the availability of stocks to borrow. Stocks are equally weighted within the baskets.

At expiry, investors receive their initial investment, **plus** the performance of the Long Basket, **minus** the performance of the Short Basket, less fees and other adjustments². Capital is at risk: if the Short Basket outperforms the Long Basket, the cash settlement amount will be less than the initial investment.

KEY ADVANTAGES

- Market neutral strategy – potential for positive returns even in a neutral or falling market
- Stock screening process developed by the European Equity Strategy Team within Morgan Stanley Research
- Short investment term (6m)

KEY INVESTMENT CONSIDERATIONS

- Capital is at risk. The payout of the certificate may be less than the original investment, or even zero.
- There is no assurance that the strategy will generate positive returns.
- Investors are exposed to the credit risk of the issuer.
- The baskets are fixed and will not be changed to reflect any change in outlook by Morgan Stanley Research or any change in the valuation metrics or Piotroski scores. Morgan Stanley Research may change its outlook on the stocks and may publish a different view or strategy at any time. Morgan Stanley is under no obligation to, and will not, notify certificateholders of such changes.

² The payout is adjusted for fees, dividends and accrued carry. Please refer to the termsheet and Offering Documents for full details.

KEY TERMS FOR LONG/SHORT CERTIFICATES

ISSUER	Morgan Stanley BV
ISSUE PRICE (PAR)	EUR 50,000
ISSUE DATE	[30] April 2009
EXERCISE DATE	[23] October 2009
CASH SETTLEMENT AMT	Par x (1 + Long Basket Performance – Short Basket Performance + Accrued Carry – Management Fees + Dividend Adjustment)
MANAGEMENT FEE	0.9% per annum
ACCRUED CARRY	EONIA – 2% per annum
DIVIDEND ADJUSTMENT	See termsheet or Offering Documents for details. The Dividend Adjustment may be positive or negative.
DISTRIBUTION	Private Placement only.

MORE ON THE PIOTROSKI SCORES

This scoring system, developed by Joseph Piotroski, an accounting professor at the University of Chicago, uses nine criteria to assess financial strength and profitability:

- Positive net income
- Positive operating cash flow
- Earnings quality: operating cash flow greater than net income
- Decreasing debt: total debt/ total assets lower than previous year
- Increasing working capital: difference between current assets and current liabilities greater than previous year
- Improving productivity: revenues/total assets greater than previous year
- Growing profitability: return on assets greater than the previous year.
- Stock issuance: number of shares outstanding is equal to, or lower, than the previous year.
- Competitive position: gross profit margin higher than previous year

Companies score a point for each criterion they meet. The higher the score, the better the financial strength of the company.

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