

Credit Opinion: Jefferies Group, Inc.

Jefferies Group, Inc.

New York, NEW YORK, United States

Ratings

Category	Moody's Rating
Outlook	Positive
Issuer Rating	Baa1
Senior Unsecured	Baa1
Subordinate Shelf	(P)Baa2
Preferred Stock	Baa3
Preferred Shelf	(P)Baa3

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Key Indicators

[1]
Jefferies Group, Inc.

	[2]2006	[2]2005	[2]2004	[2]2003	[2]2002	[3]5 Yr. Avg.
Net Revenue (\$ Mil.)	1,458	1,205	1,058	830	675	21%
Pre-Tax Earnings (\$ Mil.)	349	268	227	145	104	35%
Pre-Tax Profit Margin	23.9%	22.3%	21.4%	17.4%	15.4%	20.1%
Pre-Tax Margin Volatility	6.0%	14.0%	18.0%	13.0%	9.0%	12.0%
Comp. Expense % Net Revenue	54.3%	55.6%	56.3%	57.2%	57.2%	56.1%
Non-Comp. Expense % Net Revenue	21.8%	22.1%	22.2%	25.4%	27.5%	23.8%
Return on Common Equity	14.3%	13.5%	14.0%	11.5%	10.5%	12.8%
Long-Term Capital (\$ Mil.)	2,875	2,067	1,828	1,282	1,081	28%
IRA/TCE [4]	0.52x	0.50x	0.47x	0.57x	0.50x	0.5x
NCC/LNA [5]	7.7%	15.2%	22.0%	12.2%	36.3%	18.7%
Double Leverage	1.2	1.1	1.2	1.2	1.4	1.2
VaR to TCE (b.p.)	39.7	27.5	13.4	n.a.	n.a.	n.a.

[1] Ratio definitions and rating factor ranges are available in the "Global Securities Industry Methodology" [2] Fiscal year ended December 31 [3] CAGR for Net Revenue, Pre-Tax Earnings, Long-Term Capital. Simple average for the rest [4] Illiquid Risk Assets (IRA) divided by Tangible Common Equity (TCE) is a Moody's metric for measuring capital adequacy of market-making securities firms [5] Net Cash Capital (NCC) divided Liquid Net Assets (LNA) is a Moody's metric for measuring liquidity of market-making securities firms

Opinion

Credit Strengths

Credit strengths for Jefferies Group, Inc. are:

- Leading franchise in middle-market equities and fixed income
- Growing investment banking business

- Consistently low earnings and margin volatility
- Sound liquidity and ample capital adequacy
- Disciplined risk appetite and approach to growth

Credit Challenges

Credit challenges for Jefferies Group, Inc. are:

- Small capital base versus larger competitors
- Limited (but improving) product and geographic diversification
- Profitability constrained by high compensation burden
- Lower-than-optimal board independence
- Lending JV could increase liquidity and credit risks

Rating Rationale

On May 3rd, 2007, Moody's changed to positive from stable the rating outlook on the long-term debt of Jefferies Group, Inc. ("Jefferies"; Baa1). The positive outlook reflects the consistent progress Jefferies has made in growing the size and diversity of its earnings over the last several years, while eschewing aggressive risk-taking and keeping earnings and margin volatility firmly in check. Specifically, Jefferies pre-tax margin expanded to 24% in 2006 from 21% in 2004, as business investments made in prior years, including targeted hiring and small acquisitions, are resulting in greater operating leverage amid a robust market environment.

Jefferies is modestly-sized relative to the higher-rated "bulge bracket" firms in terms of earnings and the breadth of its product offerings. However, the firm has a leading franchise in the middle-market segment, and strong relationships with many buy-side and investment banking clients. Management has been consistent in preserving and growing this franchise, foregoing risky adventures beyond the firm's core competencies. This has enabled Jefferies' secondary equities segment - its largest - to perform well despite low market volatility and declining commission rates. The company's high-yield bond and convertibles trading business has been consistently profitable over a long period of time and is an area where Jefferies is well-positioned to add value to its clients. The recent agreement with Leucadia National Corporation, which provides for additional third-party capital for the high-yield business, should further expand Jefferies' capabilities in this space. Provided that Jefferies continues to follow a prudent risk management policy and does not aggressively shift to a proprietary trading model, Moody's views this as a positive development.

Jefferies has had notable success in expanding its middle-market investment banking franchise. The firm has been adding productive bankers and research analysts to broaden its industry coverage, and these efforts are bearing fruit. In 2006, investment banking generated revenues of \$541 million - 37% of firm-wide revenue, with a balanced mix of advisory and underwriting fees. Jefferies has also made progress in its asset management business, which, though still relatively modest in scale and asset gathering ability, should continue to broaden the firm's earnings mix by adding a more annuitized source of revenue. Asset management revenue increased to \$110 million in 2006 - 8% of firm-wide revenue.

Jefferies has a strong liquidity profile and has ample equity capital relative to its inventory of risky or illiquid assets (mostly private equity). Moody's considers this a distinct credit positive for Jefferies. While the company does occasionally engage in principal trading strategies - through both equity block trading and in its high-yield business - the attendant risks have so far been well-contained as evidenced by low earnings volatility and the historically modest value-at-risk (VAR) readings (though Moody's notes the increase in VAR as a result of increased block-trading activity in 2006). The company benefits from a combination of a sound risk management infrastructure and a well-aligned risk culture, which stems from the high level of employee ownership of the firm.

Jefferies' managerial culture is premised upon a "partnership" model, which in turn heavily influences the strengths and weaknesses of its current corporate governance. While this style of governance helps align executive and bondholder interests by fostering a longer-term management focus, primarily due to the aforementioned high level of employee ownership, the partnership corporate culture inherently lends itself to a more "insider" orientation, which can erode board independence. This is evidenced, in the case of Jefferies, by the above-average number of executives who are board members (two out of seven directors). Also, business relationships between the firm and the CEO's family may limit the perception of director independence.

Jefferies Finance, the company's lending joint venture with Mass Mutual's Babson subsidiary, is growing in a slow, measured way - consistent with Moody's expectations.

Rating Outlook

The rating outlook is positive reflecting Moody's expectation that Jefferies will continue to show solid performance in its core businesses, while also further expanding the diversity and sustainability of its overall earnings mix.

What Could Change the Rating - UP

Continued solid performance by Jefferies in its core businesses, coupled with improved diversity and sustainability of the overall earnings mix, would exert upward pressure on the rating. Any potential rating upgrade would also be predicated on the firm's current business model of a customer flow-driven market-maker, and not a significant principal investor.

What Could Change the Rating - DOWN

A significantly higher risk appetite, especially as evidenced by retention of illiquid positions or substantial commitments of capital, that leads to a deterioration of the firm's capital adequacy or an increase in earnings or margin volatility, would exert downward pressure on the rating.

Recent Developments/Results

In Q1-07, Jefferies reported pre-tax earnings of \$109 million, up 10% q/q and 6% y/y. Investment banking posted strong results as revenues climbed 17% q/q and 33% y/y to \$170 million. Pre-tax margin improved to 24.7% from 23.9% for full-year 2006.

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