

LEGG MASON INC
Form 10-Q
August 08, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended June 30, 2006

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____ to _____

Commission file number 1-8529

LEGG MASON, INC.

(Exact name of registrant as specified in its charter)

MARYLAND

52-1200960

(State or other jurisdiction of incorporation or organization)

(I.R.S. Employer

Identification No.)

100 Light Street - Baltimore, MD

21202

(Address of principal executive offices)

(Zip code)

(410) 539-0000

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant

Edgar Filing: LEGG MASON INC - Form 10-Q

was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

| | | | |
|-------------------------|-------------------------------------|-------------|-----------------------|
| | | Accelerated | |
| Large accelerated filer | <input checked="" type="checkbox"/> | filer | Non-accelerated filer |

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

131,146,761 shares of common stock and 2,214,844 exchangeable shares as of the close of business on August 3, 2006. The exchangeable shares, which were issued by a subsidiary of the registrant are exchangeable at any time into common stock on a one-for-one basis and entitle holders to dividend, voting and other rights equivalent to common stock.

PART I.**FINANCIAL INFORMATION****Item 1.****Financial Statements**

LEGG MASON, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME

(In thousands, except per share amounts)

(Unaudited)

| | Three months ended | |
|-----------------------------------|--------------------|------------|
| | June 30, | |
| | 2006 | 2005 |
| Operating Revenues | | |
| Investment advisory fees | | |
| Separate accounts | \$ 364,601 | \$ 237,050 |
| Funds | 490,236 | 125,360 |
| Distribution and service fees | 179,582 | 69,547 |
| Other | 3,801 | 5,729 |
| Total operating revenues | 1,038,220 | 437,686 |
| Operating Expenses | | |
| Compensation and benefits | 373,331 | 191,782 |
| Transaction-related compensation | 6,251 | |
| Total compensation and benefits | 379,582 | 191,782 |
| Distribution and servicing | 280,551 | 68,846 |
| Communications and technology | 38,439 | 13,776 |
| Occupancy | 22,163 | 7,193 |
| Amortization of intangible assets | 17,031 | 5,845 |
| Litigation award settlement | | (8,150) |
| Other | 43,020 | 18,147 |
| Total operating expenses | 780,786 | 297,439 |
| Operating Income | 257,434 | 140,247 |
| Other Income (Expense) | | |
| Interest income | 12,871 | 9,320 |
| Interest expense | (16,180) | (10,156) |

Edgar Filing: LEGG MASON INC - Form 10-Q

| | | |
|---|------------|------------|
| Other | (1,142) | 2,700 |
| Total other income (expense) | (4,451) | 1,864 |
| Income from Continuing Operations | | |
| before Income Tax Provision and Minority Interests | 252,983 | 142,111 |
| Income tax provision | 96,895 | 52,971 |
| Income from Continuing Operations | | |
| before Minority Interests | 156,088 | 89,140 |
| Minority interests, net of tax | (53) | |
| Income from Continuing Operations | 156,035 | 89,140 |
| Income from discontinued operations, net of tax | | 23,635 |
| Net Income | \$ 156,035 | \$ 112,775 |

LEGG MASON, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME

(continued)

(In thousands, except per share amounts)

(Unaudited)

| | Three months ended June 30, | |
|--|--------------------------------|----------------|
| | 2006 | 2005 |
| Net Income per Share | | |
| Basic: | | |
| Income from continuing operations | \$ 1.11 | \$ 0.82 |
| Income from discontinued operations | | 0.22 |
| | \$ 1.11 | \$ 1.04 |
| Diluted: | | |
| Income from continuing operations | \$ 1.08 | \$ 0.74 |
| Income from discontinued operations | | 0.19 |
| | \$ 1.08 | \$ 0.93 |
| Weighted Average Number of Shares | | |
| Outstanding: | | |
| Basic | 140,247 | 108,803 |
| Diluted | 144,171 | 121,977 |
| Dividends Declared per Share | \$ 0.18 | \$ 0.15 |

See Notes to Consolidated Financial Statements

LEGG MASON, INC. AND SUBSIDIARIES**CONSOLIDATED BALANCE SHEETS***(Dollars in thousands)*

(Unaudited)

| | June 30, 2006 | March 31, 2006 |
|---|---------------------|---------------------|
| ASSETS | | |
| Current Assets | | |
| Cash and cash equivalents | \$ 1,108,044 | \$ 1,023,470 |
| Receivables: | | |
| Investment advisory and related fees | 504,268 | 560,407 |
| Other | 244,570 | 289,433 |
| Investment securities | 153,825 | 142,206 |
| Deferred income taxes | 48,908 | 60,135 |
| Other | 48,781 | 51,080 |
| Total current assets | 2,108,396 | 2,126,731 |
| Investment securities | 9,600 | 26,272 |
| Fixed assets, net | 192,364 | 182,609 |
| Intangible assets, net | 4,477,011 | 4,493,316 |
| Goodwill | 2,337,354 | 2,303,799 |
| Other | 148,476 | 169,763 |
| Total Assets | \$ 9,273,201 | \$ 9,302,490 |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| Liabilities | | |
| Current Liabilities | | |
| Accrued compensation | \$ 348,018 | \$ 586,899 |
| Short-term borrowings | 62,000 | 83,227 |
| Current portion of long-term debt | 4,067 | 36,883 |
| Contractual acquisition payable | 300,000 | 300,000 |
| Payables for distribution and servicing | 158,293 | 135,607 |
| Other | 484,037 | 455,090 |
| Total current liabilities | 1,356,415 | 1,597,706 |
| Deferred compensation | 104,554 | 97,101 |
| Deferred income taxes | 391,281 | 392,009 |
| Other | 194,560 | 199,481 |
| Long-term debt | 1,160,833 | 1,166,077 |
| Total Liabilities | 3,207,643 | 3,452,374 |
| Commitments and Contingencies (Note 9) | | |
| Stockholders Equity | | |

Edgar Filing: LEGG MASON INC - Form 10-Q

| | | |
|---|---------------------|---------------------|
| Common stock, par value \$.10; authorized 250,000,000 shares; issued 130,762,704 shares and 129,709,847 shares, respectively | 13,076 | 12,971 |
| Convertible preferred stock, par value \$10; authorized 4,000,000 shares; 8.39 shares outstanding | | |
| Shares exchangeable into common stock | 5,590 | 5,720 |
| Additional paid-in capital | 3,310,704 | 3,235,583 |
| Employee stock trust | (48,906) | (45,924) |
| Deferred compensation employee stock trust | 48,906 | 45,924 |
| Retained earnings | 2,711,518 | 2,580,898 |
| Accumulated other comprehensive income, net | 24,670 | 14,944 |
| Total Stockholders Equity | 6,065,558 | 5,850,116 |
| Total Liabilities and Stockholders Equity | \$ 9,273,201 | \$ 9,302,490 |

See Notes to Consolidated Financial Statements

LEGG MASON, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Dollars in thousands)

(Unaudited)

| | Three months ended | |
|---|--------------------|------------|
| | June 30, | |
| | 2006 | 2005 |
| Net Income | \$ 156,035 | \$ 112,775 |
| Other comprehensive income gains (losses): | | |
| Foreign currency translation adjustment | 8,715 | (5,154) |
| Unrealized gains (losses) on investment securities: | | |
| Unrealized holding gains (losses), net of taxes | | |
| of (\$32) and \$15, respectively | (50) | 20 |
| Reclassification adjustment for losses included in net income | 2 | |
| Net unrealized gains (losses) on investment securities | (48) | 20 |
| Net unrealized gain on cash flow hedge, net of tax of \$751 | 1,059 | |
| Total other comprehensive income (loss) | 9,726 | (5,134) |
| Comprehensive Income | \$ 165,761 | \$ 107,641 |

See Notes to Consolidated Financial Statements

LEGG MASON, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Dollars in thousands)

(Unaudited)

| | Three months ended | |
|--|--------------------|---------------------|
| | June 30, | |
| | 2006 | 2005 ⁽¹⁾ |
| Cash Flows from Operating Activities | | |
| Net Income | \$ 156,035 | \$ 112,775 |
| Income from discontinued operations | | (23,635) |
| Non-cash items included in income: | | |
| Depreciation and amortization | 31,264 | 13,202 |
| Amortization of deferred sales commissions | 19,812 | 1,251 |
| Accretion and amortization of securities discounts and premiums, net | 472 | 1,791 |
| Stock-based compensation | 9,812 | 1,796 |
| Unrealized (gains) losses on investments | 6,468 | (2,240) |
| Other | 213 | 32 |
| Deferred income taxes | 10,500 | 26,514 |
| Decrease (increase) in assets: | | |
| Investment advisory and related fees receivable | 57,132 | 3,527 |
| Net purchases of trading investments | (18,089) | (8,960) |
| Other receivables | 48,321 | 19,928 |
| Restricted cash | | 20,658 |
| Other current assets | 194 | 3,072 |
| Other non-current assets | 6,844 | 2,064 |
| Increase (decrease) in liabilities: | | |
| Accrued compensation | (235,512) | (123,827) |
| Deferred compensation | 7,453 | 1,885 |
| Payables for distribution and servicing | 22,686 | |
| Other current liabilities | (19,408) | (5,225) |
| Other non-current liabilities | 32,153 | (19,871) |
| Net cash provided by operating activities of discontinued operations | | 245,954 |
| Cash Provided by Operating Activities | 136,350 | 270,691 |
| Cash Flows from Investing Activities | | |
| Payments for: | | |
| Fixed assets | (23,913) | (10,454) |
| Acquisition related costs | (5,262) | |
| Net increase in securities purchased under agreements to resell | | (294,400) |

Edgar Filing: LEGG MASON INC - Form 10-Q

| | | |
|---|-----------------|------------------|
| Purchases of investment securities | (759) | (2,233) |
| Proceeds from sales and maturities of investment securities | 16,269 | 3,236 |
| Net cash used for investing activities of discontinued operations | | (1,436) |
| Cash Used for Investing Activities | (13,665) | (305,287) |

LEGG MASON, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

(continued)

(Dollars in thousands)

(Unaudited)

| | Three months ended | |
|---|--------------------|---------------------|
| | June 30, | |
| 2006 | | 2005 ⁽¹⁾ |
| Cash Flows from Financing Activities | | |
| Net decrease in short-term borrowings | (21,227) | |
| Repayment of principal on long-term debt | (4,656) | (539) |
| Issuance of common stock | 7,571 | 21,339 |
| Dividends paid | (24,912) | (16,393) |
| Excess tax benefit associated with stock-based compensation | 2,635 | |
| Cash Provided by (Used for) Financing Activities | (40,589) | 4,407 |
| Effect of Exchange Rate Changes on Cash | 2,478 | (1,643) |
| Net Increase (Decrease) in Cash and Cash Equivalents | 84,574 | (31,832) |
| Cash and Cash Equivalents at Beginning of Period | 1,023,470 | 795,121 |
| Cash and Cash Equivalents at End of Period | \$ 1,108,044 | \$ 763,289 |

⁽¹⁾ Revised to separately disclose the operating and investing portions of cash flows attributable to discontinued operations. These amounts were originally reported as an aggregate amount for the quarter ended June 30, 2005.

See Notes to Consolidated Financial Statements

LEGG MASON, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share amounts, unless otherwise noted)

June 30, 2006

(Unaudited)

1. Interim Basis of Reporting

The accompanying unaudited interim consolidated financial statements of Legg Mason, Inc. and its subsidiaries (collectively "Legg Mason") have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information. The interim consolidated financial statements have been prepared using the interim basis of reporting and, as such, reflect all adjustments (consisting only of normal recurring adjustments) which are, in the opinion of management, necessary for a fair statement of the results for the periods presented. The nature of our business is such that the results of any interim period are not necessarily indicative of the results for a full year.

The information contained in the interim consolidated financial statements should be read in conjunction with our latest Annual Report on Form 10-K filed with the Securities and Exchange Commission. In connection with the sale of our Private Client and Capital Markets (PC/CM) businesses as described in Note 4, we have reflected the related results of operations of PC/CM as Income from discontinued operations on the Consolidated Statements of Income.

We are presenting our Consolidated Statements of Cash Flows for the three months ended June 30, 2006 and 2005 to reconcile Net income to Cash provided by operating activities. We are also presenting our Consolidated Statements of Cash Flows for the three months ended June 30, 2005, to attribute cash flows from discontinued operations to operating and investing activities. Previously, for the three months ended June 30, 2005, we reconciled Income from continuing operations to Cash provided by operating activities and also reported cash flows from discontinued operations in a single line Change in net assets of discontinued operations held for sale. These changes did not affect the Consolidated Balance Sheets, Consolidated Statements of Income, or the Net decrease in cash and cash equivalents included in our Consolidated Statements of Cash Flows for the three months ended June 30, 2005.

On December 1, 2005, Legg Mason completed the acquisition of subsidiaries of Citigroup Inc. (Citigroup) that constituted substantially all of Citigroup's worldwide asset management business (CAM). Effective November 1, 2005, Legg Mason acquired Permal Group Ltd (Permal), a leading global funds-of-hedge funds manager. As a result of the acquisitions, the results of our continuing operations for the three months ended June 30, 2006 include results from Permal and CAM whereas the results of our continuing operations for the comparable prior year three-month

period do not include Permal or CAM results. Where appropriate, the prior period financial statements have been reclassified to conform to the current period presentation.

Unless otherwise noted, all per share amounts include both common shares of Legg Mason and shares issued in connection with the acquisition of Legg Mason Canada Inc., which are exchangeable into common shares of Legg Mason on a one-for-one basis at any time. Weighted average shares for basic and diluted purposes also include the outstanding non-voting participating preferred shares issued to Citigroup in the acquisition of CAM. In addition, during July 2006, the number of authorized common shares was increased from 250 million to 500 million.

The preparation of interim consolidated financial statements requires management to make assumptions and estimates that affect the amounts reported in the interim consolidated financial statements and accompanying notes. Actual amounts could differ from those estimates and the differences could have a material impact on the interim consolidated financial statements.

Terms such as "we," "us," "our," and "company" refer to Legg Mason.

2. Significant Accounting Policies

Stock-Based Compensation

Previously, we adopted the fair value method of accounting for stock-based compensation on a prospective basis for all stock options granted and stock purchase plan transactions after April 1, 2003, using the Black-Scholes option pricing model. Under the prospective method allowed under Statement of Financial Accounting Standards (SFAS) No. 148, Accounting for Stock-Based Compensation Transition and Disclosure, compensation expense was recognized based on the fair value of stock options granted after April 1, 2003 over the applicable vesting period. No compensation expense was recognized for stock options granted prior to April 1, 2003. Therefore, the expense related to stock-based employee compensation included in the determination of net income for June 30, 2005 is less than that which would have been included if the fair value method had been applied to all awards.

On April 1, 2006, we adopted SFAS No. 123 (R), Share-Based Payment and related pronouncements using the modified-prospective method and the related transition election. Under this method, compensation expense for the three months ended June 30, 2006 includes compensation cost for all non-vested share-based awards at their amortized grant-date fair value, including awards granted prior to April 1, 2003 that were previously recorded at their intrinsic value. Additionally, unamortized deferred compensation previously classified as a separate component of stockholders' equity has been reclassified as a reduction of additional paid-in capital. Under the modified-prospective method, the results for the three months ended June 30, 2005 have not been restated. Also under SFAS No. 123 (R), cash flows related to income tax deductions in excess of stock-based compensation expense are classified as financing cash flows for the three months ended June 30, 2006. For the three months ended June 30, 2005, such amount was \$13,613 and continues to be classified as operating cash inflows.

Accumulated Other Comprehensive Income

Accumulated other comprehensive income represents cumulative foreign currency translation adjustments and net gains and losses on investment securities and an interest rate swap. The change in the accumulated translation adjustment for the three months ended June 30, 2006 primarily resulted from the impact of changes in the British pound and the Canadian dollar in relation to the U.S. dollar on the net assets of Legg Mason's United Kingdom and Canadian subsidiaries, respectively, for which the pound and the Canadian dollar are the functional currencies. A summary of Legg Mason's accumulated other comprehensive income as of June 30, 2006 is as follows:

Edgar Filing: LEGG MASON INC - Form 10-Q

| | |
|--|-----------|
| Foreign currency translation adjustments | \$ 22,368 |
| Unrealized holding gain on interest rate swap, net of taxes of \$1,689 | 2,382 |
| Unrealized losses on investment securities, net of taxes of (\$41) | (80) |
| Total | \$ 24,670 |

Recent Accounting Developments

The Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48), in July 2006. FIN 48 clarifies previously

issued FASB Statement No. 109, Accounting for Income Taxes, by prescribing a recognition threshold and a measurement attribute in financial statements for tax positions taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, interim accounting, disclosure and transition and is effective for fiscal year 2008. Legg Mason is evaluating its adoption of FIN 48 and cannot estimate the impact, if any, on its consolidated financial statements at this time.

3. Acquisitions

Effective as of November 1, and December 1, 2005, Legg Mason completed the acquisitions of Permal and CAM, respectively. The consolidated financial statements include the accounts of Permal and CAM as of the respective acquisition dates.

Following the acquisition of CAM, Legg Mason formulated plans to re-align its mutual fund complex, specifically funds acquired as part of the CAM businesses. As part of the fund realignment, certain domestic funds are being merged with funds of similar strategy, certain funds are being re-domiciled, and certain funds are being liquidated.

During the quarter ended June 30, 2006, Legg Mason recorded a liability for the estimated costs associated with these plans, which primarily include proxy solicitation, including printing and mailing, termination payments to funds directors, and legal and accounting costs, of approximately \$42.0 million, of which \$1.5 million has been paid. In addition, following the acquisition of CAM, Legg Mason began an evaluation of excess office space in several geographic regions resulting from staff reductions and business integration. During the quarter ended June 30, 2006, Legg Mason recognized a liability of \$2.7 million representing the future commitment for unused office space. The costs for mutual fund realignment and excess office space are associated with integration of the acquired CAM business; therefore, such costs are reflected as additional goodwill. Legg Mason expects to recognize additional liabilities (and goodwill) in the quarter ended September 30, 2006, when it completes its evaluation of the remaining locations acquired in the acquisition. Legg Mason expects all of these costs to be paid through the first quarter of fiscal year 2008. Involuntary termination payments of \$3.8 million were made during the quarter ended June 30, 2006.

The following unaudited pro forma consolidated results are presented as though the acquisitions of CAM and Permal had occurred as of the beginning of the period presented and excludes the results of discontinued operations (see Note 4). The pro forma results include adjustments to exclude certain non-transferred CAM businesses in accordance with the terms of the transaction agreement, to conform accounting policies of the acquired entities, and to adjust for the effect of acquisition related expenses.

| | Three months ended |
|--|--------------------|
| | June 30, 2005 |
| Revenues | \$ 951,912 |
| Income from continuing operations | \$ 148,187 |
| Income from continuing operations per share: | |
| Basic | \$ 1.14 |
| Diluted | \$ 1.04 |

4. Discontinued Operations

On December 1, 2005, Legg Mason sold the entities that comprise its PC/CM businesses to Citigroup as a portion of the consideration in the purchase of Citigroup's global asset management businesses. In accordance with SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, the after-tax results of operations of PC/CM are reflected as Income from discontinued operations on the Consolidated Income Statements for the three months ended June 30, 2005.

Results of discontinued operations for the three months ended June 30, 2005 are summarized as follows:

| | |
|--|------------|
| Total revenues, net of interest expense ⁽¹⁾ | \$ 203,471 |
| Income from discontinued operations | \$ 39,789 |
| Provision for income taxes | 16,154 |
| Income from discontinued operations, net | \$ 23,635 |

⁽¹⁾ See Note 11 for additional information on net revenues.

5. Fixed Assets

Fixed assets consist of equipment, software and leasehold improvements. Equipment consists primarily of communications and technology hardware and furniture and fixtures. Software includes purchased software and internally developed software. Fixed assets are reported at cost, net of accumulated depreciation and amortization. The following table reflects the components of fixed assets as of:

| | June 30, 2006 | March 31, 2006 |
|---|------------------|-------------------|
| Equipment | \$ 127,770 | \$ 116,967 |
| Software | 108,916 | 101,698 |
| Leasehold improvements | 111,970 | 107,634 |
| Total cost | 348,656 | 326,299 |
| Less: accumulated depreciation and amortization | (156,292) | (143,690) |
| Fixed assets, net | \$ 192,364 | \$ 182,609 |

Depreciation and amortization are determined by use of the straight-line method. Equipment is depreciated over the estimated useful lives of the assets, generally ranging from three to eight years. Software is amortized over the estimated useful lives of the assets, which are generally three years. Internally developed software is reviewed

periodically to determine if there is a change in the useful life or if impairment in value may exist. If impairment is deemed to exist, the asset is written down to its fair value or is written off if the asset is determined to no longer have any value. Leasehold improvements are generally amortized over the term of the lease. Maintenance and repair costs are expensed as incurred. Depreciation and amortization expense of continuing operations was \$14,233 and \$6,018 for the quarters ended June 30, 2006 and 2005, respectively.

6. Intangible Assets and Goodwill

SFAS No. 142 provides that goodwill is not amortized and the values of identifiable intangible assets are amortized over their useful lives, unless the assets are determined to have indefinite useful lives. Goodwill and indefinite-life intangible assets are analyzed to determine if the fair market value of the assets exceeds the book value. If the fair value is less than the book value we will record an impairment charge. There were no impairment charges recorded during the three months ended June 30, 2006 and 2005.

Edgar Filing: LEGG MASON INC - Form 10-Q

The following tables reflect the components of intangible assets as of:

| | June 30, 2006 | March 31, 2006 |
|---|------------------|-------------------|
| Amortizable asset management contracts: | | |
| Cost | \$ 740,423 | \$ 739,789 |
| Accumulated amortization | (134,846) | (117,585) |
| Net | \$ 605,577 | \$ 622,204 |
| Indefinite-life intangible assets: | | |
| Fund management contracts | \$ 3,754,634 | \$ 3,754,312 |
| Trade names | 116,800 | 116,800 |
| Total indefinite-life intangible assets | \$ 3,871,434 | \$ 3,871,112 |
| Intangible assets, net | \$ 4,477,011 | \$ 4,493,316 |

As of June 30, 2006, management contracts are being amortized over a weighted-average remaining life of 11 years. Estimated amortization expense for each of the next five fiscal years is as follows:

| | |
|----------------|------------|
| Remaining 2007 | \$ 50,733 |
| 2008 | 57,218 |
| 2009 | 54,960 |
| 2010 | 54,632 |
| 2011 | 54,632 |
| Thereafter | 333,402 |
| Total | \$ 605,577 |

The increase in the carrying value of goodwill for the quarter ended June 30, 2006 is summarized below:

| | |
|--|--------------|
| Balance, beginning of period | \$ 2,303,799 |
| Acquisition related costs ⁽¹⁾ | 44,808 |
| Other, including changes in foreign exchange rates | (11,253) |
| Balance, end of period | \$ 2,337,354 |

⁽¹⁾ See Note 3 for additional information on acquisition related costs.

7. Long-Term Debt

Edgar Filing: LEGG MASON INC - Form 10-Q

Long-term debt as of June 30, and March 31, 2006 consists of the following:

| | June 30, 2006 | | | March 31, 2006 |
|---|------------------------|----------------------|-----------------|------------------------|
| | Current Accreted Value | Unamortized Discount | Maturity Amount | Current Accreted Value |
| 6.75% senior notes | \$ 424,673 | \$ 327 | \$ 425,000 | \$ 424,632 |
| Zero-coupon contingent convertible senior notes | - | - | - | 32,861 |
| 5-year term loan | 700,000 | - | 700,000 | 700,000 |
| 3-year term loan | 11,526 | - | 11,526 | 15,776 |
| Other term loans | 28,701 | - | 28,701 | 29,691 |
| Subtotal | 1,164,900 | 327 | 1,165,227 | 1,202,960 |
| Less: current portion | 4,067 | - | 4,067 | 36,883 |
| Total | \$ 1,160,833 | \$ 327 | \$ 1,161,160 | \$ 1,166,077 |

During the three months ended June 30, 2006, all remaining zero-coupon contingent convertible senior notes were converted into 756 thousand shares of common stock.

As of June 30, 2006, the aggregate maturities of long-term debt (current accreted value of \$1,164,900) based on the contractual terms, are as follows:

| | |
|----------------|--------------|
| Remaining 2007 | \$ 3,032 |
| 2008 | 4,206 |
| 2009 | 440,926 |
| 2010 | 4,602 |
| 2011 | 703,099 |
| Thereafter | 9,362 |
| Total | \$ 1,165,227 |

Interest Rate Swap

As of June 30, 2006, an unrealized gain of \$2,382, net of tax of \$1,689, in the market value of the \$400 million 3-year amortizing variable to fixed interest rate swap (Swap) has been reflected in Other comprehensive income. The estimated gain included in Other comprehensive income as of June 30, 2006 that is expected to be reclassified to income within the next twelve months is \$1,441, net of tax of \$1,023. The actual amount will vary from this amount as a result of changes in market conditions. On a quarterly basis, Legg Mason assesses the effectiveness of this cash flow hedge by confirming that payments and the balance of the liability hedged match the Swap.

8. Stock-Based Compensation

Legg Mason's stock-based compensation includes stock options, an employee stock purchase plan, restricted stock awards and deferred compensation payable in stock. Under its stock compensation plans, Legg Mason issues stock options to officers, key employees and non-employee members of the Board of Directors.

Grants under Legg Mason stock compensation plans are generally for newly issued shares. At June 30, 2006, 24 million shares were authorized to be issued under Legg Mason's equity incentive stock plans. Options under Legg

Mason's employee stock plans have been granted at prices not less than 100% of the market value at the date of grant. Options are generally exercisable in equal increments over 3 to 5 years and expire within 5 to 10 years from the date of grant. Restricted stock awards generally vest over 2 to 4 years.

Compensation expense for continuing operations relating to stock options, the stock purchase plan and deferred compensation for the three months ended June 30, 2006 and 2005 was \$5,660 and \$1,229, respectively, and the related income tax benefit was \$1,914 and \$458, respectively. The effect of adopting SFAS No. 123 (R) on net income for the three months ended June 30, 2006 was a reduction of \$934 or \$0.01 per share.

The following tables reflect pro forma results for the three months ended June 30, 2005 as if compensation expense associated with all applicable option grants (regardless of grant date), the stock purchase plan and deferred compensation were recognized over the vesting period:

Continuing Operations

| | |
|--|-----------|
| Income from continuing operations, net of taxes | \$ 89,140 |
| Add: stock-based compensation included in reported income from continuing operations, net of taxes | 771 |
| Less: stock-based compensation determined under fair value based method for all grants, net of taxes | (2,976) |
| Pro forma income from continuing operations | \$ 86,935 |
| Earnings per share: | |
| As reported: | |
| Basic | \$ 0.82 |
| Diluted | 0.74 |
| Pro forma: | |
| Basic | \$ 0.80 |
| Diluted | 0.72 |

Discontinued Operations

| | |
|--|-----------|
| Income from discontinued operations, net of taxes | \$ 23,635 |
| Add: stock-based compensation included in reported income from discontinued operations, net of taxes | 1,079 |
| Less: stock-based compensation determined under fair value based method for all grants, net of taxes | (2,094) |
| Pro forma income from discontinued operations | \$ 22,620 |
| Earnings per share: | |
| As reported: | |
| Basic | \$ 0.22 |
| Diluted | 0.19 |
| Pro forma: | |
| Basic | \$ 0.21 |
| Diluted | 0.19 |

Consolidated Operations

| | |
|--|------------|
| Net earnings, as reported | \$ 112,775 |
| Add: stock-based compensation included in reported net earnings, net of taxes | 1,850 |
| Less: stock-based compensation determined under fair value based method for all grants, net of taxes | (5,070) |
| Pro forma net earnings | \$ 109,555 |
| Earnings per share: | |
| As reported: | |
| Basic | \$ 1.04 |

| | |
|------------|---------|
| Diluted | 0.93 |
| Pro forma: | |
| Basic | \$ 1.01 |
| Diluted | 0.91 |

Edgar Filing: LEGG MASON INC - Form 10-Q

Stock option transactions under the plans during the three months ended June 30, 2006 and 2005 respectively, are summarized below:

| | 2006 | | Three Months Ended June 30, | |
|--------------------------------|------------------|---|-----------------------------|----------|
| | Number of Shares | Weighted-Average Exercise Price Per Share | 2006 | 2005 |
| Options outstanding at April 1 | 6,370 | \$ 43.56 | 10,113 | \$ 30.42 |
| Granted | 50 | 122.93 | 57 | 80.07 |
| Exercised | (188) | 25.53 | (757) | 25.37 |
| Canceled/forfeited | (10) | 31.11 | (39) | 37.88 |
| Options outstanding at June 30 | 6,222 | \$ 44.76 | 9,374 | \$ 31.11 |

The total intrinsic value of options exercised during the three months ended June 30, 2006 and 2005 was \$14,295 and \$45,365, respectively.

The following information summarizes Legg Mason's stock options outstanding at June 30, 2006:

| Exercise Price Range | Option Shares Outstanding | Weighted-Average Exercise Price Per Share | Weighted-Average Remaining Life (in years) |
|----------------------|---------------------------|---|--|
| \$19.17 - \$ 25.00 | 1,562 | \$20.27 | 2.0 |
| 25.01 - 32.00 | 1,099 | 27.68 | 3.2 |
| 32.01 - 40.00 | 1,786 | 33.76 | 2.4 |
| 40.01 - 132.18 | 1,775 | 87.94 | 6.5 |

At June 30, 2006, options were exercisable on 3,935 shares with an aggregate intrinsic value of \$284,004 and the weighted-average exercise price was \$28.14. The following information summarizes Legg Mason's stock options exercisable at June 30, 2006:

| Exercise Price Range | Option Shares | Weighted-Average Exercise Price |
|----------------------|---------------|---------------------------------|
|----------------------|---------------|---------------------------------|

Edgar Filing: LEGG MASON INC - Form 10-Q

| | | Exercisable | Per Share |
|---------|----------|-------------|-----------|
| \$19.17 | \$ 25.00 | 1,562 | \$20.27 |
| 25.01 | 32.00 | 676 | 28.45 |
| 32.01 | 40.00 | 1,540 | 33.93 |
| 40.01 | 53.90 | 157 | 48.27 |

Stock options exercisable at June 30, 2006 have a weighted-average remaining contractual life of 2.4 years.

Edgar Filing: LEGG MASON INC - Form 10-Q

A summary of unvested stock options under Legg Mason's equity incentive plans for the three months ended June 30, 2006 follows:

| | Number of Shares | Weighted-Average Grant Date Fair Value |
|----------------------------------|---------------------|--|
| Shares unvested at April 1, 2006 | 2,241 | \$ 29.17 |
| Granted | 50 | 49.80 |
| Vested ⁽¹⁾ | - | - |
| Canceled/forfeited | (4) | 13.29 |
| Shares unvested at June 30, 2006 | 2,287 | \$ 29.65 |

⁽¹⁾ Generally, vesting occurs on anniversary dates in July of each year.

Unamortized compensation cost related to unvested options at June 30, 2006 was \$45,297 and is expected to be recognized over a weighted-average period of 2.3 years.

Legg Mason also has an equity plan for non-employee directors that replaced its stock option plan for non-employee directors during fiscal 2006. Under the equity plan, directors may elect to receive shares of stock, options to acquire shares of stock or restricted stock units. Options granted under either plan are immediately exercisable at a price equal to the market value of the shares on the date of grant and have a term of not more than ten years. Shares, options, and restricted stock units issuable under the equity plan are limited to 625 shares in aggregate, of which 31 shares have been issued. At June 30, 2006, there are 431 stock options and 3 restricted stock units currently outstanding under both plans.

Cash received from exercises of stock options under Legg Mason's equity incentive plans was \$4,257 and \$15,107 for the three months ended June 30, 2006 and 2005, respectively. The tax benefit expected to be realized for the tax deductions from these option exercises totaled \$2,128 and \$12,190 for the three months ended June 30, 2006 and 2005, respectively. The 2005 amounts include allocations to discontinued operations.

The weighted average fair value of option grants of \$49.80 and \$28.76 per share for the three months ended June 30, 2006 and 2005, respectively, is estimated on the date of grant using the Black-Scholes option pricing model with the following weighted average assumptions:

Three months ended

June 30,

| | 2006 | 2005 |
|---------------------------|--------|--------|
| Expected dividend yield | 0.79% | 0.80% |
| Risk-free interest rate | 5.07% | 3.98% |
| Expected volatility | 32.02% | 38.28% |
| Expected lives (in years) | 6.88 | 5.82 |

Legg Mason has determined that using a combination of both implied and historical volatility is a better measure of expected volatility for calculating Black-Scholes option values. Therefore, effective with grants made in the quarter ended December 31, 2005, Legg Mason estimates expected volatility with equal weighting to both implied and historical measures. Prior to the quarter ended December 31, 2005, Legg Mason estimated volatility using only historical measures.

Legg Mason has a qualified Employee Stock Purchase Plan covering substantially all U.S. employees. Shares of common stock are purchased in the open market on behalf of participating employees, subject to a 4.5 million total share limit under the Plan. Purchases are made through payroll deductions and

Legg Mason provides a 10% contribution towards purchases, which is charged to earnings. During the three months ended June 30, 2006, approximately 9 shares, have been purchased in the open market on behalf of participating employees.

During the three months ended June 30, 2006 and 2005, Legg Mason granted 76 and 143 shares of restricted common stock, respectively, at a weighted average market value of \$112.91 and \$79.35, respectively, per share. The restricted stock awards were non-cash transactions. In the quarters ended June 30, 2006 and 2005, Legg Mason recognized \$3,265 and \$304, respectively, in compensation expense for restricted stock awards related to continuing operations and \$0 and \$1,078, respectively, in compensation expense for restricted stock awards related to discontinued operations. The tax benefit expected to be realized for the tax deductions from restricted stock totaled \$507 and \$1,423 for the three months ended June 30, 2006 and 2005, respectively. Unamortized compensation cost related to unvested restricted stock awards for 475 shares not yet recognized at June 30, 2006 was \$47,239 and is expected to be recognized over a weighted-average period of 2.3 years.

In addition, deferred compensation payable in shares of Legg Mason common stock has been awarded to certain employees in an elective plan. Vesting is immediate and the plan provides for discounts of up to 10% on contributions and dividends. There is no limit on the number of shares authorized to be issued under the plan.

9. Commitments and Contingencies

We lease office facilities and equipment under non-cancelable operating leases and also have multi-year agreements for certain services. These leases and service agreements expire on varying dates through fiscal 2021. Certain leases provide for renewal options and contain escalation clauses providing for increased rentals based upon maintenance, utility and tax increases.

As of June 30, 2006, the minimum annual aggregate rentals are as follows:

| | |
|----------------|------------|
| Remaining 2007 | \$ 64,578 |
| 2008 | 65,283 |
| 2009 | 58,933 |
| 2010 | 50,748 |
| 2011 | 41,978 |
| Thereafter | 149,578 |
| Total | \$ 431,098 |

The minimum rental commitments shown above have not been reduced by \$13,692 for minimum sublease rentals to be received in the future under non-cancelable subleases.

As of June 30, 2006, Legg Mason had commitments to invest \$39,614 in limited partnerships that make private investments. These commitments will be funded as required through the end of the respective investment periods ranging from fiscal 2007 to 2011.

As of June 30, 2006, Legg Mason has contingent payment obligations related to acquisitions. These payments are payable through fiscal 2012 and will not exceed \$1,225,045.

In the normal course of business, Legg Mason enters into contracts that contain a variety of representations and warranties and which provide general indemnifications. Legg Mason's maximum exposure under these arrangements is unknown, as this would involve future claims that may be made against Legg Mason that have not yet occurred.

Legg Mason has been the subject of customer complaints and has also been named as a defendant in various legal actions arising primarily from securities brokerage, asset management and investment banking activities, including certain class actions, which primarily allege violations of securities laws and seek unspecified damages, which could be substantial. Legg Mason is also involved in governmental and self-regulatory agency inquiries, investigations and proceedings. In the Citigroup transaction, Legg Mason transferred to Citigroup the subsidiaries that constituted its private client brokerage and capital markets businesses, thus transferring the entities that would have primary liability for most of the customer complaint, litigation and regulatory liabilities and proceedings arising from those businesses. However, as part of that transaction, Legg Mason agreed to indemnify Citigroup for most customer complaint, litigation and regulatory liabilities of Legg Mason's former private client brokerage and capital markets businesses that result from pre-closing events. Similarly, although Citigroup transferred to Legg Mason the entities that would be primarily liable for most customer complaint, litigation and regulatory liabilities and proceedings of the CAM business, Citigroup has agreed to indemnify Legg Mason for most customer complaint, litigation and regulatory liabilities of the CAM business that result from pre-closing events. In accordance with SFAS No. 5 Accounting for Contingencies, Legg Mason has established provisions for estimated losses from pending complaints, legal actions, investigations and proceedings. While the ultimate resolution of these matters cannot be currently determined, in the opinion of management, after consultation with legal counsel, Legg Mason does not believe that the resolution of these actions will have a material adverse effect on Legg Mason's financial condition. However, the results of operations could be materially affected during any period if liabilities in that period differ from Legg Mason's prior estimates, and Legg Mason's cash flows could be materially affected during any period in which these matters are resolved. In addition, the ultimate costs of litigation-related charges can vary significantly from period to period, depending on factors such as market conditions, the size and volume of customer complaints and claims, including class action suits, and recoveries from indemnification, contribution or insurance reimbursement.

On October 3, 2003, a federal district court jury rendered a verdict against Legg Mason in a civil copyright lawsuit. That verdict was confirmed in a subsequent judgment and the case was ultimately settled on June 9, 2005 by a payment of \$11,500. As a result, approximately \$8.2 million of a previously recognized litigation award settlement expense was reversed during the quarter ended June 30, 2005.

10. Earnings Per Share

Basic earnings per share ("EPS") is calculated by dividing net income by the weighted average number of shares outstanding. The calculation of weighted average shares includes common shares, shares exchangeable into common stock and convertible preferred shares that are considered participating securities. Diluted EPS is similar to basic EPS, but adjusts for the effect of potential dilutive common shares.

The following table presents the computations of basic and diluted EPS:

| | Three months ended June 30, | | | |
|--|-----------------------------|------------|------------|------------|
| | 2006 | | 2005 | |
| | Basic | Diluted | Basic | Diluted |
| Weighted average shares outstanding | 140,247 | 140,247 | 108,803 | 108,803 |
| Potential common shares: | | | | |
| Employee stock options | - | 2,979 | - | 6,544 |
| Shares related to deferred compensation | - | 35 | - | 906 |
| Shares issuable upon conversion of senior notes | - | 539 | - | 5,724 |
| Shares issuable upon payment of contingent consideration | - | 371 | - | - |
| Total weighted average diluted shares | 140,247 | 144,171 | 108,803 | 121,977 |
| Income from continuing operations | \$ 156,035 | \$ 156,035 | \$ 89,140 | \$ 89,140 |
| Interest expense on convertible senior notes, net of tax | - | 84 | - | 1,004 |
| Income from continuing operations, as adjusted | 156,035 | 156,119 | 89,140 | 90,144 |
| Income from discontinued operations, net of tax | - | - | 23,635 | 23,635 |
| Net income | \$ 156,035 | \$ 156,119 | \$ 112,775 | \$ 113,779 |
| Net Income per share: | | | | |
| Continuing operations | \$ 1.11 | \$ 1.08 | \$ 0.82 | \$ 0.74 |
| Discontinued operations | - | - | 0.22 | 0.19 |
| | \$ 1.11 | \$ 1.08 | \$ 1.04 | \$ 0.93 |

Antidilutive shares of 3,688 were excluded from the computation of diluted earnings per share for the three months ended June 30, 2006.

11. Business Segment Information

Legg Mason continues to integrate and organize its ongoing operations following the consummation of the Citigroup transaction and the Permal acquisition. While much of the integration is complete, Legg Mason is still in the process of determining an appropriate method of allocating costs, primarily marketing and distribution, to determine profitability of the various business units. Legg Mason expects this process to be completed in the quarter ending September 30, 2006. Until then, Legg Mason is managing its continuing operations as a single comprehensive Asset Management business with three divisions: Managed Investments (formerly referred to as Mutual Funds/Managed Services), Institutional and Wealth Management. As a result of the transaction with Citigroup as described in Notes 3 and 4, former Private Client and Capital Markets segments are reported as discontinued operations.

Continuing Operations

Asset Management provides investment advisory services to institutional and individual clients and to company-sponsored investment funds. The primary sources of revenue in Asset Management are investment advisory, distribution and administrative fees, which typically are calculated as a percentage of the assets under management and vary based upon factors such as the type of underlying investment product and the type of services that are provided. In addition, performance fees may be earned on certain investment advisory contracts for exceeding performance benchmarks. Distribution fees on

company-sponsored investment funds are included in Asset Management, along with a corresponding expense representing fees paid to unaffiliated distributors of those funds, including parties that were related parties prior to the sale.

Results by geographic region are as follows:

| | Three months ended | |
|--|--------------------|------------|
| | June 30, | |
| | 2006 | 2005 |
| Operating Revenues: | | |
| United States | \$ 804,376 | \$ 401,288 |
| United Kingdom | 177,446 | 30,514 |
| Other | 56,398 | 5,884 |
| Total | \$ 1,038,220 | \$ 437,686 |
| Income from Continuing Operations before Income Tax Provision and Minority Interests: | | |
| United States | \$ 197,112 | \$ 134,617 |
| United Kingdom | 45,381 | 9,908 |
| Other | 10,490 | (2,414) |
| Total | \$ 252,983 | \$ 142,111 |

Intangible assets, net and goodwill by geographic region are as follows at June 30, and March 31, 2006:

| | June 30, 2006 | March 31, 2006 |
|---|---------------|----------------|
| Intangible Assets, Net and Goodwill: | | |
| United States | \$ 5,391,642 | \$ 5,364,786 |
| United Kingdom | 1,222,903 | 1,232,697 |
| Other | 199,820 | 199,632 |
| Total | \$ 6,814,365 | \$ 6,797,115 |

Discontinued Operations

Financial results of discontinued operations businesses were as follows:

Three months
ended
June 30, 2005

Net Revenues:

| | |
|---------------------------------|------------|
| Private Client | \$ 187,323 |
| Capital Markets | 63,187 |
| | 250,510 |
| Reclassification ⁽¹⁾ | (47,039) |
| Total | \$ 203,471 |

Income before Income Tax Provision:

| | |
|-----------------|-----------|
| Private Client | \$ 35,338 |
| Capital Markets | 4,451 |
| Total | \$ 39,789 |

(1)

Represents distribution fees from proprietary mutual funds, historically reported in Private Client, that have been reclassified to Asset Management as distribution fee revenue, with a corresponding distribution expense, to reflect Legg Mason's continuing role as funds distributor.

Results of discontinued operations by geographic region are as follows:

| | Three months ended June 30, 2005 |
|--|--|
| Net Revenues: | |
| United States | \$ 197,961 |
| United Kingdom | 2,142 |
| Other | 3,368 |
| Total | \$ 203,471 |
| Income before income tax provision: | |
| United States | \$ 38,703 |
| United Kingdom | 525 |
| Other | 561 |
| Total | \$ 39,789 |

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Legg Mason, Inc., a holding company, with its subsidiaries (which collectively comprise Legg Mason) is a global asset management firm. Acting through our subsidiaries, we provide investment management and related services to institutional and individual clients, company-sponsored mutual funds and other investment vehicles. We offer these products and services directly and through various financial intermediaries. We have operations principally in the United States of America and the United Kingdom but also have offices in Australia, Bahamas, Brazil, Canada, Chile, Dubai, France, Germany, Hong Kong, Japan, Luxembourg, Poland, Puerto Rico, Singapore, Spain and Taiwan.

On December 1, 2005, we completed a strategic acquisition to become a pure asset management company in which we transferred our Private Client and Capital Markets businesses (PC/CM) to Citigroup Inc. (Citigroup) as a portion of the consideration in exchange for substantially all of Citigroup's asset management business (CAM). Prior to the announcement of this transaction, we reported the PC/CM businesses as separate operating segments; however, both businesses are now included in discontinued operations for all periods presented. Effective November 1, 2005, we also purchased Permal Group Ltd (Permal), a leading global funds-of-hedge funds manager, to expand our global asset management business. Following the consummation of the CAM and Permal acquisitions and the sale of the PC/CM businesses, we are in the process of reorganizing and assimilating the acquired businesses. While much of the integration is complete, we are still in the process of determining an appropriate method of allocating costs of marketing and distribution to determine profitability of the various businesses. We expect this process to be completed in the quarter ending September 30, 2006. Until then, we are managing our continuing operations as a comprehensive Asset Management business with three divisions: Managed Investments (formerly named Mutual

Funds/Managed Services), Institutional and Wealth Management.

Our financial position and results of operations are materially affected by the overall trends and conditions of the financial markets, particularly in the United States, but increasingly in the other countries in which we operate. Results of any individual period should not be considered representative of future results. Our profitability is sensitive to a variety of factors, including the amount and composition of our assets under management, and the volatility and general level of securities prices and interest rates, among other things. Sustained periods of unfavorable market conditions are likely to affect

our profitability adversely. In addition, the diversification of services and products offered, investment performance, access to distribution channels, reputation in the market, attracting and retaining key employees and client relations are significant factors in determining whether we are successful in attracting and retaining clients. Accordingly, sustained periods of unfavorable market conditions may adversely affect our profitability. For a further discussion of factors that may affect our results of operations, refer to Item 1A. Risk Factors in our Annual Report on Form 10-K for the fiscal year ended March 31, 2006.

Terms such as "we," "us," "our," and "company" refer to Legg Mason.

Business Environment

The financial environment in which we operate was very challenging during the first fiscal quarter of 2007 due to uncertain equity markets, record high fuel prices, and turbulence in the Middle East. The Dow Jones Industrial Average¹ was up 0.4%, while the Nasdaq Composite Index² and the S&P 500³ were down 7%, and 2%, respectively, for the quarter ended June 30, 2006. The federal funds rate was raised by 0.25% on both May 10, 2006 and June 29, 2006 to 5.25% as of quarter end.

Results of Operations

Since our strategic transaction with Citigroup was announced in June 2005 we retroactively reflected the results of operations of the PC/CM businesses as discontinued operations. As a result of the acquisitions, the results of our continuing operations for the quarter ended June 30, 2006 includes results from Permal and CAM whereas the results of our continuing operations for the comparable prior year quarter do not include Permal or CAM. Following the transaction with Citigroup, portions of the CAM business have been and continue to be integrated into certain of our other asset managers. Where noted, amounts presented for the impact of CAM in the discussion below exclude amounts that have been integrated into other subsidiaries.

Net income and diluted earnings per share for the three months ended June 30, 2006 increased significantly compared to the prior year's quarter. Net income increased 38% to \$156.0 million from \$112.8 million and diluted earnings per share increased to \$1.08 from \$0.93, up 16%. Cash income from continuing operations (see Supplemental Financial Information) increased to \$202.6 million from \$100.4 million and cash income per diluted share increased to \$1.40 from \$0.83, up 102% and 69%, respectively. Income from continuing operations totaled \$156.0 million, up 75% from the prior year's quarter and operating revenues increased to \$1.0 billion from \$437.7 million, up 137%. All of the increases are primarily due to the addition of CAM and Permal revenues and expenses. Assets under management increased \$455.5 billion, or 114% in the last 12 months to \$854.7 billion, with 94% of the increase attributable to the assets of CAM and Permal on their acquisition dates, 5% from market appreciation, and 3% from net client cash flows. These increases were partially offset by assets managed by sold businesses. Higher aggregate levels of assets under management at our other asset managers, primarily Western Asset Management Company (Western Asset), Legg Mason Capital Management (LCM), and Brandywine Global Investment Management (Brandywine) contributed to the increase over the prior year. The pre-tax profit margin from continuing operations was 24.4%, down from 32.5% respectively for the quarters ended June 2006 and 2005, primarily due to a significant increase in fund revenues, of which a substantial portion is passed through to third parties as distribution and servicing expense and the

impact of the 2005 litigation award credit. The pre-tax profit margin from continuing operations, as adjusted (see Supplemental Financial Information), was 33.4% and 38.5%, respectively, for the quarters ended June 2006 and 2005 primarily attributable to an increase

- ¹ Dow Jones Industrial Average is a trademark of Dow Jones & Company, which is not affiliated with Legg Mason.
- ² Nasdaq is a trademark of the Nasdaq Stock Market, Inc., which is not affiliated with Legg Mason.
- ³ S&P is a trademark of Standard & Poor's, a division of the McGraw-Hill Companies, Inc., which is not affiliated with Legg Mason.

in overhead expenses that were allocated to discontinued operations prior to the acquisition of CAM and the impact of the 2005 litigation award credit. In each case, the factors decreasing the margins were partially offset by the impact of lower compensation as a percentage of revenue. In the prior year's quarter, income from discontinued operations, net of tax, totaled \$23.6 million. Diluted earnings per share from discontinued operations were \$0.19 in the prior year quarter.

Compared to the quarter ended March 31, 2006, net income increased 4% to \$156.0 million and diluted earnings per share were up 5% from \$1.03 to \$1.08. Income from continuing operations increased 3% from the March quarter, primarily as a result of a reduction in compensation and benefits expense. Operating revenues decreased 1% from \$1.1 billion, primarily due to a decrease in performance fees and reduced market values and net outflows of equity assets under management. In the last three months, assets under management decreased by \$12.9 billion, or 1%, from \$867.6 billion at March 31, 2006, primarily as a result of \$7 billion in client cash outflows and equity asset depreciation. Outflows in liquidity assets were offset in part by fixed income market appreciation and net client inflows into long-term fixed income assets. Compensation and benefits expense declined by \$27.2 million during the quarter, as compared with the quarter ended March 31, 2006. The decline primarily reflects a lower number of full time employees and the elimination of certain duplicative expenses related to transitioning personnel as part of the integration of the acquired CAM business.

Quarter Ended June 30, 2006 Compared to Quarter Ended June 30, 2005

Assets Under Management

The component changes in our assets under management (in billions) for the quarters ended June 30 were as follows:

| | 2006 | 2005 |
|---|----------|----------|
| Beginning of period | \$ 867.6 | \$ 374.5 |
| Net client cash flows | (6.5) | 16.3 |
| Market appreciation (depreciation), net | (6.4) | 8.4 |
| End of period | \$ 854.7 | \$ 399.2 |

Assets under management for the quarter ended June 30, 2006 were \$854.7 billion, up \$455.5 billion or 114% from the quarter ended June 30, 2005. The acquisitions of CAM and Permal accounted for approximately \$426.1 billion at their acquisition dates or 94% of the net increase, with market performance, including currency translation, accounting for \$21.8 billion or 5% of the increase and net client cash flows accounting for \$13.1 billion or 3%. These increases were partially offset by assets managed by sold businesses. Our Institutional Asset Management division represented 53% of total assets managed, our Managed Investments division represented 40% and our Wealth Management division represented 7%. Non-U.S. domiciled clients accounted for 29% of total assets under management, which

compares with 25% of non-U.S. client assets at June 30, 2005, with the increase primarily due to the acquisition of non-U.S. assets managed by CAM and Permal.

Edgar Filing: LEGG MASON INC - Form 10-Q

Our assets under management by division (in billions) as of June 30 were as follows:

| | 2006 | % of Total | 2005 | % of Total |
|------------------------------------|----------|---------------|----------|---------------|
| Managed Investments ⁽¹⁾ | \$ 338.1 | 39.6 % | \$ 74.1 | 18.5 % |
| Institutional | 452.0 | 52.9 | 275.3 | 69.0 |
| Wealth Management | 64.6 | 7.5 | 49.8 | 12.5 |
| Total | \$ 854.7 | 100.0 % | \$ 399.2 | 100.0 % |

⁽¹⁾ The Mutual Funds/Managed Services division has been renamed the Managed Investments division.

CAM's fixed income and international equity separate account assets under management are included in our Institutional division, while its U.S. equity separate accounts and all proprietary mutual and other fund assets under management are included in our Managed Investments division. Permal's assets under management are included in our Wealth Management division.

Assets under management by asset class (in billions) as of June 30, 2006 and 2005 are as follows:

| | 2006 | % of Total | 2005 | % of Total | % Change |
|--------------|---------|---------------|---------|---------------|-------------|
| Equity | \$311.5 | 36.5 % | \$151.3 | 37.9 % | 105.9 % |
| Fixed Income | 420.7 | 49.2 | 239.8 | 60.1 | 75.4 |
| Liquidity | 122.5 | 14.3 | 8.1 | 2.0 | 1,412.3 |
| Total | \$854.7 | 100.0 % | \$399.2 | 100.0 % | 114.1 % |

Our operating revenues by Asset Management division (in millions) for the quarter ended June 30 were as follows:

| | 2006 | 2005 |
|------------------------------------|------------|----------|
| Managed Investments ⁽¹⁾ | \$ 588.0 | \$ 195.5 |
| Institutional ⁽¹⁾ | 243.3 | 150.9 |
| Wealth Management | 206.9 | 91.3 |
| Total | \$ 1,038.2 | \$ 437.7 |

⁽¹⁾ Quarter ended June 2005 includes approximately \$12.9 million reclassification from the Institutional division to the Managed Investments division to reflect a change in revenue classification.

The increase in operating revenues in the Managed Investments and Institutional divisions was primarily due to the acquisition of CAM. The increase in operating revenues in the Wealth Management division was primarily due to the acquisition of Permal.

Results of Continuing Operations

Operating Revenues

Revenues from continuing operations in the quarter ended June 30, 2006 were \$1.0 billion, up 137% from \$437.7 million in the prior year quarter, with approximately \$520 million, or 85% of the increase, resulting from the CAM and Permal acquisitions, excluding certain CAM revenues that were transferred to other subsidiaries as part of the integration. Certain of our other asset managers, primarily Western Asset, Royce & Associates, LLC (Royce) and LMCM, contributed to the revenue increase, driven by strong growth in assets under management since June 30, 2005.

Investment advisory fees from separate accounts increased 54% or \$127.6 million to \$364.6 million, primarily as a result of the CAM acquisition, which accounted for approximately \$90 million or 70% of the increase, excluding certain CAM investment advisory fees from separate accounts that were

transferred to other subsidiaries as part of the integration. Growth in separate account assets managed at Western Asset, Brandywine and LMCM since June 2005 also contributed to the increase in revenues.

Investment advisory fees from funds increased 291% to \$490.2 million, with approximately 91% of the increase attributable to the acquisitions of CAM and Permal. Royce and LMCM also contributed to the increase.

Distribution and service fees increased 158% to \$179.6 million, with approximately 90% of the increase due to the addition of distribution and service fees from CAM and Permal. These fees reflect our continuing role as our proprietary funds distributor, with a related distribution expense.

Other operating revenues decreased 34% to \$3.8 million, primarily due to changes in contractual arrangements with transfer agents.

Operating Expenses

Compensation and benefits increased 98% to \$379.6 million, primarily as a result of compensation costs from the acquired businesses, including transaction-related compensation and increased revenue share-based incentive expense on higher revenues at certain of our other subsidiaries. Transaction-related compensation costs primarily include recognition of previously deferred compensation for terminated CAM employees and accruals for retention compensation for transitional CAM employees. Costs for severance at CAM were included in the purchase price allocation and are not reflected in our results of operations. Compensation as a percentage of operating revenues was 36.6% for the quarter ended June 30, 2006, down from 43.8% as a result of lower incentive compensation as a percentage of revenues from CAM and Permal.

Distribution and servicing expenses increased 308% to \$280.6 million, primarily as a result of the addition of \$196.2 million in distribution and service fees incurred by CAM and Permal.

Communications and technology expense increased 179% to \$38.4, million, primarily as a result of the addition of CAM's expenses, primarily market data and printing.

Occupancy increased 208% to \$22.2 million, primarily due to the addition of expenses at CAM and Permal.

Amortization of intangible assets increased 191% to \$17.0 million from \$5.8 million in the prior year quarter, primarily as a result of the CAM acquisition.

The litigation award settlement during the June 30, 2005 quarter reflects the reversal of \$8.2 million of charges recorded in fiscal 2004 as a result of the settlement of a civil copyright infringement lawsuit.

Other expenses increased 137% to \$43.0 million, primarily due to increased promotional costs at CAM and professional fees.

Other Income (Expense)

Interest income increased \$3.6 million to \$12.9 million, primarily as a result of higher average interest rates earned on higher average levels of firm investments. Interest expense increased \$6.0 million to \$16.2 million due to the issuance of a \$700 million term loan incurred in the CAM acquisition, offset in part by the conversion of the zero-coupon contingent convertible senior notes and the repayment at maturity of \$100 million in senior notes during the March 31, 2006 quarter. Other income (expense) decreased \$3.8 million to a loss of \$1.1 million as a result of net losses on investments in deferred compensation plans.