

Lehman Brothers

De-risking and depending on markets to hold

- ▶ **A rush-to-market earnings release and strategic response to what Moody's called a "crisis in confidence" was received skeptically by markets, although there are a few positives in our opinion**
- ▶ **Moody's downbeat conference call and threat to downgrade the firm's senior debt rating into the triple-B category highlights the need to find a long-term strategic partner**
- ▶ **The meaningful distinctions with Bear Stearns should limit how wide this name could trade; still, near-term uncertainty keeps us Underweight**

A work in progress

In an effort to restore confidence in its firm, Lehman Brothers did much of what it could do yesterday, in our opinion, in getting out preliminary Q3 earnings, such as they were, while setting a plan to materially reduce the pile of illiquid assets that have caused market participants to question the integrity of its balance sheet.

Through it all, there were positives in yesterday's announcement, including (1) feasible plans to reduce commercial and residential real estate exposure; (2) marks against the problem assets seem to be conservative; (3) evidence that the firm can still make money, ex-writedowns; (4) devising a creative way to raise capital off of its investment in asset management, while retaining a significant amount of its earnings; (5) no diminution of the firm's liquidity pool; (6) reduced financial leverage; and (7) a commitment to continue to explore strategic alternatives.

The negatives from our perspective include (1) the firm has not been able to line up a strategic partner to backstop the firm; (2) it will have to finance—both with debt and equity—most of the planned spin-off of commercial real estate assets and the sale of \$4 billion of UK residential real estate assets it is selling to BlackRock; and (3) it is still overgrown. Moreover, investor sentiment—both credit and equity—is not favorable, indicating that there are scars from September 9's powerful equity sell-off.

But the biggest negative in our opinion might have come at 4:00 pm, when Moody's belatedly opined on Lehman's ratings. The agency put the firm's long-term rating (A2) under review with the unusual qualifier that the direction is uncertain. The short-term rating was placed under review for downgrade.

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Ratings for a securities business are always important, but they are doubly so for a large, global firm, like Lehman. Smaller, niche firms can successfully operate in our opinion, with ratings below mid-single-A (Jefferies is an example, as was DLJ in the past). Moody's even pointed out that Lehman was rated in the Baa category in 1998. The difference, of course, is that Lehman was much smaller back then. With \$311 billion in net assets, Lehman needs an awful lot of counterparty risk analysts to vote confidently on the name to maximize its competitiveness.

The importance of mid-single-A is that is the breakpoint where short-term ratings go from "1" to "2". In other words, if a firm's long-term rating falls from mid-single-A to low-single-A, its short-term rating will drop to a "2". That is a meaningful drop as the short-term rating is often used by counterparty risk analysts when setting lines of credit and collateral requirements. Should Lehman's long-term ratings fall one notch (Moody's and S&P, which is reviewing the company for downgrade, rate the company right on the breakpoint, mid-single-A; Fitch is reviewing its high-single-A rating), its short-term rating at Moody's and S&P would drop to a "2" level, which would require the firm to post additional collateral with counterparties and potentially result in a loss of counterparty capacity. Moody's referred to a potential downgrade as being "suboptimal" to Lehman.

So, let's go back to Moody's announcement this afternoon. Essentially, the agency is saying that if Lehman is able to line up a strategic investment—not a financial investor such as a private equity firm—it would likely result in an upgrade. That does not sound so bad. However, "should a strategic arrangement fail to materialize in the near term," the agency went on, "...the ratings would likely be downgraded, likely into the Baa category." Moreover, the ratings would remain under review for further downgrade. When asked about a timetable on its conference call reviewing the announcement, Moody's made it clear that such a strategic investment has to happen quickly.

Notwithstanding its inability to find a strategic investor, the firm is doing what it can to reduce the illiquid assets with the highest visibility, primarily commercial and residential mortgage assets. These assets have been difficult to hedge, and so management has decided that the "best hedge is to reduce absolute exposure." At August 31, and pro forma for the upcoming sale of approximately \$4.0 billion of primarily UK residential real estate assets to BlackRock, mortgage and other asset-backed securities have been reduced to \$41.8 billion, or 1.4x tangible equity capital, down from 3.3x at November 30, 2007. That figure should be reduced to approximately 0.8x if it can launch REI Global, the proposed spin-off of commercial real estate assets planned for fiscal Q1 2009.

Overall, we are comfortable with the concept of the spin-off and the portfolio, which is well diversified. We are concerned, however, with how much of the financing Lehman is having to provide in both the sale of UK assets to BlackRock (75%) as well as REI Global. In the latter's case, Lehman will transfer equity equal to 20-25% of the assets, which is expected to be \$25-\$30 billion. That implies equity of \$5-\$7.5 billion, with the balance of the funding to come from debt that "may" be syndicated "as markets normalize." "Core Lehman" could then be run theoretically with less capital, since the riskier assets have been substantially reduced.

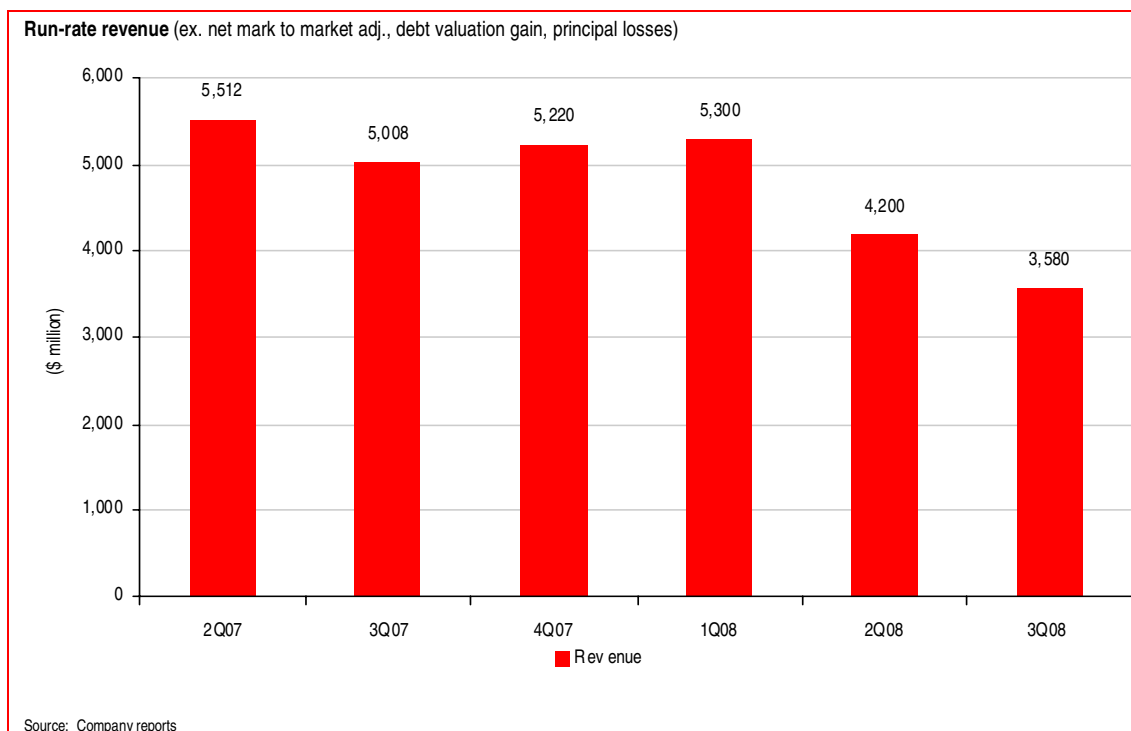
Asset exposure				
	2Q08	3Q08	Change	Comment/Assumptions
Acquisition finance	18	10.4	-42%	
HY acquisition finance	11.5	7.1	-38%	
Other asset backed positions	6.5	4.6	-29%	
Commercial Mortgage RE HFS (\$B)	39.8	32.6	-18%	\$25-30B is expected to be spun off into REI Global
Residential RE HFS (\$B)	24.9	13.2	-47%	Reduction includes impending sale of \$4B in UK residential assets that will be sold to Blackrock; a couple of add'l txn being contemplated in Europe; objective is to run this book at \$10B
<u>Asset type (\$B)</u>				
Less risky (as defined by LEH)				
Alt-A servicing rights		1.6		Most have negative correlation to deteriorating markets
Alt-A AAA IO securities		0.6		LTV of 39%
Reverse mortgages		0.6		
Asia		0.5		
2005 vintages and earlier (US)		0.9		
Remaining assets*				
Alt-A		3.7		Marked at 39 cents vs. 63 cents last quarter
Second-lien subprime		1.6		Marked at 34 cents vs. 55 cents last quarter
European exposure		3.6		Marked at 69 cents vs. 83 cents last quarter
ABS CDO		0.5		Marked at 29 cents vs. 35 cents last quarter
Additional US Exposure		0.5		Marked at 45 cents vs. 48 cents last quarter
Total*		14.1		
<u>Weighted average price per dollar (\$)</u>				
US residential book	0.59	0.39		
<u>Yield on US Book at current price (%)</u>				
		12%		Yield: L+800bps w/ default of 50% average recovery rate of 40%; Base case yield assumption include a peak to trough drop in national home prices of 32% (vs. actual of 18%, with CA down 50% (vs. actual of 27%)
<u>60+ day delinquency (includes REO)</u>				
Alt-A		18%		Yield: L+1000 w/ 44% default, L+100 w/ 63% default, and zero w/ 79% (all cases assume 20-30% recovery)
Non-prime		23%		Yield: L+1100 w/ 59% default, L+100 w/ 76% default, and zero w/ 85% (all cases assume 40-45% recovery)

*Note high-risk assets include the \$900M of 2005 vintage and earlier (US) residential assets
Source: Company reports

The capital base should be bolstered by the sale of a majority stake in IMD, which will remove \$3 billion in goodwill associated with Neuberger Berman, plus whatever gain might be achieved in the sale. In addition, the dramatic cut in the annual dividend (\$0.68 to \$0.05) will save some \$450 million.

It could have been worse

As for the quarter, we viewed it as reasonable, all things considered, which management characterized as “extremely trying.” Excluding all of the noise (net mark-to-market adjustments, debt valuation gains and principal losses), net revenues were \$3.6 billion, down 30% from the year ago period (on a run-rate basis), and 35% from the credit bubble high water mark for Lehman (Q2 2007). Adjusted pretax earnings were approximately \$600 million, down 50% from the year ago period.



Investment banking revenues of \$611 million were 43% lower year-over-year, with meaningful drop-offs in all three categories (debt underwriting, equity underwriting, M&A). Capital markets fared a bit better, down just 9% over the prior year, which was a very strong quarter in equities. Fixed income net revenues of \$1.8 billion were flat to the prior quarter, and just 18% off of its all-time record set in Q2 2006.

Equities fared far worse, posting run rate net revenues of \$425 million, 43% below the previous quarter, 69% lower than the year ago quarter, and 75% off of the firm's quarterly record (Q2 2007). Proprietary trading losses were the primary culprit as customer revenues were down just 22% sequentially.

Investment management net revenues of \$664 million got hit with a \$60 million loss on investments in hedge fund managers, which reduced net revenues by 8%. Excluding those losses, IMD accounted for 20% of the firm's net revenues run rate.

A quick word on expenses. We believe that Lehman has done a commendable job thus far of taking advantage of the opportunities opened up by the markets' dislocations. But we see growing risk that persistent overhang of staff reductions will take its toll. Is management responding to the revenue downdraft in a prudent way? Possibly yes, possibly no. Management pointed out that the majority of the cuts were targeted at "discretionary corporate areas" and at those businesses in secular decline, and only minimally toward client-facing positions. Time will tell.

Valuation

From a valuation standpoint, there are important distinctions that need to be made from our starting point, Bear Stearns. Lehman is a better, more diversified franchise. It is much more conservatively funded, and carries a huge liquidity pool of some \$42 billion. It has access to the Federal Reserve for emergency funding.

It also has one thing that it shares with Bear Stearns—it is too big to fail in our opinion. The interconnectedness of the firm within the global financial system is firmly bound. We have to believe that no regulator or central banker really wants to find out what a massive counterparty risk failure would look like.

All of this should put a lower ceiling on spread widening than what we saw at Bear Stearns, where 5-year CDS got out to close to 800 bp. Although the firm has been unable to find a strategic buyer thus far, and one could logically conclude that every day Lehman remains independent, some franchise value is lost, we believe that its business is worth preserving, and that eventually it will find that deep-pocketed strategic investor. A sovereign wealth fund-type investor could drive the name into 400 bp or so on the back of a minority investment, and, of course, acquisition by a large depository, as has been discussed in the press and on the Moody's call, would be far more beneficial to the credit. So there is considerable upside from current levels (577 bp).

But are there many potential buyers as has been widely suggested in the press? Not in our opinion. Is Lehman "cheap," now that its market capitalization has fallen to \$5 billion? Plenty of institutions could afford that, right? Maybe not. Buying any firm is not about what you have to pay, it's what it ultimately costs, in terms not only of profit and loss but also market cap impact to the acquirer. There is also the issue of size. At \$300 billion in net assets, Lehman would be a meaningful investment for even the largest of institutions to take on, especially in this capital-sensitive environment.

So while there is considerable upside, there is also near-term risk, including further pressure from markets (the stock finished down 7% on the day, after trading up 18% at one point; in after-hours trading, it was trading still lower from the close) and a possible multi-notch downgrade from Moody's. As was the case with Bear Stearns, the worse it gets the better it may get for creditors, which benefited greatly when the regulators stepped in and forced a sale to J.P. Morgan Chase. Yet the considerable uncertainty will keep us Underweight in the name for now.

Disclosure appendix

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Rating changes for long-term investment opportunities

Recommendation History of LEHMAN BROTHERS

From	To	Date
Neutral	Underweight	2008-03-17
Overweight	Neutral	2007-11-08
Not Rated	Overweight	2007-08-01

Source: HSBC

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Source: HSBC

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Company	Ticker	Recent price	Price Date	Disclosure
LEHMAN BROTHERS	LEH.N	7.25	11-Sep-2008	2, 5, 6, 7, 11

Source: HSBC

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