

Lehman Brothers

Management Has Plan, Not Action -- We Await Inv. Mgmt Sale

Lehman reported a F3Q08 loss of \$5.92/share, including \$5.6B of net write-downs. LEH also announced strategic initiatives to spin-off \$25-\$30B of comm. real estate and sell majority interest in its inv. mgmt arm. The plan buys time for credit markets to improve or for a suitor to be found. However, with rating agency downgrades looming and LEH's stock price under pressure, we believe there are material risks to Lehman in a conclusion that we see as imminent. In the meantime, CFTC data confirms clients are pulling assets.

- **Commercial mortgage portfolio spin-off likely requires equity and financing from LEH.** LEH plans to sell \$25-\$30B of comm. real estate which is marked at 85c. We see further marks of 10-15c, and expect Lehman financing of both the debt and equity. As a result of the debt financing, we believe Lehman retains downside risk.
- **55% of Inv. Mgmt. for sale – bids unclear.** LEH is trying to sell the IM business and expects a minimal impact to profits. Given CEO Fuld's standing in the financial community, we see success as possible, but the suitor needs Neuberger mgmt 'buy-in' which is unclear. We believe a spin-off will certainly mean greater earnings volatility, a less diversified earnings base, and a higher comp. ratio.
- **More write-downs to come and core business prospects uncertain.** We are not comfortable with the marks on the commercial real estate portfolio at 85c and see further downside to the resi portfolio give potential structure with BlackRock. Core business also appears to be struggling with customer retention and employee morale. CFTC data indicates that in July Lehman lost 22% in FCM customer assets, data effective prior to recent confidence issues.
- **Lowering estimates.** Low valuation does not peak our interest, and we are concerned about LEH's ability to execute its strategic plan without further depleting the capital base. We maintain our Neutral rating and do not see the stock as investable unless LEH can execute on its plan.

Lehman Brothers (LEH;LEH US)

	2007A	2008E (Old)	2008E (New)	2009E (Old)	2009E (New)
EPS (\$)					
Q1 (Feb)	1.96	0.81A	0.81A	0.77	0.42
Q2 (May)	2.21	(5.14)A	(5.14)A	0.86	0.38
Q3 (Aug)	1.54	(3.30)A	(5.92)A	0.85	0.50
Q4 (Nov)	1.54	0.46	(1.80)	1.16	0.72
FY	7.26	(6.77)	(12.32)	3.64	2.03
P/E FY	1.0	NM	NM	2.0	3.6

Source: Company data, Reuters, JPMorgan estimates. Note: Estimates include the impact of SFAS-123R.

Neutral

\$7.25

10 September 2008

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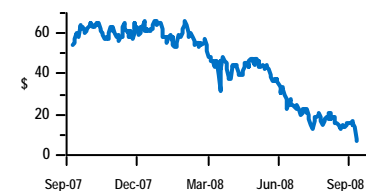
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Price Performance



Company Data

Price (\$)	7.25
Date Of Price	10 Sep 08
52-week Range (\$)	67.73 - 7.64
Mkt Cap (\$ mn)	5,011.20
Fiscal Year End	Nov
Shares O/S (mn)	691

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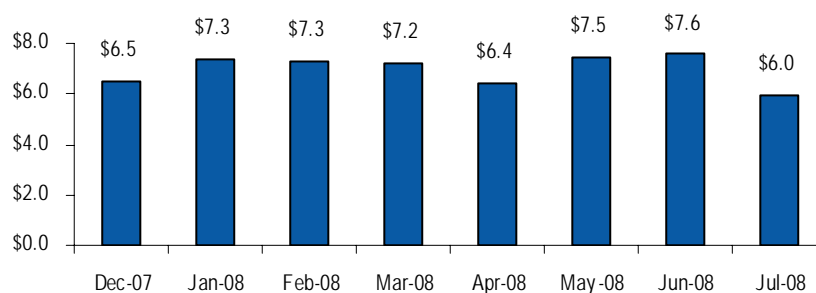
Credit outlook – downgrades a concern.

Three ratings agencies are reviewing Lehman's ratings for possible downgrades, possibly for more than one-notch. Moody's put the long-term ratings on review with direction uncertain reflecting "the high degree of fluidity in Lehman's current situation" and limited financial flexibility given the precipitous decline in the stock price. Moody's also said the ratings would be downgraded if LEH fails to find a strategic partner in the near term.

CFTC data shows declining customer assets.

CFTC data indicates that Lehman lost material customer assets where it acts as a futures commission merchant. The CFTC reports customer segregated funds for the trading of designated contracts within Lehman's FCM business.

Figure 1: LEH customer assets decline 22% in July



Source: CFTC

The recent decline in assets likely signals customer withdrawals and could be an indication of waning customer confidence in this and other businesses where disclosure does not exist. CFTC data shows Lehman has lost 22% of client assets in July, a more rapid decline than the peers. Bear lost 55% of customer assets in March 2008. While confidence in LEH slipped, it was not as extreme as was seen at Bear, although August and September, the months of greatest stock pressure Lehman could show a different story.

Table 1: CFTC Data Shows Lehman's Futures Commission Merchant Business under Pressure

(assets in billions of \$)

	Dec-07	Jan-08	Feb-08	Mar-08	Apr-08	May-08	Jun-08	Jul-08
Companies Under Stress								
Lehman	\$6.5	\$7.3	\$7.3	\$7.2	\$6.4	\$7.5	\$7.6	\$6.0
seq change		12.8%	-0.5%	-1.3%	-10.7%	16.1%	2.0%	-21.8%
MF Global	\$10.3	\$10.4	\$13.0	\$9.7	\$9.5	\$9.7	\$10.6	\$9.1
seq change		0.5%	25.3%	-25.5%	-2.4%	2.2%	9.3%	-14.3%
Bear	\$3.6	\$3.6	\$4.8	\$2.1	\$2.2	2.27	nm	nm
seq change		-1.6%	33.5%	-55.9%	4.2%	3.6%		
Companies Not Under Stress								
Goldman	\$14.9	\$15.9	\$16.5	\$17.9	\$18.8	\$19.4	\$19.7	\$18.1
seq change		6.7%	3.8%	7.0%	4.8%	3.1%	1.5%	-8.6%
JPMorgan	\$9.6	\$11.9	\$10.8	\$11.2	\$12.2	\$11.97	\$12.44	\$11.9
seq change		24.3%	-9.7%	4.3%	8.9%	-2.3%	4.0%	-4.4%

Source: CFTC

Changes to the Model – Estimates Decline

We are lowering our 2008 and 2009 estimates for LEH. The downside to our 4Q08 and 2009 estimates comes from the weaker fixed income projections given the estimated write-downs for 4Q08 of app \$3B and the slowdown in the client activity, as well as a decline in origination revenue growth.

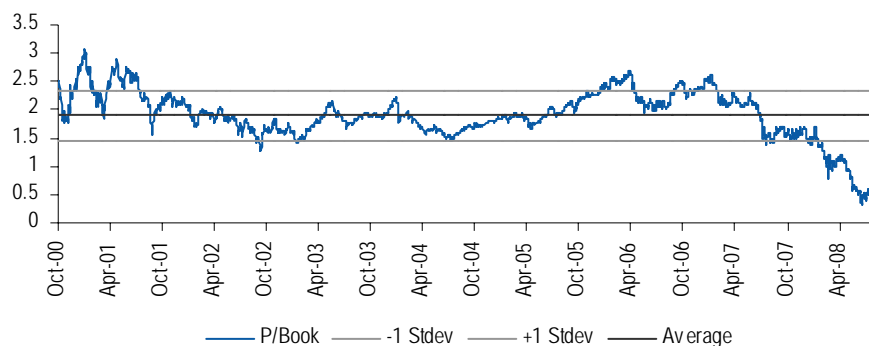
We fear that weaker market conditions in 2008 will continue to reduce the number of profitable trading days. The markets have not yet indicated that the credit and mortgage markets are getting healthier. In addition, given the decline in the investment banking backlog, we see the potential for the underwriting and advisory window to close quickly. Accordingly, we build further conservativeness to our projections.

Valuation and Rating Analysis

We rate Lehman Neutral. While we view Lehman as nimble and having one of the best cultures on Wall Street, deteriorating fixed income asset valuations and leveraged loans have led to downward earnings revisions.

LEH currently trades at 0.21 times book value, at its lowest level in eight-years and well below the current peer average, 1.29 times. Low valuation does not peak our interest, and we are concerned about LEH's ability to execute its strategic plan without further depleting the capital base. We maintain our Neutral rating and do not see the stock as investable unless LEH can execute on its plan.

Figure 2: Lehman 8-yr P/BV chart



Source: FactSet, September 10, 2008.

Risks to Our Rating

Lehman Brothers' business and earnings are highly sensitive to many economic factors, which are subject to periods of extreme volatility. Events that may cause the firm to outperform our thesis and its peer group include i) consolidation, ii) material improvement in credit markets; iii) improving valuations in CDO and mortgage asset classes; iv) increasing levels of M&A activity, amount of debt and equity capital raising; v) changes in global interest & foreign exchange rates, security valuations as well as geopolitical events; and, vi) industry competition. Events that may lead Lehman to underperform our rating and its peer group include i) inability to execute its strategic plan to spin-off \$25-\$30B of commercial real estate and sell majority interest in its investment management arm, ii) deterioration in credit markets that will

lead to further write downs; ii) inadequate risk management; iii) the firm's inability to materially improve performance in fixed income and maintain its market share gains in investment banking, iv) the firm's inability to grow its equity trading volumes in line with the market or its peers, or v) significant market underperformance at its investment management arm.

Figure 3: Lehman Earnings Model

Lehman Brothers (NYSE: LEH)

Consolidated Statement of Earnings	2006	2007	2008E	2009E	1Q07	2Q07	3Q07	4Q07	1Q08	2Q08	3Q08E	4Q08E
Revenues												
Principal Transactions	9,687	9,198			2,921	2,889	1,612	1,776	773	-3,534		
Investment Banking	3,160	3,902			850	1,150	1,071	831	867	858		
Commissions	2,144	2,470			540	568	674	688	658	639		
Interest and Dividends	30,284	41,693			9,089	10,558	10,910	11,136	9,635	7,771		
Asset Management and Other	1,434	1,740			395	414	472	459	437	506		
Total revenues	46,709	59,003			13,795	15,579	14,739	14,890	12,370	6,240		
Interest Expense	29,126	39,746			8,748	10,067	10,431	10,500	8,863	6,908		
Net Interest Income	1,158	1,947			341	491	479	636	772	863		
Revenues, net of interest expense	17,583	19,257	482	14,618	5,047	5,512	4,308	4,390	3,507	-668	-2,903	546
Operating Expenses												
Technology and Communications	974	1,146	1,220	1,128	266	287	282	311	302	309	309	300
Brokerage and Clearance Fees	630	859	955	888	194	201	224	240	253	252	232	218
Occupancy	539	641	730	640	146	152	170	173	185	188	202	155
Professional Fees	363	466	402	400	98	120	128	120	98	100	104	100
Business Development	301	378	312	356	84	100	91	103	89	87	68	68
Other	202	260	341	269	72	55	84	49	76	158	56	51
Amortization of intangibles	0	0	0	0	0	0	0	0	0	0	0	0
Special Charges	0	0	0	0	0	0	0	0	0	0	0	0
Non-Comp Operating Expenses	3,009	3,750	3,961	3,681	860	915	979	996	1,003	1,094	971	893
Operating Income before Comp	14,574	15,507	-3,478	10,937	4,187	4,597	3,329	3,394	2,504	-1,762	-3,874	-346
Compensation and Benefits	8,669	9,494	7,316	7,828	2,488	2,718	2,124	2,164	1,841	2,325	1,950	1,200
Income before Taxes	5,905	6,013	-10,794	3,109	1,699	1,879	1,205	1,230	663	-4,087	-5,824	-1,546
Pre-Tax Margin	34%	31%	-2239%	21%	34%	34%	28%	28%	19%	612%	201%	-283%
Provision for Taxes	1,945	1,821	-3,500	993	553	606	318	344	174	-1,313	-1,897	-464
Tax Rate	33%	30%	32%	32%	33%	32%	26%	28%	26%	32%	33%	30%
Net Operating Income	3,960	4,192	-7,295	2,116	1,146	1,273	887	886	489	-2,774	-3,927	-1,083
Margin (net rev.)	23%	22%	-1513%	14%	23%	23%	21%	20%	14%	415%	135%	-198%
Preferred Stock Dividends	66	68	449	652	17	17	17	17	24	99	163	163
Net Income Applicable to Common Stock	3,941	4,124	(7,744)	1,464	1,129	1,256	870	869	465	(2,873)	(4,090)	(1,246)
Basic EPS	\$7.26	\$7.63	(\$12.42)	\$2.10	\$2.09	\$2.33	\$1.61	\$1.60	\$0.84	(\$5.14)	(\$5.92)	(\$1.80)
Diluted EPS	\$6.81	\$7.26	(\$12.32)	\$2.03	\$1.96	\$2.21	\$1.54	\$1.54	\$0.81	(\$5.14)	(\$5.92)	(\$1.80)
Y/Y % Growth	25.4%	6.5%	-269.7%	-116.4%	34.8%	95.8%	4.5%	11.8%	-58.6%	-332.3%	-484.8%	-216.9%
<i>Pro forma average common shares outstanding</i>												
Basic	542.9	540.5	623.3	697.2	540.9	538.2	540.4	542.6	551.5	559.3	691.2	691.2
Diluted	578.4	568.3	628.6	722.7	575.4	568.1	565.8	563.7	572.8	559.3	691.2	691.2
Key Ratios and Statistics												
Book value per share	33.64	39.44	25.44	27.26	35.15	37.15	38.29	39.44	39.45	34.21	27.29	25.44
Dividends paid per share	0.96	1.04	1.06	0.20	0.26	0.26	0.26	0.26	0.68	0.28	0.05	0.05
Dividend payout ratio	14.1%	14.3%	-8.6%	9.9%	13.3%	11.8%	16.9%	16.9%	83.8%	-5.5%	-0.8%	-2.8%
Return on Average Tangible Equity	29.1%	25.7%			29.9%	31.6%	21.1%	20.6%	10.6%	10.6%		
Return on Average Equity	23.4%	20.8%	-38.0%	7.7%	24.4%	25.8%	17.1%	16.6%	8.6%	-55.8%	-77.0%	-27.3%

Source: Company reports and JPMorgan estimates.

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Lehman Brothers (LEH) Price Chart



Source: Reuters and JPMorgan; price data adjusted for stock splits and dividends.

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