



Analysis of Sales/Earnings
Estimates Change
Price Target Change

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Market Price:	\$7.25
Target Price:	\$10.00
Proj. Total Return:	40.7%
52 Wk. Range	\$67.73-\$6.93
Yield:	2.76%
Insider Ownership:	4.0%
Market Cap:	\$5.0bn
Book Value/Share:	\$27.29
Price/Book:	0.27
Leverage Ratio:	NA



Industry Opinion:

We are cautious on the industry as the backdrop of operating fundamentals remains weak due to turmoil in the credit markets and our forecast of a consumer-led recession for at least the remainder of 2008 and likely into 2009.

Company Description:

Lehman Brothers Holdings Inc. is a global investment bank that serves institutional, corporate, government and high-net-worth individual clients and customers. The company's business includes securities underwriting, corporate finance and strategic advisory services, private equity investments, sales and trading, research, foreign exchange, commodities, investment and derivative trading.

Broker Dealers & Capital Markets: Large-Cap Brokers

September 11, 2008

Lehman Brothers Holding Inc (LEH, \$7.25, Market Perform, Target: \$10.00)

LEH: LEH BIG 3Q08 Loss and Lays Out the Roadmap for the Future

Event-- ROCK: [(\$5.92), (\$5.92), (\$3.35), (\$3.66)] Lehman pre-announced 3Q08 EPS of (\$5.92) compared to our estimate of (\$3.66) and consensus of (\$3.35). Severe mark-to-market losses on mortgage portfolios wipe out earnings while other businesses were seasonally slow. In the limelight is the multi-faceted plan to cleanse and increase liquidity of its balance sheet and reshape and resize the firm for the future.

	R (\$5.92) reported	O (\$5.92) operating	C (\$3.35) consensus	K (\$3.66) BW			
	Earnings Per Share				P/E	%Chg.	L/Term
Year End Nov	2007A	2008E	2009E	08E	09E	09/08	Grth. Rate
KBW (Curr.)	\$7.25	(\$10.78)	\$2.95	NM	2.5x	-127.37%	NE
KBW (Prev.)	\$7.25	(\$8.07)	\$3.43	NM	4.3x	-142.50%	NE
FC (Cons.)	—	\$(7.23)	\$3.13	NM	2.3x	NaN	8.5%

	2007	2008	2009	Quarterly Earnings Per Share				
				1Q	2Q	3Q	4Q	YR
Book Value	\$39.44	\$28.85	\$29.00					
Pretax Margins	31.2%	NA	20.0%					
ROE	19.7%	NA	8.0%					

	2007A	2008E	2009E	1Q	2Q	3Q	4Q	YR
Book Value	\$1.96	\$2.21	\$1.54	\$1.54	\$7.25			
Pretax Margins	\$0.81	(\$5.14)	(\$5.92)e	(\$0.53)e	(\$10.78)			
ROE	—	—	—	—	—	—	—	—

- Lehman pre-announced 3Q08 EPS of (\$5.92) compared to our estimate of (\$3.66). Net write-downs of \$5.6 bil. were far more significant than our \$3.5 bil. forecast on both its residential and commercial real estate exposures.
- Negative revs. of (\$2.9 bil.) compared to our forecast of (\$600 mil.) owing to higher marks, lower invest. banking revs., lower equity cap. market revs., as well as lower investment mgmt revs.
- More important than the actual EPS was the slew of strategic initiatives the firm announced, which include:
 - The spin-off of \$25-\$30 bil. of its commercial real estate portfolio into a separate publicly-traded company "REI Global" in 1Q09;
 - Significant reduction of residential mortgage exposure by 47% to \$13.2 bil. incl. the bulk sale of its \$4.0 bil. U.K. portfolio to BlackRock expected to close in the next few weeks;
 - The sale of a majority stake (about 55%) of a subset of its Investment Management Division (IMD) to a yet-to-be-named buyer, expected to close in 1Q09; and
 - A dividend cut to \$0.05 annually from \$0.68 saving approx. \$450 mil. annually and preserving capital.



Risk

The risks to our price target include market conditions as well as macroeconomic events, foremost of which is a longer and more severe recession than expected.

Quick Earnings Review: LEH reported preliminary revenues of (\$2.9)bil., which include negative net mark-to-market adjustments of (\$5.6) bil., Capital markets revs. of (\$4.1) bil. vs. (\$2.4) bil. in Q2 and \$2.4 bil. a year ago; Fixed Income Revs of(\$4.6) bil. vs. (\$3.0) bil. in Q2 and \$1.1 bil. a year ago; Equities Revs. of \$0.5 bil. vs. \$0.6 bil. in Q2 and \$1.4 bil. a year ago; Investment Banking revs. of \$0.6 bil. vs. \$0.9 bil. in Q2 and \$1.1 bil. a year ago; Investment Management revs. of \$0.6 bil. vs. \$0.8 bil. in Q2 and \$0.8 bil. a year ago; Absolute comp. levels of \$1.95 bil. compared to our est. of \$1.9 bil. while noncomp./noninterest expenses were nearly 9% lower than est. The tax rate was in line and diluted share count was lower by 1.5%.

Lehman Backlog: We estimate, from Dealogic, that the current ECM backlog is \$1.3 bil. from 14 deals compared to \$1.1 bil. from 17 deals when the company reported fiscal 2Q08 results. The estimated M&A backlog is presently \$198 bil. from 59 deals compared to \$114 bil. from 47 deals when Lehman reported fiscal 2Q08 results.

The breakdown of the gross mark-to-market adjustments of (\$7.8 bil.) is as follows:

- (\$5.3) bil. on residential mortgage-related positions
- (\$1.7) bil. on commercial real estate-related positions
- (\$600) mil. on other asset-backed positions
- (\$200) mil. on acquisition finance positions.

The offsets of the gross marks, which produced net write-downs of (\$5.6) bil., are as follows:

- \$800 mil. of hedging gains
- \$1.4 bil. of debt valuation gains

In the tables below we highlight the cumulative charges that have been taken at the firm and the exposures as of quarter-end:

Exhibit 1: Net Write-downs by Asset Class (\$ in billions)

	4Q07	1Q08	2Q08	3Q08	Cumulative	% Cumulative Writedowns From 4Q07	Qtr-End Exposures				% Chg Since 4Q07
							4Q07	1Q08	2Q08	3Q08	
Residential Mortgage Positions	\$ 1.3	\$ 0.8	\$ 2.0	\$ 4.9	\$ 9.0	28%	\$ 32.1	\$ 31.8	\$ 24.9	\$ 17.2	-46.4%
Commercial Mortgage Positions & Real Estate Held for Sale	\$ 0.9	\$ 1.0	\$ 1.3	\$ 1.6	\$ 4.8	9%	\$ 51.7	\$ 49.0	\$ 39.8	\$ 32.6	-36.9%
CDO and Lending Obligations / Other ABS ^a	\$ 0.2	\$ 0.1	\$ 0.4	\$ 0.5	\$ 1.2	19%	\$ 6.2	\$ 6.5	\$ 6.5	\$ 4.6	-25.8%
Acquisition Finance Facilities [*]	\$ 0.4	\$ 0.5	\$ 0.4	\$ -	\$ 1.3	9%	\$ 14.2	\$ 14.1	\$ 11.1	\$ 6.7	-52.8%
Total	\$ 2.8	\$ 2.4	\$ 4.1	\$ 7.0	\$ 16.3	15%	\$ 110.4	\$ 107.9	\$ 88.8	\$ 67.6	-38.8%

Note: Company announced that pro-forma for sale to blackstone, residential mortgage exposure will be reduced to \$13.2 bil.

^{*} Includes both high yield unfunded and funded commitments / loans.

^a category includes securitized asset backed issuance, whole loans, credit CLOs, small business loans, student loans, credit cards and auto loans.

Source: Company reports and KBW calculations.

The comprehensive initiatives announced by Lehman to help delever, de-risk and increase the liquidity of its balance sheet are an incremental positive for the firm. However, these initiatives are not an overnight fix by any means and we believe there to be a number of unanswered questions about whether these actions will be enough for Lehman to recover from this crisis (as they have during previous crisis) that include:

- Will the markets hold up until the REI Global transaction is completed without needing to take any additional marks?
- Can we feel confident that recent events have not impaired the core client franchise and that counterparties will continue to do business with them (which thus far seems to be the case)?
- Can and will Treasury Secretary Paulson help after bailing out the GSEs and BSC or will he feel the need to make a statement that there are limits to what they will do?
- We don't think we have to be concerned with whether the government will need to get involved in the near term, but we do believe the question of whether they would in fact get involved down the road is up for debate. This is one of the major issues currently weighing on the stock, in our opinion.

Given the the EPS miss, we are lowering our 2008 EPS loss from (\$8.07) to (\$10.78). We are also trimming our 2009 estimate preliminarily at this time from \$3.43 to \$2.95 to reflect market conditions and a lower run-rate of revenues. Our price target is also being lowered from \$16 to \$10, which represents 3.4 times our 2009 EPS est. of \$2.95 and 34% of our 2009 book value est. of \$29.

The Spin-Off of Commercial Real Estate Assets

In 3Q08, the firm reduced its commercial real estate exposure by 18% from \$39.8 bil. to \$32.6 bil. During the quarter it took net write-downs of \$1.6 bil. due primarily to a weakening economy and the lack of liquidity in the market. Marks on the commercial real estate portfolio were as follows: senior whole loans were marked in the low 90% range, down from the mid 90s, and mezzanine loans were marked in the very low 80% range, down from the very high 80s. Since 4Q07, Lehman has taken aggregate net write-downs on its commercial real estate portfolio of \$4.8 bil.

The reduction in the CRE portfolio has been significant, but remaining exposures and potential for future marks have continued to weigh heavily on Lehman shares. Hopeful to alleviate this overhang, the firm announced a spin-off of the bulk of its portfolio into a separate publicly-traded company to its shareholders called Real Estate Investments Global (REI Global). REI Global's primary focus will be to maximize shareholder returns by selling assets or holding them to maturity, not making new investments in new assets. Any excess cash flow is planned to be returned to the shareholders.

The total value of the commercial real estate assets that will be transferred to REI Global will range from \$25 bil. to \$30 bil., depending on further asset sales and paydowns prior to fiscal 1Q09. Although this strategy offers the company an

opportunity to remove the risk of future write-downs from overwhelming the results of the firm's core business (mgmt estimated run-rate revs. of \$3.5 billion in F3Q08), the firm will continue to face the near-term risk in markdowns prior to the closing of the deal, which is expected in 1Q09. Following the transaction, Lehman expects to have roughly \$5 billion of remaining commercial real estate exposure.

Portfolio Composition of REI Global:

- By value, approximately 57% of the assets are in the Americas, 26% in Europe, and 17% in Asia;
- By security type, approximately 58% are debt positions, 26% are equity positions, and 16% are securities;
- No property type represents more than 22% of the portfolio, with multifamily at 22%, and office at 18%;
- Lehman intends to include its SunCal and Archstone positions in this portfolio (these had been marked to 75% of par at the end of 2Q08 and management stated that they had been marked down further in 3Q08); and
- This portfolio is currently marked at a weighted average price of 85%.

Capitalization of REI Global:

In order to establish REI Global as a stand-alone publicly-traded entity, Lehman plans to capitalize the new company with equity and debt. Lehman plans to contribute equity equal to 20% to 25% of asset value and provide debt financing for the remaining 75% to 80% of the total. Based on the actual level of assets that are spun-off when REI Global closes, we estimate that the amount of equity the firm will transfer could range from \$5-\$7.5 bil. Consistent with other publicly traded real estate entities, REI Global is expected to be capitalized at approximately three to four times debt to book equity.

Although the firm plans to spin its entire equity interest in REI Global to Lehman shareholders, the firm will continue to have exposure to the entity through the debt financing it will provide. Management stated that the debt financing provided by the firm will be liquidity-neutral to Lehman as these assets are currently funded with long-term capital. To the extent that a portion of the debt is syndicated, there will be a positive impact on Lehman's liquidity but we wouldn't envision this happening until the markets have "stabilized".

Uses of Cash:

In aggregate, this pool of assets generates significant cash flow. When combined with the normal course of asset sale activity, these cash flows will be dedicated to paying down debt, managing the assets, and returning cash to REI Global shareholders over time. Based on the expected assets to be contributed to REI Global, the portfolio is projected to generate cash flow through interest income, paydowns, debt repayment, equity distributions, and asset sales.

Over the next three years, an estimated \$5 billion per year of cash flow for debt paydown should be generated. Management expects a rapid debt paydown at REI Global, with debt to total assets decreasing from 75%-80%, to approximately 50%

within four years. Initially, REI Global expects to pay a modest annual dividend, but once leverage reaches a certain threshold, cash flows may allow for additional distributions.

Selling A Majority Stake in Investment Management Division

Lehman said it intends to sell an estimated 55% of a subset of its investment management division, which includes the asset management, private equity and wealth management businesses. It excludes, however, its middle market institutional distribution business and the firm's minority stakes in external hedge fund managers, which will be folded into its capital markets business. The company noted that it is well along the auction process and in discussions with both strategic and financial buyers with a deal likely to be announced soon. As we have consistently said, we didn't believe Lehman would sell the entire investment unit, as not only is it synergistic with other areas of the firm, but it is also provides diversification to the revenue mix and provides a "more stable" stream of EPS.

The sale of a majority stake in the IMD Business is expected to enhance the firm's already strong capital base. Goodwill related to the Neuberger Berman business is expected to be eliminated, resulting in significant improvement in the firm's Tier 1 ratio and an estimated increase of more than \$3 billion in tangible book value. Although selling a majority stake, it plans to retain a majority of the pre-tax income of the Investment Management Division as the portion that it is retaining is higher margin. If this deal had been completed last year, management stated that pre-tax income would have been impacted by less than 5%.

In the tables below we highlight Lehman's commercial real estate and RE related exposures as well as its residential mortgage exposures:

Exhibit 2: Commercial Mortgage & Real Estate Related Exposures (\$ in millions)

Whole Loans:	31-Aug-08	31-May-08	As of 31-Aug-08			Number of Positions	Avg Position Value (\$ mils)	Fixed	Float
			Americas	Europe	Asia				
Senior	15,800	19,500	8,800	3,200	3,800	702	22.4	6%	94%
Mezzanine	4,400	5,900	3,600	500	400	231	19.2	33%	67%
NPLs (purchased as NPLs, largely in Asia)	1,700	1,900	200	0	1,400	308	5.4		
Equity	6,600	7,200	4,000	1,400	1,200	571	11.5		
Securities	4,300	5,300	600	3,200	500	287	14.9		
Total Comm'l Mortg & RE Invest.	\$32,600	\$39,800	17,100	8,200	7,300	2,099	15.6		

Source: Company reports and KBW calculations.



Exhibit 3: Residential Mortgage Related Exposures

(\$ in millions)

U.S.

Alt-A / Prime:	31-Aug-08	31-May-08	29-Feb-08
Whole Loans	1,200	2,100	3,700
Securities:			
AAA (marked mid-70's)	1,900	3,900	6,400
Other RMBS (includes residuals)	1,200	2,600	2,800
<u>Servicing and other</u>	<u>1,600</u>	<u>1,600</u>	<u>1,700</u>
Total Alt-A / Prime (mostly Alt-A)	5,900	10,200	14,600
Subprime / Second Lien:			
Whole Loans	600	1,100	1,300
Securities:			
AAA (predominantly 2007 vintage)	200	900	1,600
Other RMBS (includes residuals)	800	800	1,100
Total Subprime / Second Lien	1,600	2,800	4,000
Other U.S.			
Whole Loans	900	1,000	1,600
<u>Securities</u>	<u>200</u>	<u>300</u>	<u>500</u>
Total Other U.S.	1,100	1,300	2,100
Europe (largely UK)			
Whole Loans	3,100	3,600	5,000
<u>Securities</u>	<u>4,500</u>	<u>5,700</u>	<u>4,500</u>
Total (2/3 prime/near prime, 1/3 nonconforming)	7,600	9,300	9,500
Asia-Pacific			
Whole Loans	500	500	300
<u>Securities</u>	<u>0</u>	<u>200</u>	<u>400</u>
Total	500	700	700
Other ABS	500	600	900
Total Residential Mortgage	17,200	24,900	31,800

Source: Company reports and KBW calculations.

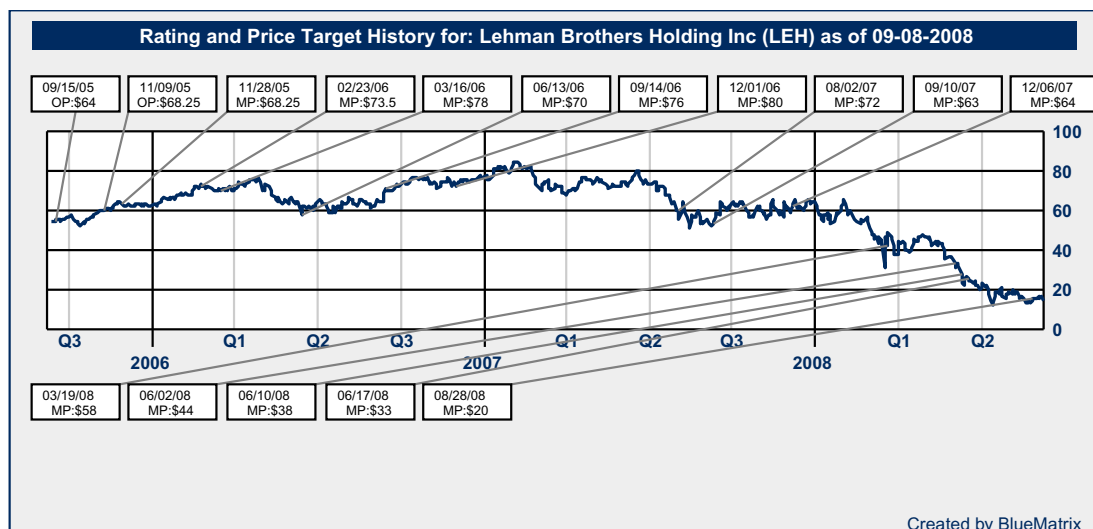


Exhibit 4: Delta Sheet

Income Statement Summary (\$ in mil.; except per share amt.)	3Q08		Variance to Forecast	2Q08	3Q07	% Change	
	Expected	Actual				Qtr./Qtr.	Yr./Yr.
Revenues							
Equity Und.	216	160	-25.9%	330	296	-51.5%	-45.9%
Debt Und.	198	220	11.1%	288	350	-23.6%	-37.1%
M&A Advisory	264	231	-12.5%	240	425	-3.8%	-45.6%
Total Inv. Banking	678	611	-9.9%	858	1,071	-28.8%	-43.0%
Equities	841	454	-46.0%	601	1,377	-24.5%	-67.0%
Fixed Income	-3,000	-4,602		-2,975	1,058		
Total Capital Markets	-2,159	-4,148		-2,374	2,435		
Asset Management	521	360	-30.9%	496	468	-27.4%	-23.1%
Private Client	352	274	-22.2%	352	334	-22.2%	-18.0%
Total Investment Management	873	634	-27.4%	848	802	-25.2%	-20.9%
Total Net Revenue	-608	-2,903		-668	4,308		
Expenses							
Compensation (Abs.)	1,900	1,950	2.6%	2,325	2,124	-16.1%	-8.2%
Comp./Net Revenue	NA	NA		NA	49.3%		
Non-Comp/Non-Interest	1,064	971	-8.7%	1,094	979	-11.2%	-0.8%
Pretax Income	-3,572	-5,824		-4,087	1,205		
Pre-Tax Margin	NA	NA		NA	28.0%		
Effective Tax Rate	32.0%	32.6%		32.1%	26.4%		
Pref. Div/Non-Operating	143	163		99	17		
Net Income	-2,570	-4,090		-2,873	870		
Share Count	702	691		559	565		
Earnings Per Share	-\$3.66	-\$5.92		-\$5.14	\$1.54		
Book Value Per Share (Reported)	29.17	27.29	-6.4%	34.21	38.29	-20.2%	-28.7%
Return on Equity (Reported)	NA	NA		NA	17.1%		

Note: Estimated pro forma book value at the end of 2Q08 is \$33.00, which accounts for the capital raisings.

Source: Company data and KBW estimates and calculations



Distribution of Ratings/IB Services
KBW

Rating	Count	Percent	*IB Serv./Past 12 Mos.	
			Count	Percent
Outperform [BUY]	151	26.73	26	17.22
Market Perform [HOLD]	347	61.42	47	13.54
Underperform [SELL]	49	8.67	4	8.16
Restricted [RES]	0	0.00	0	0.00
Suspended [SP]	18	3.19	5	27.78

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