

Lehman Bros.- Untenable position

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Confidence collapse forces change

Lehman Brother's Holdings' (LEH: A2*/A*-) continuing losses and rapid erosion of market confidence have pushed it to the brink. LEH's current organizational structure is no longer feasible, and management is effectively considering all strategic options. There is a range of potential outcomes for fixed income investors, both positive and negative, with little clarity.

LEH announces action steps, though more news to come

In conjunction with pre-announcing a \$3.9bn 3Q loss, management announced several actions it is planning to reshape its business, reduce risk, and bolster capital. These include: (1) spinning off commercial real estate assets, (2) selling a majority stake in its asset management business, and (3) reducing the annual common dividend to \$0.05/share. There is risk to completion of these actions, and we see the situation as extremely fluid.

Credit ratings under renewed pressure

Moody's placed the long-term ratings under review (direction uncertain), while S&P reiterated its negative watch announced earlier this week. Importantly, Moody's notes that senior unsecured ratings could be lowered to the Baa category in the absence of a strategic transaction with a stronger financial partner.

Liquidity not the primary concern

Despite the material erosion of liquidity in the wake of the debt and equity market sell-off, liquidity does not appear to be a major concern based on LEH reporting it had a \$42bn gross liquidity pool at the end of 3Q, and maintains borrowing access through uncollateralized assets and has access to Federal Reserve facilities. That said, the lack of customer/counterparty confidence poses significant risk to LEH's viability.

Investors should consider as part of high risk allocation

While it is clear that change is imminent, it is very unclear what form the restructuring of LEH will take. LEH bonds and preferreds have traded down sharply in recent days to discount the risks (2010 bonds trading at \$82, or 19.6% yield), though future pricing action will depend on the strategic outcome. While there is the possibility of a sale to a stronger strategic buyer, bonds and preferreds could fall further in the absence of a transaction and/or negative rating agency actions. The outcome is difficult to predict, and the overall risk profile is substantially greater than credit ratings suggest. Accordingly, we believe investors should treat any holdings as part of their high risk/high yield allocation.

This report is one of our occasional strategic assessments of corporate issuers whose bond/preferred prices have been exceptionally volatile. Although we do not provide fundamental coverage for the debt of LEH, our aim is to provide insight surrounding considerations for the holders of the bonds and preferreds. Investors should refer to the reports on the common shares by fundamental equity analyst Guy Moszkowski for further information regarding company fundamentals and risks.

As LEH considers asset sales/spins, a full sale of LEH is being explored.

Strategic outcomes are varied

LEH has announced plans to strategically reshape its business, though it is still unclear whether any of these actions will be taken. While it prepares to spin-off mortgage real estate holdings and find a majority investor for its asset management business, LEH specified in its press release that it is “committed to examining all strategic alternatives to maximize shareholder value.” That leaves a considerably wide range of outcomes for holders of bonds and preferreds.

Media reports suggest merger talks have intensified

As an indication of the rapidly evolving nature of the situation, media reports on Thursday indicated LEH is in active discussions with various suitors regarding a full scale merger. Reports also suggest that the Treasury and Federal Reserve are engaged in the discussions to help broker a solution, which would be consistent with prior statements and actions of the central bank.

Outcome for bonds and preferreds in any strategic transaction depends on many factors.

Treatment of debt in a takeover uncertain

As we have seen with the recent acquisitions of financial firms such as Bear Stearns (BSC) and Countrywide Financial (CFC), there is no definitive answer on how the public debt obligations of LEH would fare in any takeover. In addition, senior debt, preferreds, and common shareholders can experience markedly different outcomes. Ultimate credit quality, credit ratings and trading levels would depend on a number of factors such as the type of buyer (i.e., strategic versus financial), deal structure (stock or debt), capitalization, ongoing risk profile, etc.

The legal structure of any transaction would also be a significant factor for fixed income investors. Importantly, a buyer of LEH would not be required to legally guarantee any of LEH's bonds or preferreds, though there may be financial and strategic advantages in doing so. Bank of America (BAC), for example, acquired CFC but chose not to extend guarantees to its debt or preferreds. As a result, CFC's bonds and preferreds trade considerably weaker than its parent. In the case of BSC, however, JPMorgan extended guarantees to BSC's bonds and preferreds.

Multi-notch credit rating downgrades have become increasingly likely.

Rating agencies decidedly more negative

Both Moody's and S&P have commented on increased risk at LEH, and appear to be positioned for multi-notch rating downgrades. Moody's in particular has added pressure to LEH's already difficult situation by stating the company's current proposal for restructuring is inadequate. The agency cited that LEH's ratings would be downgraded to the “Baa” category and left under review if the company is unable to find a strategic partner in the “near term”. Conversely, positive rating actions could result in the event of a strategic transaction with a stronger financial partner. Merrill Lynch fundamental equity research believes that this action has effectively put LEH “in play” given the negative operational and financial consequences of a rating downgrade.

Preferred ratings more at risk if downgraded

Moody's also suggested that its current notching of preferred ratings below the senior unsecured level would be widened in the event of a downgrade. This would be a result of the lack of satisfactory improvement, increasing the risk of dividend suspensions. As such, we would expect any downgrade of LEH's senior rating to even the highest triple-B category would result in some preferreds falling to high yield.

A downgrade would not appear to trigger a liquidity crisis, but viability could become increasingly uncertain.

Downgrades would impair business model and liquidity

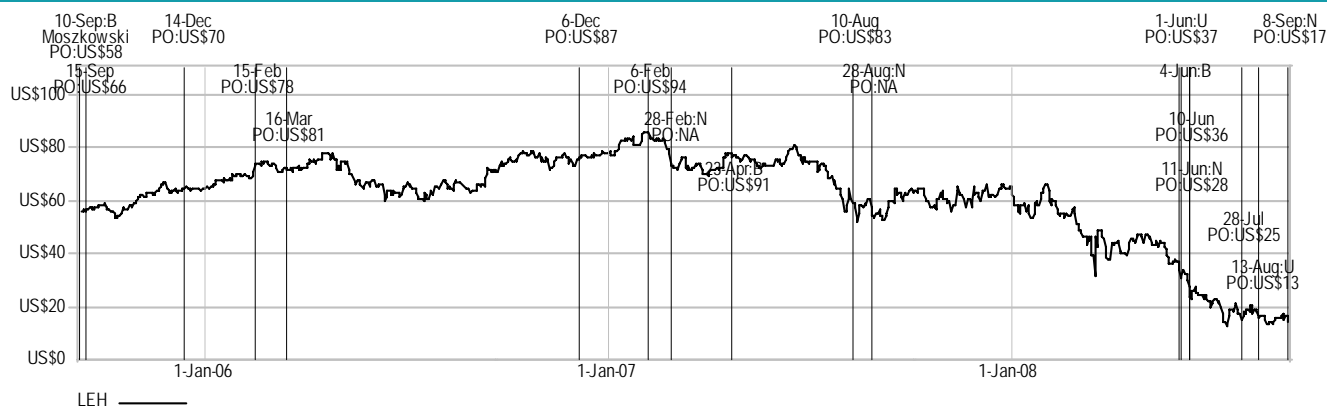
In the event LEH is unable to line up an acceptable strategic solution and is downgraded to the triple-B category, there would likely be severe ramifications to the firm. Liquidity would be impacted by less borrowing capacity and collateral postings under counterparty arrangements. Access to the Fed facilities, however, helps mitigate liquidity risk in the short term and the potential for a “run on the bank.” Operationally, however, competitive disadvantages, impaired customer/counterparty confidence, and erosion of brand value could undermine LEH's viability. If LEH were unable to find a strategic partner and it were forced into a bankruptcy/liquidation scenario, both preferred stock and trust preferred securities could see their value reduced to zero in our view. However, we do not see this as the most likely outcome.

Analyst Certification

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Important Disclosures

LEH Price Chart



B : Buy, N : Neutral, S : Sell, U : Underperform, PO : Price objective, NA : No longer valid

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