

July 14, 2008

Stock Rating
Overweight

Industry View
In-Line

Lehman Brothers Heightened Market Concerns but Fundamentals Intact

The level of concern in the marketplace, elevated by unfounded reports and the downdraft from GSE shares, drove LEH shares down sharply last week.

While we recognize it is difficult to focus on fundamentals in the current market backdrop, we believe LEH has both the capital and liquidity to weather near-term headwinds. Recent capital raises and aggressive asset sales have boosted the firm's balance sheet profile. We believe the FED's Primary Dealer Credit Facility (PDCF), supplemented by the rapid growth in parent company liquidity at LEH (+50% YoY), effectively mitigate the risk of a severe liquidity crunch. Longer-term, revenue replacement worries appear justified, but we believe they are peripheral to the current valuation story.

LEH shares are a high beta play on stabilization in mortgage/credit market sentiment, in our view. Beyond a reduction in elevated mortgage market concerns (e.g., better clarity on outlook for GSEs), progress on balance sheet repair efforts in 2H'08 is central to ring-fencing downside write-down risk. This could take the form of continued asset sales or perhaps a meaningful asset disposition via a potential partnership with a strategic investor.

We briefly address GSE market impact, firm's recent 10-Q and our investment thesis below. Additional analysis can be found in our June 30, 2008 LEH initiation (*Bruised, Not Broken – and Poised for Profitability*) and corresponding industry report (*The Broker-Dealer is Dead; Long Live the Broker-Dealer*).

Key Ratios and Statistics

Reuters: LEH.N Bloomberg: LEH US

Brokers / United States of America

Price target	\$31.00
Shr price, close (Jul 11, 2008)	\$14.43
Mkt cap, curr (mm)	\$8,071
52-Week Range	\$74.09-13.30

Fiscal Year ending	11/07	11/08e	11/09e	11/10e
ModelWare EPS (\$)	7.26	(3.40)	3.45	4.15
Prior ModelWare EPS (\$)	-	-	-	-
P/E	8.6	NM	4.2	3.5
Consensus EPS (\$)	7.26	(3.09)	3.72	4.42
Div yld (%)	1.0	4.7	4.7	4.7

Unless otherwise noted, all metrics are based on Morgan Stanley ModelWare framework (please see explanation later in this note).

\$ = Consensus data is provided by FactSet Estimates.

e = Morgan Stanley Research estimates

Quarterly ModelWare EPS

Quarter	2007	2008e Prior	2008e Current	2009e Prior	2009e Current
Q1	1.96	-	0.81a	-	0.97
Q2	2.21	-	(5.14)a	-	0.81
Q3	1.54	-	0.08	-	0.76
Q4	1.54	-	0.30	-	0.92

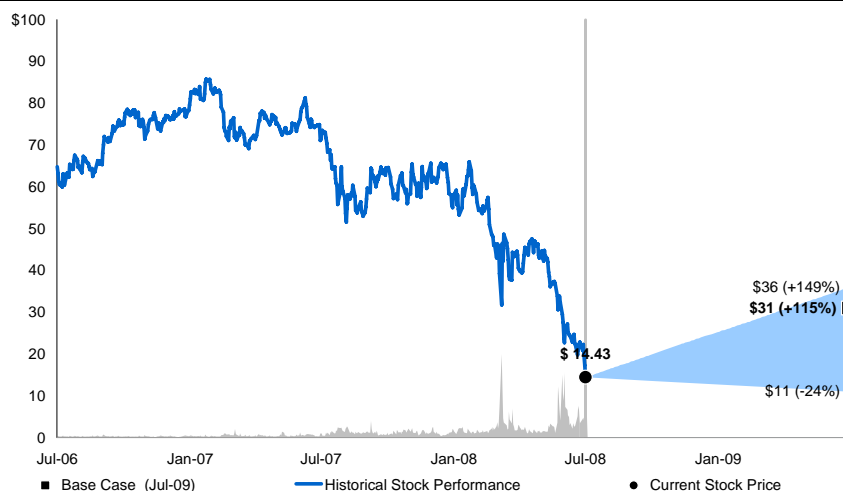
e = Morgan Stanley Research estimates, a = Actual company reported data

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Risk-Reward Snapshot: Lehman Brothers (LEH, \$14.43, Overweight, PT \$31)

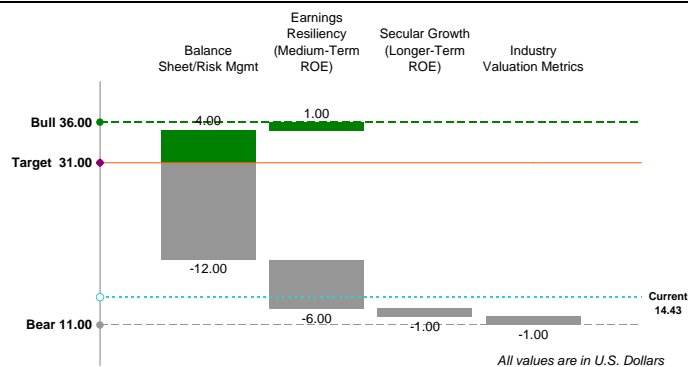
Near-Term Downside Risks Offset Compelling Upside in a Recovery



Source: FactSet, Morgan Stanley Research

Price Target \$31		Equal to 0.9x 12-month forward Stated BV of \$34.48 (0.8x 12-month forward Tangible BV of \$28.73).
Bull Case \$36	1.0x Forward Book Value of \$35.64	Moving on, moving forward. Balance sheet overhang managed down swiftly; core business units support long-term ROE generation. Write-downs (2H08) = \$1.2bn (pretax). Balance sheet/risk mgmt drives \$4/share upside, earnings resiliency, \$1.
Base Case \$31	0.9x Forward Book Value of \$34.48	Write-downs impact book value, but multiple recovers on better visibility. U-shaped progression as near-term write-down overhang in context of uncertain credit markets limit catalysts. Write-downs (2H08) = \$2.5bn (pretax)
Bear Case \$11	0.4x Forward Book Value of \$31.68	BV hits exceed 15%. Balance sheet overhang more intractable than thought, with larger-than-expected near-term hits. Write-downs (2H08) = \$5.4bn (pretax). Balance sheet/risk mgmt drives \$12/share downside; earnings resiliency, \$6; secular growth and valuation, \$1 each

Bear to Bull: Balance Sheet and Valuation Metrics Key Catalysts



Note: Scenario inputs correspond with key investor debates (but as they relate to LEH): balance sheet/risk management, revenue resiliency (near-term ROE), secular growth/competitive environment (normalized ROE), and investor confidence in broker valuation inputs (Book Value, ROE).
Source: Morgan Stanley Research

Investment Thesis

- A return to profitability — in the context of a healing credit market backdrop — should be sufficient to drive valuation closer to book value.
- Meanwhile, aggressive Fed moves (i.e., PDCF) and adequate capital cushion should help the firm weather near-term headwinds stemming from balance sheet overhang.
- Longer term, revenue replacement worries appear justified, but they are peripheral to the current valuation story.

Key Value Drivers

- Timing and magnitude of asset sales (and potential valuation hits) stemming from illiquid asset overhang.
- While write-downs/deleveraging will obscure bottom-line results in 2008, sense for “normalized” run-rate visibility should bolster confidence in sustainable earnings power.

Potential Catalysts

- Credit markets beta: healing will aid deleveraging/asset wind-down, while after-shocks would of course raise level of difficulty on this front.
- 2H08 EPS releases should help investors mark balance sheet repair efforts to market environment.
- Meaningful asset disposition that would allay concerns regarding balance sheet overhang (i.e., potential partnership with a strategic investor to manage illiquid overhang, curbing firm’s risk).

Overview

Important to differentiate between GSE equity and agency-backed MBS. Despite the downdraft in GSE equity shares, the key thing for the brokers is the ability of the GSEs to continue in their current form – avoiding the prospect of unfounded concerns driving a widening in agency-backed MBS spreads (the better proxy for potential inventory impairment issues at the brokers).

“Uneventful” 10-Q filing consistent with recent EPS disclosure. Finally, the firm released its 2Q08 10-Q filing after the close on July 10. The 10-Q was largely in line with 2Q EPS results and corresponding conference call commentary (e.g., Level III assets, Tier 1 capital, etc.).

- LEH provided additional disclosure on investment in R3 (\$4.5bn asset sale executed at fair value – encompassing “primarily corporate bonds and loans”, rather than “toxic” mortgage product as had been speculated previously).
- Incremental detail on prime brokerage (PB) balances revealed PB asset decline of 17% YoY (in the context of what was described as a “modest” sequential decline in customer assets on 2Q EPS conference call). While LEH is not an outsized player in this business, this is clearly an area to monitor going forward. However, we believe a collection of factors are at play here, including: broader hedge fund deleveraging and increased focus on diversifying assets across multiple prime brokers, as well as a more disciplined allocation of LEH’s balance sheet to prime broker clients. Further, resizing this business is consistent with the firm’s efforts to de-lever its balance sheet (total LEH assets down 19% sequentially).

Significant valuation leverage to more stable macro backdrop. To reiterate – our investment thesis on LEH pivots on the firm weathering near-term credit conditions and returning to profitability in 2009. We believe near-term risk of incremental write-downs is balanced by solid liquidity and capital footing. We believe the stock’s discount to book value prices in significant write-downs impairing franchise and profit growth. Return to respectable ROE generation would help shares trade closer to book value. We expect ROE to rise from 3% in 2H08 to 12% in 2009 and 14% in 2010 (even as debt trading declines 28% vs. peak). Medium term, we see optionality to monetize value if franchise and profitability concerns persist in a stabilizing credit environment.

The key fundamental risk to our thesis is a much more severe collapse in mortgage market conditions, which would exacerbate systemic worries in the marketplace. The other risk – which we can not model – is potential fallout from

relentless pressure on LEH’s share price, which could impact the firm’s ability to operate in an optimal manner.

LEH currently trades at 0.44x stated book value (versus 1.67x for GS and 0.95x for MER). This discount to book clearly goes beyond concerns on meaningful asset write-downs and significant franchise erosion, in our view. Adjusting reported 2Q08 BV for our base and bear case write-down assumptions (\$2.5bn and \$5.4bn, respectively) yields implied P/B multiples of 0.47x and 0.51x, respectively (see Exhibit 1 below).

Exhibit 1

Write-Down Forecast for 3Q08-4Q08E

	Bear ⁽¹⁾	Base ⁽²⁾	Bull ⁽³⁾
Writedown	(5,420)	(2,451)	(1,225)
LBO	(597)	(453)	(227)
CMBS/Real Estate	(2,794)	(1,345)	(672)
Alt-A	(874)	(414)	(207)
ABS CDO/Subprime	(923)	(168)	(84)
Other ABS	(233)	(70)	(35)
After-Tax	(3,594)	(1,625)	(812)
Basic Shares (3Q08E)	702	702	702
Book Value Impact	(\$5.12)	(\$2.31)	(\$1.16)
2Q08 Book Value ⁽⁴⁾	\$33.15	\$33.15	\$33.15
2Q08 Tangible Book Value ⁽⁴⁾	\$27.30	\$27.30	\$27.30
% of Current BV	-15.4%	-7.0%	-3.5%
Pro Forma 2Q08 BV	\$28.04	\$30.84	\$32.00
Pro Forma 2Q08 TBV	\$22.19	\$24.99	\$26.15
12-mth Forward BV	\$31.68	\$34.48	\$35.64
12-mth Forward TBV	\$25.93	\$28.73	\$29.89
Current Price	\$14.43	\$14.43	\$14.43
Implied Price/BV			
On Pro Forma 2Q08 BV	0.51x	0.47x	0.45x
On Pro Forma 2Q08 TBV	0.65x	0.58x	0.55x
On 12-mth Forward BV	0.46x	0.42x	0.40x
On 12-mth Forward TBV	0.56x	0.50x	0.48x

(1) Assumes “base case” writedown of \$2.5bn plus \$3.0bn in 2H08

(2) Assumes \$2.5bn in 2H08

(3) Assumes \$1.2bn in net writedowns in 3Q08

(4) Adjusted for the \$4bn common stock offering on 6/9/09

Source: Company data, Morgan Stanley Research E = Morgan Stanley Research estimates

While we are maintaining our \$31 price target, we are reducing our bear case downside scenario valuation to \$11 – which approximates the value of the firm’s asset/wealth management

businesses – to reflect heightened mortgage and systemic concerns (our bear case write-down estimate remains unchanged at \$5.4bn).



Morgan Stanley ModelWare is a proprietary analytic framework that helps clients uncover value, adjusting for distortions and ambiguities created by local accounting regulations. For example, ModelWare EPS adjusts for one-time events, capitalizes operating leases (where their use is significant), and converts inventory from LIFO costing to a FIFO basis. ModelWare also emphasizes the separation of operating performance of a company from its financing for a more complete view of how a company generates earnings.

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(as of June 30, 2008)

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Stock Rating Category	Coverage Universe		Investment Banking Clients (IBC)		
	Count	% of Total	Count	% of Total IBC	% of Rating Category
Overweight/Buy	910	42%	278	44%	31%
Equal-weight/Hold	898	42%	265	42%	30%
Underweight/Sell	353	16%	86	14%	24%
Total	2,161		629		

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Overweight (O). The stock's total return is expected to exceed the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months.

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More volatile (V). We estimate that this stock has more than a 25% chance of a price move (up or down) of more than 25% in a month, based on a quantitative assessment of historical data, or in the analyst's view, it is likely to become materially more volatile over the next 1-12 months compared with the past three years. Stocks with less than one year of trading history are automatically rated as more volatile (unless otherwise noted). We note that securities that we do not currently consider "more volatile" can still perform in that manner.

Unless otherwise specified, the time frame for price targets included in Morgan Stanley Research is 12 to 18 months.

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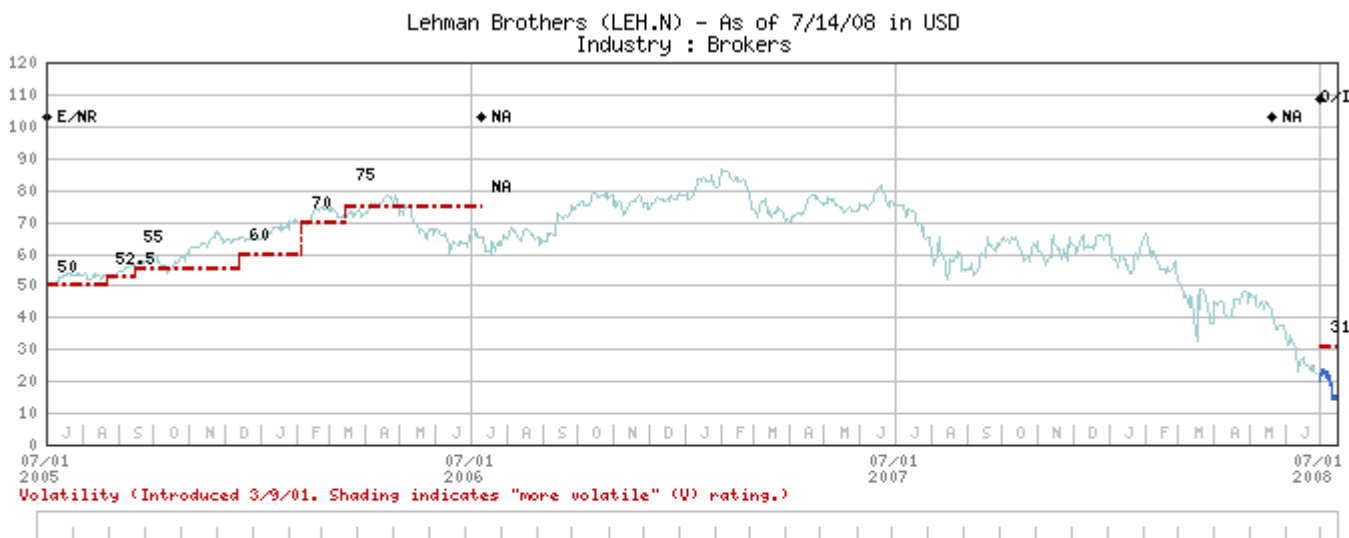
Attractive (A): The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be attractive vs. the relevant broad market benchmark, as indicated below.

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Benchmarks for each region are as follows: North America - S&P 500; Latin America - relevant MSCI country index or MSCI Latin America Index; Europe - MSCI Europe; Japan - TOPIX; Asia - relevant MSCI country index.

Stock Price, Price Target and Rating History (See Rating Definitions)



Stock Rating History: 7/1/05 : E/NR; 7/10/06 : NA; 5/20/08 : NA; 6/30/08 : O/I

Price Target History: 12/2/04 : 50; 8/21/05 : 52.5; 9/14/05 : 55; 12/13/05 : 60; 2/5/06 : 70; 3/15/06 : 75; 7/10/06 : NA; 6/30/08 : 31

Source: Morgan Stanley Research Date Format : MM/DD/YY Price Target --- No Price Target Assigned (NA)
Stock Price (Not Covered by Current Analyst) — Stock Price (Covered by Current Analyst) —
Stock Ratings abbreviated as below (Effective 3/18/02, ratings appear as Stock Ratings/Industry View) ♦
Stock Ratings as of 3/18/02: Overweight (O) Equal-weight (E) Underweight (U) More Volatile (V) No Rating Available (NAV)
Stock Ratings prior to 3/18/02: Strong Buy (SB) Outperform (OP) Neutral (N) Underperform (UP) No Rating Available (NAV)
Industry View: Attractive (A) In-line (I) Cautious (C) No Rating (NR)

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Industry Coverage:Brokers

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Lehman Brothers (LEH.N)	O (06/30/2008)	\$14.43
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