

August 27, 2008

Stock Rating
Overweight

Industry View
In-Line

Lehman Brothers

Reducing 3Q EPS to Reflect Mortgage Marks, De-risking

Reducing 3Q08 EPS to \$(2.80). Our new EPS implies a pretax write-down of \$3.5bn, driven by expectation of a significant deleveraging in a deteriorating credit market environment. We believe a key question for investors is not the size of the write-down, but how remaining illiquid asset exposure squares with capital cushion. This will reflect action by LEH to restore confidence in balance sheet marks and its capital position (e.g., potential stake sale, 3rd party venture to manage portfolio). Otherwise, franchise erosion is a real risk. We remain Overweight.

Strategy will likely crystallize in conjunction with 3Q EPS. We believe LEH recognizes that prolonged uncertainty beyond 3Q results is not an option. For the franchise (and shares) to turn the corner, we think management needs to announce a significant bulk asset sale or framework for investors to evaluate the structure/pricing of likely asset disposals (and incremental capital, should it be needed). The combination in 3Q of an exceptionally weak macro backdrop and widening credit spreads makes this more urgent (and difficult).

Incremental write-downs may be needed to move a meaningful block of illiquid assets (beyond the ~\$15bn reduction we expect in 3Q); however, we believe LEH has ample capital (Tier 1 capital ratio would still exceed 10% after a ~\$10bn write-down). Yet we caution that rating agencies may be less charitable than regulators, as write-downs north of \$7bn could require more equity to rebalance a higher preferred equity component in shareholders equity (currently 28%).

Outright sale of asset management business?

Barring an asset disposal to a 3rd party in which LEH contributes equity, we believe that a stake sale in conjunction with a partnership to manage assets may provide the best path forward. Sale of the AM business (unconfirmed — *FT*, August 26) is not an attractive scenario, in our view, as the remaining business would require incremental capital to offset absence of a recurring high ROE earnings stream from Neuberger, which would reduce normalized ROE outlook and increase EPS volatility of the surviving entity.

Key Ratios and Statistics

Reuters: LEH.N Bloomberg: LEH US

Brokers / United States of America

Price target	\$31.00
Shr price, close (Aug 26, 2008)	\$14.03
Mkt cap, curr (mm)	\$7,847
52-Week Range	\$67.73-12.02

Fiscal Year ending	11/07	11/08e	11/09e	11/10e
ModelWare EPS (\$)	7.26	(7.30)	3.25	3.85
Prior ModelWare EPS (\$)	-	(3.40)	3.45	4.15
P/E	8.6	NM	4.3	3.6
Consensus EPS (\$)	7.26	(5.13)	3.43	3.92
Div yld (%)	1.0	4.8	4.8	4.8

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	0.92
Q2	2.21	(5.14)a	(5.14)a	0.81	0.75
Q3	1.54	0.08	(2.80)	0.76	0.70
Q4	1.54	0.30	(0.41)	0.92	0.87

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

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Investment Case

Reducing 3Q08E EPS to \$(2.80) from \$0.14, vs. \$(1.24) consensus

Write-down Summary

As noted, our new estimate reflects a \$3.5bn pretax write-down stemming from ongoing asset sales and mark-to-market reductions across the Resi and Commercial Real Estate portfolio. Our write-down estimate is net of \$1.2bn in offsetting gains from hedges (equating to a hedge effectiveness rate of 25%, approximating the midpoint of 1Q08 and 2Q08 hedge performance). While hedges appear poised to work better than in the prior quarter, we believe the significant decline in the difficult-to-hedge Alt-A portfolio will obscure some of this improvement.

3Q08 estimate reflects significant a deterioration in commercial mortgage market as well as another leg down in Alt-A residential mortgages. We believe the combination of spread widening and forced asset sales at discounts to prevailing market prices will drive \$1.0bn in write-downs in the commercial mortgage book, \$1.7bn in write-downs in Alt-A book, as well as \$0.8bn in write-downs across remaining the Resi portfolio and LBO loan book (outlined in Exhibit 1).

As outlined below, our 3Q08 base case for net write-downs of \$3.5bn equates to a 10% reduction in 2Q08 pro forma book value and a 110bps reduction in Tier 1. For stress-testing purposes, we illustrate the impact of ~\$11bn in write-downs on both book value and Tier 1 Capital. Offsetting portion of hit to equity, Tier 1 ratio actually moves an incremental 100bps higher for each \$20bn reduction in Risk Weighted Asset (RWAs) below \$217bn level at end of 2Q08.

However, as noted, comfort on the regulatory capital front does not necessarily equate to a green light from the ratings agencies. Currently, LEH's preferred equity contributes 28% of its total shareholders equity. A scenario resulting in write-downs in excess of \$7bn would increase the preferred component in capital structure to north of ~33%, which could necessitate need for incremental equity capital.

Exhibit 1 Exposures and 3Q08 Net Write-down Scenarios

Asset Class ⁽¹⁾	Net Write-Downs Taken	2Q08 Exposures Remaining	Potential Net Write-Down Scenarios	
			Base	Severe
LBO	(1.4)	11.5	(0.2)	(0.7)
CMBS/Commercial Mortgages	(1.8)	29.4	(0.7)	(3.0)
Real Estate Held For Sale	(0.6)	10.4	(0.3)	(1.6)
Residential Mortgages	(3.0)	24.9	(2.2)	(5.5)
Alt-A/Prime ⁽²⁾		10.2	(1.7)	(3.0)
Subprime		2.8	(0.2)	(0.5)
Other		11.9	(0.4)	(2.0)
Non-Mortgage ABS	(0.4)	6.5	(0.1)	(0.3)
Other	(1.5)		-	-
Total	(8.7)	82.7	(3.5)	(11.1)
After-Tax Writedown			(2.3)	(7.4)
Book Value Impact			(\$3.30)	(\$10.49)
% of 2Q08 BV			-10%	-32%
Adjusted Pro Forma BV			\$29.85	\$22.66
Adjusted Pro Forma BV (Tangible)			\$24.00	\$16.81
Adjusted Pro Forma Tier 1 Ratio (pre-RWA Reduction)			12.4%	10.1%
Adjusted Pro Forma Tier 1 Ratio (post-\$20bn RWA Reduction)			13.7%	11.1%
<u>Memo: 2Q08 Metrics</u>				
Book Value ⁽³⁾			\$33.15	\$33.15
Tangible Book Value ⁽³⁾			\$27.30	\$27.30
Tier 1 Capital Ratio (Pro Forma)			13.5%	13.5%

(1) (a) Residential mortgage exposure does not include \$1bn in prime mortgages; (b) "Other Resi-Mortgage" includes non-US mortgages; (c) "Other" includes net writedowns that have been disclosed in aggregate and not by product specifically. The writedowns are spread across mortgages and leverage loans; and (d) LBO amount does not include investment-grade acquisition facilities of \$6.5bn

(2) We estimate Prime constitutes \$1bn

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

Source: Company data, Morgan Stanley Research estimates

Illiquid Asset Overhang

We believe the company is on pace to reduce illiquid residential and commercial mortgage overhang by at least 20% in 3Q. However, this implies "only" a \$13 billion reduction in a \$65 billion portfolio. We believe another \$10-15 billion reduction (likely via a large asset disposition to a third party) may be needed to assuage fears regarding the potential marks and level of toxicity of its remaining illiquid portfolio (i.e., "survivor bias" fears).

Absent clarity on this front we worry franchise erosion becomes a clear and present danger, given the prospect of elevated CDS spreads increasing counterparty costs as well as prolonged uncertainty (and stock price pressure) impacting employee base. Employee and client retention can become a full-contact sport in this environment, a level of effort that is probably difficult to sustain over a prolonged period of time without an improving story line (i.e., CDS spreads, share price).

Operating Environment

Unfortunately, earnings in core businesses will provide little reprieve from credit market headwinds. LEH is not alone on this front, as industry-wide market conditions have deteriorated in 3Q, exacerbating normal seasonal weakness (see our note cutting estimates for GS, *"Cutting 3QE to \$1.65 on Broad-Based Market Weakness"*, August 27, 2008).

Accordingly, reduction in outlook for key business lines reflects weaker macro backdrop, including spread widening in credit markets, lower volatility across interest rate/FX markets, significant decline in global equity indices (including mark-to-mark losses of ~\$100m on private equity stakes), and decrease in equity and debt underwriting volumes.

Excluding write-downs and structured credit gains on LEH's own debt (~\$0.6bn), our forecast for "normalized" revenue declines ~20% to \$3.3bn (vs. comparable metric of \$4.2bn in prior quarter). Importantly, despite the reduction in our net revenue forecast, we are maintaining our compensation expense estimate as we believe firm is rightly focused on accruing year-end bonus compensation in a conservative manner given the need to hold franchise together.

Exhibit 2

LEH Summary Outlook 3Q07–3Q08E

	3Q07	2Q08	3Q08E	3Q08E vs.	
				QoQ	YoY
Trading					
Fixed Income	1,063	-2,975	-2,066	nm	-294%
Equity	1,372	601	1,070	78%	-22%
Total	2,435	-2,374	-996	nm	-141%
Investment Banking					
Debt	350	288	140	-51%	-60%
Equity	296	330	250	-24%	-16%
Advisory	425	240	220	-8%	-48%
Total	1,071	858	610	-29%	-43%
Investment Management					
Retail Brokerage	334	352	338	-4%	1%
Asset Management	468	496	487	-2%	4%
Total	802	848	825	-3%	3%
Total Net Revenues	4,308	-668	439	nm	-90%
Comp Expenses	2,124	2,325	1,950	-16%	-8%
Non-Comp Expenses	979	1,094	1,010	-8%	3%
Pretax Income	1,205	-4,087	-2,520	nm	-309%
Taxes	318	-1,313	-781	nm	-346%
Net Income	870	-2,873	-1,763	nm	-303%
EPS	\$ 1.54	\$ (5.14)	\$ (2.80)	nm	-282%
Avg. Diluted Shares	565.8	571.3	861.8	51%	52%
Avg. Basic Shares	540.4	559.3	630.8	13%	17%
Key Metrics					
Comp Ratio	49.3%	nm	nm		
Non-Comp Ratio	22.7%	nm	nm		
Pretax Margin	28.0%	nm	nm		

Source: Company data, Morgan Stanley Research

Reducing 4Q08E and 2009-10 Estimates

- **4Q08E to \$(0.41) from \$0.30 (vs. \$0.20 consensus).** New estimate reflects higher write-down forecast (\$1.2bn), plus more muted outlook for trading and investment banking, in addition to higher compensation expense given the need for the firm to retain and motivate key employees.
- **2009 to \$3.25 from \$3.45 (consensus \$3.43), 2010 to \$3.85 from \$4.15 (consensus \$3.92).** Estimate cuts reflect in equal measure reduction in trading and investment management outlooks.

Valuation

Our price target of \$31 is equal to 1.0x our estimate of 12-month forward book value per share. We assign a multiple on this book value based on relative near-term and long-term ROE generation capacity of the firm, in the context of observed historical relationship between the stock's valuation and ROE outlook. This target multiple reflects, where appropriate, incremental asset impairment risk to our outlook (beyond what may already be reflected in our EPS outlook, to avoid double-penalizing).

Key Risks

Significant illiquid asset overhang is the key risk to achieving our \$31 price target. Downside risks stem from balance sheet overhang being more intractable than we expect, as well as protracted/intensified credit market distress. Additionally, prolonged share price weakness and elevated CDS spreads could impact the firm's ability to operate in an optimal manner.

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Exhibit 3

Lehman Brothers Earnings Model (\$ in millions, except per share data)

INCOME STATEMENT	1Q07	2Q07	3Q07	4Q07	1Q08	2Q08	3Q08E	4Q08E	2006	2007	2008E	2009E	2010E	Comparisons			
														YoY Growth			
														'07A	'08E	'09E	'10E
Capital Markets:																	
Fixed Income	2,164	1,891	1,063	727	262	(2,975)	(2,066)	(308)	8,447	5,844	(5,087)	5,136	5,650	-31%	nm	nm	10%
Equities	1,338	1,703	1,372	2,000	1,410	601	1,070	1,209	3,559	6,413	4,290	4,978	5,550	80%	-33%	16%	12%
Total	3,502	3,594	2,435	2,727	1,672	(2,374)	(996)	901	12,006	12,257	(797)	10,114	11,201	2%	nm	nm	11%
Investment Banking:																	
Global Finance - Debt	428	540	350	233	322	288	140	220	1,425	1,551	970	1,103	1,214	9%	-37%	14%	10%
Global Finance - Equity	175	333	296	210	215	330	250	240	814	1,015	1,035	1,114	1,281	25%	2%	8%	15%
Advisory Services	247	277	425	388	330	240	220	250	921	1,337	1,040	906	996	45%	-22%	-13%	10%
Total	850	1,150	1,071	831	867	858	610	710	3,160	3,903	3,045	3,123	3,491	24%	-22%	3%	12%
Investment Management																	
Asset Management	416	460	468	533	618	496	487	475	1,432	1,877	2,076	2,035	2,233	31%	11%	-2%	10%
Private Investment Management	279	308	334	299	350	352	338	345	985	1,220	1,385	1,426	1,512	24%	13%	3%	6%
Total	695	768	802	832	968	848	825	819	2,417	3,097	3,460	3,461	3,745	28%	12%	0%	8%
Total Net Revenues	5,047	5,512	4,308	4,390	3,507	(668)	439	2,430	17,583	19,257	5,708	16,698	18,436	10%	-70%	193%	10%
Non-Interest Expense Items:																	
Comp/Net Rev Ratio	49.3%	49.3%	49.3%	49.3%	52.5%	nm	nm	74.1%	49.3%	49.3%	138.7%	49.8%	49.3%				
Compensation and Benefits	2,488	2,718	2,124	2,164	1,841	2,325	1,950	1,800	8,669	9,494	7,916	8,316	9,089	10%	-17%	5%	9%
Non-Comp Expenses	860	915	979	996	1,003	1,094	1,010	1,014	3,009	3,750	4,121	4,089	4,240	25%	10%	-1%	4%
Non-Comp/Net Rev Ratio	17.0%	16.6%	22.7%	22.7%	28.6%	nm	nm	41.7%	17.1%	19.5%	72.2%	24.5%	23.0%				
Technology/Communication	266	287	282	311	302	309	309	309	974	1,145	1,229	1,244	1,269	18%	7%	1%	2%
Brokerage, Clearing and Distribution Fees	194	201	224	240	253	252	249	264	630	859	1,019	1,015	1,056	36%	19%	0%	4%
Occupancy	146	152	170	173	185	188	184	182	539	641	740	729	758	19%	15%	-1%	4%
Business Development	84	100	91	103	89	87	80	82	301	378	338	352	377	26%	-11%	4%	7%
Professional Fees	98	120	128	120	98	100	95	97	363	466	390	407	416	28%	-16%	4%	2%
Other	72	55	84	49	76	158	92	80	202	261	406	340	364	19%	56%	-16%	7%
Total Non-Interest Expenses	\$3,348	\$3,633	\$3,103	\$3,160	\$2,844	\$3,419	\$2,960	\$2,814	\$11,678	\$13,244	\$12,037	\$12,404	\$13,329	13%	-9%	3%	7%
Pretax Income	1,699	1,879	1,205	1,230	663	-4,087	-2,520	-384	5,905	6,013	-6,329	4,294	5,107	2%	nm	nm	19%
Provision for Income Taxes	553	606	318	344	174	-1,313	-781	-119	1,945	1,821	-2,039	1,331	1,583	-6%	nm	nm	19%
Tax Rate	32.5%	32.3%	26.4%	28.0%	26.2%	32.1%	31.0%	31.0%	32.9%	30.3%	32.2%	31.0%	31.0%				
Dividends on Trust Preferred	0	0	0	0	0	0	0	0	0	0	0	0	0				
Operating Income before Pref. Dividends	1,146	1,273	887	886	489	-2,774	-1,739	-265	3,960	4,192	-4,289	2,963	3,524	6%	nm	nm	19%
Preferred Dividends	17	17	17	16	24	99	24	24	66	67	171	96	96	2%	155%	-44%	0%
Operating Income	1,129	1,256	870	870	465	-2,873	-1,763	-289	3,894	4,125	-4,460	2,867	3,428	6%	nm	nm	20%
Discontinued Operations	0	0	0	0	0	0	0	0	0	0	0	0	0				
Extraordinary Items	0	0	0	0	0	0	0	0	47	0	0	0	0				
Net Income (Reported)	\$1,129	\$1,256	\$870	\$870	\$465	-\$2,873	-\$1,763	-\$289	\$3,941	\$4,125	-\$4,460	\$2,867	\$3,428	5%	nm	nm	20%
Operating EPS	\$1.96	\$2.21	\$1.54	\$1.54	\$0.81	-\$5.14	-\$2.80	-\$0.41	\$6.73	\$7.26	-\$7.30	\$3.25	\$3.85	8%	nm	nm	18%
Share Count																	
Avg. Diluted Shares	575.4	568.1	565.8	563.7	572.8	559.3	630.8	703.8	578.4	568.3	611.3	882.9	890.9	-2%	8%	44%	1%
Avg. Basic Shares	540.9	538.2	540.4	542.6	551.5	559.3	630.8	703.8	543.0	540.5	611.3	717.0	723.5	0%	13%	17%	1%
EOP Basic Shares	534.9	530.2	529.4	531.9	551.4	559.3	702.3	705.3	533.4	531.9	705.3	719.5	727.6	0%	33%	2%	1%
Key Metrics																	
Return on Equity	24.4%	25.8%	17.1%	16.6%	8.6%	nm	nm	nm	23.3%	20.9%	nm	13.0%	14.2%				
Return on Tangible Equity	30.0%	31.6%	21.1%	20.6%	10.6%	nm	nm	nm	29.0%	25.8%	nm	16.0%	17.1%				
Pretax Profit Margin	33.7%	34.1%	28.0%	28.0%	18.9%	nm	nm	nm	33.6%	31.2%	nm	25.7%	27.7%				
Net Profit Margin	22.4%	22.8%	20.2%	19.8%	13.3%	nm	nm	nm	22.4%	21.4%	nm	17.2%	18.6%				
Book Value / Share	\$35.15	\$37.15	\$38.29	\$39.45	\$39.45	\$34.21	\$30.03	\$29.45	\$33.87	\$39.45	\$29.45	\$32.01	\$34.58	16%	-25%	9%	8%
Tangible Book Value / Share	\$28.75	\$30.90	\$31.22	\$32.46	\$32.15	\$27.14	\$24.19	\$23.64	\$27.62	\$32.46	\$23.64	\$26.36	\$28.94	18%	-27%	12%	10%
Gross Leverage (Assets / Equity)	28.1x	28.7x	30.3x	30.7x	31.7x	24.3x	21.5x	22.1x	26.2x	30.7x	22.1x	21.9x	21.8x	17%	-28%	-1%	-1%
Net Leverage	15.4x	15.3x	16.1x	16.0x	15.4x	12.1x	10.7x	11.0x	13.8x	15.7x	12.3x	10.9x	11.0x	14%	-22%	-11%	1%

Source: Company data, Morgan Stanley Research

e = Morgan Stanley Research estimates

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(as of July 31, 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	909	42%	290	45%	32%
Equal-weight/Hold	913	42%	270	42%	30%
Underweight/Sell	348	16%	83	13%	24%
Total	2,170		643		

Data include common stock and ADRs currently assigned ratings. An investor's decision to buy or sell a stock should depend on individual circumstances (such as the investor's existing holdings) and other considerations. Investment Banking Clients are companies from whom Morgan Stanley or an affiliate received investment banking compensation in the last 12 months.

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Analyst Stock Ratings

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.

Equal-weight (E). The stock's total return is expected to be in line with 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.

Underweight (U). The stock's total return is expected to be below 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.

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.

Analyst Industry Views

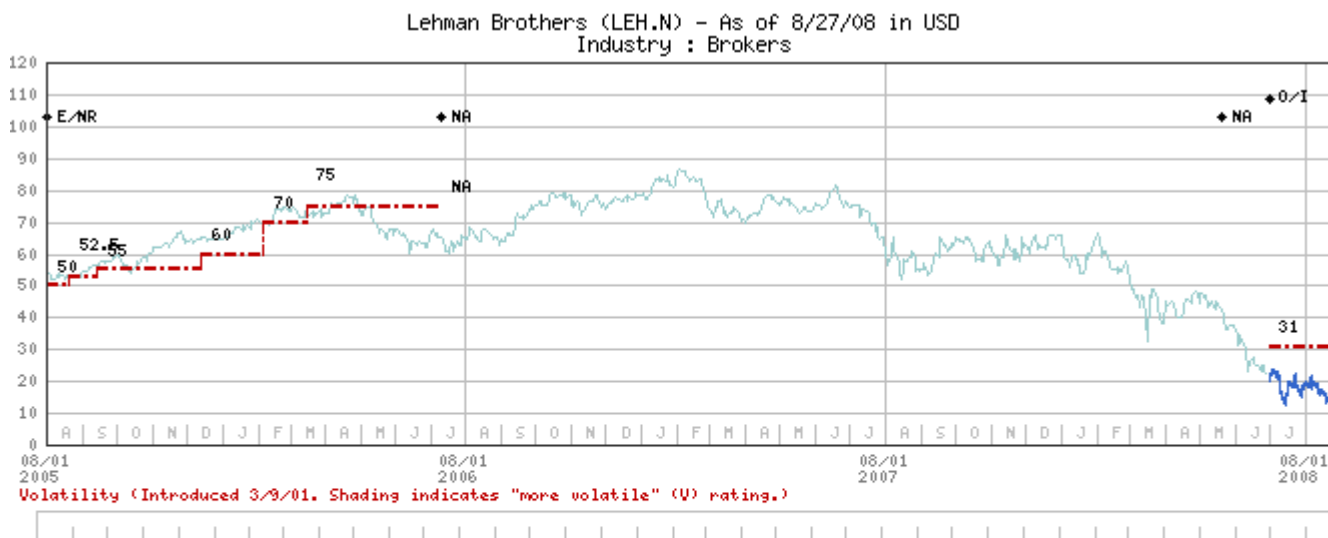
Attractive (A): The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be attractive vs. the relevant broad market benchmark, as indicated below.

In-Line (I): The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be in line with the relevant broad market benchmark, as indicated below.

Cautious (C): The analyst views the performance of his or her industry coverage universe over the next 12-18 months with caution vs. the relevant broad market benchmark, as indicated below.

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: 8/1/05 : 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 (NAU)
Stock Ratings prior to 3/18/02: Strong Buy (SB) Outperform (OP) Neutral (N) Underperform (UP) No Rating Available (NAU)
Industry View: Attractive (A) In-line (I) Cautious (C) No Rating (NR)

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For a discussion, if applicable, of the valuation methods used to determine the price targets included in this summary and the risks related to achieving these targets, please refer to the latest relevant published research on these stocks.

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Industry Coverage:Brokers

Company (Ticker)	Rating (as of)	Price (08/26/2008)
Patrick Pinschmidt		
Goldman Sachs Group (GS.N)	O (06/30/2008)	\$155.91
Lehman Brothers (LEH.N)	O (06/30/2008)	\$14.03
Merrill Lynch (MER.N)	E (06/30/2008)	\$24.1

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