

Lehman has been operating in an even more difficult environment since the collapse of Bear Stearns in mid-March, 2008. With the company considered a more direct peer to Bear Stearns, the market's concern has been whether Lehman is the next firm to fall. There are differing views on the street and Citi's Corporate Bond Research analyst (Ryan O'Connell) recently commented that it feels "another Bear-Stearns type funding squeeze is overblown" for Lehman. Nonetheless, as Lehman has felt the heat, the company has made significant efforts to have more open and effective communication with investors, creditors and the markets by articulating its financial strength, stressing its strong liquidity profile, and risk management strategy. The firm reported a good 1Q08 and raised \$3bn in convertible debt. Moody's completed an analysis of the firm's liquidity in April 2008 concluding that it remains very strong, which we agree.

MARKET EXPECTATIONS / 2Q 2008 EARNINGS

Lehman is scheduled to announce its 2Q 2008 earnings around 6/16/08 and is expected to have a weak quarter due to ineffective hedging during the quarter as well as difficult market conditions. With that they could record sizeable write-downs against these positions. While no details were provided, it is believed that the write-downs could be related to the fact that both the CMBS and CMBX derivative indices rallied during the quarter. This news has fueled further questions regarding Lehman's hedging strategy, its accounting, and capital level. Its' CDS spreads are trading around 250bps (more like a below investment grade credit) compared to 80 bps back in Sept 2007. Its stock has fallen 50% since the beginning of 2008, but is only off a few cents since March 17, 2008, the Monday following Bear Stearns rescue. Current price is \$31.40.

In anticipation of sub-par results, several analysts have revised down their 2Q2008 estimates for Lehman and have asserted that:

- Lehman used special one-time charges and gains to artificially inflate its first-quarter results.
- The company did not disclose its holdings of collateralized debt obligations before the first quarter.
- The company has not valued its commercial mortgage related assets based on market prices, and
- That it will need to raise further capital.

S&P's recent rating action - lowering the company's long term debt rating to A from A+ - agrees that Lehman as well as several of the other major brokers will experience weakness in core revenues and earnings in the short to medium term fueling the downgrades and negative outlooks.

CITI'S BOND RESEARCH REPORT – "NO SMOKING GUN"

In Citi's Corporate Bond Research Report dated 5/28/08, the analyst was relatively less concerned than other analysts and took a more positive view commenting that:

- Lehman follows a prudent funding practice and unlike Bear Stearns, the firm does not rely on customer balances in its prime brokerage operation to finance its balance sheet.
- Lehman has reduced its net leverage to 16X which is below that of its peer (18X – 22X).
- He "does not believe that Lehman's major franchises have been impaired."
- Lehman's exposure to sub prime mortgages is \$4bn, which it considers manageable and the Firm is on track to reduce its commercial mortgage/CMBS exposure by \$5bn in the second quarter.
- Lehman has been open in its communication with investors.

CITIGROUP'S RELATIONSHIP / EXPOSURE

- Lehman is a lead GTS relationship where Citi provides significant intraday liquidity lines and supported by committed backstop credit facilities.
- Lehman is expanding rapidly in Asia, Russia and Brazil, and giving most regional GTS business to Citibank.
- It is a large trading relationship, credit relationship, and treasury relationship. Total facilities and outstandings (across risk types) were \$6.05Bn and \$2.55Bn as 5/31/08.
- Citi co-lead the \$1.9 billion preferred stock issue for Lehman in Feb 2008 primarily for retail distribution.
- Lehman's \$2.0bn 3-year unsecured committed revolver, which was launched prior to their 1Q08 earnings release, was substantially oversubscribed by 40 participating banks.
- 2007 Total revenues were \$63MM, NI \$17MM and RORC 90%. March YTD '08 Revenues \$12MM w/ RORC 98%.

RECENT PROPOSED STRUCTURED FINANCE TRANSACTION WITH CITI

In early May 2008, Lehman's CEO contacted Vikram Pandit about Citi providing some liquidity against certain commercial real estate assets in its portfolio. A structure was presented to CMAC recommending the financing be provided via a borrow versus pledge transaction, where Citi borrows a security (a RACERS Trust Note, which is backed by the Commercial Real Estate Assets) from Lehman versus a pledge of US Agency Mortgages. Lehman would in turn lend out the agency securities in return for cash. The commercial real estate assets are loans against Hilton properties. Senior Risk Management was not comfort in taking on additional exposure to Hilton properties and declined to approve.

The initial request was for up to \$1bn with an initial stated maturity of 13 months, and each month the parties will decide whether to extend the stated maturity date by 1 month. Had the deal been approved, it would have been booked as direct exposure (not PSE) given that Citi's ability to liquidate the collateral under a Lehman bankruptcy remained questionable.

Redacted for Privilege

RECENT RATING ACTIONS:

- Following the release of their 1Q08 results, Lehman's rating was re-affirmed by S&P (A+ / Negative) and Moodys (A1 / Stable). The rating agencies noted Lehman abundant liquidity and strong Risk Management.
- However, on June 2, 2008, S&P lowered its Senior Unsecured rating and Lehman Brothers Holdings and its subs. The downgrade was in conjunction with a review of the global securities industry (Merrill Lynch and Morgan Stanley were downgraded as well). The downgrade was primarily reflective of uncertainties regarding future earnings. S&P is concerned that the pace and extent of earnings improvement could be considerably less than previously assumed given a generally slower business environment and the negative effects of its hedges. S&P did mention that Lehman bolstered its liquidity and funding profile to ensure sound liquidity and considers its funding profile as very stable, with an excess liquidity position and contingent funding plan that they consider sound.

FINANCIAL RESULTS – 1Q 2008

- Lehman reported record revenues and earnings in 2007 despite asset write-downs.
- 1Q08 profits were \$489mm down 57% compared with 1Q07 (\$886mm), which was well in range of analyst expectations. Net revenues were \$3.5bn representing decreases of 31% and 20%, respectively, from \$5.0 billion reported in the first quarter of fiscal 2007 and \$4.4 billion reported in the fourth quarter of fiscal 2007.
- Net revenues for the first quarter of fiscal 2008 reflect negative mark to market adjustments of \$1.8 billion, net of gains on certain risk mitigation strategies and certain debt liabilities.
- Non US revenues accounted for 62% of total net revenues compared with 50% for 1Q07.
- Stockholder's equity at 2/29/08 was \$24.8bn and long term capital was \$153.2bn compared with \$19.2bn and \$100.4bn at year-end 2006.
- Leverage was 31.7X at 2/28/08 compared with 30.1X and 28.1X at 11/30/07 and 2/28/07, respectively.
- Net Leverage (excludes matched book business) was 15.4X compared with 16.1X and 15.4X.

LIQUIDITY

- Lehman's conservative funding framework allowed the Firm to maintain a strong liquidity and cash capital position despite the difficult market conditions. Lehman's liquidity plan has 4 principals:
 1. Remain in a constant state of liquidity readiness sufficient to absorb the impact of a very severe liquidity event
 2. Do not rely on asset sales or increases in unsecured borrowings in a liquidity crisis.
 3. Do not overestimate the availability of secured financing in a liquidity crisis
 4. Create a separate Cash Capital Model for each regulated entity and Holding Company Chain.
- During the Bear Stearns Collapse, Lehman maintained is liquidity thorough the difficult period \$31bn (3/14), \$30bn (3/17) and \$33bn (3/20).
- Lehman's liquidity pool was \$34.9bn as of 2/29/08 which account for 124% of total short term debt (\$28.1bn) and is \$7bn over its cash capital requirements. Thus; there is no need to access the public markets for over one year.
- The holding company had other unencumbered assets of \$64bn and its other regulated entities (Lehman's banking entities) had unencumbered assets of \$99bn.

- Lehman has minimal reliance on the commercial paper market (\$3.1bn at 11/30/07) and ST ABCP programs (\$7.6bn).
- Further bolstering Lehman's liquidity the Federal Reserve has given primary dealers access to its discount window through the Primary Dealer Credit Facility. This supplemented support that the Fed has made to Primary Dealer also includes the Term Securities Lending Facility, which allows firms to swap certain types of agency collateral for treasury securities. In addition, Lehman has excess to funds thru the European Central Bank (through Lehman Bankhaus) as lenders of last resort.

MTM ADJUSTMENTS AND MORTGAGE RELATED / HIGH YIELD DEBT EXPOSURE

- Lehman strong risk management is evidenced by how well the firm managed through the volatile and challenging financial markets during the past 9 months.
- Level III assets as of 2/29/08 was \$42.5bn (\$41.9bn at YE07) accounting for 171% and 5% of total equity and assets respectively. These ratios are better than Morgan Stanley (235% & 7%) and Goldman (226% and 8%). 1Q08 information for Merrill is not available.
- During 1Q08 Lehman recorded a negative mark to market adjustment of \$1.8bn net (\$4.7bn gross) of gains on risk mitigation strategies and gains on debt liabilities. The net write down was broken down as follows: Residential Mortgages - \$0.8bn, commercial Mortgages - \$0.7bn and \$0.5bn related to leverage loans.
- Lehman's participation in "troubled" asset classes are limited:
 1. For ABCP, Lehman acts as an agent only.
 2. Lehman does not own or sponsor any SIV's.
 3. Net exposure to monolines (after hedges and credit reserves) is not significant.

Refer to page 3 of this memo for further breakdown of these exposures.

MARK TO MARKED ADJUSTMENTS AND GROSS BALANCES

In Billions

For the quarter ended Feb 29, 2008	MTM - Gain/(Loss) *		Gross balances as of *	
	Gross	Net	29-Feb-08	30-Nov-07
Residential mortgages:				
Securities			\$18.20	\$16.70
Whole loans			11.9	14.2
Servicing and other			1.7	1.2
	(\$3.00)	(\$0.80)	\$31.80	\$32.10
Other asset-backed (non-residential)	(\$0.20)	(\$0.10)	\$6.50	\$6.20
Commercial mortgages:				
Whole loans			\$24.90	\$26.20
Securities and other			11.2	12.7
	(\$1.10)	(\$0.70)	\$36.10	\$38.90
Real estate-related investments (f)	(\$0.30)	(\$0.30)	\$12.90	\$12.80
Acquisition Finance Facilities: (g)				
High Grade				
Contingent Commitments			\$7.20	\$10.20
Unfunded Commitments			0.8	-
Funded Loans			2.9	1.7
			10.9	11.9
High Yield				
Contingent Commitments			\$3.70	\$9.70
Unfunded Commitments			2.2	2.7
Funded Loans			11.9	11.5
			\$17.80	\$23.90
	(\$0.70)	(\$0.50)	\$28.70	\$35.80
Debt liabilities measured at fair value ~	\$0.60	\$0.60	\$37.20	\$36.20
Total	(\$4.70)	(\$1.80)		
* Less certain economic risk mitigation strategies. Balances do not reflect the impact of economic hedges.				
~ These gains represent the effect of changes in the Company's credit spread and exclude any interest income or expenses as well as any gain or loss from the embedded derivative component of these instruments.				

The Company's aggregate residential mortgage inventory at February 29, 2008 and November 30, 2007 can be classified into the following product categories:

In billions	Feb. 29, 2008	Nov. 30, 2007
Prime and Alt-A ¹	\$14.6	\$12.7
Europe	9.5	10.2
Subprime/Second Lien ²	4.0	5.3
ABS-CDO	0.9	1.1
Asia-Pacific	0.7	0.5
Other U.S.	2.1	2.3
	<u>\$31.8</u>	<u>\$32.1</u>

The Company's commercial mortgage inventory at February 29, 2008 and November 30, 2007 was:

In billions	Feb. 29, 2008	Nov. 30, 2007
Americas	\$17.4	\$20.6
Europe	10.0	10.4
Asia-Pacific	8.7	7.9
	<u>\$36.1</u>	<u>\$38.9</u>