

# LEHMAN BROTHERS

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## MEMORANDUM

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**TO:** Dave

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**FROM:** Tim

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**DATE:** July 3, 2008

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**SUBJECT:** Strategic Imperatives for the Firm

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The challenges we face over the next nine-eighteen months are enormous. We have a large overhang of illiquid, devaluing assets which are dragging down our earnings, threatening our capital base and undermining the confidence of investors, counterparties and employees. We have “lost” two of our largest, historically most profitable businesses (commercial and residential securitization), which accounted for more than 20% of firm revenues in recent years, and lack a clear, well-defined plan for how we will replace that revenue. And we have recently issued a significant amount of new equity, such that we will be challenged to earn a reasonable ROE for the foreseeable future. Taken together, these factors create a crisis environment where long-term strategy is almost unimportant and near-term tactical actions to shore up the franchise are critical. This memo lays out a number of potential near-term work streams that we should consider pursuing

### **Move Assets**

The most important feedback we are receiving from investors is that we should move aggressively to dispose of our commercial and residential real estate positions. During Dick and Bart’s Boston roadshow on Monday, some of our largest investors expressed a deeply held concern that the broader economic picture was going to get significantly worse before it gets better and that many financial institutions are going to be forced to dump assets into the marketplace to clean up their balance sheets. Their view is that we would be significantly better off taking our “\$5B hit now rather than a \$10B hit later.”

Whether or not they are right about the broader economy, their beliefs will force other banks to dispose of these assets, in effect creating a self fulfilling prophecy. We need to deal with this reality and have a focused effort on moving these assets in bulk. The challenge is that the team responsible for selling down these positions is the same one that originated them, so they lack the incentive to do the right thing now, since they will want to retain the option of digging themselves out of the hole. The Firm should assign responsibility for managing the asset disposition to an experienced risk operator, given him specific targets and a budget. We should also aggressively pursue the new co asset spin idea, which is being worked on by Investment Banking.

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**Reduce Costs**

We are in the middle of a massive and long lived recession within our industry which is spilling over into the broader economy. We need to deal more directly with that reality. Many of our most senior operators believe that the best possible revenue outcome for the Firm in 2009 is \$15B and only a few believe that our revenues will rebound significantly from that level any time soon. In that type of an environment, we need to get back to the “old Lehman.” We need a cost structure which is consistent with our revenue base and will enable us to earn adequate returns in a lower revenue market. On a back-of-the-envelope basis, this implies that we need to reduce our comp ratio to 47% and our NPE to \$3.1B to achieve even a 12% ROE.

To do that, we need a dedicated effort led by a senior operator focused on eliminating marginal businesses, functions and geographies. We need a parallel effort focused on ripping out non-personnel costs. In the mid-late 1990s, we more than doubled firm revenues while maintaining essentially flat NPE because we had a real cost reduction effort, led by real dedicated operators. With his current scope of responsibilities, it will be hard for Ian to dedicate sufficient time to this initiative, and Bob lacks the experience, energy and analytic mindset to be effective. Most importantly, this effort must begin today for us to realize any of these gains in 2009, which if we survive 2008, will be the make or break year for the Firm.

**Improve ROA**

This is not a popular way of thinking about our businesses, but given the decline in our overall leverage, we only have two levers for improving ROE. One is our net income margin, addressed above, and the second is our revenue return on assets (ROA).

<b>Revenue productivity of assets</b>	x	<b>Margins</b>	x	<b>Leverage</b>	=	<b>Return on Equity</b>
<u>Revs</u> Assets	x	<u>Net inc</u> Revs	x	<u>Assets</u> Equity	=	<u>Net inc</u> Equity

Much has already been done in this area, particularly around introducing risk-weighted capital charges. The key is to ensure that these are fully understood by the operators and adhered to such that they reallocate assets towards their highest risk-adjusted uses.

In addition, we should launch a top-down effort to assess the ROA of all of our businesses and put pressure on the operators to either: (1) justify the returns on the lowest performing operations or (2) improve their performance. As one example, we should be looking hard at reducing our Firm Relationship Loan positions since these earn meager returns and consume significant balance sheet. There are clearly other such opportunities.

We should also have a systematic effort to develop a coherent pricing strategy within our businesses, based on individual, customer-specific analysis. For example, within Prime Services

we should have an analytic framework for determining pricing for each account, not make pricing decisions based on a intuitive sense of what we can get away with. Similarly, we should have a targeted effort to minimize loss ratios, since revenue “leakage” like this degrades ROA. These types of changes are critical since improvements in ROA fall directly to the bottom line.

### **Increase Confidence**

Probably the biggest threat to our franchise - excluding writedowns - relates to investor and counterparty concerns about our ongoing viability. While they are unable to articulate the concise reason we cannot continue in our current form, many feel we “lack the size” to survive. As above, this logic can create a self-fulfilling prophesy in which counterparties and investors pull away from us, creating a downward death spiral.

We have long danced around this issue and in good times that has not been a problem, but today it has become a real strategic challenge which we need to address. One solution would be to sell the firm to a strategic investor, although the list of potential investors is small. We should have a view on which firms make the most sense and a “pitch book” prepared for each.

A second option would be to sell a substantial minority stake to strategic – one that would provide an implicit backstop since the market would believe that they would step in to support our franchise if we were to suffer significant future losses. Here we need to develop that list of potential investors, craft a compelling value proposition to them and begin marketing. The challenge will be in developing a compelling investment thesis. Historically, we have (rightly) been very focused on driving a hard bargain with potential investors, and as a result, our value proposition to them has been weaker than it could have been. We need a dedicated effort to flesh this out, led by a senior sponsor.

A third option would be to launch a take private transaction with a group of investors who have expertise in the space, know us well and whom we trust. Here we should be open minded and look beyond the traditional list of universal banks to other institutions in our space (e.g., Tishman Speir). Earlier this week, I received a call from Jerry Speir’s son-in-law about this – he thinks Jerry would be interested. More generally, we should have a dedicated team looking into this issue.

### **Shape Regulatory Environment / Industry Structure**

Over the next 12-24 months our industry will experience a significant change in the regulatory environment. We will either be regulated like a bank under existing Financial Holding Company regulations or we will be regulated under a new regime which we can help shape.

Being regulated like a bank would be an economic disaster for the firm. We would have to maintain substantially less leverage – even on an intra-quarter basis – than we do today which would drive down revenues and profitability (financial holding companies must maintain a 20x ratio of average daily gross assets to Tier I capital – we typically run at 25-30x). This matters because leverage is historically very cyclical in our industry, and while we are currently

operating in a lower leverage environment, we will want to increase our leverage as market conditions improve. Locking ourselves into a permanently lower leverage rate would destroy significant value.

Moreover, it will be difficult for us to capitalize on many of the advantages of being a bank. For example, the broker-dealer subsidiaries of commercial banks cannot typically access the Discount Window. So unless the Fed were to make the Primary Dealer Credit Facility permanent, we would gain limited liquidity relief. Additionally, it would be difficult for us to buy or build a meaningful deposit base. Most of the truly attractive depository franchises have been acquired over the past 15-20 years and acquiring one now would be significantly dilutive to shareholders. An online bank would also provide only limited benefit, since the largest competitor to ING Direct (Countrywide) has only \$34B in total deposits and the cost of such deposits is relatively high.

So our strategic objective should be focused on shaping the regulatory outcome such that we maintain discount window access, but are permitted to operate in higher leverage way. We have already been working on this analysis, but need more dedicated time to focus on it and a broader base of senior management sponsorship.

I look forward to discussing with you when you get back.