

*Confidential Presentation to:*

# Executive Committee Offsite

## Opportunities for Additional Risk Deployment

*August 3, 2006*

LEHMAN BROTHERS

---

## Executive Summary

# Executive Summary (I)

---

- ◆ The Firm is currently under-deploying its Risk Appetite: Usage has been around \$1.5 billion vs. a limit of \$2.3 billion (65%)
  - We are still evolving our risk taking culture
    - Perceived tolerance for revenue volatility
    - Zero loss mentality around counterparty credit risk
    - Trader skill set and expertise
  - Our primary strategy has been to focus on servicing the flow from our client franchise, with less emphasis on principal risk taking
  - The Firm is fully deploying its equity capital from a balance sheet net leverage perspective
    - We are in active dialogue with the rating agencies to de-emphasize balance sheet net leverage as a constraint
    - However, less liquid assets will remain a key rating agency consideration
    - Eventually, we expect CSE to become the most important measure of capital adequacy
- ◆ Some of our competitors have been increasing their risk taking in the recent past, especially in principal investing, proprietary trading, and counterparty credit risk
- ◆ We have been growing our principal and proprietary trading businesses as well. In 2006 H1, these businesses generated a strong performance, accounting for 23% of the Firm's revenues and 44% of the Firm's pretax income

# Executive Summary (II)

---

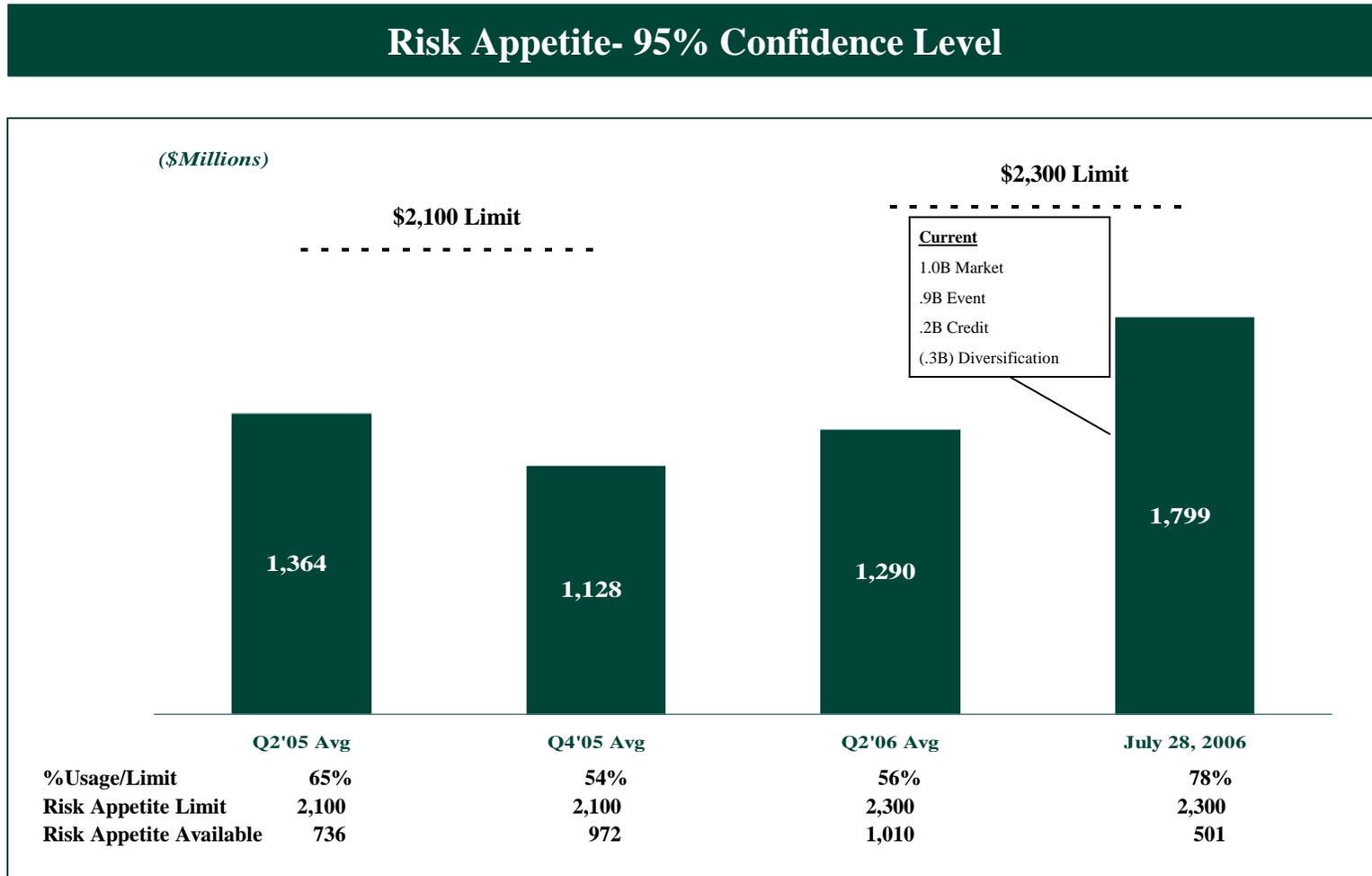
- ◆ The impact of increasing the risk profile on stock price performance is not clear cut
  - In the case of GS (the biggest risk taker), we have seen their price/earnings multiple deteriorate significantly over time, both in absolute terms and relative to the S&P500
    - GS price/earnings multiple has moved to the bottom of the peer group
    - Over the past three years, the P/E ratios of the peer groups have converged to a narrow band
  - During the recent cycle, GS has generated significant revenue and earnings increases from risk taking activities
    - The additional revenues have generated additional compensation that is available to pay existing people and/or fund growth
    - However, during other parts of the cycle, heavy reliance on risk taking activities is likely to result in pressure on financial performance and compensation adequacy
- ◆ There are several opportunities to deploy additional Risk Appetite that are currently under consideration
  - Client related activities, such as derivative solutions, the expansion of our hedge fund financing business, and middle market lending, among others
  - Principal activities such as private equity investments (Lehman funds and co-investments with financial sponsors), real estate, and investments in hedge funds (both minority stakes and seed money), among others
- ◆ In prioritizing these opportunities we need to be conscious of the attractiveness of the opportunities, our competitive advantage, as well as our ability to execute them effectively
- ◆ The success of our client focused strategy has been validated, and we believe it should continue to be the focus of the Firm
- ◆ However, we believe we can increase our risk taking within our existing risk capacity without negative implications on our stock price multiple and credit ratings

---

## Risk Utilization

# Unused Risk Capacity

- ◆ Our internal risk model shows a sizeable underutilization of Risk Appetite



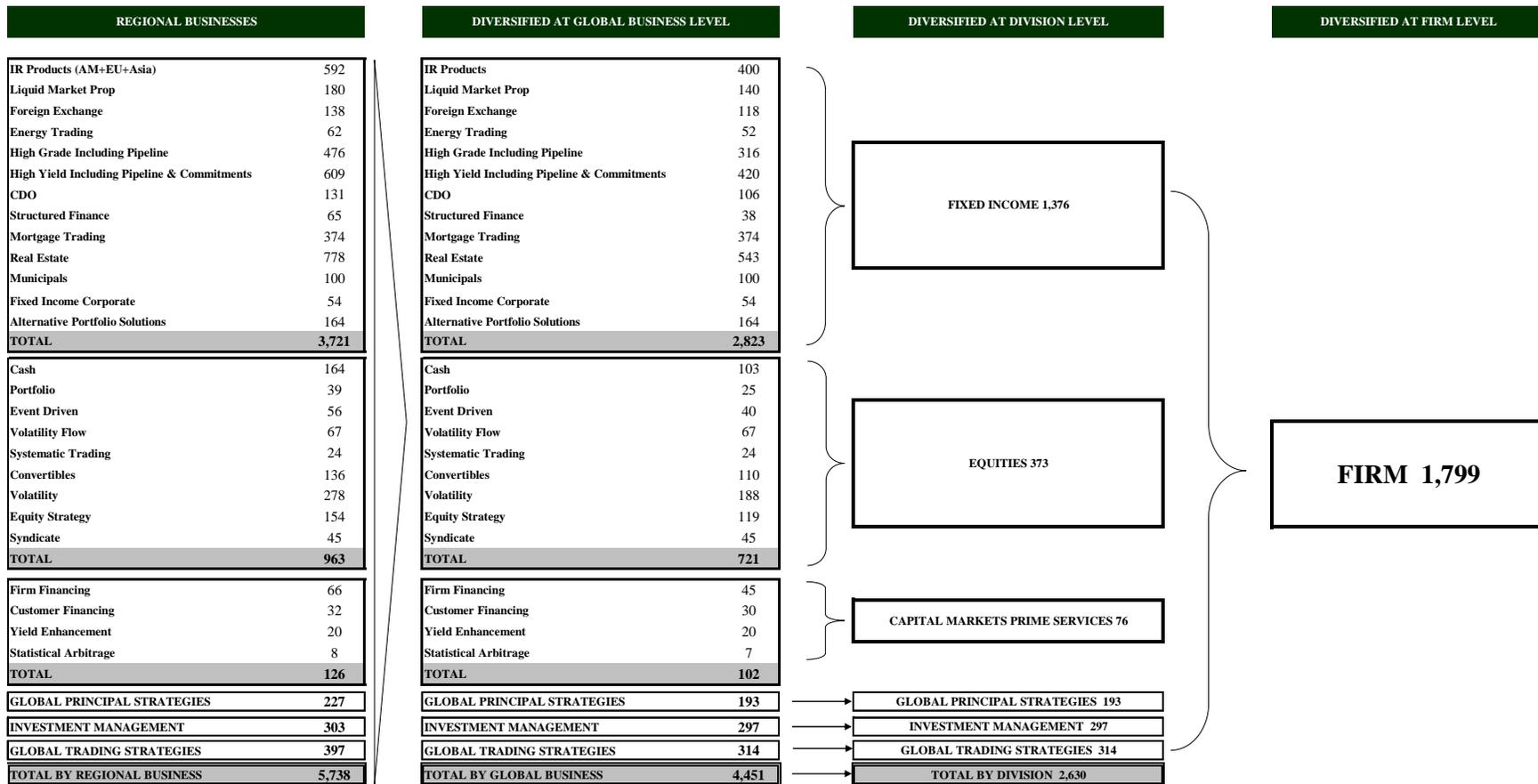
Note: Market volatility has been low. Current Risk Appetite could increase by \$200M with increased market volatility based on historical comparisons

# Risk Appetite and Diversification

- The breadth of our franchise gives us the benefit of significant diversification. Usage amounts to \$5.7B at the regional business level, but only \$1.8B at the Firm level (a 70% diversification benefit)

95% Confidence Interval (\$Millions)

## Risk Appetite Usage



1. Data as of July 28, 2006

# Competitor Overview

# Value At Risk

- ◆ Our competitors have recently increased their VaR. We have the second lowest ratio of VaR to equity in the peer group
- ◆ Our competitors, with the exception of BSC, appear to have a more diversified franchise as measured by the diversification benefit within VaR

## Average Value At Risk

### AVERAGE VALUE-AT-RISK (VaR) <sup>(3)</sup>

<i>\$M (VaR), \$B (Equity)</i>	<b>FY 2004</b>	<b>FY 2005</b>	<b>Q2 2006</b>	<b>'06 vs. '04</b>	<b>'06 vs. '05</b>	<b>Diversification/ VaR</b>
Lehman Brothers VaR	27	31	35	31%	12%	32%
<i>Equity used in leverage calculations</i>	<i>12.6</i>	<i>15.6</i>	<i>17.4</i>			
VaR / Equity	0.21%	0.20%	0.20%			
Goldman Sachs VaR	67	70	112	67%	60%	71%
<i>Equity used in leverage calculations</i>	<i>22.5</i>	<i>25.3</i>	<i>28.8</i>			
VaR / Equity	0.30%	0.28%	0.39%			
Morgan Stanley VaR <sup>(1)</sup>	49	49	58	18%	18%	78%
<i>Equity used in leverage calculations</i>	<i>21.4</i>	<i>20.0</i>	<i>23.5</i>			
VaR / Equity	0.23%	0.25%	0.25%			
Merrill Lynch VaR <sup>(2)</sup>	28	38	45	61%	18%	51%
<i>Equity used in leverage calculations</i>	<i>27.8</i>	<i>32.1</i>	<i>33.7</i>			
VaR / Equity	0.10%	0.12%	0.13%			
Bear Stearns VaR	16	21	34	113%	64%	18%
<i>Equity used in leverage calculations</i>	<i>8.9</i>	<i>10.7</i>	<i>11.6</i>			
VaR / Equity	0.18%	0.19%	0.29%			

1. Morgan Stanley VaR based on a 95% confidence level and one-year factor history. Equity is for securities business only

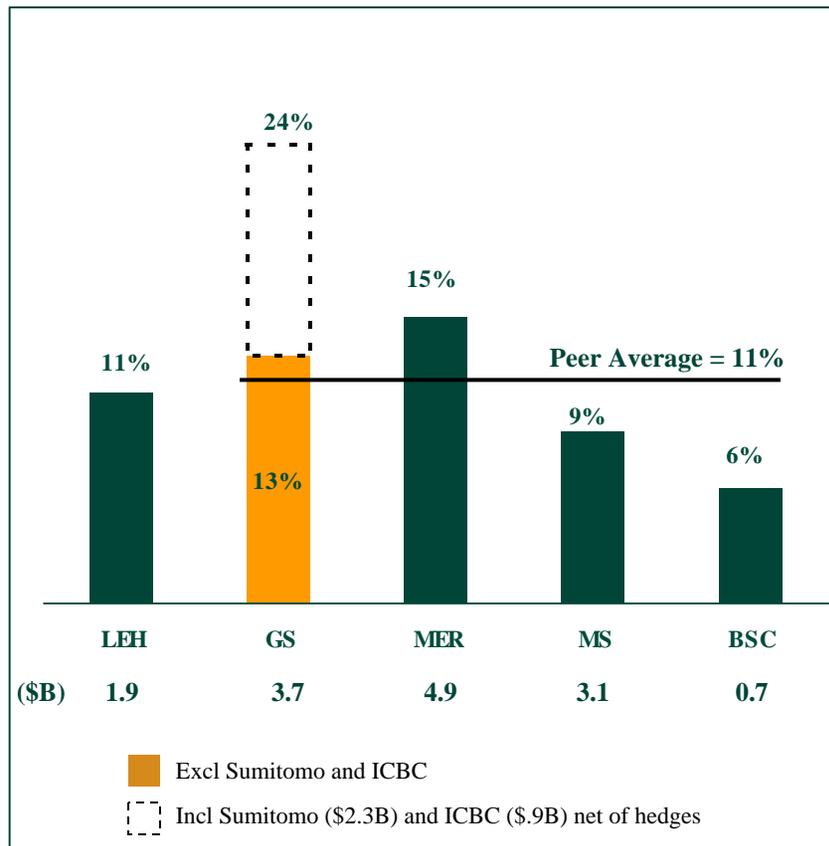
2. Merrill Lynch 2006 VaR is for 2006 Q1

3. 95% confidence level and one day time horizon. Data across firms not directly comparable because of differences in modeling VaR

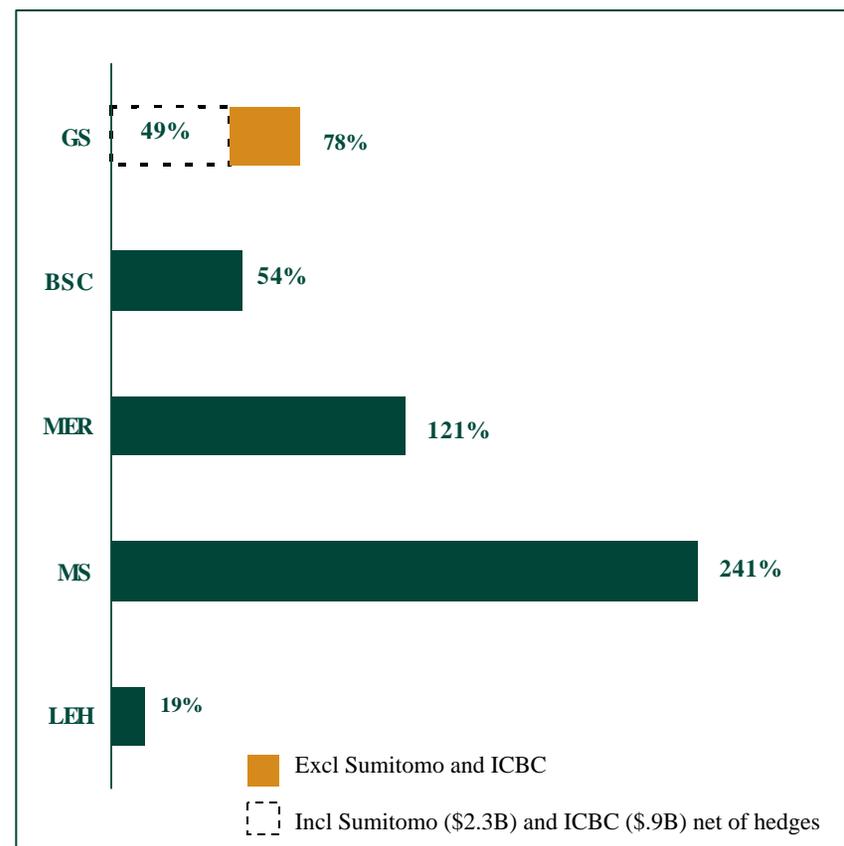
# Private Equity Disclosure

- ◆ Lehman Brothers has maintained its private equity disclosure at approximately 10% of equity, in line with our peer group. However, all peer firms have grown their Private Equity investments faster than us

Private Equity Disclosure/ Equity <sup>(1)</sup> (2Q06)



Percentage Change 2Q06 vs 4Q04



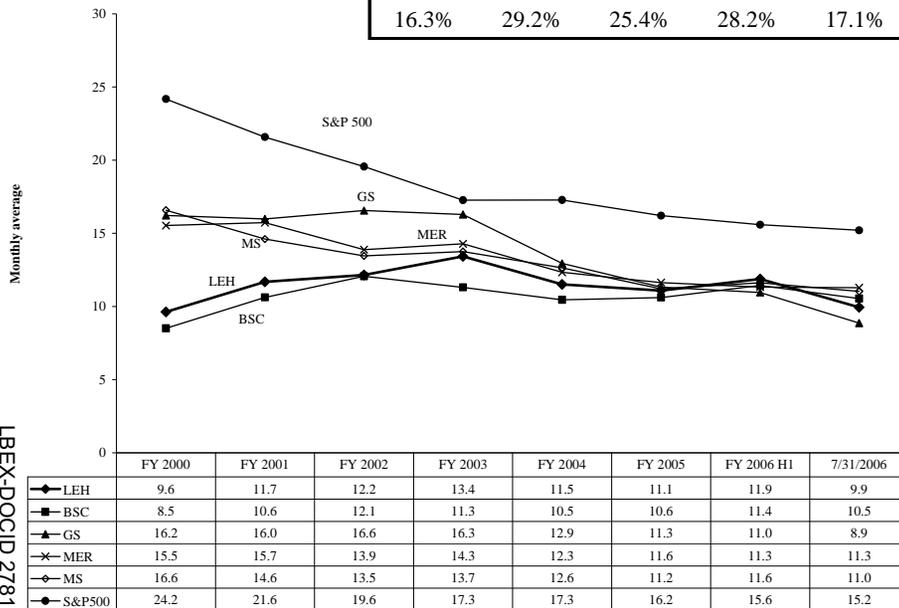
1. Lehman data excludes direct equity investments in Real Estate (\$3.4B as of 2Q06). Including these, the private equity disclosure/equity ratio amounts to 30%

# Valuation Convergence

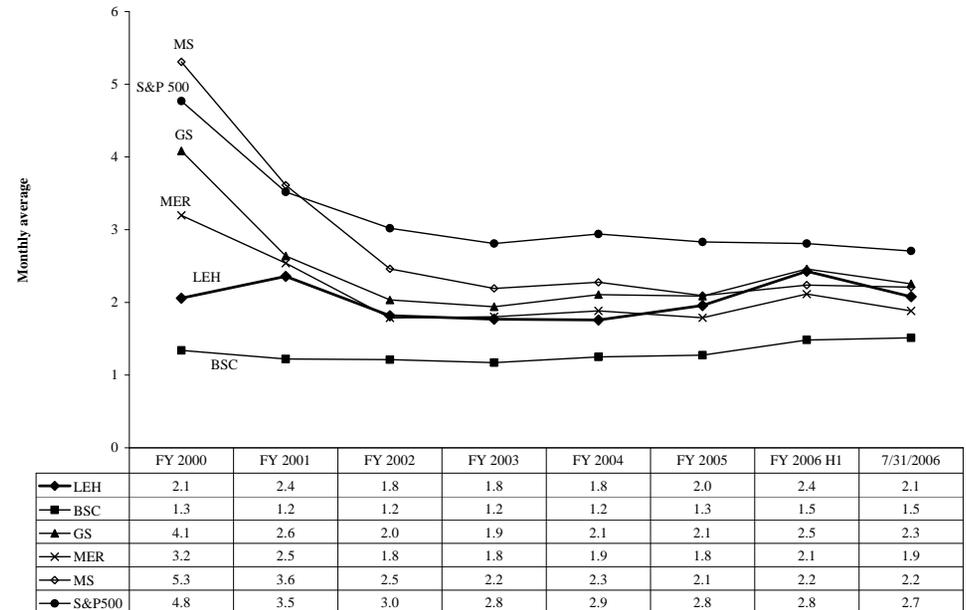
- ◆ Valuation multiples in our industry, particularly price-to-earnings ratio, have converged over time
- ◆ Thanks to its client-focused strategy, which delivers strong recurring earnings streams, Lehman has seen its valuation multiples improve relative to its peers
- ◆ Goldman has seen its valuation premium erode relative to its peers, as the market discounts the future reliability of its strong earnings performance

## Forward P/E Ratio

EPS Volatility 1Q 02 - 2Q 06				
LEH	GS	MER	MS	BSC
16.3%	29.2%	25.4%	28.2%	17.1%



## P/B Ratio



---

## Opportunities to Deploy Additional Risk

# Overview

## Our activities can be categorized into client and principal

- ◆ Client Activities include all of our traditional Capital Markets flow businesses, our asset origination and securitization businesses, as well as our Investment Banking and Investment Management businesses
- ◆ Principal Activities can be categorized as follows:
  - Principal Investments: The principal transaction portion of our Real Estate business (PTG), our participation in the Firm's Private Equity funds, investments in hedge funds (e.g. GLG, Marble Bar, Ospraie), co-investments in partnership with Financial Sponsors, and corporate investments
  - Proprietary Trading: Business lines that are segregated from our client business. These include Global Trading Strategies (GTS- Millard), Global Principal Strategies (GPS- Rieder), as well as Liquid Markets Proprietary within Fixed Income, and Equities Strategies within Equities. In general, these businesses trade liquid instruments that have observable prices
  - In-Business Dedicated Proprietary Trading: Proprietary trading activities within our client facing business lines in Fixed Income and Equities, which can be delineated from our client activities (dedicated personnel, revenue and balance sheet tracked separately). Examples include:

### **FID:**

- HY Distressed Proprietary
- Credit Proprietary
- Muni Proprietary
- IRP Proprietary

### **Equities:**

- Liquid Markets Americas Proprietary
- Execution Services Europe and Asia Proprietary
- Convertibles Proprietary Trading
- Volatility Europe and Asia Proprietary

# Firm Performance Overview

- ◆ In 2006 H1, Principal Activities accounted for 23% of the Firm's revenues and 44% of the Firm's pretax income

	<i>(May YTD Actual, \$M)</i>		<b>Net</b>		<b>Net Balance</b>		<b>Risk</b>		<b>Pre Tax</b>			
	<i>(Net Balance Sheet, \$B)</i>		<b>Revenues</b>		<b>Sheet (\$B)</b>		<b>Pre tax</b>	<b>%Firm</b>	<b>Appetite</b>	<b>%Firm</b>	<b>Margin</b>	<b>ROA</b>
Real Estate- PTG	513	6%	12.3	5%	402	13%	334	23%	78%	8%	312%	
Private Equity- Principal	69	1%	1.2	0%	25	1%	262	18%	36%	12%	54%	
Asset Management- Principal <sup>(1)</sup>	50	1%	0.7	0%	46	2%	67	5%	92%	15%	151%	
Corporate Investments	(16)	0%	0.3	0%	(16)	-1%	n/a	n/a	n/a	-11%	n/a	
<b>Principal Investments</b>	<b>616</b>	<b>7%</b>	<b>14.5</b>	<b>6%</b>	<b>457</b>	<b>15%</b>	<b>543</b>	<b>37%</b>	<b>74%</b>	<b>9%</b>	<b>231%</b>	
Global Trading Strategies (Millard)	200	2%	2.4	1%	112	4%	298	20%	56%	17%	137%	
Global Principal Strategies (Rieder) <sup>(2)</sup>	117	1%	2.3	1%	95	3%	176	12%	81%	10%	135%	
Liquid Markets Proprietary	182	2%	1.1	0%	142	5%	119	8%	78%	32%	310%	
Equities Strategies	183	2%	2.4	1%	125	4%	112	8%	68%	16%	331%	
<b>Proprietary Trading</b>	<b>681</b>	<b>8%</b>	<b>8.2</b>	<b>3%</b>	<b>473</b>	<b>16%</b>	<b>471</b>	<b>32%</b>	<b>69%</b>	<b>17%</b>	<b>294%</b>	
FID In-Business	283	3%	3.9	2%	174	6%	114	8%	61%	15%	504%	
EQ In-Business	420	5%	7.5	3%	246	8%	219	15%	59%	11%	390%	
<b>In-Business Dedicated Proprietary</b>	<b>703</b>	<b>8%</b>	<b>11.4</b>	<b>5%</b>	<b>419</b>	<b>14%</b>	<b>251</b>	<b>17%</b>	<b>60%</b>	<b>13%</b>	<b>569%</b>	
<b>Total Principal Activities</b>	<b>2,000</b>	<b>23%</b>	<b>34.1</b>	<b>14%</b>	<b>1,349</b>	<b>44%</b>	<b>824</b>	<b>56%</b>	<b>67%</b>	<b>12%</b>	<b>493%</b>	
<b>Traditional Customer Flow</b>	<b>5,601</b>	<b>63%</b>	<b>159.9</b>	<b>66%</b>	<b>1,116</b>	<b>37%</b>	<b>988</b>	<b>67%</b>	<b>20%</b>	<b>7%</b>	<b>1152%</b>	
<b>Securitization/ Origination</b>	<b>1,297</b>	<b>15%</b>	<b>44.4</b>	<b>18%</b>	<b>623</b>	<b>20%</b>	<b>313</b>	<b>21%</b>	<b>48%</b>	<b>6%</b>	<b>843%</b>	
<b>FRL</b>	<b>(26)</b>	<b>0%</b>	<b>2.4</b>	<b>1%</b>	<b>(38)</b>	<b>-1%</b>	<b>98</b>	<b>7%</b>	<b>n/m</b>	<b>-2%</b>	<b>-53%</b>	
<b>Total Client Activities</b>	<b>6,873</b>	<b>77%</b>	<b>206.7</b>	<b>86%</b>	<b>1,700</b>	<b>56%</b>	<b>1,060</b>	<b>72%</b>	<b>25%</b>	<b>7%</b>	<b>1317%</b>	
<b>TOTAL FIRM</b>	<b>8,872</b>	<b>100%</b>	<b>240.7</b>	<b>100%</b>	<b>3,049</b>	<b>100%</b>	<b>1,470</b>	<b>100%</b>	<b>34%</b>	<b>7%</b>	<b>1227%</b>	

1. Asset Management principal includes minority stakes, seed money, and other strategic investments

2. GPS business commenced trading in June. GPS includes Capital Arbitrage, Aviation Finance, and Credit Arbitrage revenues as of May

# Risk Capacity

- ◆ Growth of our overall franchise will allow us to increase our Risk Appetite limit by \$400 million to \$2.7 billion and provide \$600 million of Risk Appetite for new opportunities in 2007
- ◆ Growth in equity and a higher Net Leverage ratio will allow us to grow our net balance sheet by \$49 billion and to provide \$31 billion for new opportunities
- ◆ Growth in equity and a higher Less Liquid Asset ratio will allow us to grow our less liquid assets by \$5 billion

## Risk Capacity— Risk Appetite, Balance Sheet, Less Liquid Assets

(\$Billions)	Risk Appetite		Net Balance Sheet <sup>(1)</sup>		Less Liquid Assets	
	2006	2007	2006	2007	2006	2007
Equity used in leverage calculations			18.8	20.9	18.8	20.9
Leverage ratio			13.9x	14.9x	105%	115%
<b>Limit</b>	<b>2.3</b>	<b>2.7</b>	<b>262</b>	<b>311</b>	<b>20</b>	<b>24</b>
Current usage	1.8	1.8	240	240	19 <sup>(2)</sup>	19 <sup>(2)</sup>
Organic growth of client franchise	0.1	0.3	19	40		
Total uses	1.9	2.1	259	280	19	19
<b>Available for new opportunities</b>	<b>0.4 <sup>(3)</sup></b>	<b>0.6 <sup>(3)</sup></b>	<b>3</b>	<b>31</b>	<b>1</b>	<b>5</b>

1. Gross balance sheet usage has been running at \$455B (gross leverage of 25.3x).

2. \$6.8B high yield, \$9.1B of real estate, \$0.8B of retained interests, \$1.9B of private equity and \$0.4B of OTC derivatives HY counterparty credit exposure

3. Including \$200M of "safeguard" for market volatility increase

# Overview of Opportunities (I)

Opportunity	Description
<b>Approved Opportunities</b>	
Private Equity	New fund launches, including MLP, CA Land, Yen R/E and possibly others
MCD International	Build-out of origination platform in Asia and continental Europe, including flow agreements (e.g. Italy)
Student Loans	Extension of securitization expertise to new asset class through acquisition
Middle Market Lending	Extension of securitization expertise to medium sized company loans
Financial Sponsors Co-Investments - Global	Deal-specific side-by-side investments with strategic sponsors
<b>Client Related Opportunities</b>	
Derivative Solutions	Become preeminent global risk solution provider to corporate clients; Requires to take substantially more unsecured counterparty credit risk
Energy/ Commodities	Accelerated build-out of Energy business
Hedge Fund Financing	Organic growth of Capital Markets Prime Services platform, including innovative counterparty credit risk taking
New Markets- India/Emerging Europe/ Latin America	Build Capital Markets business in India and build presence in emerging Europe/ Latin America
Private Placements	Investment in non-registered securities for future distribution

FOIA CONFIDENTIAL TREATMENT  
REQUESTED BY LEHMAN BROTHERS HOLDINGS INC.

LBEX-DOCID 2781866

# Overview of Opportunities (II)

FOIA CONFIDENTIAL TREATMENT  
REQUESTED BY LEHMAN BROTHERS HOLDINGS INC.

Opportunity	Description
<b>Principal Based Opportunities</b>	
Real Estate (PTG)	Continued build-out of PTG, including a significant amount of additional investments as LP in LEH Real Estate funds
European Private Equity	Raise European focused funds, for example: Secondary LBO fund, Restructuring LBO fund, Infrastructure fund, and Structured Credit fund
Global Principal Strategies (Rieder)	Growth of dedicated proprietary trading effort
Single Name Credit (Distressed, Mezz, etc.) - Europe	Invest in mid-sized private transactions and distressed opportunities in Europe
Insurance Principal Investing	Acquisition of insurance assets (primarily life insurance), including temporary financing of reinsurance blocks, closed fund opportunities, and pension fund assets
Hedge Fund Investments	Minority stakes, third party seed money, and LEH Fund seed money
Distressed Portfolios	Expand NPL business (Poland, etc.)

LBEX-DOCID 2781866

# Detail of Opportunities

(\$Millions)

Opportunity	Net Assets End 2007	Risk Appetite	Revenues 2007	Pretax Margin	New Init. Comp.
<b>Approved Opportunities</b>					
Private Equity (MLP, CA Land, Yen R/E, etc.)	300	70	80	50%	12
MCD International	1,500	20	75	40%	10
Student Loans	250	10	60	50%	-
Middle Market Lending	1,000	25	30	15%	10
Financial Sponsors Co-Investments - Global	1,000	230	-	n/a	-
<b>Client-Related Opportunities</b>					
Derivative Solutions	5,000	160	200	50%	65
Energy/ Commodities	500	150	150	30%	-
Hedge Fund Financing	12,000	40	120	5%	10
Regional Expansion- India	1,000	50	100	n/a	30
Private Placements	100	23	10	40%	2
Regional Expansion- Emerging Europe and Latin America	TBD- to be presented at Sun Valley				
<b>Principal Opportunities</b>					
Real Estate (PTG)	2,500	80	75	75%	-
European Private Equity (Sec. LBO, Infrastructure, Str. Credit) <sup>(1)(2)</sup>	-	92	62	60%	40
Global Principal Strategies (Rieder)	1,000	95	60	70%	-
Single Name Credit (Distressed, Mezz, etc.) - Europe	1,000	230	45	75%	5
Insurance Principal Investing	400	10	30	50%	-
Hedge Fund Seed Money (Third Party)	500	150	30	80%	-
LEH Fund Seed Money (excl. Private Equity) <sup>(3)</sup>	250	75	24	80%	-
Hedge Fund Minority Stakes	400	120	20	80%	-
Distressed Portfolios (NPL - Poland, etc.) <sup>(2)</sup>	1,000	60	25	75%	3
<b>Total<sup>(4)</sup></b>	<b>29,700</b>	<b>Gross 1,690 ; Net 507</b>	<b>1,196</b>	<b>47%</b>	<b>187</b>

1. Assumes funds will be closed but not significantly invested, but commitments are captured in Risk Appetite

2. Pretax margin assumes top quartile performance in a steady state for LBO and Distressed Portfolio opportunities

3. \$150M for European funds approved (5 funds with \$30M per fund)

4. Total for Risk Appetite assumes 70% diversification

# Conclusion and Next Steps

---

- ◆ We are in a position to deploy additional Risk Appetite based on our current limit and we will increase our risk capacity as we grow the Firm
- ◆ We are in active dialogue with the rating agencies to de-emphasize balance sheet net leverage as a constraint, which will allow us to deploy additional balance sheet
- ◆ We will revisit our counterparty credit and country limits to ensure they are aligned to our overall Risk Appetite
- ◆ In general, our Principal Activities are accretive to the Firm's pretax income and generate compensation to pay the franchise and for additional investments. However, these activities can create additional pressure on financial performance and compensation at the bottom of the cycle
- ◆ We believe we can increase our risk taking within the risk capacity we have laid out without negative implications on our stock price multiple and credit ratings
- ◆ We have a series of opportunities, some of which already started and some of which require additional planning and analysis, as well as new initiative funding. The next step is to get agreement from the Executive Committee on which of these opportunities we should pursue, and finalize business plans as soon as possible