

Loan Syndicate / Year-End Recap

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Lehman Brothers Leverage Loan Franchise

Another Successful Year for Lehman Brothers' Syndicated Leveraged Loan Franchise:

Despite the market correction which took place over the summer, Lehman Brothers completed another successful year in the syndicated loan business. Lehman's US leveraged loan volume almost tripled, reaching a record high of more than \$142 billion, an increase from \$49 billion in 2006.⁽¹⁾ In 2007, Lehman Brothers acted as a Joint Lead Arranger on 74 leveraged loans, of which 31 were \$1.0 billion or greater and 12 deals that were \$2.0 billion or greater. Lehman Brothers participated in many of the marquee deals of 2007, helping the firm increase its market share and league table standings. This year Lehman Brothers was Lead Left Arranger on 44 deals, up significantly from last year's 26 deals. These deals included: the \$1,375 million Credit Facility for Pinnacle Foods Finance; the \$775 million Credit Facility for Yankee Candle, in which Lehman also acted as Quarterback for the High Yield Bonds in conjunction with the LBO; the \$1,330 million Credit Facility for Entegra Power Group; the \$2,050 million Credit Facility for Dresser Inc.; and the \$1,350 million Credit Facility for Sequa Corporation, which Lehman successfully syndicated post the mid-year market correction.

This past year Lehman provided committed financing for some of the largest deals ever financed in the leveraged loan market, including TXU and First Data. During an especially turbulent fourth quarter, Lehman was one of the most active underwriters, successfully syndicating deals for LKQ Corporation, Tenaska Power (TPF II), Varel International and Sequa Corporation. Looking forward to 2008, Lehman will continue to provide this superior execution in a challenging market environment.

2007 U.S. Leveraged Loans				2007 U.S. Sponsored Leveraged Loans			
<i>(\$ in millions)</i>		Amount (\$bn)	Share	<i>(\$ in millions)</i>		Amount (\$bn)	Share
1	JP Morgan	\$208.3	19.1%	1	JP Morgan	\$65.4	17.0%
2	Banc of America Securities LLC	147.1	13.5%	2	Citi	46.7	12.2%
3	Citi	115.8	10.6%	3	Goldman Sachs & Co	42.1	10.9%
4	Goldman Sachs & Co	78.6	7.2%	4	Lehman Brothers	31.5	8.2%
5	Credit Suisse	64.7	5.9%	5	Banc of America Securities LLC	30.9	8.1%
6	Deutsche Bank AG	59.6	5.5%	6	Credit Suisse	30.9	8.0%
7	Merrill Lynch	55.7	5.1%	7	Deutsche Bank AG	25.7	6.7%
8	Lehman Brothers	50.5	4.6%	8	Merrill Lynch	21.1	5.5%
9	Wachovia Corp	49.5	4.5%	9	Morgan Stanley	17.4	4.5%
10	Morgan Stanley	34.5	3.2%	10	UBS	12.7	3.3%

Note: League tables as of December 31, 2007 as tracked by Thompson Financial. Deal volume is divided equally to all bookrunners in deal.

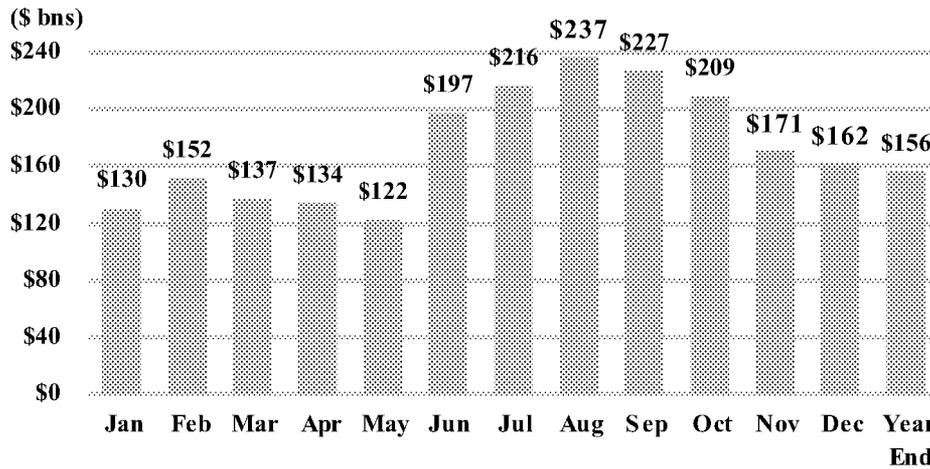
(1) Totals assumes full deal credit for all Bookrunner managed deals

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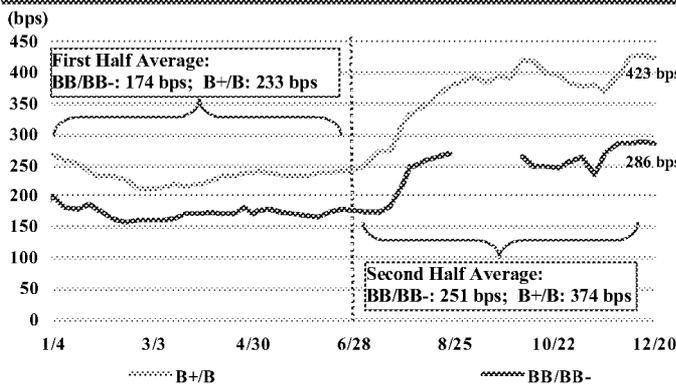
Introduction – Year-End Review

2007 was not another routine year for the leveraged loan market. A swift and severe correction occurred and is far from over going into 2008. There was no question that the market at the end of 2006 and in early 2007 was cruising at an unsustainable pace, with a rapidly growing new-issue forward calendar – though what would derail it, when, and how severe the correction would be, was still up for debate. The housing crisis had established itself by 2007 as a worthy threat to trigger a market meltdown. The loan market shuddered in late February as the China sell-off and mounting housing fears combined to send the broader markets tumbling. However, it wasn't until June, once the forward calendar had swelled to a massive \$210 billion and the news that two hedge funds were forced to the brink of collapse due to subprime losses, that the market careened off-course. The news prompted a vicious backlash on leveraged loans by way of drying up demand from the long-time buoy of the loan market, the CLOs. Volatility was rampant throughout the second-half as the market struggled to find consistent sources of demand. Heading into 2008, the market tone continues to be cautious and tentative as the remaining forward calendar pushes into the new year.

Institutional Forward Calendar

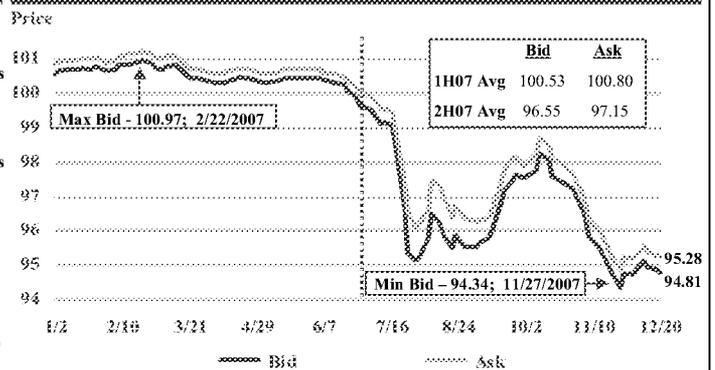


Average All-in Institutional New-Issue Spreads



Source: Standard & Poor's LCD
 Notes: 1) New-issue spread represents a 4-week rolling average
 2) All-in spread includes OID assuming a 3-year average life

Average Secondary Bid/Ask for S&P Flow Names

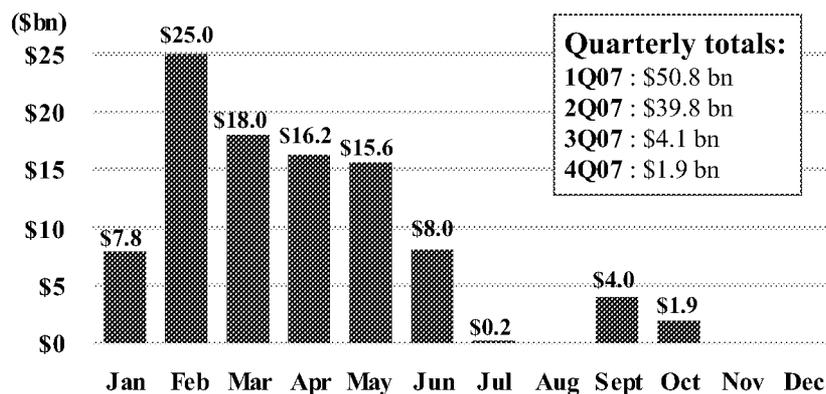


Year-End Recap

First Quarter

The year began with an explosion of new-issue, a single-quarter record of \$186 billion, besting the previous quarter's short-lived record of \$148 billion. This surge of volume was met by enthusiastic demand. The eagerness for paper was continued from the tail-end of 2006 when inflows into traditional accounts exceeded new-issue supply by \$11.8 billion in December. Much of the first quarter was characterized by accounts' desperate need for paper. This demand spurred record covenant-lite volume, razor thin spreads and an onslaught of repricings. The issuer-friendly market gained momentum in the face of the heavy supply thanks to healthy CLO issuance, crossover investments from high yield accounts and hedge funds. A wave of repricings swept across the market as spreads narrowed to historical lows. The BB/BB- institutional spread average as tracked by LCD tightened to L+157 in February, marking a new low from the previous record of L+161 in April of 2006. Similarly, the B/B+ institutional spread average reached an all-time low at L+214 in February from L+269 at year-end. The repricing phenomenon encompassed a whopping 26% of the institutional outstandings during the first quarter. A total of 100 issuers were able to cut spreads. This represented price-cutting on \$104 billion of institutional paper, eclipsing the \$28 billion from the same period last year. As the issuer-friendly environment progressed, the repricing fever lead way to a restructuring one – where a number of deals sought to strip maintenance covenants in vogue with the many new-issues which were clearing without covenants. Covenant-lite volume during the first quarter soared to \$51 billion, boosted by the two largest covenant lite loans on record – the \$7.6 billion deal for Freeport McMoran and the \$7.5 billion loan for Univision. This one-quarter total topped not only 2006's entire covenant lite issuance, it exceeded the last 10 years combined (\$27 billion). This issuance drove the share of covenant lite loans to 35% of overall institutional volume. However, by the tail-end of the quarter, the first signs of softening appeared as the secondary market began to slip with large allocations weighing heavily on prices. By late March, market conditions had become somewhat more challenging for issuers. Repricing faced mounting pushback and a number of covenant lite deals had difficulty clearing the market.

2007 Monthly Covenant-lite Issuance



Source: Standard & Poor's LCD

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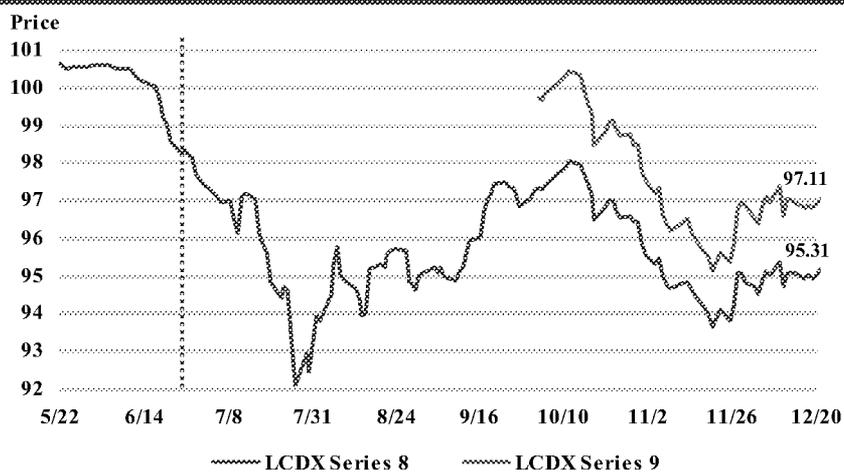
Second Quarter

In terms of volume, it was the same story, different quarter – April through June was another record breaking quarter, bringing \$188 billion of new-issue and edging out the brief record from the first quarter. What was very different however, was market tone. All-in-all, volume was largely driven by M&A activity. Acquisition-related loans jumped to a record \$106 billion during the second quarter, up from \$95 billion during the first quarter. This brought year-to-date M&A activity to \$201 billion, up from \$133 billion in the first six months of 2006. Dividend-related loans totaled \$21 billion in 2Q07, up from \$16 billion during 2Q06. This brought the first half total dividend-related volume up to \$47 billion compared to \$35 billion during the same period in 2006. Covenant-lite volume during the quarter reached \$40 billion, bringing the first-half total to \$91 billion, up 27% from \$24 billion in 2006.

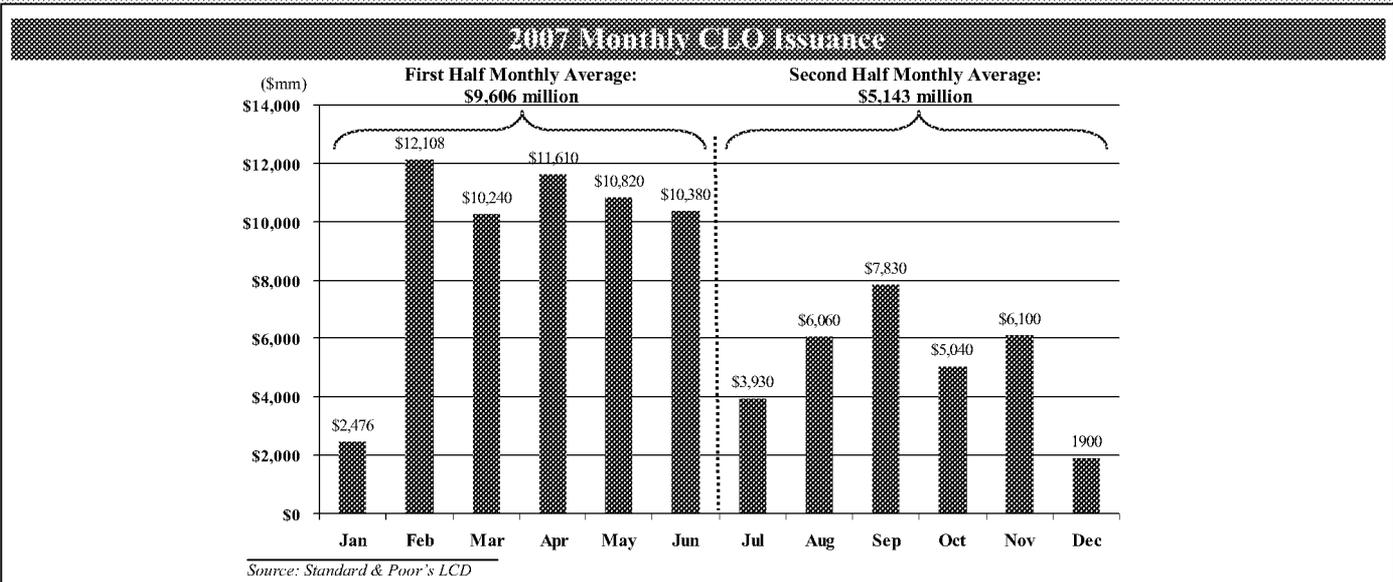
Much of the volume reflected the issuer-friendly conditions, however, undercurrents of unrest had begun to brew. During the busiest quarter in history for new-issue, concerns mounted around the subprime meltdown and a dark cloud gathered over covenant-lite loans and other aggressive structures. The ratings agencies expressed concerns around the issue, including S&P with their report “The Covenant Lite Juggernaut is Raising CLO Risks - And Standard & Poor's is Responding” released in mid-June. This report was largely in response to mounting concern that loan ratings were not adequately differentiating between covenant-lite loans and those with meaningful covenants. As a result of the report, CLO managers were bombarded with inquiry on how they were mitigating the risks of covenant lite loans, second-lien paper and highly levered loans. That said, the CLO machine was in full force throughout the second quarter. CLO issuance totaled \$32.8 billion in the second quarter, up from \$24.8 billion in the first quarter according to S&P LCD. However, CLO demand was noticeably more fragile at the end of the first half, and the late-June collapse of two Bear Stearns hedge funds magnified this sentiment. With the key driver of leveraged loan demand in question, conditions were set for a turning of the tide going into the second half of 2007.

Another major story in the second quarter was the debut of the LCDX Index. The LCDX is comprised 100 equally weighted single-name credit default swaps referencing first lien loans. Similar to HY CDX the LCDX index trades on a price basis with a fixed coupon (initially 120 bps). The LCDX launched on May 22 and traded vigorously. The index allowed investors for the first time to access leverage loans on an unfunded basis, as well as the ability to hedge loan portfolios. This product along with LCDS contributed to the market volatility in late June as they allowed investors to exercise a negative view on individual credits and the market.

LCDX Indices

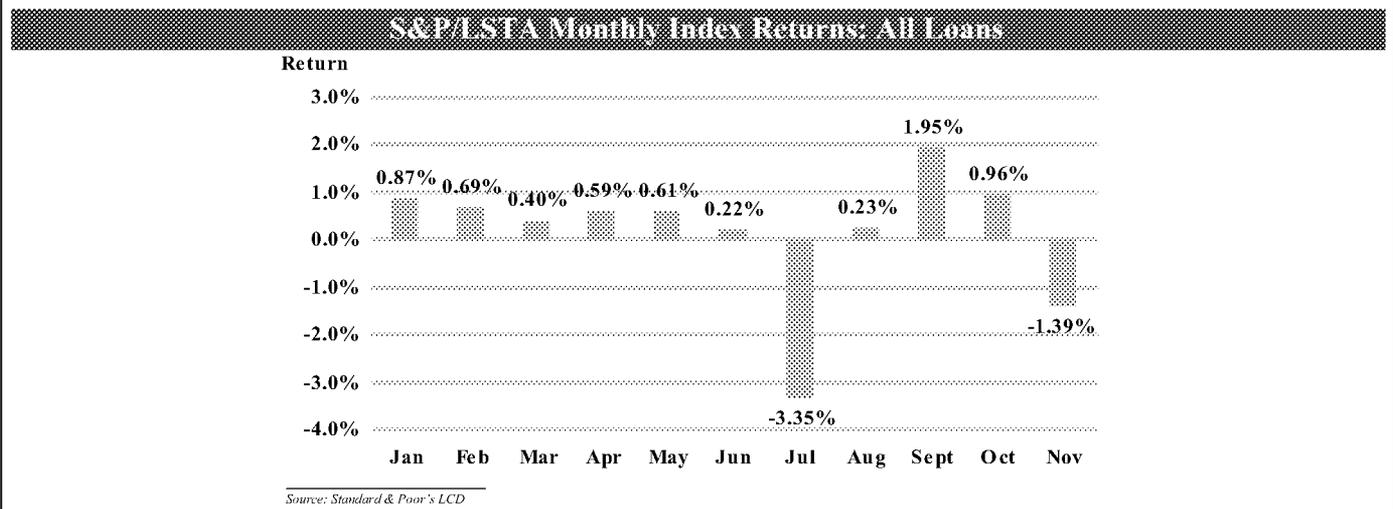


Year-End Recap



Third Quarter

The second half was truly a different story than the first, on all accounts. The subprime collapse sent the vulnerable loan market into a tailspin and the underwriters of the largest forward calendar in history were caught wearing the risk. In response to the dried up demand, new-issue slowed to a trickle in the third quarter. Leveraged loan volume plummeted to \$84 billion, from a record \$188 billion during the previous quarter, representing a 53% decline – the largest quarter-over-quarter decline since LCD started tracking volume in 1997. The CLO activity that had driven exponential growth in the loan market over the last several years, all but halted in July. Underwrites ceased creating new warehouses while rumors of warehouses unwinding pervaded the market. When this demand meltdown combined with the largest forward loan pipeline in history, a whopping \$237 billion as of August 1st, loan prices plummeted. The average secondary bid of LCD flow-names dropped 455 basis points in July, falling to 95.13% of par - the lowest reading on record, at that time. Meanwhile, the S&P/LSTA Leveraged Loan Index suffered a 3.35% decline, bringing the year-to-date return to negative 0.03%, virtually erasing all of the first-half gains. This marked the single worst month for loans on record, eclipsing the next largest setback of 1.54% from October 2001. Covenant-lite loans bore the brunt of the backlash and were the worst performing category over the year, returning negative 1.62% in the first seven months of 2007.

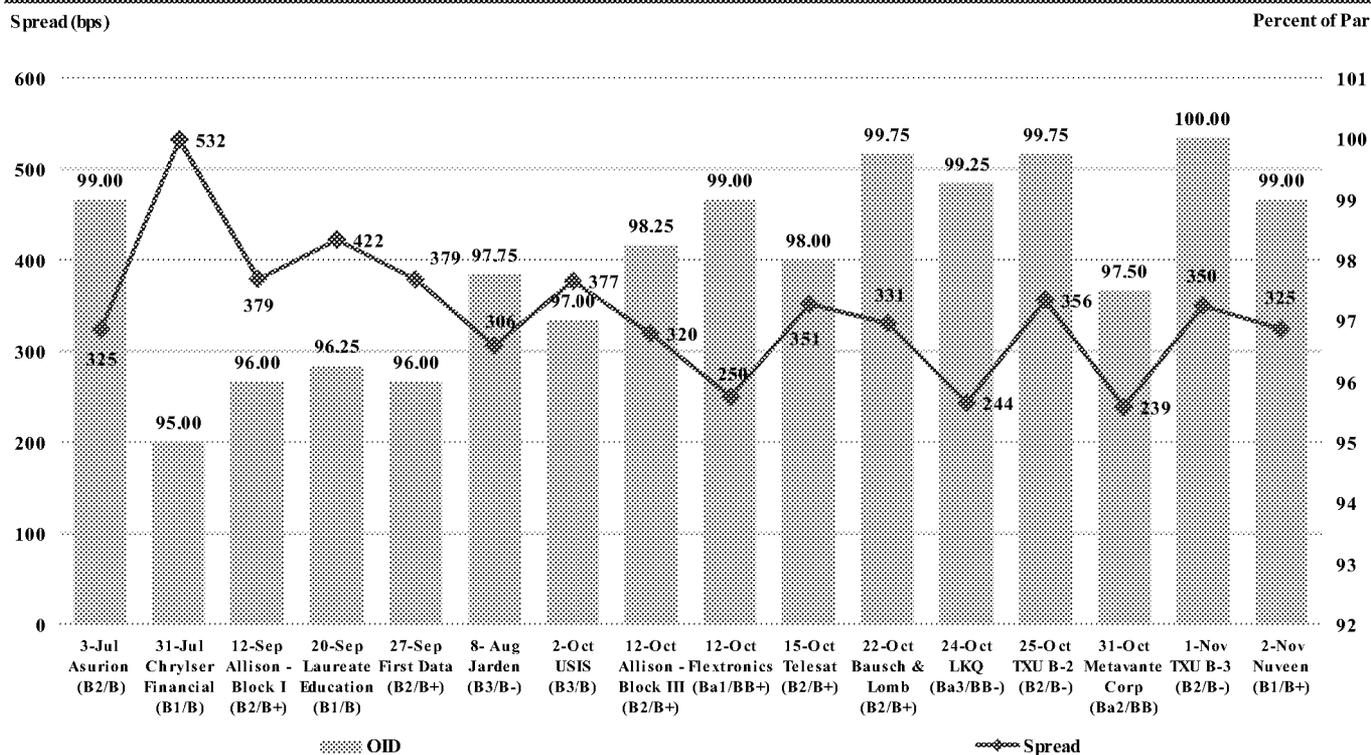


Year-End Recap

In the midst of a market meltdown, arrangers provided the much needed stability – facing funded bridge loans and a slew of commitments already locked up, arrangers sent a clear message to the market by: slowing new-issue launches to a trickle; holding on to paper; and supporting their credits. Arrangers systematically released deals when market windows appeared. With this attitude, the market was able to recover somewhat in the September, as broader markets picked up and the Fed cut interest rates. At the same time, investment banks were reporting milder-than-expected losses, easing concerns that investment banks might panic-sell prior to their November 30 fiscal year ends.

This strategy was reinforced by several syndication success stories post-Labor Day including Allison, First Data and TXU helping to lift market sentiment. The pipeline had whittled down to \$190 billion thanks to several large deals falling away altogether, some restructuring to pro rata heavy structures and others found support from all corners of the loan market. With all eyes on First Data to guide market sentiment going into the fourth quarter, the deal's success brought much hope to the post-Labor Day loan market. The deal's goal of moving \$5 billion of paper (modest compared to the first half, but met with considerable doubt at the time) was thrust ahead after catching the draft of positive momentum sweeping through the market. Most of all, a new source of demand had picked up unexpectedly, catapulting the deal. Crossover investors – primarily high yield investors, dislocation funds and hedge funds – surprised the market with their appetite for new-issue loans. These relative-value players dove into the market looking to put money to work in large, liquid leveraged loans as the high-yield components of these bellwether deals (Allison and FDC) were still on the shelf. Both deals sported hefty OID, making them all the more appealing. These successes opened a market window for new-issue as demand ramped up on the back of positive news.

All-in Spread and OID for Recent Deals



Year-End Recap

Fourth Quarter

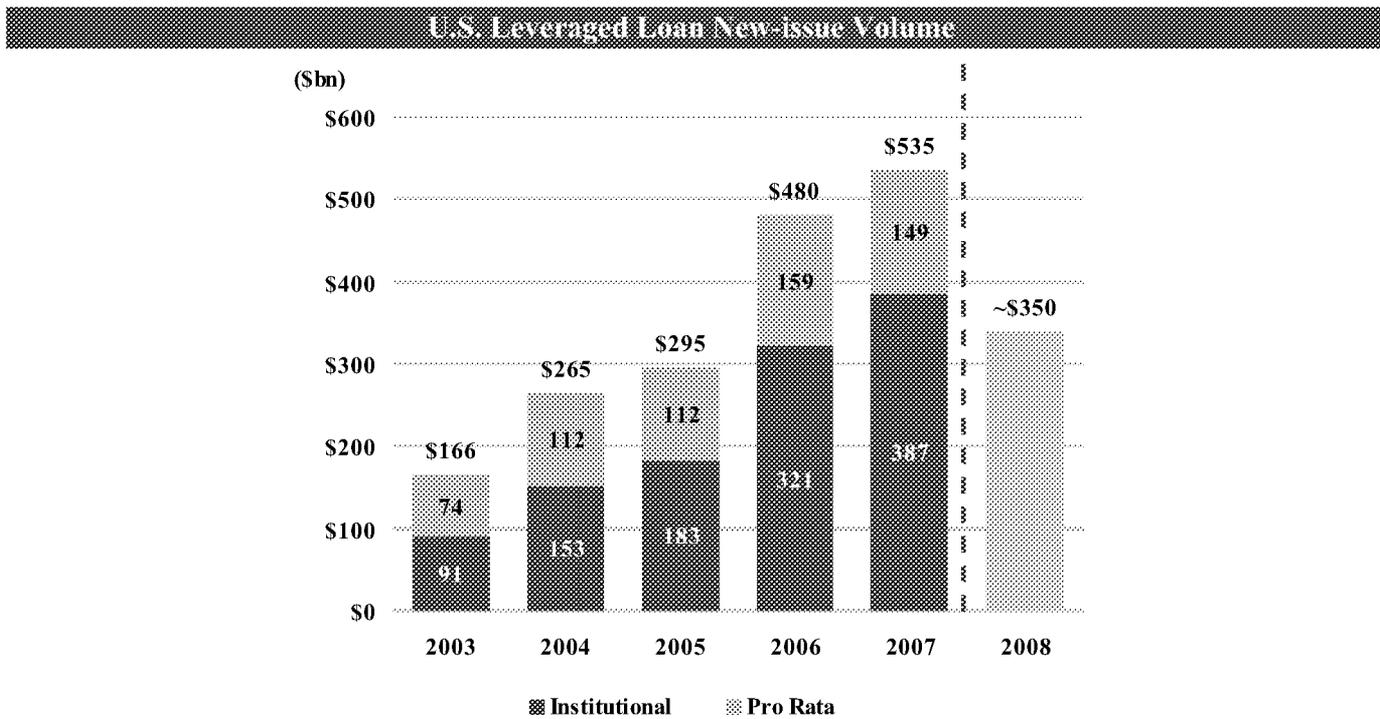
But as market windows open, so do they shut. With everyone waiting for the same window, the result is an inevitable pile-up of deals trying to squeeze through at the same time. October was the beginning of a traffic jam, with TXU and Nuveen prepped to take the stage in October along with a surfeit of other transactions. The two large deals were able to draft off the success of First Data and Allison as hoped, but the ensuing rush of deals to market proved too much to bear. This is especially true given the toxic combination of market trends and news reports that hit the market simultaneously with the onslaught of new-issue. The much anticipated TXU loan launched in mid-October at the slight discount of 99.5 (however, with a wider spread than anticipated), taking advantage of the positive swing in the market. Much like First Data the deal was able to push through more than was initially offered while slashing OID by 25 basis points. This marked the peak of the post-Labor day market rally.

There were a number of forces combined to derail any momentum the loan market had gathered. A major confidence breaker was the series of announcements of massive write-downs from a number of investment firms, including Merrill Lynch's \$8.4 billion reported on October 24 and Citigroup's initial \$6.5 billion reported on October 15 followed by an announcement of an additional \$8-11 billion three weeks later. The hits kept coming and have fueled concerns over potential further losses in the financial sector ultimately pushing down the broader market. The secondary loan market suffered under the weight of these announcements as well, with the average LCD flowname bid falling to 94.74% or par by the end of November, down from a two-month high of 98.24 on October 16. The plummeting secondary deflated the new-issue market that had finally caught a head of steam. Many investors that participated heavily in the recent bellwether deals, driving the post-labor day rally, have now pulled back in the face of falling secondary prices. These investors were largely relative-value players such as crossover high yield investors and dislocation funds. This opportunistic investor base brings greater volatility to the market compared to the buy-and-hold CLOs that are currently sidelined. The Federal Reserve's actions on October 31 did little to inspire confidence as the 25 basis point reduction just met predictions and harsh language around inflation and economic growth drove markets lower. The Fed's move on December 11 disappointed the market, with only a 25 basis point reduction versus an expected 50 bps. A bleak macroeconomic picture, mounting writedowns and weak earnings reports weighed heavily on the loan market and all but slammed shut the brief market window with scores of issuers still wriggling to get through.

This leaves much of the \$156.5 billion forward pipeline to clear in 2008. Loan volume for the fourth quarter was \$78 billion, marking a two-year low and down 47% from the same period in 2006. Opportunistic trades were hit the hardest, which was no surprise given the details above, with dividend related deals down to a scant \$1.3 billion (down from a quarterly average of \$16 billion in 2007), refinancing fell to \$7 billion (down from a quarterly average of \$35 billion) and finally repricing activity grinded to a halt. It was a tough end to the year for loan returns with November's 1.39% loss⁽¹⁾. In the end, loans posted a 2.02% return in 2007 after two distinct halves – the first half which returned 3.43% and the second half where returns fell to negative 1.36%.

(1) According to the S&P/LSTA Leveraged Loan Index

Conclusion & Outlook



The new-issue loan market has transformed from a revolving door in January to a veritable gauntlet by year-end. With continuing concerns about the credit markets and a substantial forward calendar heading into the new year, expectations are that this challenging environment will continue well into 2008. The following expectations and trends are noteworthy heading into 2008:

Supply:

- After record supply of more than \$535 billion in 2007, we believe that issuance should be closer to \$350 billion, buoyed by the remaining \$156 billion in the pipeline. For context, this would leave issuance levels above the \$295 billion in 2005, but well below the 2006 level of \$480 billion.
- LBO activity is expected to decline in 2008. Given the higher cost of debt and lower attainable leverage levels, sponsors are now looking at much lower multiples to achieve targeted returns. However, the average purchase price multiple has only declined by half a turn.
- Strategic buyers are likely to drive M&A activity as LBOs face greater difficulty meeting economic hurdles.
- Opportunistic refinancing will be reduced as a result of much higher market yields, however, a natural level of refinancing will occur to deal with maturities, IPO related refinancings and acquisitions.

Year-End Recap

Demand:

- Market capacity for large transactions is constrained because of limited CLO issuance. Reduced demand for CLO liabilities (particularly in the AAA tranches) has deprived the loan market of growth from its largest investor class. Instead of CLOs, the new loan market will rely on recently established “credit opportunity” funds, hedge funds and banks returning to prominence (with a subsequent increase in pro rata tranches). The new, largely opportunistic investor base brings greater volatility to the market compared to the buy-and-hold CLOs.
- Despite the sidelined CLOs, most players have stuck with the loan market and with the increase in opportunistic participants the total of active institutional accounts increased in 2007, reaching 307 from 254 a year ago. If the CLO problem persists, some managers will be forced to exit in 2008, while others consolidate. These departures should be balanced by a number of relative-value players entering the market to take advantage of today’s wider spreads.
- LCDS and LCDX volumes soared in 2007 – a trend that is expected to continue in 2008 as the indices give investors for the first time the opportunity to short paper and hedge the market. The products are more transparent and liquid than the cash loan market giving accounts the ability to enter and exit the asset class with greater ease – resulting in greater volatility in recent months. With no accurate measure for the price of risk in the loan market historically, we expect the LCDX to continue to serve as a key indicator of market sentiment.

Credit Fundamentals:

- Given how aggressively the latest generation of LBO's are leveraged, default rates are expected to rise materially over the next 12 to 18 months. This will likely have the effect of constraining leverage levels from returning to the pre-market correction levels.
- Because of loans’ senior position in the capital structure and traditionally higher recovery rates, we believe there will still be demand for the loan asset class in the event of a credit cycle downturn.

New-issue:

- The underwriting community is still undergoing a healing process having incurred significant losses in the latest generation of LBO's. The willingness to commit will be tempered by this and the near term results will likely be lower commitment levels, wider caps and lower leverage
- New-issue timing will be driven largely by market windows as arrangers wait to take advantage of any rallies
- While the market has stepped up in size for transactions such as Chrysler Financial, First Data and TXU – demand will require yields of L + 350 - 450 to continue to attract the non-traditional buyers who have populated these books (a fluid benchmark given the volatile secondary). The 9% yield for the senior most part of the capital structure may be a constraint on new deals being committed.

For the detailed 2008 outlook please see Lehman Brothers’ Fixed Income Research – U.S. Credit Strategy Publication – “*When Will Liquidity Return*”/ *Leveraged Loans and CLOs*.

Source: Standard & Poor's LCD and Prospect News Daily

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