

FINAL TRANSCRIPT

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LEH - Q3 2008 Preliminary Lehman Brothers Holdings Inc. Earnings Conference Call

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PRESENTATION

Operator

Good morning and welcome to Lehman Brothers investor conference call. At this time all participants are in a listen-only mode. [Operator Instructions]. Today's call is being recorded, and if you have any objections you may disconnect at this time.

I would now like to turn the call over to Ms. Shaun Butler, Director of Investor Relations. Ms. Butler, you may begin.

Shaun Butler - *Lehman Brothers - IR Director*

Thank you for joining us this morning. Before we begin, let me point out that this presentation contains forward-looking statements. These statements are not guarantees of future performance. They only represent the firm's current expectations, estimates and projections regarding future events.

The firm's actual results and financial condition may differ, perhaps materially, from the anticipated results and financial condition in any such forward-looking statements. These forward-looking statements are inherently subject to significant business, economic and competitive uncertainties and contingencies, many of which are difficult to predict and beyond our control.

For more information concerning the risks and other factors that could affect the firm's future results and financial condition, see risk factors and management's discussion and analysis of financial condition and results of operation in the firm's most recent annual report on Form 10-K and the most recent quarterly report on Form 10-Q as filed with the SEC. The firm's financial

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statements for the third fiscal quarter of 2008 are not finalized until they have filed in its quarterly report on Form 10-Q for the third fiscal quarter of 2008.

The firm is required to consider all available information through the finalization of its financial statements, and the possible impact on its financial condition and results of operations for the reporting period, including the impact of such information on the complex and subjective judgments that will be discussed on today's call, as well as estimates the firm made in preparing certain of the preliminary information included in these remarks. Subsequent information or events may lead to material differences between the preliminary results of operations described in these remarks, and the results of operations that will be described in the firm's subsequent earnings release, and between such subsequent earnings release and results of operations described in the firm's quarterly report on Form 10-Q for the third fiscal quarter of 2008.

Those differences may be adverse. Listeners to these remarks should consider this possibility. This presentation contains certain non-GAAP financial measures relating to these financial -- information relating to these financial measures can be found in the morning's preliminary earnings press release which has been posted on the firm's website, www.Lehman.com and filed with the SEC in a Form 8-K available at www.SEC.gov.

At the end of the call we will open the session to Q&A, and Bart McDade will be joining us for that portion of the call. I will now turn the call over to Dick Fuld.

Dick Fuld - *Lehman Brothers - Chairman, CEO*

Shaun, thank you. I want to thank all of you for joining us today on what's clearly short notice.

In light of these last two days, this morning we pre-released our quarterly results. We are also announcing several important financial and operating changes that amount to a significant repositioning of the firm, including aggressively reducing our exposure to both commercial real estate and residential real estate assets.

These will accomplish a substantial de-risking of our balance sheet and reinforce the emphasis on our client-focused businesses. They are also meant to mitigate the potential for future write-downs, and to allow the firm to return to profitability and strengthen our ability to earn appropriate risk-unadjusted equity returns.

I will discuss the strategic actions we are taking to restructure and reposition the firm, and then the rationale for each. After my comments, Ian will discuss the mechanics of the various transactions, our results for the quarter, our remaining asset exposures at the quarter end, and pro forma for today's announcements and our current capital and liquidity positions.

This quarter's loss was mostly due to the sales and write-downs of our residential and commercial real estate assets (technical difficulty) extent, a slower business environment. Since the second quarter, there was a significant additional deterioration in the credit markets, and with a disproportionate impact on the legacy asset classes where we had remaining exposures.

In addition, part of the move to more quickly exit the real estate positions further added to the losses. As you know over the past few quarters our plan was to protect our shareholders, our capital and our franchise by maintaining strong liquidity and exiting our real estate exposures in a measured way over time.

Losses created by these concentrated legacy assets have clouded the underlying value of our franchise. In addition, there's been intense public scrutiny which caused us significant distractions among our clients, our counterparties, and also our employees.

When you look at our segment performance, investment banking, fixed income and equities and IMD, our market share and how we are winning mandates, you'll see that our client relationships remain strong. Now, I spent a great deal of time in this

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quarter with our clients, our creditors and our employees. And while they continue to stand with us, we nevertheless cannot put the strength of our franchise and their continued trust at risk.

The set of decisions announced today will best protect the core client franchise, and create a very clean, liquid balance sheet. So today we are taking a number of necessary actions. Here's the summary.

We put a concrete plan in place to exit the vast majority of our commercial real estate. We are reducing our residential and leveraged loan exposures down to appropriate operating levels.

We are in the final stages of raising capital with sale of a majority stake in IMD. Strengthening our capital base -- excuse me -- as we strengthened our capital base in June, protected our liquidity and are cutting our dividend.

We reshaped our human capital and product depth, expense base to these changing markets. Lastly, we implemented a series of management changes, some of which you saw in the last couple of days. Taken together, these actions have quickly de-risked and resized the firm. Let me just go through each in more detail.

Today we announced a plan to separate a vast majority of our commercial real estate assets from our core business by spinning off those assets to our shareholders and to an independent, publicly-traded entity which will be adequately capitalized. The spinoff improves our balance sheet while preserving value for our shareholders. The spinoff entity will be able to manage its assets for economic value maximization over a longer time horizon, given the fact that it will not be a marked-to-market entity but rather use held-to-maturity accounting.

This will preserve economic value for our shareholders. We also significantly reduced the residential mortgage and acquisition finance exposures. In addition to the selldown of residential over the course of this quarter, we are finalizing with BlackRock a bulk sale of our UK residential assets (technical difficulty) sale within the next few weeks.

This will bring our total residential exposure down by approximately half since the second quarter. These remaining residential assets have been significantly marked down, and are now at levels that imply a default and cumulative loss rates well above the fundamental expectations. Ian will provide further transparency here, including detail on how we are marking the remaining positions.

Next, let me talk about our investment management division. (technical difficulty) more thorough review of this business and reached out to third parties to validate the value proposition that we've been building. While IMD continues to have a strategic connection to some of our other businesses, and adds diversification value to our earnings, we believe that we can capture capital benefits of a partial monetization while also continuing to build value through a series of commercial partnering agreements.

We are in the final stages of selling a majority stake in our IMD business. We've been running a process with selected strategic and financial investors, and we expect to reach a definitive agreement on a transaction that appropriately values this attractive asset and maintains a strategic relationship.

This will serve two primary purposes -- one, raise tangible equity capital for the firm on a cost-efficient basis; and two, maintain strategic ties to the business through commercial arrangements and a large minority stake which will continue to give us a significant amount of IMD's earnings into our income. Next, we are cutting our annual dividend to \$0.05 per share to preserve capital, given the near-term operating environment.

We ended the quarter with more tangible equity than we started, and at a net leverage ratio of 10.6 versus 12.1 at the end of the second quarter. We'll think about future capital by looking at the total equity capital raised from IMD, and by ensuring the core Lehman Brothers after the commercial real estate spinoff has proper tangible capital to support our client franchise.

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Taking all this together, the spinoff of our commercial real estate assets, the significant reduction in our residential and acquisition finance exposure, monetization of a majority stake in IMD, dividend cut, we will have what we believe to be a strong and clean balance sheet which will allow us to focus on supporting our core client businesses. In addition to all of this, we remain committed to examining all strategic alternatives to maximize shareholder value.

This firm has a history of facing adversity and delivering. We have a long track record of pulling together when times are tough and then taking advantage of global opportunities.

I believe as a firm we've made (technical difficulty) choices and we've put the changes in place. We are on the right track to put these last two quarters behind us.

We will not be distracted from our (technical difficulty) which is protecting and building our client franchise. Today's strategic actions, each of which is significant in its own right, taken together as a whole significantly reduces our remaining risk and greatly improves our ability to create value for our shareholders.

So I want to thank our clients, thank our counterparties for their tremendous support during this period. Today we've taken definitive steps and have put in place a credible plan. Ian, let me turn it over to you now.

Ian Lowitt - *Lehman Brothers - CFO*

Thanks, Dick. During the past quarter we experienced significant market pressure and scrutiny around our legacy residential and commercial real estate assets, and more recently, speculation around our various strategic alternatives. In the last two trading days, this speculation has intensified such that it became prudent to release our results and clarify our restructuring plan early, recognizing the need to move quickly and decisively to resolve the overhang on our business.

Importantly, as we will discuss today, we ended the third quarter with a capital position and leverage ratios stronger than the second quarter. Total shareholder equity increased 8% to \$28 billion; we reduced net leverage to 10.6 times from 12.1 times, and our Tier 1 capital ratio is estimated at approximately 11% versus 10.7% last quarter.

Today, I shall walk you through our restructuring around commercial real estate, residential mortgages, other asset exposures, and our investment management division. And then I will review our results for the quarter along with our current liquidity and our operating model going forward.

I will start with our commercial real estate initiatives. We face specific concerns with respect to our commercial real estate exposure, which as you know is comprised of a large diversified portfolio of individually underwritten assets.

As of the close of the third quarter, our commercial mortgage and real estate held-for-sale positions totaled \$32.6 billion, down 18% from the \$39.8 billion at the end of the second quarter. We have successfully sold down a significant amount of these assets over the past few quarters. In order for us to realize fair value, buyers require lengthy asset-specific diligence on each position.

Despite our success in reducing assets over the past few quarters, the current strategy does not accomplish the disposition of assets quickly enough. To accomplish the goals of rapidly separating us from the legacy commercial assets and enabling our shareholders to retain the value of this portfolio, we will be spinning off the commercial real estate portfolio from our remaining business through the formation of Real Estate Investments Global or REI Global.

We expect to spin REI Global to our existing shareholders as an independently managed and traded public company in the first quarter of 2009. This transaction will separate core Lehman Brothers from these legacy assets, and importantly it will enable

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shareholders to retain upside in this high quality asset portfolio, where the assets will be held to maturity or sold over time in a disciplined manner to optimize value.

Moving on to execution, approximately \$25 billion to \$30 billion of commercial assets are expected to be transferred into REI Global. The exact amount of assets transferred will be determined after taking into account activity in this portfolio until the spinoff is completed. We expect continued paydown and some additional dispositions over this period.

Pro forma for the transaction, our remaining commercial mortgage and real estate held for sale positions in core Lehman are expected to be approximately \$5 billion. The portfolio we expect to contribute to REI Global is highly diversified across regions and asset types. By value, approximately 57% are in the Americas, 26% in Europe, and 17% in Asia. Approximately 58% are debt positions, 26% are equity positions, and 16% are securities.

No property type represents more than 22% of the portfolio, with multifamily at 22%, and office at 18%. And lastly, we also intend to include our SunCal and Archstone positions in this portfolio. This portfolio is currently marked at a weighted average price of 85.

All assets will be transferred to REI Global and are carrying values as of the time of the spin. Our commercial mortgage positions are carried at marked to market, reflecting all current market pricing information for each asset.

The real estate held-for-sale portfolio, consisting of assets across the capital structure, is booked at lower of cost or market as we take write-downs on this book, but do not reflect market value gains until a sale event occurs. REI Global will account for its assets on a held-to-maturity basis and will be able to manage the assets without the pressure of marked to market volatility. REI Global will not be forced to sell assets below what it believes to be their intrinsic value.

In terms of capitalizing REI Global, Lehman Brothers will contribute equity equal to 20% to 25% of asset value and provide debt financing for the 75% to 80% of the total. So it will be capitalized at approximately three to four times debt to book equity, which is consistent with other publicly traded real estate entities.

The firm will spin its entire equity interest in REI Global to Lehman shareholders. Debt financing provided by Lehman Brothers will be liquidity-neutral to Lehman as we currently fund these assets with long-term capital. To the extent we syndicate a portion of the debt, this will have a positive impact on our liquidity.

In aggregate, this pool of assets generates significant cash flow. When combined with the normal course of asset sale activity, these cash flows will be dedicated to paying down debt, managing the assets, and returning cash to REI Global shareholders over time. Based on the expected assets to be contributed to REI Global, the portfolio is projected to generate cash flow through interest income, paydowns, debt repayment, equity distributions, and asset sales.

We estimate cash flow for debt paydown of approximately \$5 billion per year over the next three years. We expect rapid debt paydown at REI Global, with debt to total assets decreasing from 75% to 80%, to approximately 50% within four years. Initially, REI Global expects to pay a modest annual dividend, but once leverage reaches a certain threshold, cash flows may allow for additional distributions to equity.

We have conducted extensive stress tests on the portfolio, and are confident that REI Global has sufficient equity even in severely stressed scenarios. For our stress test, we identified two year time periods from 1990 to 2006 with the largest decline in property values for each property type in every geographic market where REI Global will own material commercial real estate assets, and applied these declines to our current portfolio.

We believe these stress tests are conservative for several reasons. First, we are applying price declines to already marked down positions, and applying worst-case scenarios for all regions and property types simultaneously.

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Second, we assume we sell our assets at the low point of the stress scenario. And finally, our sample timeframe includes periods of severe commercial real estate stress when there were significantly greater oversupply than the current environment.

We applied the stress test before any deleveraging of the portfolio which, given the expected cash flows, should be deleveraging quite rapidly. Even under this extreme stress test, REI Global will be adequately capitalized and is not expected to result in impairment to the debt.

Following the spinoff, our shareholders will hold shares of both Lehman Brothers and REI Global. Importantly, these actions will enable our shareholders to benefit from the intrinsic value of our commercial real estate portfolio.

As part of an independent company without the need to mark to market, assets may be monetized in an orderly manner over time, with more negotiating leverage and at prices which maximize returns. We've resolved all material execution obstacles and are highly confident that we can complete this transaction in the first quarter of 2009.

Moving onto our efforts on the residential front, during the quarter we moved quickly to bring our residential mortgage exposures down significantly, from \$24.9 billion in the second quarter, to \$13.2 billion, a reduction of 47%. This includes a reduction of approximately \$4 billion in UK residential assets that we are formally engaged with BlackRock to sell.

Please note that since the BlackRock transaction will be completed after the close of the third quarter, it will be reflected in our fourth-quarter numbers. Excluding these sales, our residential mortgage position as of the third quarter was \$17.2 billion, a 31% reduction versus last quarter.

After these dispositions, our residential mortgage inventory will be \$13.2 billion, of which approximately 32% of the assets are in less-risky asset classes, including \$1.6 billion of Alt-A servicing rights, and \$600 million of Alt-A AAA I/O securities, both of which have negative correlations to deteriorating markets; and \$600 million of reverse mortgages that have an LTV of approximately 39%, \$500 million in Asia, and approximately \$900 million of assets across the US portfolio in vintages 2005 and earlier.

The rest of the assets – and this includes the \$900 million of the 2005 and earlier vintages – are as follows. \$3.7 billion of additional Alt-A exposure, marked at an average of 39 versus 63 last quarter; \$1.6 billion of subprime and second-lien exposure, marked at an average of 34 versus 55 last quarter; \$3.6 billion of European exposure, marked at an average of 69 versus 83 last quarter; \$500 million of remaining ABS CDO assets, marked at an average of 29 versus 35 last quarter; and \$500 million of additional other US exposure which is marked at an average of 45 versus 48 last quarter. Overall, the US residential book had a weighted average price of 59 at the beginning of the third quarter, and now has a weighted average price of 39, a decline of 20 points.

During the quarter we traded significant US residential assets, with sales of \$5.5 billion and purchases of \$3.2 billion, for total trading activity of \$8.7 billion. This market activity gives us confidence in the accuracy of our marks as of the third quarter.

We'd like to note that we believe current market prices reflect an exceptionally conservative valuation outlook for the US residential market. At current prices, our US residential portfolio generates a 12% yield or approximately LIBOR plus 800 if approximately 50% of the loans default and average recovery rates are only 40%.

This base case assumes national home prices drop 32% peak to trough, versus 18% to date, with California down 50% versus 27% to date. For a 0% yield and only principal repayment, over 80% of the borrowers would need to default with an average 35% recovery rate.

In our Alt-A portfolio, the assets would generate a yield of LIBOR plus 1000, with 44% defaults, LIBOR plus 100 with 63% defaults, and a 0% yield at 79% of defaults, each with a 40% to 45% recovery rate. The current 60-day delinquency rate including real

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estate owned is 18% on this portfolio. So defaults would need to be 2.5 times the current delinquency rates for the LIBOR plus 1000 case, 3.6 times for the LIBOR plus 100 case, and 4.5 times for the 0% yield case.

In our nonprime portfolio, the assets would generate a yield of LIBOR plus 1100 with 59% defaults, LIBOR plus 100 with 76% defaults, and a 0% yield at 85% defaults, each with a 20% to 30% recovery rate assumption. The current 60-plus day delinquency rates including real estate owned is 23% on this portfolio, so defaults would need to be 2.5 times the current delinquency rates for the LIBOR plus 1100 case, 3.2 times for the LIBOR plus 100 case, and 3.7 for the 0% yield case. So current prices imply extremely severe additional deterioration in housing.

Our pro forma remaining \$13.2 billion of residential assets are diversified across product type and region, with about 32% of the exposure in servicing AAA I/O's, reverse mortgages, Asian exposure, and 2005 and earlier vintages. We plan to reduce this position somewhat over the coming quarters, maintaining a balance sheet necessary to support the market-making opportunities. Bid/ask spreads continue to be attractive, with multiple distinct business opportunities across secondary and distressed trading, servicing and NPL management, as well as client advisory.

Regarding other exposures, our other asset-backed positions were reduced by 29%, from \$6.5 billion to \$4.6 billion during the quarter, and we reduced our acquisition finance exposure by 42%, from \$18 billion to \$10.4 billion, which includes a 38% decline in our high yield acquisition finance exposures from \$11.5 billion to \$7.1 billion.

Pro forma for the BlackRock sale and commercial real estate spinoff, our aggregate exposure to residential and commercial mortgage assets, other asset-backed and acquisition finance will be reduced from \$89 billion at the end of the second quarter, to approximately \$30 billion to \$35 billion; so very significant progress in moving the legacy assets and creating a clean balance sheet for core Lehman going forward.

Turning to the investment management division, today we announced our intent to sell a majority stake of a subset of our investment management business. The subset includes our asset management, private equity and wealth management businesses, but excludes our middle-market institutional business which will be folded into capital markets, and our minority stakes in third-party hedge fund managers. This transaction has attractive capital and operating characteristics.

On the capital front, we will be receiving significant proceeds at closing. Additionally, goodwill on our books related to the Neuberger business will be eliminated, resulting in an estimated increase of over \$3 billion in our tangible book value and Tier 1 capital.

Following the transaction closing, IMD's operating results will not be consolidated. Given that we will be retaining a meaningful interest in a subset of IMD, as well as 100% of the middle-market institutional business, and our minority investments in hedge fund managers, the impact on our pretax earnings is estimated to be modest.

On a fiscal 2007 basis, the pro forma impact would have been less than 5% of the firm's pretax earnings. After closing, IMD will have an autonomous governance structure from our investment banking and capital market divisions. However, IMD will remain an important strategic platform for the firm.

The business will continue to operate under the Lehman Brothers and Neuberger Berman brands. Clients will continue to be able to access all of the capabilities of the firm across operating units. We are in advanced discussions with a number of potential partners for the IMD business, and expect to announce the details of the transaction in due course.

We realize that we have given you a lot to absorb with regard to the restructuring, but hopefully we have been able to clarify some of the mechanics and rationale behind our initiatives. To help put our actions into perspective, taking into account all the transactions we have announced today, our balance sheet exposures will be reduced to the following levels – approximately \$5 billion of commercial assets, approximately \$13 billion of residential assets, less than \$5 billion of other asset-backed positions,

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and approximately \$10 billion of acquisition finance facilities which includes \$7 billion of high yield facilities. We believe that the Lehman of early 2009 will be significantly de-risked financial institution.

To reiterate, these actions represent the major components of the restructuring which, once complete, will allow Lehman to emerge as a clean company and be able to thrive away from its legacy assets. This will allow us to refocus our efforts on growing our client-facing franchise. Additionally, core Lehman Brothers can be more fairly valued in the public markets, and we will be better able to restore the confidence of our key stakeholders including equity investors, debt investors, clients, counterparties and employees. We will be discussing core Lehman Brothers in greater detail in the section on our operating model.

Turning to our capital position, despite our third-quarter loss, we ended the quarter with a larger equity base and greater capital ratios versus the prior period, driven by our June capital raise and a decrease in risk-weighted assets. As of June 31, total stockholder equity was approximately \$28 billion, up 8% from the second quarter, and our long-term capital ended the quarter at \$143 billion.

During the quarter we reduced our gross assets by approximately 6%, from \$639 billion to approximately \$600 billion, and we reduced our net assets by approximately 5%, from \$328 billion to approximately \$311 billion. We ended the quarter with gross leverage of 21.1 times, compared to 24.3 times as of the second quarter, and our net leverage was 10.6 times versus 12.1 times last quarter.

We estimate that our Tier 1 capital ratio under the CSC regulatory framework will be approximately 11%, and our total capital ratio between approximately 16.5% and 17% as of August 31, compared to 10.7% and 16.1% at the second quarter, respectively. Our third-quarter Tier 1 ratio is well above our target level, and the total capital ratio is well in excess of the 10% minimum regulatory threshold.

Book value per share declined this quarter to 27.29, driven by the June capital raise and our third-quarter loss. Additionally, the sale of a majority stake in the part of our IMD business, and the reduction in our annual common stock dividend from \$0.68 a share to \$0.05 a share for an annual saving of \$450 million, are both intended to give us greater capital flexibility going forward.

Turning to the third quarter, we posted our second consecutive quarterly loss with net revenues of negative \$2.9 billion, a net loss of \$3.9 billion, and a diluted loss per share of \$5.92. The loss was driven primarily by gross marked to market adjustments of \$7.8 billion, including a \$5.3 billion gross write-down on residential mortgage assets, \$1.7 billion related to our commercial mortgage and real estate portfolio, \$600 million on other asset-backed assets, and \$200 million on our acquisition finance facilities.

Gross marked to market adjustments were offset by \$800 million of hedging gains during the quarter, and \$1.4 billion of debt valuation gains resulting in \$5.6 billion in net write-downs. We also experienced approximately \$716 million of principal losses during the quarter, including approximately \$380 million in fixed income, \$320 million in equities, and \$[50] million in IMD.

Gross write-downs of \$5.3 billion on residential assets in the third quarter were driven by market factors, including rising delinquencies and loss expectations, supply overhang concerns, and a continued difficult financing environment as well as our own accelerated selling activity during the period. Net mark to market adjustments on residential assets totaled \$4.9 billion, as hedges offset only 8% of gross write-downs.

The majority of our write-downs were in Alt-A driven by an increase in Alt-A delinquencies and loss expectations which were specific to Alt-A prices and did not affect the performance of our hedges. Unfortunately there is no direct hedge for Alt-A assets, as there is in subprime with ABX.

Our strategy around hedging is to break the exposures into spread and HBA credit exposure. We use ABX to hedge the HPA exposure, and a combination of CDX, CMBX, single name financial CDS, and swaps to hedge the spread exposure. Our HPA

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hedges were ineffective as Alt-A prices dropped 20 to 25 points during the quarter, while ABX AAA on average dropped eight points and ABX subs -- that's AA through triple B- -- dropped only four points.

And our spread hedges were also ineffective, as residential credit sectors widened significantly by 200 to 600 basis points while other spread sectors were more range bound. Our corporate hedges, for example, widened only 35 basis points. This difficulty in hedging and associated basis risk supported our decision to more rapidly decrease our residential assets this quarter, as our best hedge is to reduce absolute exposure.

In the commercial market, gross marked to market adjustments totaled \$1.7 billion, compared to 900 in the second quarter and \$1.4 billion in the first quarter of 2008.

Real estate values continued to come under pressure during the third quarter, mainly due to the weakening economy and the lack of liquidity in the market. Our write-downs are driven by higher discount rates, changes in our exit capitalization rate assumptions, as well as credit events related to certain properties. On a net basis, commercial write-downs for the quarter totaled \$1.6 billion.

Excluding net marked to market adjustments, debt-valuation gains and principal losses, our remaining revenues were \$3.5 billion, implying positive pretax results of approximately \$600 million and extremely trying circumstances. In investment banking, revenues of \$611 million were in line with a slower overall banking market, where estimated global market fees are down 25% on an annualized basis, year over year.

While underwriting activity was depressed across the debt and equity markets, M&A activity remained solid. We posted revenues of \$634 million in investment management. Our AUM was slightly down at \$273 billion, versus \$277 billion in the second quarter, as market depreciation more than offset net inflows. However, management fees remain stable, quarter over quarter.

Total IMD revenues were done sequentially, driven by lower transactional activity in private investment management, and a smaller contribution from our stakes in alternative asset managers. During the third quarter, we recorded a loss of \$60 million associated with our investments in hedge fund managers, compared to a gain of approximately \$70 million in the second quarter.

In capital markets we reported revenues of negative \$4.1 billion. Excluding net marked to market adjustments, debt valuation gains and losses on principal investments, our run-rate revenues in capital markets were \$2.2 billion, or down 15% versus \$2.6 billion in the second quarter on a comparable basis.

Despite a difficult operating environment in the third quarter, our underlying client franchises remained solid. On a year-to-date basis, capital market client revenues, the internal operating metric by which we track client activity, were up 11% versus the first nine months of last year. And while third-quarter client revenues were down 19% sequentially, this period results are comparable to our average quarterly client revenue for full-year 2007.

In fixed income capital markets, the run-rate revenues were flat versus the second quarter at \$1.8 billion. During the quarter we had strong trading revenues in rates, foreign exchange and credit products. Overall activity levels remained robust year to date, with particular strength in commodities, foreign exchange, securitized product and credit.

In equities capital markets, run rate revenues were approximately \$425 million, down 43% versus \$750 million last quarter. While client revenues were down approximately 22%, run-rate revenues were impacted by trading losses and volatility products.

Cash equities and flow volatility activity generally remained strong in the US this quarter, with more pronounced declines in Europe and Asia. Structured volatility activity remained depressed across regions given the weakening equity market worldwide.

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Prime services revenues and equities were also down from last quarter, mainly reflecting continued deleveraging among hedge fund clients, and diversification of balances across brokers and not a lost clients. Year to date, the prime services business is well ahead of 2007 revenues.

With respect to expenses, given the continued difficult overall market environment, we remain diligent on cost initiatives, with notable developments during the quarter. We've reduced headcount by approximately 1500 positions since the beginning of the third quarter in discretionary corporate areas, and those businesses which we believe are in secular decline. We expect small reductions in staffing in our client-facing businesses, which should bolster our revenue capacity once we reach a more stable part of the cycle.

Non-personnel expenses were \$971 million in the third quarter, down 11% from the \$1.1 billion in the second quarter. We've identified a set of near-term cost reduction opportunities totaling \$250 million in annualized cost savings before any additional impact from potential divestitures.

Although we expect these savings in future quarters, it is important to note that with our third-quarter revenue run rate of \$3.5 billion and third-quarter expenses of \$2.9 billion, we are pretax-positive for the quarter excluding the markdowns, debt valuation gains, and principal losses. I will now provide an update on our liquidity position, which remains very strong.

We maintained our cash capital surplus at \$15 billion at the end of the third quarter. Our liquidity pool also remains strong at \$42 billion, versus a record \$45 billion at May 31. The decline in this figure versus the end of the second quarter is strictly attributable to our managing down our commercial paper outstandings, which ended the quarter at \$4 billion versus \$8 billion at the end of the second quarter.

Funding provided by our wholly owned banking entities also remained stable this quarter, with \$47 billion of assets funded in our banks, versus \$46 billion last quarter. And we have a focused effort to increase this amount in the coming quarters. In particular, we expect amounts funded in our Utah-based industrial bank to increase going forward, as our three year de novo period ended at the end of August.

As an update, on our secured funding positions, total tri-party repo was approximately \$211 billion as of the third quarter, of which \$115 billion is treasuries and agencies. The remaining \$96 billion of tri-party repo compares to the \$105 billion last quarter and includes \$39 billion of collateral which is central-bank eligible.

The \$57 billion of non-central-bank-eligible collateral compares to \$65 billion of non-eligible collateral last quarter, and includes \$25 billion of highly liquid investment-grade fixed income securities and major index-listed equities. Now, the \$9 billion of non-central-bank-eligible collateral is currently funded through repos with our own banking entities, versus \$8 billion last quarter.

The remaining \$23 billion of collateral, half of which is client collateral, is covered more than 190% by liquidity pools available to the broker-dealers. By comparison, last quarter our remaining collateral was \$32 billion, and this amount was covered more than 150% by liquidity pools available to the broker-dealers.

The average tenor of our non-central-bank eligible tri-party repo remains broadly in line with the last few quarters at over 35 days. Nearly half of our total tri-party repo has a tenor greater than one week, and nearly 30% is over one month. Additionally, we have maintained a significant overfunding position in tri-party repo of approximately \$32 billion, versus \$27 billion last quarter.

Throughout the market volatility of the past six months, our liquidity and funding framework has served us extremely well, and we remain focused on increasing the funding available in our bank entities and mitigating any liquidity risks to our secured and unsecured funding positions. Through last night, our liquidity pool remained essentially unchanged at \$41 billion.

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Let me briefly review our operating model going forward, as we focus again on core Lehman Brothers and executing our business plan in today's market environment. Despite difficult market conditions, essential client needs have not changed. With the need for investment ideas, trading liquidity, and restructuring advice increasing, our core business model remains strong.

We will continue to focus on the client franchise, looking to increase wallet share with a targeted group of global clients. Our client franchise rests on a foundation of delivering intellectual capital through research and our commitment to idea generation, as exemplified by our top-ranked research in both fixed income and equities, as well as differentiated service.

While the market has undoubtedly changed, Lehman's core competencies and culture remain as relevant as ever to the marketplace. Importantly, our operating model going forward incorporates a number of significant attributes. We expect core Lehman Brothers to be well-capitalized with anticipated leverage of 10 to 12 times, and capital to support a \$300 billion net balance sheet, slightly smaller than where we are today.

Clearly, a greater proportion of this balance sheet will be dedicated to client activities, as our real estate-related assets fall from approximately 30% of our total inventory at the end of the third quarter, to approximately 5% under the spinoff scenario. Core Lehman Brothers is intended to have less reliance on wholesale secured funding for our less-liquid assets, and an increased use of bank deposits from our wholly owned bank subsidiaries. And even under the scenario of limited debt-issuing capacity in 2009, we anticipate that core Lehman will have ample cash capital to sustain its business activities.

Under various revenue scenarios, we believe core Lehman Brothers can generate at least \$13 billion of revenues, using a detailed bottoms-up analysis by business and adjusting for the IMD transaction. This is reinforced by our run-rate revenues of \$7.7 billion for the second and third quarters of this year, excluding the marked to market adjustments, debt-valuation gains and principal losses over the last six months, but including IMD for the period.

Our objectives in establishing core Lehman Brothers are to refocus our efforts on growing our client-facing franchise, while restoring the confidence of our key stakeholders, including equity investors, debt investors, clients, counterparties and employees. Additionally, we believe core Lehman Brothers can be more fairly valued in the marketplace.

Let me conclude by making the following points. We believe that the comprehensive plan we've outlined today directly addresses the issues the market has been grappling with in recent weeks. We have introduced a solid plan and timetable to deal with our remaining commercial real estate exposure. We have materially reduced our residential mortgage exposure, and marked our remaining holdings to levels that make future write-downs unlikely.

We have made significant progress in cleansing our balance sheet so that core Lehman can stabilize and ultimately grow and thrive with a strong and clean balance sheet. We have maintained our strong liquidity and capital profiles even in this difficult environment, and the potential sale of IMD further improves our capital position.

Our clients and counterparties have continued to stick with the firm, which has been instrumental in supporting our client run rates, and we believe that core Lehman has the appropriate foundation to achieve sustainable profitability going forward.

That concludes the prepared remarks, and we would like to move on to Q&A.

QUESTIONS AND ANSWERS

Operator

Thank you. (Operator Instructions) Glenn Schorr.

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Glenn Schorr - UBS - Analyst

UBS. Okay, so a lot of moving parts, but I will try to stay focused on the key issues of the commercial real estate spin, the current marks and Lehman's capital position after. So let me just check a couple things.

Tier 1 of 11% is as of the end of August. Is that pro forma with the Neuberger gain or not?

Ian Lowitt - Lehman Brothers - CFO

No, that's not pro forma. That's our actual levels at the end of August.

Glenn Schorr - UBS - Analyst

Okay, and then the \$3 billion, it's worded interesting. So I've got to ask the question. The \$3 billion tangible book value benefit, what does it do for total capital in Tier 1? What's Tier 1 pro forma Neuberger sale, or IMD sale?

Ian Lowitt - Lehman Brothers - CFO

Well, I mean with the sale, clearly we remove the goodwill and that improves Tier 1 capital by over \$3 billion. You know, we don't want to speculate on exactly what the proceeds are going to be, but the --

Glenn Schorr - UBS - Analyst

Okay, I don't need the proceeds, I just want to make sure that theoretically if tangible book value benefit is \$3 billion, all else equal your Tier 1 benefits by \$3 billion?

Ian Lowitt - Lehman Brothers - CFO

Yes, and to the extent that there's gains relative to the book value on an after-tax basis, that would increase it. But clearly, you know, all of the indications are that we will be materially -- the bids will be materially above the book value of -- I'm sorry, the goodwill value and as a consequence, minimally what will happen is that you gain over \$3 billion as a result of the goodwill. And there may be additional gains in Tier 1 based on whatever the actual price itself is.

Glenn Schorr - UBS - Analyst

Okay. So it's not a clear one to one, that's for sure.

Ian Lowitt - Lehman Brothers - CFO

Minimally, it clears out the goodwill.

Glenn Schorr - UBS - Analyst

Okay. And I know what the tax basis of what -- at the time of the Neuberger transaction, but can you help us with the tax basis of IMD?

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Ian Lowitt - *Lehman Brothers - CFO*

We would rather not go into that.

Glenn Schorr - *UBS - Analyst*

You'll wait till after the sale? Okay. So then, the REI spin, the marks are -- I'm assuming that there -- there was thoughts about selling all of the commercial real estate assets and that you were exploring all options and you viewed this one better than selling them at whatever the bids came in. But my gut is the bids came in well below the \$0.85 average mark.

Reconcile that difference as that's -- the difference is the equity that you are putting into the spin. So Lehman is putting in somewhere between 5 and \$7.5 billion of equity into the REI spin, if the percentage -- the \$25 billion to \$30 billion times the 20% to 25% equity that you gave us. So is that all equity from Lehman or is any of that third party raised?

Ian Lowitt - *Lehman Brothers - CFO*

Yes, I think that the way we would think about the alternatives with regard to the real estate is maybe a little different than you described it. I mean, if we did try to sell the whole portfolio in a very rapid timeframe, you would clearly pay a very substantial bid/offer spread on that. And the capturing of that value would essentially be value that was retained by the shareholders or whichever the acquiring entity was. By creating the spin, we are obviously shifting the assets off our balance sheets, still to our shareholders, but it's our shareholders that capture that value associated with the disposition of the assets over a period of time, rather than locking in a known loss at this point.

Glenn Schorr - *UBS - Analyst*

I understand, but the way the math looks is if you are going to inject equity to protect REI, and make people feel okay about it, it's the equivalent of a 20%/25%.

Ian Lowitt - *Lehman Brothers - CFO*

So we would in fact be contributing equity in exactly as you are describing. You know, that's in part to -- the level of equity is determined based on what you need to do to support the seller financing, and the amount of equity that we put in as you described, in that sort of range.

Obviously, it's hard to know exactly what the asset levels are likely to be because we will continue to have dispositions and paydowns over the remaining time. But that's sort of the range of it. Clearly we are holding a chunk of equity in our existing Lehman against those exposures. So it's not as though there's a complete -- so that obviously needs to be get factored into how does that play through in terms of the capitalization of core Lehman.

Glenn Schorr - *UBS - Analyst*

I am with you. And then, are you able to tell us, ex-Archstone/SunCal what the average mark is on the rest of the portfolio?

Ian Lowitt - *Lehman Brothers - CFO*

Well, the portfolio is at about 85 and the -- SunCal and Archstone, which were 75 last quarter, have been marked down some amount this quarter.



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Glenn Schorr - UBS - Analyst

Got it. And is the Archstone debt included in this, or is that part of the leverage lending?

Ian Lowitt - Lehman Brothers - CFO

Archstone debt and SunCal debt would be included in the new company.

Glenn Schorr - UBS - Analyst

Okay. And then does it need shareholder approval, the REI spin?

Ian Lowitt - Lehman Brothers - CFO

No.

Glenn Schorr - UBS - Analyst

Okay, and then I guess the biggie after all this, if that equity contribution is being made across to REI and some of it might have been already theoretically in there against those assets, what do you anticipate the capital needs of "good Lehman" or the more de-risked Lehman, post spin? Because obviously you can't fund the 5 to \$7 billion equity injection into REI and maintain your Tier 1 around where it is now.

Ian Lowitt - Lehman Brothers - CFO

No, I think that -- we think that clearly with -- our capital position at the moment is strong. We recognize that with the REI spin we are going to need to put equity into that.

But with the IMD sale and the proceeds associated with that, and the de-risking that goes on, in order to maintain our ratios which is 10 to 12 on the \$300 billion balance sheet, Tier 1 of sort of 11%, we are confident that we can maintain that. So we would in fact be going down some amount of equity as a result of the spin. We will be increasing our equity as a result of IMD.

We will have much less risk on our balance sheet which would allow us to let our leverage drift up from, say, 10.5 times to, say, 12 times which would then leave you with a requirement for leverageable equity around \$25 billion. And in order to maintain the 11% Tier 1 ratio, we will be as a result of the de-risking, bringing down our risk-weighted assets. So we feel that in combination, these things allow us to maintain our strong capital ratios within the construct of the set of things that we're doing now.

Glenn Schorr - UBS - Analyst

Okay. I should end there and let others have a chance. Thank you.

Operator

Michael Hecht.

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Michael Hecht - Banc of America Securities - Analyst

Banc of America. Can you guys help us -- following up on Glenn's question just, I mean book value ended the quarter at 27 and change. So you guys kind of run the numbers on what you think pro forma book value per share would be, post the REI transaction and the IMD transactions?

Ian Lowitt - Lehman Brothers - CFO

I mean, I think that -- lots of things moving around with regard to that. You know, I think that you can compute it in part based on how much equity we are going to shift over to REI and what that is as a share of the total common. And I think on the basis of that you will get pretty close to the number. And then the remainder is obviously in core Lehman.

Michael Hecht - Banc of America Securities - Analyst

Okay. And then I guess, you talked a little bit about the -- well, I guess how should we think about the impact you guys are seeing on the client-facing franchise? I mean, how much of the 20% or so sequential decline that you mentioned some of the run-rate revenues is from the client-facing side versus just some of the cyclical pressures? And then can you touch on the impact you think you are seeing so far in September, especially given the pressure the stock has been under?

Ian Lowitt - Lehman Brothers - CFO

I think that the -- we think that the marketplace itself was sort of seasonally slow in the third quarter, and our estimates of that are in the 10% to 20% range. So we think that -- and the other indications we have don't suggest real share erosion. So we think that broadly our activity is in line with what we think the marketplace has been, and I think that what we're seeing into September is broadly similar.

I think over the last two days, obviously there's been more impact in terms of what's happened with the stock, what's happened with our debt spreads. But we are obviously hopeful that in the description of what our plan is and being clearer about what our quarter is and what we're doing going forward, and what we're planning with regard to IMD, that those stabilize and as a consequence the impact on the client business is more limited. And as a consequence of people getting excited about clean Lehman and the fact that the plan actually separates us from our legacy assets, that we actually do have the platform to really succeed and grow.

Michael Hecht - Banc of America Securities - Analyst

Okay. And then I guess the various issues [thrown] around the firm, can you just talk a little bit about the impact you're seeing on morale, turnover, and then also senior managements relationship with the Board and how management and the Board is currently weighing the cost of staying independent versus maybe selling out to a larger player to help diversify the firms funding mix and maybe restore confidence?

Dick Fuld - Lehman Brothers - Chairman, CEO

Let me talk about that; this is Dick. First on employee morale, clearly we spent a ton of time over these last number of years building a strong, very cohesive culture. As I said in my comments, we've been through adversity before and we always come out a lot stronger.

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It would be foolish for me to say that all of our employees have gone through this period unaffected, because that clearly is not the case. They've been distracted by rumors, they've been distracted a little bit by comments in the press which I mentioned in my comments.

But I will tell you the employees of this firm are holding wonderfully and continuing to do their business day to day in a very strong way, and that culture is holding. As far as turnover, I see no indication of anything that would be abnormal at all. As far as the Board, I'm not sure what you were asking me there. Were you asking me, what is the relationship of (multiple speakers) --?

Michael Hecht - Banc of America Securities - Analyst

Yes, just a little perspective on how they are kind of viewing the various things going on and the different strategic alternatives you guys are weighing including staying independent versus a potential outright sale.

Dick Fuld - Lehman Brothers - Chairman, CEO

Well, we've had a number of board meetings -- some in person, some telephonic -- over the last number of weeks and months. A clear goal was to discuss all of these which we've taken you through today, and all of the strategic options. I must say the Board has been wonderfully supportive, clearly understand and understood each of those options and the implications of each to the Firm.

As far as the last question about a sale of part or all of the Firm, I have always said that, if anybody came with an attractive proposition that made it compelling for shareholder value, that would be brought to the Board, discussed with the Board and evaluated. That has not changed.

Michael Hecht - Banc of America Securities - Analyst

Okay. I just have a follow-up on the investment-management business. I mean, one, just thinking about the sales structure, it seems pretty unique. Can you give us a little more color on how you kind of sell 55% of something but yet kind of retain a majority of the earnings contribution?

Then also, just looking at the flow trends in the asset management business in the quarter, I mean, overall pretty strong but it looked like you had another \$10 million of outflows from money funds after seeing \$11 billion or so last quarter. Obviously not a big revenue deal but I just wanted to get some color on what's going on there.

Then, if you had \$11 billion in inflows overall, it implies some pretty strong inflows in some of the long-term products -- maybe just some color there, too.

Ian Lowitt - Lehman Brothers - CFO

Sure. Yes, I think as you point out, the investment-management business is doing well through this period and on a net basis, we are seeing inflows. You know, there are outflows in the money market product, but to your point, that doesn't have a lot of impact on revenues.

You know, with regard to how this plays through, clearly when you think about the IMD segment, it includes the middle-market institutional business, which we are retaining, the minority stakes, and then it also, if we were going to move forward with this in this form, we would obviously retain our share of whatever the earnings are of the portions of IMD that we are selling off in this form.



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So the combination of those things, retaining two of the revenue streams and earning streams at 100%, and then a little bit less than 50% of the earnings streams that we sell, (inaudible) how the pretax impact of this is the levels that we indicated in the remarks.

You know, the way in which one would essentially establish this is we will have to create a separate entity, which is our IMD business, and then that will have separate governance associated with it. But I think a lot of the value how it integrates into the rest of Lehman Brothers. While that will now be done on a probably more formalized basis with service-level agreements and things of that kind, we are confident that that's the best way to get the most value out of it, both for sort of core Lehman as well as for the investor.

Michael Hecht - Banc of America Securities - Analyst

Okay. Thanks a lot, guys.

Operator

Mike Mayo.

Mike Mayo - Deutsche Bank - Analyst

Deutsche Bank. I have one general question but with some specifics. So, the real issue I'm trying to get my arms around is what are the remaining marks that you have on your real estate exposure? So I guess I will start with the residential real estate. It's down to \$17 billion, and you said it will decline by another \$4 billion with the pending sale to BlackRock. Are the marks for that pending sale in the third-quarter results? If not, what kind of marks might we expect in the fourth quarter?

Bart McDade - Lehman Brothers - President, COO

Mike, it's Bart. A significant amount of the marks for the pending sale have been taken in the third quarter.

Mike Mayo - Deutsche Bank - Analyst

But there's still some in the fourth quarter?

Ian Lowitt - Lehman Brothers - CFO

Yes, there's probably some in the fourth quarter, based on where the final pricing comes out.

Mike Mayo - Deutsche Bank - Analyst

Okay. To what degree have you provided seller financing?

Ian Lowitt - Lehman Brothers - CFO

On the BlackRock transaction, we will be providing seller financing probably at the 75% level. There's cash sweep features that create additional protection for us, but we will be providing seller financing on that transaction.

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Mike Mayo - Deutsche Bank - Analyst

Of the remaining \$13 billion, how aggressive might you be in off-loading that?

Ian Lowitt - Lehman Brothers - CFO

We think that there are a couple of additional trades in Europe that are currently being contemplated, which would reduce that exposure some amount beyond that. But I think we feel our objective is to run this business in and around \$10 billion over a period of time, so we are not anticipating aggressive additional dispositions. Obviously, we will continue to buy and sell assets but that's probably the level that we're hoping to operate at.

Mike Mayo - Deutsche Bank - Analyst

Okay, so residential real estate is mostly where you want it to be with these pending transactions?

Bart McDade - Lehman Brothers - President, COO

That's correct, Mike. I think, if you looked at, and Ian gave you a flavor for the diversification now in the book, it really feels like a set of trading books that [aren't] appropriate size to operate in these markets.

Clearly, we're going to continue to trade out of assets that we see having less value and try to acquire, in the trading activity, assets that, in the flow, assets that have more value. But across the board, US and Europe, it now really looks and feels and is operating as an active trading book.

Mike Mayo - Deutsche Bank - Analyst

So let's just accept what you're saying as absolutely correct. That implies the main issue is the lingering commercial real estate exposure. I appreciate the breakdown, how much it's been marked down in each of the subcategories of residential, but you didn't give us that same breakdown for the commercial real estate exposure. At a minimum, whole loans are two-thirds of the commercial mortgages. How much have those whole loans been written down?

Ian Lowitt - Lehman Brothers - CFO

Well, I think that, last quarter, we said that, within the whole loans, the seniors were in the mid-90s. Now they are sort of in the very low 90s and the mezzanine piece, which was in a very high 80s, is now in a very low 80s.

Mike Mayo - Deutsche Bank - Analyst

Okay. Then more conceptually, why do you need more capital? I mean, I can answer this question, but you said you capital ratios -- tier 1 in total -- are well above the minimums, yet at the same time you are raising tangible equity by \$3 billion. So that implies you need some additional capital.

Is one way to think about this is that the remaining marks on the commercial real estate are maybe \$7 billion, because that's what you need to capitalize REI with?

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Ian Lowitt - *Lehman Brothers - CFO*

No, I think that would be absolutely the wrong way to think about it. The way I think you should think about it is we are basically going to be spinning off a series of assets at much, much lower leverage ratios than the leverage ratios we want to operate with in aggregate. So if we want to operate in aggregate with a leverage ratio of 10 to 12, and then you spin off a chunk of your assets and you're leveraging that at 3 to 4 times, then a consequence of that is you need to or you want to have more tier 1 capital in order to maintain your leverage ratio in that sort of 10 to 12 range rather than have it increased more than that. So I think that's the predominant way to think about that.

Mike Mayo - *Deutsche Bank - Analyst*

Then as a follow-up, to the extent you might need \$7 billion to capitalize that entity, and you'll get \$3 billion with the spin of part of IMD, how would you get the other \$4 billion?

Ian Lowitt - *Lehman Brothers - CFO*

Well, we don't feel that we need to raise that extra amount to cover the \$7 billion, because you will have less sort of leverageable equity in core Lehman than in, you know, where you are at the end of this quarter. So at the end of this quarter we are at 29.5, basically, of leverageable capital.

The amount that you need in the remaining core Lehman, given that it has \$300 billion of assets and you're going to lever at, say, 12 to 1, is only sort of 25 times. So you could actually have your leverageable equity come down some amount and have the \$5 billion to \$7 billion sitting in the real estate entity and still be well-capitalized within sort of the remaining core Lehman.

Mike Mayo - *Deutsche Bank - Analyst*

Last question -- it will be debated on probably many phone calls today, but what last statement can you say to give comfort that there aren't major additional marks in the commercial real estate before the transfer -- before the REI spin? Dick, maybe you can respond to that, because this is I think that is the issue right now.

Dick Fuld - *Lehman Brothers - Chairman, CEO*

You're talking about strictly the commercial real estate?

Mike Mayo - *Deutsche Bank - Analyst*

Yes, just commercial real estate.

Dick Fuld - *Lehman Brothers - Chairman, CEO*

We had a number of sales this last quarter, and it's been a very hard -- I think actually Ian spoke about it -- a very hard stress analysis at the losses though that we did incur were more limited and driven in part to the increase in yield expectations among investors. We do not envision large write-downs in the commercial real estate portfolio, given the current market.

Mike Mayo - *Deutsche Bank - Analyst*

But the CMBX declined a lot this quarter. Can you help reconcile the two thoughts?



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Ian Lowitt - *Lehman Brothers - CFO*

I think CMBX actually tightened a lot last quarter, and there were no gains associated with it is our portfolio is almost exclusively floating-rate. So there's really no real impact on our real estate position as a result of the CMBX. I think that clearly there's an enormous amount of attention from -- in our auditors and others around our marks with regard to the real estate. You know, as we spin it off, we're going to be filing of Form 10, we're going to have the audited balance sheet associated with that.

To Dick's point, we sold a lot of real estate last quarter and this quarter, and our sales are in and around our marks, which again gives us comfort that, even in a difficult environment where people are looking to take advantage of the fact that we are obviously looking to reduce our exposure quite quickly, the fact that we are selling in and around our marks over many, many billions of dollars of transactions and many, many different accounts and many, many different positions, that again gives us comfort that the marks that we maintain and the levels at which we will be transferring these assets into the new entity are essentially the right levels.

Mike Mayo - *Deutsche Bank - Analyst*

Okay, that's helpful. Thank you.

Operator

Douglas Sipkin.

Douglas Sipkin - *Wachovia Securities - Analyst*

Wachovia. Just one follow-up on some of the discussion, and then just a general comment about the recent government activity. I'm just trying to understand the book value implications for the spin into the commercial business. I know a couple of other analysts have highlighted about \$6 billion to \$7 billion in equity basically transferring over in. I mean, is there going to be a significant book value implication from this transfer? I'm just not clear on that.

Ian Lowitt - *Lehman Brothers - CFO*

I think we would say that, if it was the \$6 billion to \$7 billion, it would be \$6 billion to \$7 billion out of the \$19 billion of tangible book that we actually operate with, and that would give you a way to split the book value that we think goes into the new entity and the book value that remains.

Douglas Sipkin - *Wachovia Securities - Analyst*

So you've identified \$3 billion of I guess essentially goodwill coming back, because you're selling a majority stake in Neuberger Berman, but that doesn't account for any potential gain that might exist. Is that correct?

Ian Lowitt - *Lehman Brothers - CFO*

That is correct.

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Douglas Sipkin - *Wachovia Securities - Analyst*

So arguably, that \$3 billion could be, depending upon the pricing -- I mean, a considerable amount higher I would imagine, even though it's probably a challenging environment to sell a piece of an asset-management business, the AUM level is substantially higher from when you first bought it. Isn't that correct?

Ian Lowitt - *Lehman Brothers - CFO*

Exactly right, so I think you're thinking about it exactly the right way.

Douglas Sipkin - *Wachovia Securities - Analyst*

Then just a general question, and I know it's kind of early into the government action over the weekend. What are your views on the impact that's going to have on your business? Have you seen any tangible impact of that already? I know agency spreads have rallied. Just generally speaking, what do you think that can potentially do over the next three to six months to the mortgage markets?

Bart McDade - *Lehman Brothers - President, COO*

Doug, it's Bart. I think we would argue the event itself was extremely constructive from a point of view of both the specific actions around the capital market's affect on the capital structure of Fannie and Freddie, but as significantly, the notion of and the actions of the treasury to move into using the balance sheet and actually acquire mortgage assets we thought was equally impactful. So we were very constructive. We have held a number of research calls in from the risk side. We are very constructive. That was a very significant event, not only for the companies but for the markets as a whole.

To answer your question what's happened, a lot of market experts have seen it; we've seen a change in positive psychology, a slight improvement. We were not expecting that it would be an over-night affect, but over time, the impact, the positive impact of both of the events we think does lead to more constructive and more liquid markets, which is what we all need.

Douglas Sipkin - *Wachovia Securities - Analyst*

Then just a follow-up, I mean, obviously, there's a pretty substantial backlog of debt that needs to get refinanced. Any view as to when maybe that business can start to open up again? It's possible this action helps, or any viewpoint as to when it may come or does it just require a little bit better tone around the economy?

Bart McDade - *Lehman Brothers - President, COO*

I think, if you're speaking to -- you are speaking to the securitized markets or you're speaking (multiple speakers)?

Douglas Sipkin - *Wachovia Securities - Analyst*

No, no, like just debt finance -- I mean you guys always talk about there's a huge backlog of refinancing and there's a lot of money on the sidelines. I'm just talking sort of corporate debt.

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Ian Lowitt - *Lehman Brothers - CFO*

We think it's obviously helpful at some level, but I think that more stabilization is probably necessary to be able to address what's already a lot of buildup.

Douglas Sipkin - *Wachovia Securities - Analyst*

Great, thanks.

Operator

Bill Tanona.

Bill Tanona - *Goldman Sachs - Analyst*

Goldman Sachs. Good morning. I guess the first question is are you guys providing financing for the investment management sale?

Ian Lowitt - *Lehman Brothers - CFO*

You know, we are expecting bids back very, very soon, and we will see, as a result of what comes back, whether that's necessary, but it's not currently anticipated.

Bill Tanona - *Goldman Sachs - Analyst*

Okay. Then I guess, in terms of understanding, I know somebody else had already asked the question but I guess I just don't understand the financial impact of the sale. Will this still be consolidated, considering that you are retaining the majority of the pretax income, or how should we think about the revenue impact as a result of this sale? Because I just don't understand how you guys can sell 55% yet retain the vast majority of the pretax income.

Ian Lowitt - *Lehman Brothers - CFO*

No, I think you are right that we would not be consolidating, and I think that maybe I can clarify on this question sort of what's happening there.

It's actually, you take the whole segment and divide it into a piece that's being sold and a piece that isn't. The piece that isn't being sold obviously just stays inside Lehman Brothers and gets incorporated in predominantly into our Capital Market segment.

For the piece that we are selling, we won't be consolidating that, and that represents a small piece of the earnings but actually a larger fraction of the revenues. So we think that the revenue impacts might be quite a bit larger in that sense, but that the pretax effect is more muted in part because the margins on the pieces that we're selling are lower than the margins on the pieces that we're keeping, and then, of the pieces that we're selling, we're still going to retain 45% to 49% of those earnings.

Bill Tanona - *Goldman Sachs - Analyst*

Okay. I guess, taking that a step further in terms of thinking about the run rate that you guys provided, exit these write-downs this quarter at \$3.5 billion, what would be kind of the run rate pro forma for this sale of the investment-management division



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as well as the transfer of the assets to the new co., considering that was I guess \$5 billion of cash flow a year that you guys had indicated?

Ian Lowitt - *Lehman Brothers - CFO*

Yes, we think that 2008, excluding the marks and excluding our IMD, the run rate, pre the debt valuation, is 14.6, so that includes the earlier time periods. But essentially what we're forecasting for next year is a little bit lower than what we've had for the full year, but it's obviously in line with what we have for the last two quarters.

Bill Tanona - *Goldman Sachs - Analyst*

But does that exclude the cash flows from the spinoff of the new co.? Because I'm trying to understand that \$5 billion in cash flow and the paydown in debt being reduced to 50-50 over the course of four years and the impact that might have on the revenues as well.

Ian Lowitt - *Lehman Brothers - CFO*

Yes. Actually, what we're doing with a lot of the cash flow that comes in is using it to just mark down the bases, so the impact on our revenues of that is not significant. A lot of the reduction in our commercial positions is coming down as a result of sort of paydowns. So part of the reduction this quarter is the result of paydowns. They don't go into revenue; they just enable you to reduce your balances within commercial. So that was between \$1.5 billion and \$2 billion this quarter.

So the run rate that we are seeing of sort of paydowns is actually consistent with what's forecast from a cash flow perspective going forward.

Bill Tanona - *Goldman Sachs - Analyst*

Okay. Then in terms of there's a lot of questions on the marks of the portfolio. Will there be an independent firm that actually verifies the value at which these commercial real estate assets are actually being put into this new hold co.?

Ian Lowitt - *Lehman Brothers - CFO*

There will be audited financials as part of the Form 10 filing.

Bill Tanona - *Goldman Sachs - Analyst*

Okay. Then just lastly, in terms of buying shares, you look at the stock trading right now at about a third of book value; it has been for a while. We really haven't seen much in the way of senior executives buying the stock. I assume part of that is because of your involvement around some of these transactions. I guess, going ahead, what is it going to take to kind of see some of the senior executives purchasing stock down here as a sign of confidence?

Ian Lowitt - *Lehman Brothers - CFO*

Yes, I think the reason is obviously there's been a great deal of nonpublic and material information which has precluded any of our senior executives from buying any stock. We also have not been using the Firm's capital to go into the marketplace and buy stock because we feel that preserving capital in this environment is the most important thing that we can actually do. So, I think that's really all of the dynamics around the stock.



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Bill Tanona - *Goldman Sachs - Analyst*

I guess, going forward, what would it take to get senior executives to be purchasing stock?

Ian Lowitt - *Lehman Brothers - CFO*

I think we need to be in a circumstance where there isn't any nonmaterial public information that is precluding us from doing that.

Bill Tanona - *Goldman Sachs - Analyst*

Okay, thanks.

Ian Lowitt - *Lehman Brothers - CFO*

I think we have time for just one more question, because we wanted to conclude this before the markets actually open.

Operator

Our last question comes from Guy Moszkowski. Please state your company name.

Guy Moszkowski - *Merrill Lynch - Analyst*

I'm with Merrill Lynch. Is it correct to assume that REI will be structured as a REIT? And is that why it won't be subject to mark to market?

Ian Lowitt - *Lehman Brothers - CFO*

It's not going to be structured as a REIT, and it won't be subject to mark to market because it's going to be just on a held-to-maturity basis and the discussions that we've had have confirmed that that's the way in which it will be treated.

Guy Moszkowski - *Merrill Lynch - Analyst*

Okay. Just switching to IMD, is there something contemplated in the way this will be structured which will enhance the retention of IMD personnel?

Ian Lowitt - *Lehman Brothers - CFO*

I think the retention of IMD folks is a critical element of the structuring, so that's something that both we and whoever the acquirer is would be very, very attentive to.

Guy Moszkowski - *Merrill Lynch - Analyst*

So presumably that will be included in the economics and would probably affect the price to some extent?



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Ian Lowitt - *Lehman Brothers - CFO*

Yes.

Guy Moszkowski - *Merrill Lynch - Analyst*

Has there been any change in how you calculate your debt valuation gains in the quarter? Because for the period up to the end of August, we couldn't see a degree of spread widening in your debt that was commensurate with the scale of the gain.

Ian Lowitt - *Lehman Brothers - CFO*

Yes, I think we mark off the cash curves in the US and also in Europe for the European debt. We could certainly show you those numbers.

Guy Moszkowski - *Merrill Lynch - Analyst*

Okay, that might be helpful. Maybe I will follow-up later.

Then finally, with the big spinoff of the CRE assets, and you did talk about generally rightsizing businesses internally, can you give us a sense of how you are sizing personnel and capital commitment of that business going forward, relative to kind of the run rates of commercial real estate over the last couple of years?

Ian Lowitt - *Lehman Brothers - CFO*

Sure. I think we're looking to migrate that business from, you know, to one which is much, much more focused on advice and restructuring advice. To the extent that there is sort of investment within the business that would be done really through the private equity investment funds, not on balance sheet. So I think that is the principle ways in which we are thinking of restructuring that business.

Guy Moszkowski - *Merrill Lynch - Analyst*

Okay, that's helpful. Thank you very much. Thanks for doing the call this morning.

Ian Lowitt - *Lehman Brothers - CFO*

Well, thank you all for joining us on short notice. Obviously, there were a lot of questions; we got through a lot of important stuff. I'm sure there will be follow-up questions that you and others have. We are obviously ready to deal with those questions and at your disposal. We would like to close by thanking our clients, our employees, our investors and our counterparties for standing with us.

Operator

That concludes today's call. Thank you for participating. You may now disconnect your line.

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