February 7, 2008

To: Files

From: Nicholas McClay

CC: Wyatt de Silva
Jerry Gruner

Re: US PTG Analytics

Overview

PTG assets are financial investments in entities whose purpose is to invest in commercial real estate assets (land development, condo development/conversion, commercial office, hotel, etc). The nature of Lehman's investments in these entities takes a variety of forms, including, but not limited to, senior debt, mezzanine debt, preferred equity, and common equity. To evaluate PTG investments for fair value considerations, Lehman's Product Control group models assets based on projected cash flows, property valuations, and other factors. For more details on this process, related controls, and testing, please see B22 and BB22 workpapers.

Introduction

In response to events in the credit markets and the resulting impacts on all financial investments, and potentially those involving real estate, we identified in planning that portfolio-level and sub-portfolio-level analytics of the PTG portfolio should be performed to serve as a means of analyzing trends experienced by the portfolio and to supplement our tests of controls of Product Control's price verification procedures, our use of EY's Real Estate Advisory Services (REAS) group to perform desktop property valuations, our substantive review of significant realized and unrealized P&L in the PTG portfolio and other substantive procedures outlined in J2.6 Memo and in J2 and related procedures in our GAMx file. These analytics are meant to supplement our other procedures and primarily support our valuation assertion and secondarily support our existence assertion.

Approach

Time Horizon

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EY designed our analytics to cover the period from 11/30/06 to 8/31/07, and subsequently, from 8/31/07 to 11/30/07. Please see "Year End Update" section below for our discussion of 8/31/07 to 11/30/07.

Position Population

EY tests Product Control's monthly price verification processes, which includes a completeness reconciliation from Quest for all positions used in pricing. As EY noted no exceptions when testing the completeness of this process, EY utilized Product Control's price verification files from 11/30/06, 2/28/07, 5/31/07, 8/31/07, and 11/30/07 as the source for our position populations at each respective date.

Position Categories

There are many ways to sub-divide PTG assets within Debt or Equity, including property type, property location, lien position, LTV ratio, and more. However, EY chose property type and property location as the two key subdivisions to use in our analytics. These categories were chosen because property types such as land development, condo renovation, hotels, and other property types, while sharing some similar characteristics common to PTG assets, have substantially different business plans, sources of cash flows, resale markets, and operating restrictions. Similarly, property locations differentiate properties, particularly in challenged markets, as not all markets develop at the same rate, experience the same demand increases and contractions, and react to changes in local economies similarly.

Value Metrics

Because of the complexity of PTG positions, movements in the portfolio are difficult to evaluate solely on mark or total balance changes as might be the case with liquid-listed financial products. To address this complexity, EY analyzed the portfolio using position notional, market value, implied mark, appraised values, weighted average appraisals, and portfolio concentrations by property type or location. Together, this combination of variables allows EY to identify both portfolio movements and developing concentrations as well as isolate increases in market value relative to increases in notional as well as monitor relationships between underlying property values and position marks and values.

Expectations

Our expectations are based on our knowledge of the marketplace, our frequent interaction with Product Control, and research sources such as PwC's Korpacz Investor Survey. Below, we have listed key expectations from each date of the Korpacz Survey.

12/31/2006 – "Fundamentals are strong; the economy is stable; and capital remains plentiful…" "Sales of significant office properties reached a new record in the third quarter of 2006…" "Certain assets…located in the top-performing office markets – such as Manhattan, Washington, DC, and San Francisco – continue to warrant top dollar prices." "We are bullish on apartment acquisitions." "It is a great time to hold assets."

3/31/2007 – "The U.S. Economy's steady, albeit slowing, growth continues to benefit the commercial real estate industry by creating demand for all property types – office, industrial, retail, apartment, and lodging." "…investors remain optimistic about the future performance of the real estate industry." "…(buyers) have shifted their attention to buying value-added properties that offer income and value appreciation and higher returns through retenanting, repositioning, and/or the re-leasing of available space."

6/30/2007 – "Despite slower economic growth and meager, if any, recent declines in national vacancy rates, many investors remain bullish about the commercial real estate industry's future due to positive leasing trends resulting from steady job growth and strong corporate profits." "This is the best we have felt about our company's portfolio performance in a very long time." "Stable office assets… are pricey due to the tremendous amount of capital still looking for a home in commercial real estate." "(Opportunistic deals) appeal to many investors given the strength and resiliency of the U.S. consumer." "…Investors are optimistic that trends will stay positive for the remainder of 2007."

9/30/2007 – "Like many commercial real estate investors predicted, the problems stemming from the rising number of delinquencies among subprime residential borrowers have overflowed into the commercial real estate industry." "The credit crunch moved swiftly from the residential sector to the commercial sector because lenders, as a whole, became nervous and either tightened their lending requirements or ceased it altogether for most property types." "The seller is willing to take a slight reduction in the sale price in exchange for knowing the deal will get done." "The pressure to reduce pricing is occurring mostly with deals in tertiary and secondary markets, where risk is higher and cap rates are expanding." "How much of an impact is unclear." "Fundamentals are extremely healthy and the ability to increase property values…still exists."

12/31/2007 – "Still rattled by the subprime mortgage crisis that has disrupted investment activity and put pressure on an already sensitive U.S. economy, it appears that the year ahead will be filled with challenges for all those involved in the U.S. commercial real estate industry." "The instability in the financial markets has had a domino effect in the investment market for commercial assets, impacting lenders first and moving right through to buyers and sellers." "Deals have been cancelled, loans have fallen apart, and offerings have been postponed." "The degree to which these events impact individual markets (and specific properties) will vary greatly based on underlying fundamentals and property characteristics." "The main challenge will be coming to terms with the current price correction."

Based on our knowledge and the insight provided by the above highlights, our expectation is that, while trends for PTG asset portfolios are difficult to predict due to the individual nature of each investment, generally, we would expect to see continued investment from Lehman in the early parts of the year, coupled with strong valuations

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and appraisals. This should be followed by a gradual flattening in Lehman's 3Q and some downward pressure – particularly in developmental investments and distressed geographies such as Florida, California, and Nevada. EY expects property and investment values to remain relatively consistent in top-tier markets such as New York and DC, with noted Lehman investment in these areas.

Results and Analysis – 11/30/2006 – 8/31/2007

Debt

Portfolio Composition – EY noted that Lehman's portfolio composition remained balanced, with increases in New York and diversification to other locations where Lehman did not previously have investment concentrations. Additionally, EY noted stable to decreasing concentrations in California, Nevada, Florida, and Michigan. Regarding property type, EY notes steady increases in Land investments throughout the year and decreasing investments in Condo projects, which corresponds generally to the geographic concentration trends in the portfolio. These trends coincide with our expectations.

Total Notional – EY notes total notional increases in other locations such as Texas, Boston, and Hawaii. This correlates to the observed changes in portfolio concentration. However, California, New York, and Florida show notional increases, while Michigan and DC were flat to down. As a result, we infer that while concentrations remained steady, investments in California, in particular, spiked in the later part of the second quarter and early third quarter. This is in line with expectations as California presented many of the "opportunistic" deals discussed above as market players with profiles such as Lehman became interested in "value added" properties.

Weighted Average Appraisal – EY notes marked increased in average appraisals in California, where market demand for opportunistic assets appeared to grow substantially through the summer months. EY notes a 33% increase in average appraisal compared to an 18% increase in notional during Lehman's third quarter. While this number appears large, it appears to correlate well with the 6/30/07 Korpacz Survey results for these assets. A similar argument can be made for Florida assets, which, through August, noted steady increases in appraised values as "opportunistic" condo development dominated the market. EY notes that increases in appraisals for Land and Condo Development correspond to location analytics for California and Florida. Other markets, such as New York and DC, which are known to be stable premium markets, showed some signs of flattening as investors sought higher returns. These results appear reasonable.

Weighted Average Mark – EY notes that, through the 3rd Quarter, there were limited movements in marks on PTG Debt assets. Of particular note is that marks on nearly all asset categories, including development assets in California and Florida were flat while "completed" properties such as offices began to show some downward movement. This correlates to the slight downward trend in marks in New York and DC portfolios. Also, EY notes that while appraisals generated increases in appraised values, the value of debt

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position marks did not increase as Lehman's debt positions would face a return ceiling. However, the increased appraisal values would provide Lehman comfort that marks, which essentially represent collectibility and returns are reasonable. Based on our understanding of the information available, these results appear reasonable.

Equity

Portfolio Composition – EY notes the largest geographic concentration of Lehman's equity portfolio lies in "Other." This category includes a wide range of geographies including Texas, Hawaii, Massachusetts, and other states. Additionally, there are several investments that are in partnerships that hold portfolios of assets and may include a variety of states from California to Ohio to DC. Other major equity concentrations include California and New York, which decreased throughout the year, and DC, which increased substantially through the 2nd quarter and showed some exit in the 3rd quarter, but finished up for the interim period. Property type concentrations began the year split between offices and land developments, with offices taking a larger presence throughout the year and land decreasing as the year went on, with condos also playing a significant role in the portfolio. These movements appear in line with the movements suggested by the Korpacz survey and EY notes that Lehman's unwillingness to significantly increase equity investments in longer-horizon development deals appears to reasonably reflect a changing market sentiment by the end of August while acknowledging the market's and Lehman's continued appetite for higher-returning assets. Based on our understanding the information available, these results appear reasonable.

Total Notional – For the interim period, EY notes that total notional for the majority of the portfolio, when viewed geographically, remained relatively stable. Noted increases were in DC, consistent with the portfolio composition analysis, and in Other, where two large 3rd Quarter investments, one in Texas, one in a diversified portfolio, drove increases. On a property type basis, condos and land showed steady increases while office investments increased markedly, with some 3rd Quarter pullback, and industrials showed an increase based on one sizeable acquisition in the 3rd Quarter. EY notes that the increases in Total Notional represent a continued general positive outlook in commercial real estate through August and similar trends as those noted in the portfolio composition discussion above. Based on our understanding the information available, these results appear reasonable.

Weighted Average Appraisal – EY notes appraisal increases across locations and property types during the interim period, with the largest increases noted in the DC, New York, Florida, and Other locations and across primarily office and hotel property types. EY notes that elements of the DC and Industrial increases are caused by significant additions to the respective portfolios that skew graph results. Generally, however, appraised values appears to remain strong across land and condo development assets, which should be consistent providing generally solid market outlook and the longer life horizon for property value increases in developing or undeveloped properties. Increases in Office and Hotel values are driven primarily by Lehman's concentrations of "A Grade" prime properties in these asset types in strong markets such as Manhattan and DC

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for offices and Hawaii and the Caribbean for Hotels. Based on our understanding the information available, these results appear reasonable.

Weighted Average Mark – EY notes that weighted average mark changes appear to coincide with movements in appraised values, which is reasonable given that equity partners, unlike debt investors, share more volatility in upside and downside risk. As anticipated, the increased appraised values in Offices and Hotels led to improved marks in these asset categories, while Land posted moderate increases. Geographically, diversified portfolios posted the majority of mark increases, while Michigan, which is a distressed geography due to local economics, showed significant mark decreases. Other geographic classes remained stable, to slightly down as some cooling market sentiment appeared to take hold in August. EY notes that these results appear consistent with our knowledge of market movements, the above research, and expected correlations with portfolio concentration, notional investment, and average appraisal movements.

Results and Analysis – Year-End Update

Debt

Total Notional – In most markets, including California, DC, Florida, Hawaii, and New York, EY notes continued investment in PTG Debt transactions as notional increased during the fourth quarter, but at slower rates. EY notes approximately $1.2BN in new funding during the quarter, with approximately $392M of positions closing, netting to an incremental $800M of PTG debt investment. When analyzing by property type, it appears that the investments are distributed across $477M of condos, $228 M of land, and $153M of hotels, with smaller decreases in industrial and office assets. Based on the conditions evolving in the marketplace during the quarter, this more measured investment trend appears reasonable and appears to reflect an emphasis on asset selection as the market slows.

Weighted Average Appraisal – In geographical markets, weighted average appraisals remained relatively flat to slightly down in the fourth quarter. This could be attributable to several factors, including the size of positions in the portfolio, however, it also indicates generally some softening in geographical markets as the increases of prior quarters flatten out. Also, some of the modest decreases in California and Florida begin to illustrate softening markets. This is also supported by flat average appraisals in Land assets, while Condo and Hotel appraisals showed decreasing average appraisals. While average appraisals can be affected by several variables, including additions and removals of positions, the larger trend in appraised values provides directional consistency to movements in position marks.

Weighted Average Mark – Average marks by geography generally trended downward during the fourth quarter, with California, New York, Hawaii, Texas, and Virginia all showing average mark decreases while DC, Florida, and Michigan remained flat. On a property type basis, hotels, industrials, and land experienced the largest decreases in marks while offices, condos, and retail spaces remained largely flat. This trend coincides

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with our expectations of weakened land markets and a slowing economy. While the average mark for condos showed a 2% increase, this is due to appraised value increases on some of the larger, developing condo properties in the portfolio, while the majority of condo positions showed flat to decreasing appraisals and corresponding flat to decreasing marks. We note that although on a total portfolio basis, average marks do not appear to have moved significantly, Lehman recorded nearly $300 million in writedowns on US PTG assets in the fourth quarter – refer to summary schedule of commercial real estate writedowns at **J2.6HA**. As noted above, EY has tested a sample of significant writedowns on PTG assets during the year – refer to J2.6 workpapers for testing.

Based on our understanding of the current market conditions, EY notes that these results appear consistent with our knowledge of market movements, the above research, and expected correlations with notional investment, market values, and average appraisal movements.

Equity

Total Notional – Contrary to the more measured investment approach in debt assets, equity notional investments experienced their largest quarterly increased as total equity notional increased from $4.5B to $6.6B. In major geographical areas such as California, New York, DC, Florida, and Texas, portfolios remained stable, with only moderate increases or decreases. The majority of increases were due to components of the Archstone REIT transaction of approximately $1.9B, which is not considered in the remainder of this analysis as it is an outlier and is tested separately in our transaction work. Excluding the Archstone transactions, the major geographic concentrations showed notional portfolios consistent with previous quarters, with California increasing $50M, paired by decreases in DC and New York, for a net $9M increase from major geographies. By property type, increases continued to be in land and condos, for a combined $71M in investment paired by a $55M and a $49M decrease in investment in hotels and offices, respectively. While continued investment in land in California may contradict expectations on the surface, this increase is due to three California investments and is a noted decrease from 3Q, when Lehman originated $130M of land positions. The same is true of condo originations, where the increase in condos may seem counter market movements, Lehman's 3Q originations were $80M relative to 4Q originations of $35M. This movement is in line with expectations based on the market indicators outlined above.

Weighted Average Appraisal – Appraised values on equity positions were largely stable in the fourth quarter as DC was the only major geography to post an increase in excess of $10M, while California, Florida, Hawaii, and New York all showed average appraisal decreases. On a property type basis, industrial properties were down $14.5M while hotels gained $9M and land decreased $2M and condos increased $2M, on average. These movements are in line with expectations as deterioration in commercial real estate has lagged behind residential declines. As such, a trend of softening markets illustrated by stable or lower appraisals is apparent and consistent with expectations.

Weighted Average Mark – On average, marks for equity positions were stable for the quarter as many of the positions experienced larger markdowns in 3Q. Because PTG positions are long horizon positions and commercial real estate markets are not fluid, significant marks in a previous quarter make additional marks in the subsequent quarter likely consistent due to limited new information. In major geographies, Hawaii and Texas experienced mark increases, largely due to property development updates, while California, Florida, and New York remained consistent with 3Q and the DC metropolitan area showed decreases in Maryland and Virginia. In property types, Land and Condos were down two basis points each while hotels and industrials were both up six points and retail marks returned to par. The increase in hotels is attributable to international hotels in the Meridien portfolio, which explains value increases and resilience to U.S. market impacts. The increase in industrials is attributable to one new position in the fourth quarter, whose mark is 92 based on recent origination and valuation models. Without consideration for these outlier positions, weighted average mark trends reflect diligent pricing in the third quarter and continued softening, in the fourth quarter for land and condo developments as real estate markets soften. We note that although on a total portfolio basis, average marks do not appear to have moved significantly, Lehman recorded nearly $300 million in writedowns on US PTG assets in the fourth quarter – refer to summary schedule of commercial real estate writedowns at **J2.6HA**. As noted above, EY has tested a sample of significant writedowns on PTG assets during the year – refer to J2.6 workpapers for testing.

Based on our understanding of the markets, assets, and expectations outlined above, the movements of equity marks during the fourth quarter appears reasonable.

Analytics Files

For the data, charts, and supporting graphs relating to this analysis, please see:

J2.4a Interim PTG Debt Summary Analytics
J2.4b Interim PTG Equity Summary Analytics
J2.4c Discount Rate Matrix Historical
JJ2.15a PTG Debt YE Analytics
JJ2.15b PTG Equity YE Analytics

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