LEHMAN MONTHLY RISK MEETING (MEETING HELD 6/19/08)

FINANCIAL RESULTS (MARTIN KELLY, GERRY REILLY)

- Net revenues for May were $591m and net income was a loss of $555m. Investment banking revenues were $379m with advisory revenues down. They were involved in all but one recap in the financial services sector during the month. Investment Management revenues were $303m, with nothing unusual to report.
    - Equities revenues were $339m. On the positive side, execution services performed well. On the negative side, the vol business in Europe was down $107m on some negative gamma positions along with a struggle to maintain sales credits. Apparently they had been trading around volatility and ended up with trades that were expensive to cover. GTS lost $120m on the KSK position as well as other equity positions. Asia equities revenues were off as structured note issuance was down (this is generally a bull market product).
    - FID revenues were negative $431m. On the positive side, client revenues remain strong. Lehman estimates a run rate (which includes sales credits + IMD fees + IB fees) of $4.2bn for the quarter, which would be on par with previous quarters. The losses for the quarter were driven by writedowns as well as defensive position losses from being short credit and continuing to have a steepener position. Details of revenues by business are:
        - Liquid markets -$45
        - Credit products +$202
        - Securitized products -$855
        - Real estate -$935
        - Munis +$67
        - Energy +$55
        - Prime services +$100
        - Gains on debt +$251
        - Gains on CVA +$701 ($666 for the quarter)
    - Gerry Reilly spoke about the chunky markdowns for the month, which totaled $1.6bn.
        - There was a large NPL trade with a $1.7bn notional which Lehman sold at a price below 50 and had been marked in the 60s. They then took 40% of the trade back via an SPV to share in any possible upside. They noted remarking all NPLs and scratch and

dents and taking $400m in writedowns, I think as a result of that trade.

    - As discussed in the credit risk section, Lehman sold chunks of Applebee's and Home Depot at 5 points below the marks.
    - Real estate markdowns for the month were $800m, including $350m for Archstone and $100m+ for Suncal. Realized losses, however, were $135m for the quarter. This includes $42.7m for B-Notes/Mezz Floating, $43.6m for B-Notes/Mezz Fixed, $11.45m for large loans, $22.4m for other, all in Americas, and $15.4m for Europe positions offset by a gain of $3.7m for Asia positions. Most of the losses were below $10m, with the largest being a Rosslyn B-Note ($20m loss).

- Lehman gave us some detail on the Q2 asset reductions in the "financial instruments and other inventory" bucket, which decreased to $268.1m from $326.7m, a change of $58.6m. Details of the selldown includes:
    - Mortgages and asset-backed securities down $12.1bn to $72.5bn. Resi mortgages down $6.9bn, other ABS (non-resi) flat, and commercial mortgages down $6.7bn. Note that these aggregate numbers hide trading activity. Within resi mortgages, Lehman bought $11bn of mortgages, primarily AAA-rated prime, for general market making activity. Also, with other ABS, the sell-down of Applebee's is included in that number.
    - Govi and agencies declined $17.6bn.
    - Corp debt and other declined $9.9bn, including $2.1bn of acquisition finance funded loans.
    - Corp equities were down $9.9bn.
    - Real estate held for sale was down $1.8bn on a gross basis and $2.5bn on a net basis.
    - CP and other money market instruments were up $1.3bn.
    - Derivatives and other contractual agreements were down $8.6bn.
- LBI excess capital for the quarter-end was $3.041bn, up from $2.536bn at the end of 1Q. Subs for LBI are not guaranteed by LBI, and FINRA has asked to have LBHI guarantee any losses. Lehman does not have a problem with that and is looking into doing that. More broadly, there is an internal project underway to move subs out from LBI. LBI was profitable in May, with net revenues of $408m and net income of $167m, a trend which is continuing in June.
- Looking ahead to June, FID was hit when the Euro swap curve inverted. This affected derivatives notes and lingering front/end exposure in Sterling and Europe inflation positions. It appears that rates lost $150m in a day, and $200m in total. They had been cutting their positions, but had enough on to get whacked.

CREDIT RISK (VINCE DIMASSIMO, STEVE SIMONTE)

Leveraged Lending

- Commitments (unfunded) dropped from $826m on 5/13 to $634m on 6/17. There was one new commitment to Converteam Group SAS for $309m. Barclays is selling this entity to sponsors, and Lehman is acting as one of five staple providers. The $309m is Lehman's share. Revised commitments included Bonten Media Group (-$168m) which expired and Wesco Aircraft Hardware Corp (-$75m) which was syndicated down. Two deals were closed: PQ Corp for $100m and McJunkin for $158m.
- Funded exposures decreased significantly from $7.728bn on 5/13 to $5.055bn on 6/17. Management actively worked to sell the risk down in advance of quarter-end, both for risk purposes as well as disclosure purposes. Drivers of the changes included:
    - Closed deals: PQ Corp (+$100m) and McJunkin (+$158m)
    - Changes:
        - Applebee's/IHOP (-$865m): Lehman sold a $400m block of this Whole Business Securitization without financing on the last day of quarter for 5 points below the price at which the position was marked. The other $465m of sales were completed in smaller chunks over the course of the quarter closer to the marks in the book. To sell the large block, Lehman priced in a large liquidity discount, thus the 500 bp discount. Lehman then marked down the remaining portfolio to the new lower levels consistent with the transaction price. The remaining position ($1.08bn in bonds) is AAA-wrapped by Assured. In total, Lehman lost $200m on the position.
        - Home Depot Supply (-$565m): Similar to the Applebee's story, Lehman sold a large block of HDS with a liquidity discount, 5 points off their internal marks. In this case, Lehman did provide financing, with a 35% haircut. The remaining position consists of $185m of loans and $82m of bonds.
        - PQ Corp (-$320m): Position from 2007 was sold off. $12m of loans remain.
        - Sequa Corp (-$283m): No more positions remain.
        - CDW Corp (-$226m): Lehman provided financing with a 50% haircut associated with the sale of this position. The sale price was above the internal marks of the position. $100m of loans and $148m of bonds remain.
        - Other sales included: Vought Aircraft (-$200m), First Data Corp (-$175m), Houghton Mifflin Riverdeep (-$141m), PQ Corp (-$100m), McJunkin (-$58m) and Targa Resources (+$2m).

- The syndicate for Endemol Holdings is working together to try to sell the position. Lehman's position consists of $292m in loans and $65m in bonds. Pricing is tight relative to current marks.
- Besides the liquidity discounts associated with the block sales of Applebee's/IHOP and HDS, the sale prices during the past month were pretty close to the marks on the positions. During the quarterly review on July 16, we have asked Finance to provide us with a detailed list of all positions, marks, and sale prices.
- The Firmwide Risk for 5/19 again highlighted the Local Insight Media exposure which was discussed in last month's writeup. Lehman was in dispute with LIM on a deal-contingent interest rate swap on which LIM owed Lehman $25m. A WBS needed to be completed by 5/30 according to the terms of the swap. LIM indicated that cash settling the swap would require a capital injection by LIM's parent company, potentially negating the tax-free nature of the merger. Lehman has since agreed to split the difference on the mark-to-market exposure, and to go ahead with the WBS later this summer. We will continue to monitor this exposure.
- The Firmwide Risk for 6/2 highlighted the high yield financing facilities. Lehman has executed a total of 17 financing facilities through May 31 against $3.9bn face amount of HY collateral previously owned by Lehman. Advance rates range from 35% to 80%, and total amount funded was roughly $2.1bn against $3.3bn in market value of the collateral. Margin terms vary, but include a combination of daily margin, margin holidays, and/or margin triggers following a specified decline in value.

<u>High Grade</u>

- Lehman is sole advisor to Allstate in its bid to acquire RBS's auto insurance business for $11-13bn. They are considering underwriting up to 50% of a $8-10bn bridge facility. Final bids are not due until mid-July. The bridge would be taken out with a combination of debt and equity.
- Two concentrated positions are now gone. Imperial Tobacco was taken out with a rights offering (to take out a $1.23bn bridge) and senior loans ($950m) were taken out via the secondary markets. Likewise, Carlsberg is now gone, with a rights offering taking out a $1.78bn bridge and senior loans ($180m) reduced via secondary markets.
- Alcoa and Altria are two other concentrated positions. Both are undrawn CP backstop facilities with a $1bn notional. Alcoa is expected to be held until maturity in January 2009 or until cancelled by borrower and Altria will be taken out by a bond issue this summer. The market value of these positions are $995m and $998m respectively, the result of some small initial marks taken at the time the positions were put on.

<u>Counterparty Credit Exposure</u>

- CCE decreased by $1.5bn to $53.854bn, driven by a decline in CCE of $2.7bn in stock loan/borrow due to a decline in dividend arb trades. Also, the large exposure to Corona rolled off (more below).
- As discussed last month, the Corona Borealis CDO was liquidated. Lehman received $730m of cash from liquidation of the CDO's assets (a Rabobank GIC and a portfolio of ABS securities). The remainder of the $1.15bn CE was settled against Lehman's VFN liability. There was some negative P&L associated with the VFN liability, but from a counterparty credit perspective Lehman was made whole.
- Notable names on the top CE and MPE exposures:
    - The Italy exposure is up over the month, to a CE of $2.9bn. Lehman increased its credit hedges during the month, and is now long $1.9bn of credit protection.
    - A new name appeared, Stichting Pensioenfonds ABP with a CE of $529m as the result of stock loan and derivatives activity.
    - Lehman has a $435m current exposure to an SPV, KBC Investments, for a balance sheet trade supporting the fund derivatives business. Lehman offers products that link their returns to hedge fund returns, and Lehman owns the hedge fund shares (a diversified basket) as a hedge to those positions. In order to get these hedge fund shares off Lehman's balance sheet, Lehman sold $1.2bn of shares to KBC and entered into a TRS to receive the economics of the return. Lehman posted 1/3 of the money as initial margin which is driving the CE.
    - Exposure to XL is $246m after reserves. During the past month they increased the reserve percentage to 53%. Fong led a process where he looked at specific spread curves, and analyzed what the reserves should be based on implied probability of default and recovery. In the past Lehman has given latitude to the businesses to set their own reserves, but are now working to harmonize the reserves across desks and are computing this weekly.
        - Generally other monoline exposure increased as well, with reserves from $200m-$332m. The exposures themselves are not moving in a material way. We will ask them to include a page in our monthly risk package listing the monoline exposures for the near future.
    - Exposures in the energy space are increasing due to increased volatility in the market. As a result, Lehman has been purchasing CDS protection against specific names. In one case (Chesapeake Energy Corp, CE $247m) they are restructuring their credit agreement in order to get a secured interest in the assets. As a result of this volatility, there is more focus on the CVA desk now, with Fong running CVA every day.

With generally strong performance in May, hedge funds have seen a rebound in the sector. However, the sector may have net outflows for the month given poor earlier results. This would be the first instance of negative net flows in a long Market

MARKET RISK (VINCE DIMASSIMO, STEVE SIMONTE)

- Market overview: Markets calmed in mid-May, and then picked up again. In the middle of May, spreads tightened and then moved out again. The VIX in mid-May was at 16, the lowest level in 6-9 months, and is now at 22-24. These market moves pushed up VaR, while positions were actually cut, especially in equities. VaR ended the month at $115.5m, versus $134.1m the prior month. FID was at $108.8m versus $105.4m, while Equities was at $20.9m versus $32.6m.
    - VaR methodology change: There was an increase in Europe RE driven by better risk capture. The VaR hadn't been tracking with the volatility in the market, and this was caught when vols went up and VaR didn't go up proportionately. This was discussed further on a subsequent phone call.

- Risk appetite decreased by 162m, mostly from reductions in market risk with the GPS spinoff as a big driver.

- The IR01 in rates rose from 1.44m/bp to 3.3m/bp, but there was lots of flux in the 10-30y part of the curve. Historically, being long rates provides something of a hedge for long equity delta or CS01.

- Equities delta fell from 2.9b to 2b over the last month. Much of this was being driven directly by the equities division (1.4b to 900m), and there were also reduction in principal inventories where deltas were down by ½ (Mark said 1.7b to .8b - his numbers don't exactly add up).

- Laura gave us a Principal investing risk report that laid out Lehman's principal investments (in GTS, GOG, and direct (e.g. R3, DE Shaw)) quite clearly. See presentation for details.

- Real Estate Discussion (Paul ?, Ken Cohen's partner)

    - Paul noted that the sales that closed in Q2 began in Q1. As of our meeting, they had closed 500m of sales begun in Q2, and had about $750m in soft circles. A sale of mezz or B-notes might take 45-90 days, while securities are taking 1-2 weeks. In Europe and Asia, there are slightly more securities selling than equities (Lehman is also focused on getting their equity exposure down as well). For mezz debt, the loans have yields in the high 7s (but typically under 10). When they go out, they get a huge range of bids from swaps+500 to 30,40,50 in the price space (vulture bids). While there is lots of capital out there for mezz, they have higher yield requirements now. RE opp funds tend to look at equity-like pieces. Also, new entrants without big real research ability are entering the market.

- Last quarter Lehman did a fixed-rate conduit deal with UBS, and every class was oversubscribed. At the time of our meeting, BOA/Barclays were out with a similar deal. In Europe, trading is "by appointment" and the exit of choice is whole loans. While it is more efficient to fund in security form, in some cases Lehman is taking the loans out of the securitization to facilitate sales.
- Paul noted that Lehman had done a floating rate securitization in August, but the circles from the deal had just walked. He characterized the current situation as "buyers and sellers just staring at each other."
- Going forward, they want to be a motivated rather than distressed seller, and at the time, were not interested in "crappy bulk deals." The origination infrastructure has been downsized, and there are no new deals right now (although they are still working on legacy Asia deals). Paul said that there were no hard b/s targets.
- Archstone: $2b of assets had been sold to date, and 500m of assets are under contract. $1.5 are in various stages of negotiation. At the time, they were working on a block trade of NY assets that was described as a wild card. Paul anticipates that TL A may be fully paid by Q109, and mostly paid by the end of this year. The company is deleveraging through asset sales and asset-specific financing. Archstone has a much larger development pipeline than other public REITs, and a huge asset management arm. Paul stated that they need the development to continue. Lehman is discussing the bridge equity position with a strategic partner, but they have to pay down the debt first in order to get the leverage structure right-sized. The original management team is still in place, and the board has both Tishman and Lehman representation.
- Suncal: There is no Lehman equity involvement here, and this consists of 24 discrete projects. The RE equity fund did a number of deals, but Lehman (corporate) is predominantly a lender. 90% of the overall exposure is from debt positions. There is a 25% cumulative markdown across the positions. There has been a good deal of focus on specific assets, but only 16% is the "inland empire." Paul was particularly focused on a waterfront property in Orange County, which he considered to be very valuable.

FOR THE MEMO

- During the past month, Lehman sold a significant portion of its funded leveraged financing exposure. The firm sold large blocks of both Applebee's/IHOP and Home Depot Supply, two commitments that were made pre-credit crunch last year. In order to sell the large blocks, Lehman was forced to price the debt at a significant discount to the prevailing marks. Meanwhile, the business has been able to sell smaller pieces of loans without such discounts. Lehman has continued to remark its positions to reflect the latest sales prices.

- Lehman has incurred some large trading losses over the past few months, across various assets classes including rates, credit, and equities. While not necessarily material at the holding company level, the losses are somewhat unusual in their magnitude. We’ve discussed these incidents with the chief risk officer, who has attributed them to large dislocations in the markets. In addition, he feels that the new senior management has a strong trading background, and has quickly moved to focus on both risk-taking and accompanying trading losses. We’ll continue to discuss trading strategies and profitability, along with overall market risk appetite.