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Sent: Thursday, September 11, 2008 11:22 AM
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Subject: RE: Time Sensitive - LEH Survey

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1. Do you think Lehman will have to raise additional capital? What sort of size in shares? Dollars? What is the sense on timing?

While Lehman's management yesterday said that it does not expect to have to raise capital in order to reach its destination of being a "new" LEH (sale of NEU, spinoff of CRE/CMBS, etc), we are skeptical. Our work in our Monday piece implies that LEH would have to raise $7.5 billion in order to capitalize this spin off adequately and maintain a 20x leverage ratio.

Given the fact that LEH is on ratings review from S&P (with negative implications) and Moody's (with direction unknown), they will have to convince them (more than anyone else) that they are adequately capitalized as an A/A2 firm.

The number of shares they would need to raise all depends on the share price. We think that if LEH can get successfully implement its strategic initiatives, its valuation should improve. I wouldn't expect a capital raise until the spin-off occurs. LEH will certainly have an easier go at raising capital (or even being taken over) post the spin off...

Lehman is optimistic abut not needing capital but we are skeptical of this claim -- the real decision makers on the issue of capital are the rating agencies and the lawyers and the auditors especially if there are more write-downs on the CMBS portfolio, we believe the firm will have to raise additional capital as the credit rating agencies may force the firm to do so in an effort to thwart a downgrade. In terms of the size, that would completely depend on the amount of writedowns the firm would take, but we believe a loss in Q4 would certainly prompt a capital raise. We believe a sale of NEU offsets the loss this quarter and could provide enough equity to put into the spin-off. We note that while the firm says it doesn't need to raise additional capital, their comments seem to suggest this is based on regulatory standards and unfortunately for a brokerage firm it's not about regulatory standards but credit rating agency standards.

2. What sort of Book Value multiple will Lehman trade at after the effect of the CMBS spinoff, Blackrock UK RMBS sale and 55% IMD sale?

This all depends on the amount of capital they may need to raise if

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there are further marks on their assets. Assuming the firm returns to normalized earnings in 2009 and 2010, we believe

If Lehman can generate ROEs inline with its cost of capital, it would demand a market value of 1.0x tangible book. The problem is that its cost of capital has been increasing steadily over time as its Beta rises (and has been rising faster than peers). So, right now, its cost of capital is closer to 17% vs. the 13% for the rest of the group.

3. What do you think the ultimate size of losses will be on Lehman's portfolio? What is the timing on them? Of the total losses expected how many have already been provisioned?

Unfortunately, this is anybody's guess as we don't know how the firm is hedging these positions or have any insight into how they're marking them. We know that they are marking their CMBS portfolio at $0.85 on the dollar and they only took $1.70 billion of writedowns on this exposure this quarter vs. $5.30 on residential.

It appears that they will have to take additional marks on its CRE/CMBS exposures, especially if they are looking to spin them off. I have trouble believing that auditors would sign off on the current value of these assets were they to be spun off tomorrow.

In our call on Monday, we estimated the firm would have to take an additional $5bil of writedowns on this book. They took $1.3 billion yesterday, so we could see another $3.3 billion.

As we said, if the firm continues to take markdowns on these assets, they may have to raise additional capital. Remember, if the CMBS portfolio gets marked down further, Lehman will take the hit through the income statement but that will mean they will need less equity capital in the new spin-off entity to reach its goal leverage ratio.

4. What do you think normalized earnings are going forward? How long until Lehman starts producing normalized earnings?

We think the firm will ultimately warrant a 10% ROE in 2009 and 13% in 2010 assuming the firm is able to execute on the blueprint they provided yesterday. However, we may be optimistic here in terms of the timing.

It still has a leading global investment banking business and fixed income division, which also suggests the firm is a ripe takeover candidate once they shed these assets.

5. What does Lehman's liquidity look like? Can there be a run on the bank?

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Lehman's liquidity profile appears fine, especially with the Fed backstopping the firm. After Tuesday's market close, every major broker dealer has announced they continue to trade with the firm and we believe it is likely that the Fed is encouraging other firms to continue to trade with Lehman to avoid a funding run.

6. How can Lehman really blow up?

Lehman's stock could fall to $1 or rise to $20 and the firm will be able to go about business as usual as long as firms continue to lend to it. The Fed's facilities are certainly helping keep these lines open.

But if a large counterparty decides to pull lines and other firms catch wind and pull their lines, then the Fed will have to decide what to do because Lehman would look to it for funding. It's a massive game theory. No large counterparty wants them to fail, so as long as people lend, it won't.

Not executing on the firm's strategic initiatives would likely be detrimental to the firm, or the Fed doesn't continue to backstop the firm. We do not think this will happen as the Fed is doing everything within its power to avoid one of these firms to fail. Even if the equity goes to $2, as long as people are trading and lending to the firm, Lehman survives.

7. In the CMBS SpinCo scenario: Is there any possibility they can shift their existing debt or prefs over to the new entity?

In theory but it seems highly unlikely given the new entity will be under intense scrutiny from rating agencies, regulators and auditors.

In our research on Monday we forecasted the new entity would not be able to sport a leverage ratio of more than 3-to-1. Yesterday the firm came out and said that it expects to spin off these assets at a ratio of 4 or 5-to-1. Given the scrutiny of the rating agencies and regulators, we expect this SpinCo/REIG (Real Estate Invesmtent Group) will have a very conservative capital structure.

From our understanding Lehman does not have the legal authority to transfer debt and or preferred equity to the spin-off. Why, because people bought the debt and preferreds refernced to Lehman's name, not SpinCo's!

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