

Company Flash

28 March 2008 | 9 pages

Lehman Brothers Holdings Inc (LEH)

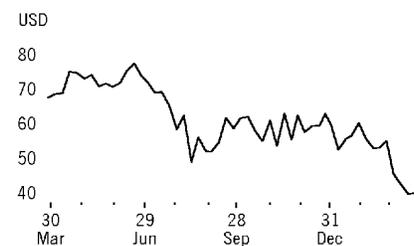
Change in opinion
 Rating change

Upgrading To Buy; Reality Will Trump Fear

- **Buy Lehman.** After being on the sidelines for a couple of years, we see the current valuation as an extremely attractive entry point into Lehman shares. Furthermore, the recent profitable quarter in a tough environment, the coordinated actions taken by the Fed & Treasury to provide meaningful liquidity, and Lehman's management team's excellent track record of creating value and managing risk all serve as excellent downside protection.
- **In our view, it's tough to have a liquidity-driven meltdown when you're being backed by government entities that have the ability to print money.** Lehman has ample liquidity to run its business. With \$34b in liquidity at the parent company, the ability to get access to over \$200b in liquidity from the Fed's primary dealer credit facility, and its ability to tap the term auction facility, access to liquidity is a non-issue. Actions speak louder than words and in a post Bear Stearns era, the coordinated Fed & Treasury actions are designed to prevent a crisis of confidence leading to liquidity issues for any of the major investment banks. The liquidity backstop buys the time necessary to restore confidence and quell fears that are not based on fundamentals. It's worth noting that Lehman has not used the facility other than the initial \$2b test run.
- **Core earnings highlight diversity and excellent risk management.** We estimate that writedowns aside, Lehman had its 2nd best fixed income trading quarter ever and generated a 20%+ ROE during 1Q08. We estimate that even in a stress-case scenario on the commercial real estate, residential mortgage, and leveraged loan portfolios, Lehman will generate positive earnings and grow book value per share this year. See our 3/20/08 note for analysis of 1Q08 earnings. <https://www.citigroupgeo.com/pdf/SNA17079.pdf>
- **We see 70% upside in Lehman shares.** LEH's valuation is compelling based on virtually any historical metric, leading to an excellent risk/reward opportunity. Using our DCF based valuation model, LEH shares are discounting less than a 10% over-the-cycle ROE and our 15% ROE forecast results in a \$65 stock or almost 70% upside. Furthermore, on an absolute P/B, tangible P/B and relative P/B basis, Lehman is trading at some of its lowest levels in more than a decade. See Figures 1,2,3, and 4 showing Lehman is trading trough levels.

Buy/High Risk	1H
<i>from Hold/High Risk</i>	
Price (27 Mar 08)	US\$38.71
Target price	US\$65.00
Expected share price return	67.9%
Expected dividend yield	1.3%
Expected total return	69.2%
Market Cap	US\$20,539M

Price Performance (RIC: LEH.N, BB: LEH US)



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See Appendix A-1 for Analyst Certification and important disclosures.

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Once liquidity and confidence issues are put to rest, the focus on valuation will move front and center, and Lehman is cheap by virtually any historical metric.

Discounted Cash Flow

68% upside to get to conservative 15% ROE

Figure 1. Lehman Derived Target Price

	Assumed Cost Of Equity						
	7%	8%	9%	10%	11%	12%	13%
10%	\$54	\$51	\$48	\$45	\$42	\$40	\$38
11%	\$59	\$56	\$52	\$49	\$46	\$44	\$41
12%	\$65	\$61	\$57	\$54	\$50	\$47	\$45
13%	\$71	\$66	\$62	\$58	\$55	\$52	\$49
14%	\$77	\$72	\$68	\$63	\$59	\$56	\$53
15%	\$84	\$79	\$73	\$69	\$65	\$61	\$57
16%	\$92	\$85	\$80	\$75	\$70	\$66	\$62
17%	\$100	\$93	\$87	\$81	\$76	\$71	\$67
18%	\$108	\$101	\$94	\$88	\$82	\$77	\$72
19%	\$118	\$110	\$102	\$95	\$89	\$83	\$78
20%	\$128	\$119	\$111	\$103	\$97	\$90	\$85

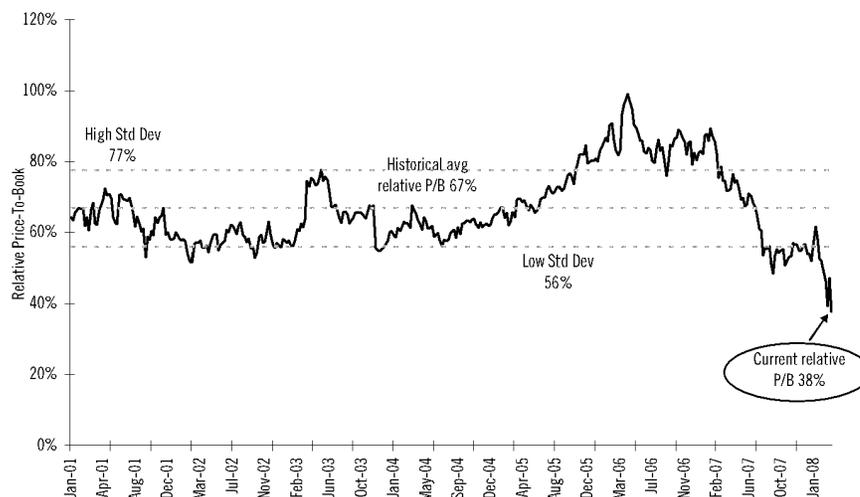
Source: CIR estimates

Relative P/B

78% upside to revert to mean

49% upside to get to low

Figure 2. Lehman P/B Valuation Relative To S&P 500 P/B



Source: FactSet, StockVal, CIR

Absolute P/B

96% upside to revert to mean

62% upside to get to low

Figure 3. Lehman Historical P/B Valuation



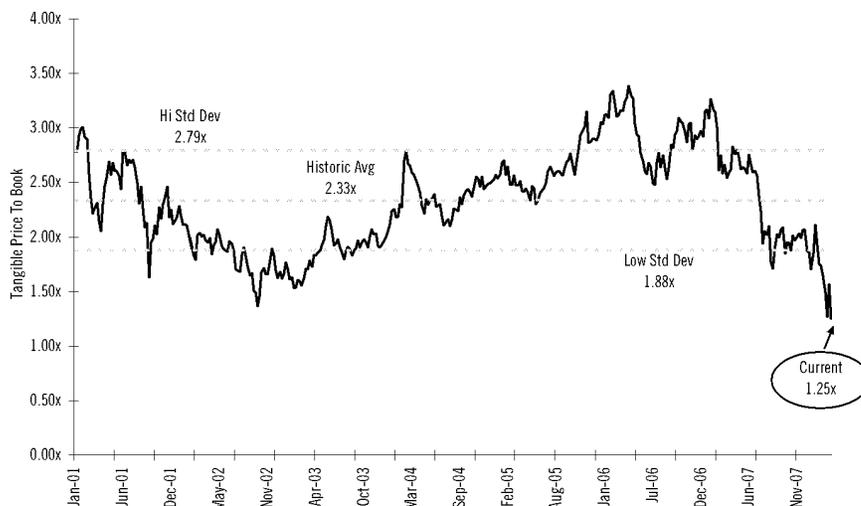
Source: FactSet, StockVal, CIR

Tangible P/B

87% upside to revert to mean

50% upside to get to low

Figure 4. Lehman Brothers Historical Tangible P/B Valuation



Source: FactSet, StockVal, CIR estimates

Lehman Brothers Holdings Inc

Company description

Lehman Brothers Holding, Inc. (LEH), founded in 1850, provides services in equity and fixed income sales, trading and research, investment banking, private equity, and private client services. Headquartered in New York, with regional headquarters in Tokyo and London, Lehman Brothers is organized within three business units: Investment Banking, Capital Markets, and Investment Management. The company's fiscal 2007 revenue was comprised of 39% fixed income-related revenue, 41% equity and M&A-related revenue, 16% private client and asset management-related revenue, and 4% private equity and other revenue.

Investment strategy

We rate the shares of Lehman Brothers Holding Inc. Buy/High Risk (1H) (vs Hold previously). We see the current valuation as an extremely attractive entry point into Lehman shares. Furthermore, the recent profitable quarter in a tough environment, the coordinated actions taken by the Fed & Treasury to provide meaningful liquidity, and the Lehman management team's excellent track record of creating value and risk management all serve as excellent downside protection. Furthermore, we estimate that Lehman shares are discounting less than a 10% ROE and that the earnings power of the franchise will conservatively result in an ROE that is 50% higher than the stock is currently discounting.

Valuation

We rate the shares of Lehman Buy / High Risk (vs Hold previously) with a target price of \$65. The primary driver of our upgrade is our view of the excellent risk/reward in Lehman shares based on a combination of its earnings power and our view that it has an excellent liquidity position. Our valuation methodology to derive our target price utilizes a discounted cash flow valuation model that uses net income as a proxy for cash flow. Our model uses a combination of our near-term earnings estimates and our view of longer-term earnings estimates (which are derived by using our forecasted over-the-cycle return on equity). Our growth in equity takes into account income generation and several other factors including dividend pay-out ratio, buybacks, new share issuance, etc. Our cost of equity is derived primarily using the CAPM formula. Our model assumes a cost of capital of 11% for the firm, an over-the-cycle ROE of 15%, a terminal book value multiple of 1.7x, a 4-year beta of 1.4 (source: Bloomberg), a risk free rate of 5.0% and a current market premium of 4%. Using these assumptions, we derive a target price of \$65.

Risks

We rate LEH shares High Risk driven by its relatively less diversified revenue streams vs. peers in addition to a higher level of non-annuity trading-type revenue streams. Key risks related to Lehman shares not reaching our price targets are primarily related to the macro environment, including the strength of the economy and strength of the operating environments for investment

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Appendix A-1

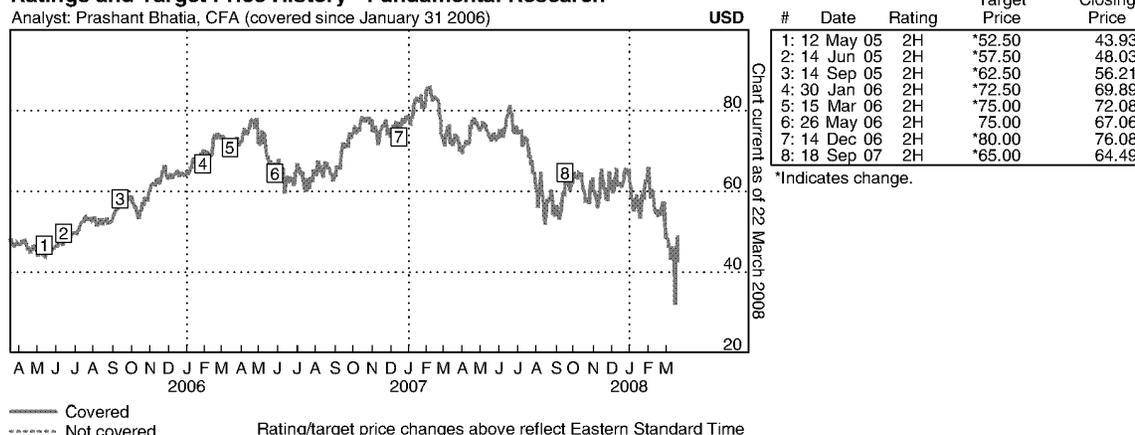
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Analyst: Prashant Bhatia, CFA (covered since January 31 2006)



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