

16 June 2008

Lehman Brothers Holding

Reuters: LEH.N Bloomberg: LEH UN Exchange: NYS Ticker: LEH

2Q08 EPS in line w/Pre-Release; Exposures Clearer

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CEO Says Okay with Valuations of Balance Sheet

Lehman's 2Q08 was in line w/its pre-release but gave more detail. Pro forma total capital is above minimum (19% vs. 10%) and reflects a healthy Tier 1 (12.5%). The CEO said that he was okay with balance sheet valuations as of today. We estimate Lehman has taken \$14B of write-downs and has \$2B more to go (est. \$1.50/share haircut), mostly in commercial, though we expect book value of \$33 to remain about steady given other offsets. Maintain Buy.

Estimated \$3B of Additional Write-Downs to Go

Cumulative residential real estate write-downs have been \$11B, about what is needed based on our estimates, and cumulative commercial real estate write-downs have been \$3B, whereas we estimate this may be about \$2B short of what is needed. Herein is our analysis that provides these estimates. The write-downs, while not over, should be much less and continue to decline by year-end, in our view.

Valuation & risks

We believe LEH should trade at a discount to its five-year average multiple (1.9x book) as the deteriorating credit environment outweighs relative strength in risk management. Our TP implies a multiple of 1.2x our 2009E book value. Given the volatile nature of earnings, we view book value as a better, more stable, basis for valuation purposes than P/E. LEH is currently trading at about 0.9x reported book value of \$34 (0.8x our 2009 estimated book value), below its five-year average price-to-book of 1.9x (range of 1.1-2.6). The key risk is LEH's ability to manage a turbulent fixed-income market while it invests for future growth.

Forecasts and ratios

Year End Nov 30	2007A	2008E	2009E
1Q EPS ¹	1.96	0.81A	-
2Q EPS	2.21	-5.14A	-
3Q EPS	1.54	0.33	-
4Q EPS	1.54	0.59	-
FY EPS (USD)	7.25	-3.40	3.10
P/E (x)	9.7	-	8.3
Dividend yield (%)	0.9	2.3	2.3

Source: Deutsche Bank estimates; company data

¹ Includes the impact of FAS133R requiring the expensing of stock options.

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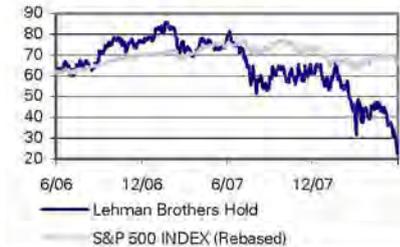
DISCLOSURES AND ANALYST CERTIFICATIONS ARE LOCATED IN APPENDIX 1

Results Review

Buy

Price at 13 Jun 2008 (USD)	25.81
Price Target	42.00
52-week range	81.30 - 22.70

Price/price relative

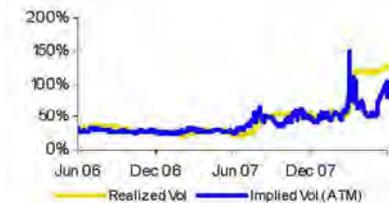


Performance (%)	1m	3m	12m
Absolute	-39.9	-43.9	-66.9
S&P 500 INDEX	-3.1	3.4	-10.3

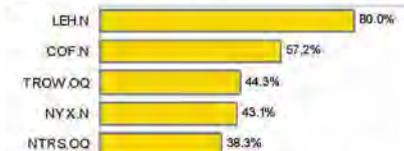
Stock & option liquidity data

Market Cap (USD)	14,385.2
Shares outstanding (m)	557.4
Free float (%)	96
Volume (13 Jun 2008)	13,235,900
Option volume (und. shrs., 1M avg.)	19,495,422

Implied & Realized Volatility (3M)



Implied Volatility (3M, ATM) vs. Peers



*Weighted-avg. of index components
 Data as of 13-Jun-08

Discussion

Write-Down Analysis

Lehman has taken \$14B cumulative real estate losses via \$11B in residential mortgages and \$3B in commercial real estate. We estimate that the residential write-downs are close to what is needed whereas the commercial real estate write-downs seem light by about \$2B based on our estimates. However, the CEO said that he was okay with valuations at quarter-end and as of today. The company gave more detail than it has given in the past. There is still information risk since the best detail was given for 2Q08 (commercial real estate) and 1Q08 along with 2Q08 (residential real estate) but not for the original balances. As a result, we perform our write-down analysis based on more recent balances and then increase the results by 1/4th to get to estimated needed marks on the original totals (i.e., balances that we use as the basis for marks are 1/4th lower than the estimated original balance).

Residential Real Estate Write-Downs

We est. a starting level of residential mortgages at \$40B, which declined to \$32B at the end of 1Q08 and \$25B at the end of 2Q08. This quarter, Lehman gave more information about the components relative to 1Q08, which is therefore the best historical base to use for the marks. Since the 1Q08 total of \$32B was 1/4th less than the original level of \$40B, we increase our estimated marks - when done - by 1/4th. (this analysis assumes that all components of the residential real estate category declined by the same proportion). Moreover, Lehman had cumulative buys and sells during the quarter of \$20B, reflecting high turnover of its inventory.

We estimate that Lehman needs \$8.7B of write-downs on its \$32B balance at the end of 1Q08. If this is increased by 1/4th, implies \$11B of write-downs, or equal to what the firm has taken. In other words, based on this data, it seems about right. Also, Lehman indicated that it had sold \$11B of residential mortgage assets during the quarter and that total marks are down to 70-80 cents on the dollar, so it seems that the company has current pricing data.

We estimate that U.S. Alt-A, which declined from \$15B to \$10B (1Q08 to 2Q08) needs marks of \$5.5B assuming write-downs of 30% on starting 1Q08 balances of whole loans (\$3.7B), 30% on AAA rated securities (\$6.4B), 60%, on other RMBS securities (\$2.8B), and 50% on servicing and other (\$1.7B). Our assumption for the write-down for AAA securities is based on ests. that 40% of its book is super sr. (est. 20% mark), 40% is mezz (est. 40% mark), and 20% is other AAA securities (est. 25% mark).

We est. that subprime/second lien, which declined from \$1.3B to \$1.1B, needs marks of \$1.8B assuming write-downs of 80% on whole loans (\$1.3B) and 50% write-downs on AAA securities (\$1.6B), the latter which is based on vintages mostly in the 2007 period (i.e., higher write-downs for this - LEH said this was the case).

We est. mark-downs in Europe, which stayed around \$9B, need to be around \$1.4B (15% write-down) given that Lehman said that 2/3rds is prime (10% marks) and 1/3rd is nonprime (30% marks). We do not assume write-downs on Asia-Pacific. Of the \$9B, est. \$2.3B is outside the UK, so this could potentially reduce the amount of the needed mark.

Taken together - est. write-downs on Alt-A (\$5.5B), subprime (\$1.8B), and Europe (\$1.4B) total \$8.7B or - grossed-up by 1/4th to equate to the est. original balance, equals \$10.9B, or perhaps half a billion short of what it has taken with several caveats..

Commercial Real Estate Write-Downs

Lehman gave better detail as of 2Q08. Of its \$40B of commercial mortgage exposure, we give no negative marks on the \$8B that is in Asia or for the portion of the \$26B of whole loans that are fixed rate (assume that this can get hedged).

As per the marks:

Per senior whole loans (\$19.5B), we assume 15% marks on the portion (\$14B) that is in the U.S. or Europe and is floating rate (91% of all senior whole loans).

Per mezz whole loans (\$5.9B), we assume 30% marks on the portion (\$4.5B) that is in the U.S. or Europe and is floating rate (85% of all mezz loans), and 10% write-downs on securities of \$5B.

The 30% marks on the the mezz whole loans could change based on any new information that breaks down jr. mezz (est. 60% write-downs) vs. sr. mezz (est. 25%).

Taken together, this implies needed write-downs of about \$4B, vs. actual of \$3.1B. Wildcards could include the equity component, though Lehman noted that Archstone had been written down to 75 cents and has an exposure of under \$1.8B. Increasing the \$4B to account for the higher initial balance that was about 1/4th higher means that Lehman needs additional marks of \$5B vs. those actually taken of \$3B.

Valuation

Our price target implies a multiple of 1.2x our 2009 book value estimate. Given the volatile nature of earnings at the investment banks, we view book value as a better, more stable, basis for valuation purposes than P/E. We believe Lehman should trade at a discount to its historical average price-to-book (1.9x), as the deteriorating credit environment outweighs relative strengths in risk management.

Risks

We cite the following key company-specific factors: slower growth in fixed income markets, less customer flow, reduced trading, growing pains with new products, exposure to hedge funds, leverage to mortgage banking, stock compensation's potential impact on retaining key personnel, and potential issues related to succession of CEO Dick Fuld.

Non-specific risks to our investment thesis include weak global economic conditions, increasing unemployment and bankruptcies (which affect counterparty credit quality), the level of U.S. interest rates (real and nominal), fraud committed by corporate clients (which may directly lead to legal risks and has an indirect negative impact on capital markets sentiment), actions taken by governments and regulators, and potential legal settlements that significantly exceed allocated reserves.

Appendix 1

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Additional information available upon request

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Lehman Brothers Holdings Inc	LEH.N	25.81 (USD) 13 Jun 08	2,6,7,8,14,15

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Historical recommendations and target price: Lehman Brothers Holdings Inc (LEH.N)

(as of 6/13/2008)



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- Strong Buy
- Buy
- Market Perform
- Underperform
- Not Rated
- Suspended Rating

Current Recommendations

- Buy
- Hold
- Sell
- Not Rated
- Suspended Rating

*New Recommendation Structure as of September 9, 2002

1. 4/11/2007:	Buy, Target Price Change USD90.00	5. 4/1/2008:	Buy, Target Price Change USD52.00
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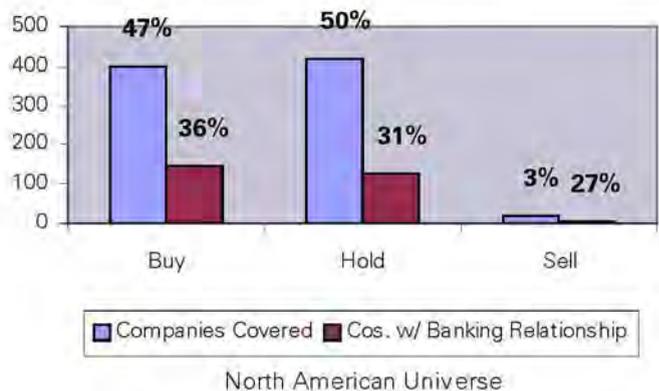
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June 16, 2008

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2:30 P.M. Edition

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LEH Follow Up

Lehman Brothers Holdings Inc.

Analyst: Douglas Sipkin, CFA

(BROKERS, OVERWEIGHT)

(LEH, \$27.31, MARKET PERFORM / V)

Sector Rating: Brokers, OVERWEIGHT

* LEH provided materially more disclosure this quarter around related mortgage positions. We intend to review in a note.

* Fears over liquidity and capital going forward seem unlikely. Pro forma for the equity raise, net leverage is 10x and TIER 1 capital is above 12%.

* The company feels comfortable with where it is carrying positions. We suspect now that LEH is under less pressure to sell, any future marks will be smaller than the current quarter. Level 3 assets declined from \$40 billion to \$38 billion.

* LEH marked archstone \$350 million this quarter and this was reported in equity trading. Accordingly, equity trading trends were better than indicated by the segment number.

* Prime brokerage was a record and up 5% from last quarter. This has positive implications for GS and MS, in our view.

* All in all, we think LEH did a reasonable job on the call and we are optimistic that improved liquidity and capital will bring some stability to shares.

HUGH: Telematics Sister Company Acquired

Hughes Communications, Inc.

Analyst: Jurgan Usman

(ALTERNATIVE SERVICE PROVIDERS, MARKET WEIGHT)

(HUGH, \$49.35, OUTPERFORM / V)

Sector Rating: Alternative Service Providers, MARKET WEIGHT

SISTER COMPANY ACQUIRED. This morning, Hughes Telematics (HT), an Atlanta-based start-up that develops in-car telecommunications services (similar to OnStar), has agreed to be acquired by a publicly traded investment company Polaris Acquisition Corp in an all-stock deal which values the combined company at \$700MM. HT was founded with backing from Apollo Management LP, which is the largest shareholder of HUGH (about 57% ownership).

BUSINESS RELATIONSHIP WITH HUGH. As a reminder, HUGH currently is doing customer-funded R&D efforts for HT, and will supply HT with the telematics device to be installed in cars. HT will then run the service that provide cars with navigation, diagnostics, Internet access, and media & entertainment. So far, HT has signed up Chrysler and Mercedes-Benz (roughly 2.2-2.5MM cars produced a year). The device is to be installed starting in model year 2010 (Fall 2009 delivery)

Equity Sound Bites

HIGHLIGHTS FROM CALL. In a call hosted this morning, HT said that its current management will run the combined company as HT will own about 65% of the combined company. Closing is expected in early 2009. HT plans to install the device in all Chrysler and MB cars by 2012-13 time frame (regardless whether the service is activated or not). It is also still actively pursuing other OEMs for similar agreements.

BOTTOM LINE - POSITIVE. This is essentially a reverse IPO for HT and thus we expect the HUGH relationship to stay the same. The capital infusion should help HT to get past the start-up phase and as such we think that this is a positive for HUGH. In addition, this reinforces our belief that the telematics opportunity is real. As a reminder, in our current estimates we have yet to include the contribution from the telematics business, which could be significant. We estimate that this could add about \$350-400MM of revenue and ~\$40MM of EBITDA annually within 3-4 years.

Weekly Restaurant Industry Menu

Analyst: Jeff Omohundro, CFA

(RESTAURANTS, MARKET WEIGHT)

Sector Rating: Restaurants, MARKET WEIGHT

ON THE MENU THIS WEEK...

June 16 No announcements expected

June 17 No announcements expected

June 18 No announcements expected

June 19 No announcements expected

June 20 Wachovia Cattle and Corn Industry Update Conference call at 11:00AM ET. U.S. Participant
Dial: 800-374-1206, Passcode: 52098527.

MPG: New CEO Provides 30-Day Update On Initiatives

Maguire Properties, Inc.

Analyst: Christopher Haley

(OFFICE, MARKET WEIGHT)

(MPG, \$13.01, MARKET PERFORM / V)

Sector Rating: Office, MARKET WEIGHT

As we have previously discussed in our squawk over the weekend, Nelson Rising, MPG's new CEO provided a 30-day update on his initiatives. Some incremental details include:

PERSONNEL: Executive Officers who will leave include: Martin Griffiths, CFO; Paul Rutter, EVP of Major Transactions; William Flaherty SVP of Marketing. In connection with these changes, MPG has commenced a search for a new EVP and CFO and in the interim, Shant Koumriqian, SVP and Chief Accounting Officer,

Equity Sound Bites

will assume responsibility for accounting and reporting matters. Mark Lammas will continue to serve as EVP and will undertake responsibility for acquisitions, dispositions, financings and other transactional matters

MOVE BACK DOWNTOWN: The company, as previously announced, has completed its corporate office move back to downtown LA.

ORANGE COUNTY SALES: MPG has stated that it has begun marketing its Park Place assets, a 105-acre RE campus that is expected to be fully developed over the next 5-7 years, with Eastil Secured, with the proceeds targeted to pay down debt and for other general corporate purposes. Active discussions have also been renewed or commenced with interested buyers for certain of the company's other Orange County properties.

RECAPITALIZATION OF PLAZA LAS FUENTES: MPG also said that it is in advanced discussions with EuroHypo Bank, with whom it has an existing banking relationship, to obtain a short-term, floating-rate loan on its Pasadena-based properties, Plaza Las Fuentes & the Westin Pasadena Hotel. Proceeds are expected to range between \$100-\$110mm and will not be immediately deployed as they are intended to provide the company with an additional liquidity cushion. The financing is expected to close in the Q3'08.

Although the details of a potential equity infusion have not been discussed in the press release, we are somewhat reassured to see that 3 of the major initiatives have been set in motion.

Required Disclosures

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ATTN: Research Publications

LEH - Rating and Target Price Changes/Disclosures						HUGH - Rating and Target Price Changes/Disclosures						MPG - Rating and Target Price Changes/Disclosures					
Update Date	Publication Price	Rating	Valuation Range	Closing Price		Update Date	Publication Price	Rating	Valuation Range	Closing Price		Update Date	Publication Price	Rating	Valuation Range	Closing Price	
6/14/05	NA	OUTPERFORM	\$52-\$55	47.44		12/4/07	48.65	OUTPERFORM	\$66-\$72	48.50		6/14/05	NA	MARKET PERFORM	\$21-\$27	26.80	
7/20/05	NA	OUTPERFORM	\$60-\$62	52.90		4/7/08	54.84	OUTPERFORM	\$65-\$70	53.40		8/3/05	NA	MARKET PERFORM	\$26-\$30	30.10	
12/6/05	NA	OUTPERFORM	\$65-\$68	63.08								8/4/05	NA	MARKET PERFORM	\$27-\$31	30.18	
1/10/06	NA	OUTPERFORM	\$68-\$71	65.27								2/9/06	NA	MARKET PERFORM	\$30-\$34	32.25	
3/3/06	NA	OUTPERFORM	\$74-\$76	73.35								5/4/06	NA	MARKET PERFORM	\$31-\$35	34.07	
3/15/06	NA	OUTPERFORM	\$76-\$78	71.58								8/2/06	NA	MARKET PERFORM	\$33-\$37	36.08	
4/5/06	NA	OUTPERFORM	\$82-\$85	73.72								8/28/06	NA	OUTPERFORM	\$37-\$43	40.15	
5/2/06	NA	MARKET PERFORM	\$73-\$76	72.33								11/2/06	NA	OUTPERFORM	\$40-\$45	41.33	
6/13/06	NA	MARKET PERFORM	\$68-\$72	59.11								2/13/07	NA	MARKET PERFORM	\$39-\$45	42.06	
9/14/06	NA	MARKET PERFORM	\$71-\$73	71.79								4/4/07	NA	OUTPERFORM	\$39-\$45	36.81	
11/2/06	NA	MARKET PERFORM	\$79-\$84	75.74								8/2/07	NA	OUTPERFORM	\$30-\$36	27.40	
2/1/07	NA	MARKET PERFORM	\$88-\$91	84.82								12/6/07	25.36	MARKET PERFORM	\$30-\$36	26.29	
3/14/07	NA	OUTPERFORM	\$84-\$86	71.72								1/30/08	26.95	MARKET PERFORM	\$22-\$32	27.39	
9/11/07	53.85	OUTPERFORM	\$66-\$68	55.18								5/19/08	15.28	MARKET PERFORM	\$14-\$17	14.85	
9/18/07	64.49	OUTPERFORM	\$71-\$72	64.49													
3/19/08	46.49	OUTPERFORM	\$53-\$56	42.23													
6/10/08	29.48	MARKET PERFORM	\$33-\$34	27.50													
6/12/08	24.31	MARKET PERFORM	\$26-\$27	22.70													

*Rating Scale Conversion

Additional Information Available Upon Request

I certify that:

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1 = Outperform: The stock appears attractively valued, and we believe the stock's total return will exceed that of the market over the next 12 months. BUY

2 = Market Perform: The stock appears appropriately valued, and we believe the stock's total return will be in line with the market over the next 12 months. HOLD

3 = Underperform: The stock appears overvalued, and we believe the stock's total return will be below the market over the next 12 months. SELL

SECTOR RATING

O = Overweight: Industry expected to outperform the relevant broad market benchmark over the next 12 months.

M = Market Weight: Industry expected to perform in-line with the relevant broad market benchmark over the next 12 months.

U = Underweight: Industry expected to underperform the relevant broad market benchmark over the next 12 months.

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V = A stock is defined as volatile if the stock price has fluctuated by +/-20% or greater in at least 8 of the past 24 months or if the analyst expects significant volatility. All IPO stocks are automatically rated volatile within the first 24 months of trading.

As of: June 16, 2008

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Lehman: Pre-released 2Q08 Loss, Fuld Speaks, Details Peak?

Date Published: 16 Jun 2008, 14:58

- Lehman's 2Q08 loss was in-line with pre-announced results
- Balance sheet leverage falls significantly linked, both on a gross and net basis
- Significant capital raising completed last week
- CEO takes full responsibility as SOX signer, but no other remediations
- Provided a full load of details on business prospects, capital, liquidity, still no firm date on normalization of operations
- We downgrade Lehman's credit rating to low-A given asset value uncertainty and revenues challenges

Lehman Brothers - Summary Views								
Equity View and Valuation Metrics			Debt View and Valuation Metrics					
LEH - \$27.21 @ 06/16/08			ST Cash Rec: Overweight CreditSights Rating: A-					
52 Week H/L - \$20.25 - \$82.05			ST CDS Rec: Overweight Rating Agency: A1 ▾/A(II)					
Rec - Marketweight			Total Debt: \$150.7 B					
CS Target - \$30			Market Cap: \$19.0 B					
Shares Outstanding (mil) 696.6								
EPS			Credit Metrics					
	2006	2007	2008 E	ROAE	Pre-tax Comp. Margin	Adj. Ratio	Leverage	
1Q	1.83	1.96 A	0.81 A	Actual (2008)	ND	NM	NM	12.5x
2Q	1.69	2.21 A	-5.18 A	Forward Trend	▲	▲	▲	▲
3Q	1.57	1.54 A	0.25 E					
4Q	1.72	1.55 A	0.75 E					
FY	6.73	7.26 A	-3.37 E					
Current Benchmarks					Rich (-)/ Cheap (+)			
P/E	11.59x	8.15x	NA	@ 06/16/08	6M Avg.	FV		
P/B	2.18x	NA	NA	5.75s of 2017	349 bp	288 bp	333 bp	+16 bp
Divd Yld			2.50%	5-YR Sr. CDS	280 bp	197 bp	232 bp	+48 bp
LTM Rev: \$115B Rev Gr*: -40.1% EPS Gr**: 11.85%								

Source: Company Reports, Bloomberg, CMA, CreditSights

*Reflects current price over our FY2008 estimated EPS, **Revenue Growth is v. Prior 12 Mo. Period

***EPS Growth is Bloomberg consensus estimate of long-term growth

↔ = Stable Trend, ▲ = Improving, ▼ = Deteriorating

Lehman Brothers reported a 2Q08 net loss of (\$5.14), which was in-line with the company's pre-announced results last week. Results were driven primarily by a significant decrease in fixed income capital markets, largely related to write-downs in real estate-related securities as well as hedge losses. By business segment, **capital markets** reported negative revenues of -\$2.4 billion. Within this segment, **fixed income** was the culprit as it reported huge negative revenues of -\$3.0 billion, which represented a swing of -\$4.9 billion from the year ago quarter. **Equities capital markets** fell due to principal investments losses and lower volatility revenues. The **other major segments of the company were flat to slightly down with investment banking** flattish with the linked quarter, but down sharply from the prior year. **Investment management** was lower on lower gains from third party alternative investments, while core assets under management were flattish.

CEO Fuld Opens Conference Call

In contrast to the pre-announcement call, in which CEO Fuld did not speak, the CEO opened the

comments on Lehman's conference call. CEO Fuld called the results "totally unacceptable" and took personal responsibility for the loss. CEO Fuld noted that Lehman had accumulated various positions and **admitted that it had not reacted quickly enough to cut back on these positions when the external environment was deteriorating.**



Lehman was also frank that it **faced significantly diminished revenues in mortgage-related businesses, both residential and commercial**, for the foreseeable future. Additionally, Lehman expects **leveraged lending opportunities will remain weak for the next 6-18 months**. However, the company noted that these businesses represented less than 10% of net revenues in 2007, and so believes it can weather the current environment without significant long-term negative impact.

We note that these other businesses (the other 90%) were not enough to offset the massive losses recognized from accumulated positions in mortgage securities and leveraged lending in the current quarter, and we cannot rule out that the company could have further write-downs in the next several quarters. Overall, we felt that the comments from CEO Fuld were frank, and in our view should serve to partly restore investor confidence as the company appears to be more willing to respond to critics, address investor concerns by providing more financial information, and emphasize growth in various businesses which are still performing well.

De-Leveraging Mostly Over, Capital Ratios Robust

Lehman's total shareholder's equity was \$26 billion, which should rise to \$32 billion pro forma for the recent capital raise. The company's gross leverage ratio improved to 24.3x (vs. 31.7x in 1Q08) and its net leverage ratio decreased to 12.0x, down from 15.4x in the prior quarter. The improvement in the leverage ratios were driven by lower asset levels, partially offset by a drop in equity as the firm delevered its balance sheet. Lehman noted that it had **finished the balance sheet de-leveraging it wanted to achieve, but it had not achieved the balance sheet mix that it wanted. So, we sense the company will continue to opportunistically dispose of mortgage-related exposures and leveraged lending.** The leverage calculations do not include the \$6 billion of new capital Lehman raised last week, so these leverage figures have come down somewhat more following the capital raise.

Lehman estimated that its Tier 1 capital ratio would be approximately 10% under Basel II as of 2Q08. *Pro forma* for the recent capital raise, Lehman believes its **Tier 1 ratio would rise to at least 12.5%**. Looking at total capital, Lehman estimated this ratio would be approximately 15% under Basel II as of 2Q08, which would go up to about 19% following its recent capital raising.

We note that these capital ratios seem to be robust compared to banks, which typically have Tier capital around 8%, and total capital in the 11%-14% range. Still, we think this is warranted for Lehman given the market's demands for higher capital in the current environment. We also believe higher capital appropriate for brokers given that they typically have less availability of stable core deposits compared to retail banks. So, we view higher equity capital for brokers an

offset to the lower level of stable deposit funding compared to banks.

Other factors that need to be considered include the Basel II standards themselves which allow companies some flexibility in determining their capital allocation based on their own credit/capital models. How much that has enhanced the ratios is not determinable at this point, and it may not be as the company never adopted the BIS I regime. In contrast banks adopting the BIS II standards can do so over a transition period during which they report under both standards. This allows analysts to decide how much flexibility between BIS I and BIS II is warranted and how much is discretionary to the benefit of the companies.

As a rule of thumb we have been using the net leverage ratio as an approximation of the Tier 1 ratio under a more BIS I-like regime. Reverse translating the pro forma Tier 1 ratio of 12.5% would imply net leverage of 8x. This is considerably lower than the 12.5x pre-capital raise in 2Q08, and the level of just under 10x mentioned in last week's call. In any case we would find it challenging for Lehman to rebuild its mid-teen equity returns with low leverage of 8x to 10x and given market conditions that could stymie revenue growth.

We would note that in order to reach a 15% ROE given this leverage by year-end 2008, core revenues would need to grow by 7% per quarter. To reach a LTM 15% ROE return by 1Q09, core revenues would need to grow by 5% and for a year from now at 2Q09, 4%. We find it hard to see core revenues growing to this run rate by at least mid-2009 and there could be a good deal of asset markdown pressure between now and then that could delay this equity returns goal (see: [Lehman Brothers President and CFO Replaced: Lehman Loves Liquidity - Who Loves Lehman?](#))

Lower Leverage: Always Good for Bondholders?

According to conventional wisdom, lower balance sheet leverage is a positive for bondholders, but a negative for shareholders. From a shareholder's perspective, lower balance sheet leverage is likely to lead to lower earnings over the long term. While we view lower leverage as typically positive for bondholders, we note that Lehman needs balance sheet capacity to conduct its business.

So, even though lower leverage by itself is a positive, in this case we have to take a more holistic view of whether the significant leverage pull-back could have an adverse impact to Lehman's operating flexibility. If so, this could lead the company to lower earnings and potential franchise impairment in the long term. **So, perhaps more than any other industry, brokers face a delicate balancing act of finding the appropriate size and leverage of its balance sheet to operate in the market while also maintaining appropriate ratings and addressing bondholders concerns.** At this point, it seems that Lehman has taken the bondholders' view with regard to leverage. Still, we note that significant further balance sheet reductions at Lehman could be a negative vis-à-vis its competitive position in the brokerage industry.

Liquidity Position Higher

Lehman also provided an in-depth review of its liquidity position. The company stated that its **liquidity pool rose to \$45 billion from \$34 billion.** Additionally, the company stated that it had completed its funding plan for 2008, having issued all the long-term debt needed to refinance current portions this year. The company said that it does not expect to return to the markets for funding in 2008, unless it sees an opportunity for pre-fundings for refinancings in 2009. Lehman also noted that it had increased the funding provided by the bank subsidiaries, with \$47 billion of assets funded from the bank level as of 2Q08, up \$3 billion sequentially. So, Lehman noted that bank funding represents around 19% of the company's inventory, up from around 14% at 1Q08.

Lehman noted that its holding company liquidity position, which excludes liquidity at the regulated broker-dealers and banks, fully covered all maturing unsecured debt over the next 12 months. The holding company liquidity pool is also available to fund potential outflows from loan commitments being drawn, losses of secured funding, and other contingencies.

Appoints Grundhofer to the Board

In April, Lehman announced that it had appointed Jerry Grundhofer to the Board of Directors of Lehman. Mr. Grundhofer was the former CEO and Chairman of U.S. Bancorp, and was a long

time bank executive with Firststar and Star Banc before joining U.S. Bancorp. Our initial reaction to appointment of a retail banker such as Mr. Grundhofer to the Board of a mostly wholesale institutional firm such as Lehman is that we found it somewhat surprising. We sense that Mr. Grundhofer may lend his expertise on banking regulation and operating under the auspices of the Fed, as we believe the brokerage industry may become subject to greater regulatory oversight by the Fed following the creation and use of the Fed's broker-dealer funding facilities.

CEO Fuld noted that he has a seat on the New York Fed where he is a Class B director reelected in December 2007 to a three-year term through 2010. Given that big picture vantage point, CEO Fuld seemed to concede that there would be greater regulatory oversight in return for the borrowing privileges.

Yet, both Mr. Grundhofer on the Lehman board and CEO Fuld on the NY Fed board does present some interesting optics. Is it possible that as part of CEO Fuld taking responsibility down the road that he relinquishes the Chairman role and that Mr. Grundhofer would be the most suitable to take it given his experience with big financial organizations? Also, with Lehman having borrowed under the PDFC and CEO Fuld on the NY Fed board, does this present some kind of inconsistency in the oversight process? These are much debatable issues, that can go in various tangents, but we thought it was helpful to reflect on them in any case.

We also cannot rule out that the appointment signals that Lehman might consider a transformational merger or sale to a retail bank, which would provide the company a bigger balance sheet and more secure deposit funding for its operations. However, a major hurdle on this front is that the most likely buyers—such as Barclays, HSBC have their own credit and/or capital issues. BNP could be another interested party that could get top notch fixed income skill sets from Lehman. U.S. Bancorp could be another possible combination with Lehman, though it had disposed of its capital markets and retail brokerage, Piper Jaffrey, beginning in 2003. It is intriguing that former CEO Grundhofer is now on the Lehman board at this time when the broker may need a strong balance sheet bank to get it through the rough markdown waters in mortgages.

Rating Agency Dynamics—Moody's Placed Lehman on Review

Last Friday, Lehman's credit ratings were placed on review for possible downgrade by Moody's Investor Services. The agency noted that ratings action follows the company's announcement that it replaced two top executives (President/COO and CFO), which the rating agency views as potentially damaging to investor confidence and as well as exacerbating the risk of franchise impairment (see: [Lehman Brothers President and CFO Replaced: Lehman Loves Liquidity - Who Loves Lehman?](#)). Moody's felt that the management changes "increased the risk of franchise impairment." Moody's stated that its rating review will focus on the degree to which Lehman's franchise has been affected by market condition and potential further write-downs within Lehman's residential and commercial mortgage portfolios. Previously, Moody's placed Lehman on a negative outlook when the company pre-announced its 2Q08 earnings loss.

CreditSights: Downgrading to Low A

Based on the difficulty we believe Lehman may have in hitting its 15% ROE target given its lower leverage and lack of meaningful revenues traction we are taking our rating down to low-A from solid-A with a negative outlook. We believe that the current operating environment is very unfavorable for Lehman, which has a traditional strength in fixed income as this area has been the center of the market collapse on the mortgage origination sides (see: [U.S. Brokers: 2Q08 Preview - More Better Blues?](#)). Additionally, we remain concerned about the size of Lehman's remaining exposures to commercial and residential real estate securities/loans as these could be subject to further write-downs. We do incorporate the well thought out liquidity, PDFC backstop, and recent capital raising as supportive to a low-A.

Markdowns/Hits Summary

As previously reported, Lehman stated that it incurred \$4.0 billion in gross negative marks related to risky assets (\$4.1 billion on a net basis), partially offset by \$400 million in gains related to debt liabilities. Results were further weakened by hedging related losses (\$700 million), and principal investing (\$500 million). We note that the bulk of the mark-to-market losses (60%) were due to residential mortgage positions (see chart), while commercial mortgages were responsible

for another 18% of the marks. We note that as a percentage of reported exposures, residential mortgages, including ABS CDOs and subprime loans/securities, resulted in a -7.5% mark, followed by other asset backed (-4.6%), real estate held for sale (-2.3%), commercial mortgages (-1.9%), and acquisition finance (-1.0%).

Lehman: Markdowns Summary	2Q08		1Q08	% Mark
	Gross	Net	Exposure	
Residential mortgage-related	(\$2.4)	(\$2.0)	\$31.8	-7.5%
Other asset-backed	(0.3)	(0.3)	6.6	-4.6%
Commercial mortgage-related	(0.7)	(1.1)	36.1	-1.9%
Real estate held for sale	(0.3)	(0.3)	12.9	-2.3%
Acquisition finance	(0.3)	(0.4)	28.7	-1.0%
Total Marks	(4.0)	(4.1)	116.1	-3.4%
Debt liabilities measured at FV	0.4	0.4		
Marks, net of gains on debt	(3.6)	(3.7)		-3.1%

Source: Company reports, CreditSights

In \$ billions.

Risk Asset Exposures - Details

In our 2Q08 broker preview, we detailed risky asset exposures and related potential marks for brokers using 1Q08 data. Lehman provided details of its 2Q08 hot stove exposures (\$82.7 billion) including residential mortgages (\$24.9 billion), commercial real estate (\$29.4 billion), real estate investments (\$10.4 billion), and leveraged loans (\$18.0 billion). We note that total hot stove exposures declined to \$82.7 billion, down \$33.4 billion (-29%) from 1Q08. Within residential mortgages, the U.S. (\$14.3 billion) accounted for 57% of the entire portfolio and was largely concentrated in Alt-A (\$10.2 billion). Europe had the next biggest concentration at \$9.3 billion (see chart). We note that the company's linked quarter decline was primarily driven by AAA-rated Alt-A and prime securities, and to a lesser extent by loans.

Residential Mortgage Exposure	2Q08	1Q08	Linked Δ
U.S.			
Alt-A/Prime:			
Whole loans	\$2.1	\$3.7	-43%
AAA	3.9	6.4	-39%
Other RMBS*	2.6	2.8	-7%
Servicing and Other	1.6	1.7	-6%
Subprime/Second Lien:			
Whole loans	1.1	1.3	-15%
AAA	0.9	1.6	-44%
Other RMBS*	0.8	1.1	-27%
Other U.S.			
Whole loans	1.0	1.6	-38%
Securities	0.3	0.5	-40%
Europe			
Whole loans	3.6	5.0	-28%
Securities	5.7	4.5	27%
Asia-Pacific			
Whole loans	0.5	0.3	67%
Securities	0.2	0.4	-50%
Asset-backed securities	0.6	0.9	-33%
Total	24.9	31.8	-22%

Source: Company reports, CreditSights

In billions, *Includes amounts related to residuals

Of the company's commercial mortgage portfolio, little north of 50% is backed by U.S. properties, while Europe (27%), and Asia (21%) accounted for the rest. By type, the commercial portfolio comprised of whole loans (\$19.9 billion), securities and other (\$9.5 billion), and real estate held

for investment (\$10.4 billion). Lehman noted that included in its commercial real estate portfolio were mezzanine level loans (\$5.9 billion), purchased nonperforming loans (\$1.9 billion), and equity (\$7.2 billion). Lehman's leveraged loan exposure declined about -37% during the quarter and was driven mainly by a drop in its contingent financing facilities. At 2Q08, funded loans amounted to \$12.7 billion (~71% of total leveraged loans), followed by unfunded commitments (\$3.2 billion or 18%), and contingent financing facilities (\$2.1 billion or 12%).

Acquisition Finance Facilities			
	2Q08	1Q08	Linked Δ
High Grade			
Contingent	\$1.7	\$7.2	-76%
Unfunded	1.1	0.8	38%
Funded	3.7	2.9	28%
High Yield			
Contingent	0.4	3.7	-89%
Unfunded	2.1	2.2	-5%
Funded	9.0	11.9	-24%
Total	18.0	28.7	-37%

Source: Company reports, CreditSights
In billions

We noted in our broker preview that based on our stress test estimates, Lehman could incur further marks of between \$2.0 billion to \$4.0 billion related to its residential portfolio, and \$1.3 billion to \$2.6 billion in its commercial mortgage book in the event of further weakness in the real estate market.

Commercial Mortgage Exposure			
	2Q08	1Q08	Linked Δ
Whole Loans:			
Senior	\$19.5	\$24.3	-20%
Mezzanine	5.9	7.2	-18%
Nonperforming Loans	1.9	2.0	-3%
Equity	7.2	8.2	-12%
Securities	5.3	7.5	-29%
Total	39.8	49.2	-19%

Source: Company reports, CreditSights
In billions

SunCal, Archstone Exposures

Lehman touched on its commercial real estate positions in SunCal and Archstone. SunCal is one of the largest privately held developers of planned communities in the Western region of the U.S. Lehman's exposure to SunCal is through the developer's portfolio in southern California (23 residential land development projects and a luxury condo development). The aggregate carrying value of these positions was \$1.6 billion, with approximately 90% originated as senior debt. **SunCal's position is held in real estate held for sale and is currently marked in the mid-70s.**

Archstone owns a diversified portfolio of apartment assets. Lehman stated that it took a markdown of \$350 million in 2Q08 related to its Archstone exposure. The company **accounts for its Archstone exposure as an equity investment and is carried at around 75 cents.** The total exposure to Archstone is just south of \$1.8 billion.

VaR Moved Higher

Lehman reported that its average historical simulation VaR fell to \$123 million in 2Q08, a **-5% decrease** from the \$130 million reported in 1Q08. Lehman's historical simulation approach to measuring VaR involves constructing a distribution of hypothetical daily changes in the value of its financial instruments based on risk factors in the current portfolio and historical observations of daily changes in these risk factors. Lehman's period end VaR declined to \$104 million down -2 million (-2%) from the prior quarter.

In addition to reported VaR, we adjust the figures to better analyze the loss potential in a

potential fat-tail event. After adjusting to a 99% **confidence** level for **gross VaR** (excluding the diversification effect), Lehman's VaR increased to \$253 million for 2Q08, which compares to \$251 million in 1Q08.

Adjusting to a ten day holding period and applying a five sigma formula (Basel II pro forma standards) to the company's average gross VaR, we estimate that Lehman could lose about \$2.5 billion or 82% of its 2009e EPS in a five sigma fat-tail event. So just as we have for the last 15 months, we remain concerned about Lehman's outsized risk appetite in relation to its effects on earnings.

Segment Results

Capital markets net revenues **decreased** to -\$2.4 billion, down \$4.0 billion compared to revenues of \$1.7 billion in 1Q08. The company attributed the sequential decline to mark-to-market losses in **fixed income capital markets**, which fell to a loss of \$3.0 billion, down \$3.2 billion from \$262 million in 1Q08. **Equity capital markets** net revenues fell to \$601 million, down \$809 million (-57%) sequentially. We note that this is Lehman's first quarterly loss within fixed income capital markets during the past six years.

Lehman noted that it has taken about \$17 billion of cumulative writedowns since early 2007 on various hot stove exposures including residential mortgage-related (\$11 billion), commercial real estate (\$3.5 billion), and leveraged lending (\$2.2 billion). Over that time frame it had hedging benefits of around \$7.5 billion or about 44% of losses.

It made some brief comments on its Archstone REITs deal and Suncal. In both cases it noted that following markdowns, the underlying assets were improving with mid-teen IRRs for both projects.

Segment Results - Capital Markets					
	2Q08	1Q08	2Q07	Linked %	YoY %
Fixed Income	-\$2,975	\$262	\$1,902	NM	NM
Equities	\$601	\$1,410	\$1,692	-57%	-64%
Total Capital Markets	-\$2,374	\$1,672	\$3,594	HM	HM

\$ in millions

Source: Company Reports, CreditSights

Investment banking was flattish sequentially with revenues of \$858 million. On a sequential basis, **revenues weakened in Global Finance - Debt** to \$288 million, down \$34 million (-11%), and strengthened in **Global Finance - Equity** to \$330 million, up \$115 million (+53%), while **Advisory Services** revenues **declined** to \$240 million, down \$90 million (-27%). On a YoY basis, all segment revenues were lower with Global Finance - Equity, slightly down \$3 million (-1%), followed by Advisory Services, down \$37 million (-13%), and Global Finance - Debt, down \$252 million (-47%).

Segment Results - Investment Banking					
	2Q08	1Q08	2Q07	Linked %	YoY %
Global Finance - Debt	\$288	\$322	\$540	-11%	-47%
Global Finance - Equity	\$330	\$215	\$333	53%	-1%
Advisory Services	\$240	\$330	\$277	-27%	-13%
Total Investment Banking	\$858	\$867	\$1,150	-1%	-25%

\$ in millions

Source: Company Reports, CreditSights

Investment Management net revenues **declined** to \$848 million, down \$120 million (-12%) sequentially. The sequential decline was led by lower Asset Management revenue of \$496 million, down \$122 million (-20%) from 1Q08, while Private Investment Management revenue

was flattish at \$352 million, up \$2 million (+1%) from the prior quarter.

Income Statement

Net revenues was reported at a loss of \$668 billion, compared to \$3.5 billion the prior quarter. The linked quarter decline was driven by negative mark to market adjustments, as well as principal trading, and hedging related losses. These markdowns were driven by cash sales and better price visibility on many of its troubled positions. Lehman noted that it reduced its residential and commercial mortgage-related, real estate held for sale positions by around 20% in each asset class. Leveraged finance declined by 35%, while high yield inventory, including leveraged finance fell by 20%. We believe that going forward, the lower asset base may contribute to a decline in the company's revenues.

Partially offsetting these decreases was an increase in global equity finance of investment banking, up \$115 million (+53%). Fixed income capital markets saw the largest declines at -\$3.0 billion, compared to \$262 million in 1Q08. Declines in equities capital markets (-57%) and asset management (-43%) sequentially also contributed to Lehman's negative revenues.

Non interest expenses increased to \$3.4 billion, up \$575 billion (+20%) sequentially. **Compensation costs were higher** sequentially due in part to severance related expenses at \$2.3 billion, up \$484 million (+26%) from the prior quarter. The company noted that it would be taking a \$150 million restructuring charge related to company headcount reductions and related activities. Lehman noted an effective tax rate of 32.1%.

Geographically, non-U.S net revenue declined to -\$442 million, down \$2.6 billion from the linked quarter and was driven by decreases in both Europe and Middle East (down \$1.3 billion) as well as in the Asia-Pacific region (down \$1.3 billion). In the Americas, net revenues fell to -\$226 million, down \$1.6 billion from the prior quarter. Americas' results were driven by a \$1.6 billion decline in the United States, partially offset by a \$7 million increase in other Americas, the only geographic segment to report revenue growth.

Capital Strategy

Lehman did not disclose its share repurchases for the second consecutive quarter. Common shareholders' equity declined to \$19.3 billion at 2Q08, down \$2.6 billion (-12%) from the linked quarter. The **company's gross leverage ratio improved** to 24.3x (vs. 31.7x in 1Q08) and its **net leverage ratio decreased** to 12.0x, down from 15.4x in the prior quarter. The improvement in the leverage ratios were driven by lower assets, partially offset by a drop in equity as the firm delivered its balance sheet.

Segment Results - Investment Management					
	2Q08	1Q08	2Q07	Linked %	YoY %
Asset Management	\$496	\$350	\$308	42%	61%
Private Investment Management	\$352	\$618	\$460	-43%	-23%
Total Investment Management	\$848	\$968	\$768	-12%	10%

\$ in millions

Source: Company Reports, CreditSights

Income Statement					
	2Q08	1Q08	2Q07	Linked %	YoY %
Revenues					
Principal transactions	-\$3,534	\$773	\$2,889	-557%	-222%
Investment banking	\$858	\$867	\$1,150	-1%	-25%
Commissions	\$639	\$658	\$568	-3%	13%
Asset management and other	\$506	\$437	\$414	18%	22%
Net interest income	\$863	\$772	\$491	12%	76%
Total Net Revenues	-\$668	\$3,507	\$5,512	-119%	-112%
Non-Interest Expenses					
Compensation and benefits	\$2,325	\$1,841	\$2,718	26%	-14%
Technology and communication	\$309	\$302	\$267	2%	8%
Brokerage, clearance, distribution fees	\$252	\$253	\$201	0%	25%
Occupancy	\$188	\$185	\$152	2%	24%
Professional fees	\$100	\$98	\$120	2%	-17%
Business development	\$87	\$89	\$100	-2%	-13%
Other	\$158	\$76	\$55	108%	187%
Total Non-Interest Expenses	\$3,419	\$2,844	\$3,633	20%	-6%
Return on common equity	NM	8.6%	25.8%	NM	NM
Pre-tax profit margin	11M	18.9%	34.1%	11M	11M
Efficiency ratio	NM	81.1%	65.9%	NM	NM
Compensation ratio	NM	52.5%	49.3%	NM	NM

\$ in millions

Source: Company Reports, CreditSights

Capital					
	2Q08	1Q08	2Q07	Linked %	YoY %
Total assets	\$639,000	\$786,035	\$605,861	-19%	5%
Net assets	\$326,899	\$396,673	\$337,667	-18%	-3%
Shareholders' equity	\$26,276	\$24,832	\$21,129	6%	24%
Gross leverage ratio	24.3x	31.7x	28.7x	-7.4x	-4.4x
Net leverage ratio	12.0x	15.4x	15.4x	-3.4x	-3.4x

\$ in millions

Source: Company Reports, CreditSights

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Lehman Brothers

Outperform

LEH

USD27.40*

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Fate Lies Simply in Hedging Efficacy (Or Lack Thereof)

Data	
52-week range (USD)	22.70-81.30
Price Target (USD)	62.00
Upside/downside to price target (%)	126.3
Market cap (USDm)	15,170.0
Dividend (USD)	na
Dividend Yield (%)	na

Performance (%)				
	1W	1M	3M	YTD
Price performance	-7.1	-37.2	-30.2	-58.1
Rel. S&P 500	-6.9	-34.2	-33.9	-54.8
Rel. FPKCCW Investment Bank	-8.2	-31.4	-26.7	-40.7

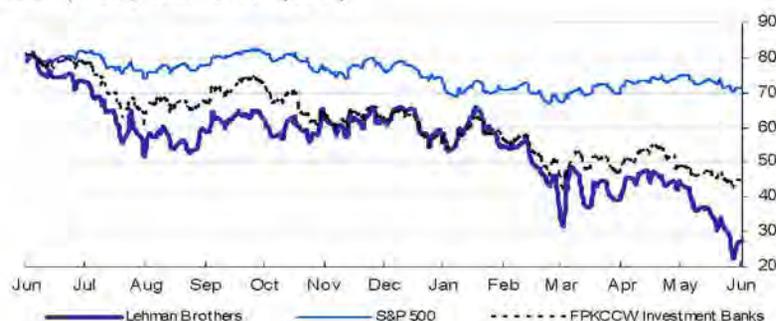
Operating EPS (USD)			
Quarterly EPS breakdowns			
	2007	2008e	2009e
1Q	1.96	0.81 a	1.07
Consensus			1.08
2Q	2.21	-5.14 a	1.15
Consensus			1.05
3Q	1.60	0.36	1.00
Consensus		0.40	0.97
4Q	1.54	0.81	1.28
Consensus		0.85	1.14
Annual	7.32	-3.16	4.50
Consensus		-2.27	4.27

- Despite all the sound and fury, the only thing that separated Lehman's big loss in 2Q08 vs. prior post-bust quarters was the ineffectiveness of its hedges. In fact, asset write-downs/losses in 2Q08 were merely in line with the average of the prior three quarters.
- Before 2Q08, Lehman took \$13 bil. in cumulative gross write-downs/losses, but enjoyed almost \$8 bil. in short gains. Thus, at that point, it had executed one of the best risk mitigation responses in the history of Wall Street—otherwise it may have faced bankruptcy before 2Q08.
- However, the breakdown in this strategy in 2Q08 resulted in a \$4 bil. hit at a time when all of the bulge firms are facing cyclically falling revenues and with still fat staffing levels. A \$2.8 bil. net loss resulted and (helped by misinformation in the market) confidence in Lehman was shaken and a capital raise emerged. We believe hedging efficacy is THE ISSUE, given the large scale on both the long and short side of the equation.
- Meanwhile, a tremendous amount of attention is focused on whether or not Lehman is marking assets fully. We frankly find this baffling, given that the investment community is so far removed from the specific books, that any view—whether pro or con—is purely speculative.
- Also, all brokers are opaque, and there is no particular reason to suspect Lehman is doing anything different than the others (whose stocks are not under siege), in our view. The only thing that we DO see is a company that has meaningfully reduced problem assets, de-levered, grown its liquidity pool, and still maintained a strong, diversified client franchise.
- Per our FC note on Friday, we see Lehman's asset mgmt and private client businesses as worth a combined \$10 bil., and the inv. bank worth about \$9 bil. We believe these units are top-tier competitively, quite attractive in growth/profitability, and ring-fenced from the problem-assets issue. And their combined est value is more than the current mkt cap.
- The various trading units—which come for free—must be discounted for the risk of a general counterparty panic. Even so, many of these still have significant values, particularly the equity trading unit, which is among the best on the cash side and growing rapidly in derivatives.
- While the fate of Lehman and its peers are far from certain, we believe LEH shares have a superior relative risk/reward profile. Something as simple as its hedges resuming prior effectiveness could bring Lehman right back to the black, and the stock back to \$40 in short order, in our view.

Valuation Data			
YE (Nov 30)	2007	2008e	2009e
Operating P/E (x)	3.7	nm	6.1
BVPS (USD)	39.45	na	na
P/BV (x)	0.69	na	na
ROE (%)	19.8	na	na
Revenue Growth (%)	9.5	na	na
Net income (USDm)	4,125.0	na	na
PTOM (%)	31.2	na	na
Comp ratio (%)	49.3	na	na
Non-Comp ratio (%)	19.5	na	na

* Price as at Jun 16, 2008 10:15

Share price performance (USD)



Analyst certifications and required disclosures begin on page 2.

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Table with 3 columns: Rating type, % of covered companies currently assigned this rating, % of companies assigned this rating with which FPK has provided investment banking services over the past 12 months. Rows include Buy, Hold, and Sell ratings with their respective percentages.

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Global company rating definitions

- Outperform (OP) We expect the stock to outperform its sector over the next 12 months
In Line (IL) We expect the stock to perform in line with its sector over the next 12 months
Underperform (UP) We expect the stock to underperform its sector over the next 12 months

Global sector ranking definitions

- Overweight (OW) We expect the sector to outperform the relevant market index over the next 12 months
Marketweight (MW) We expect the sector to perform in line with the relevant market index over the next 12 months
Underweight (UW) We expect the sector to underperform the relevant market index over the next 12 months



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