

Confidential Presentation to:

Executive Committee

Financial Sponsors Strategies
(Including Lending Capacity Solutions)

August 3, 2006

LEHMAN BROTHERS

Table of Contents

I. Context for the Discussion

A. Introduction

B. Market Update

C. Competitive Landscape

II. Issues to be Addressed and Potential Solutions

A. Increasing Lending Capacity for Corporate Acquisitions

B. Increasing Lending Capacity for Sponsor LBOs

C. Becoming More Aggressive in Proposing Terms

D. Developing Additional Strategies to Become More Proprietary with Sponsors

III. Summary of Specific Recommendations

I. Context for Discussion

A. Introduction

- ◆ The opportunity to finance Corporate Acquisitions and Financial Sponsors LBOs has grown significantly. However it is becoming increasingly competitive. Large commercial banks are using their balance sheets to offer high leverage on very aggressive terms, while other investment banks are also competing on the basis of their proprietary ideas and relationships.
- ◆ In order to achieve and maintain a top 5 market position with Sponsors,^(a) the Firm needs to win lead mandates for the large transactions both by further developing our proprietary ideas and relationships with Sponsors and by being aggressive in using our balance sheet and in proposing financing terms.
- ◆ However, the Firm is at a competitive disadvantage on the largest transactions because of the relatively smaller size of our tangible equity base.
- ◆ The Firm needs to increase our lending capacity for Sponsors LBOs to create a more level playing field.
- ◆ In addition, the Firm needs to develop more competitive advantages by enhancing our proprietary ideas and relationships with Sponsors.
- ◆ The Firm also needs to increase our lending capacity for High Grade Corporate Acquisitions to increase our revenue share on these transactions.

a) Lehman Brothers currently ranks #5 in the U.S. and #6 globally in total Sponsors fees.

B. Market Update – Corporate Acquisitions and Sponsor LBOs

I. Context for Discussion

Global M&A deal volume is on par with 2000; Sponsors now account for >25% of volume and growing. Larger LBOs are fueled by record fundraising, club deals and higher leverage.

2000– 2006 Global Announced M&A (\$T) (a)



1998–2006 Global Sponsor Ann. M&A (\$bn) (a)



U.S. LBOs >\$4bn: Announced or Completed YTD (\$bn) (b)

Ann. Date	Compl. Date	Target Company	Sponsors	Deal Value	Deal Multiple	Debt Value	Lev Level
7/24/06		HCA	Bain, KKR, Merrill Lynch PE	33.3	7.7x	28.0	6.5x
5/29/06		Kinder Morgan	Morgan Stanley, Blackstone, Goldman	21.8	12.8x	14.5	8.5x
1/23/06	6/2/06	Albertsons	Cerberus	17.4	7.2x	8.5	3.5x
6/27/06		Univision	Providence, TPG, TH Lee, Saban, MDP	13.7	16.4x	10.2	12.3x
4/3/06	6/26/06	GMAC (51% stake)	Citi Venture Capital, Cerberus	10.1	n/a	n/a	n/a
5/1/06		ARAMARK	Goldman, TH Lee, Warburg Pincus, CCMP	7.8	8.5x	6.3	6.8x
6/30/06		Michaels Stores	Bain Capital, Blackstone	6.0	12.0x	4.0	8.0x
6/30/06		Travelport	Blackstone	4.3	6.6x	3.6	5.5x
5/31/06		West Corp.	TH Lee, Quadrangle	4.2	9.3x	3.2	6.5x

a) Source: SDC. 2006 YTD through 7/28/06.

b) Source: SDC, banks books, offering memoranda.

LEHMAN BROTHERS

B. Market Update – Market Dynamics

Market Characteristics

- ◆ Low defaults, rising rates, strong economy, unprecedented buying power and high equity valuations resulting in:
 - Corporate M&A up 33%: \$2.9 trillion YTD 2006 annualized vs. \$2.2 trillion in 2005. ^(a)
 - Sponsor M&A up 31%: \$1 trillion YTD 2006 annualized vs. \$770 billion in 2005. ^(a)
 - High activity expected to persist given Sponsor fundraising is continuing at a rapid pace:
 - Blackstone, TPG and KKR have funds >\$15bn; Apollo, GS, Warburg Pincus and Carlyle have >\$5bn.
 - Alternative sources of fund raising (GP / LP IPOs) are being developed.

Capital

- ◆ Capital is plentiful and becoming commoditized leading to:
 - Leverage levels reaching all-time highs.
 - Aggressive pricing.
 - Aggressive structuring, e.g., covenant lite.
 - Expansion of mezz applications.
 - New asks from Sponsors, e.g., bridges to IPOs.

Competition

- ◆ Fierce competition, led by large commercial banks, is driving willingness to:
 - Disregard market volatility in underwriting decisions.
 - Weather market volatility and store assets on balance sheet.
 - Take both debt and equity risk.
 - Risk fees.
 - Make “client” statements.

Risk / Reward

- ◆ Balance of power is skewed in favor of issuers / borrowers.
- ◆ Risk adjusted P&L margins for initial lending are low.

Key Takeaways

- ◆ **Controlling the deal is critical.**
- ◆ **To win mandates, firms must differentiate themselves with:**
 - **Proprietary ideas and relationships.**
 - **Balance sheet and aggressive terms.**

a) Source: SDC. 2006 YTD through 7/28/06 annualized.

B. Market Update – Leveraged Finance

I. Context for Discussion

Americas High Yield Bond League Table YTD 2006 (a)

		Volume (\$bn)	Share
1	JP Morgan	11.1	16.7%
2	Citigroup	9.7	14.5%
3	CSFB	7.2	10.9%
4	Banc of America	6.3	9.4%
5	Deutsche Bank	5.4	8.1%
6	Lehman Brothers	5.2	7.8%
7	Merrill Lynch	5.1	7.7%
8	Morgan Stanley	3.5	5.2%
9	Bear Stearns	3.3	5.0%
10	Goldman Sachs	2.9	4.3%

Americas Leveraged Loan League Table YTD 2006 (a)

		Volume (\$bn)	Share
1	JP Morgan	77.0	19.5%
2	Banc of America	71.1	18.0%
3	Citigroup	43.1	10.9%
4	Wachovia	23.5	6.0%
5	Deutsche Bank	22.6	5.7%
6	Credit Suisse	19.2	4.9%
7	Goldman Sachs	17.9	4.5%
8	Merrill Lynch	12.6	3.2%
9	Lehman Brothers	11.1	2.8%
10	UBS	9.5	2.4%

High Yield Pipeline (b)

	Thermo	Electron	Univision	Pages Jaunes
◆ Lehman Brothers' pipeline: \$29bn				
– Pipeline deals with significant risk:				
Expected Commitment	\$1.5bn	\$1.2bn	\$1.2bn	
STL Risk, Quarterly Loss at 99.5%	\$300mm	\$262mm	\$245mm	

High Yield Origination Risk Appetite (d)

	Limit	Low	Average	High
Global	300	65	133	370
Americas	150	42	88	146
Europe	185	10	60	299

Credit PV/01 for High Yield Bonds and Loans (c)

	U.S.		Europe	
	Bonds	Loans	Bonds	Loans
Notional Risk	\$1.49bn	\$2.65bn	\$138mm	\$1.90bn
Spread cushion	6 bp	16 bp	50 bp	19 bp
All in cushion	45 bp	82 bp	122 bp	73 bp
Gross fees	\$35.4mm	\$45.6mm	\$6.2mm	\$32.9mm
Gross premium paid on hedges	\$2.5mm			
Mandated PV-01	\$0.9mm	\$0.7mm	\$0.9mm	\$0.6mm
Potential PV-01	\$0.2mm	\$1.0mm	\$ -	\$1.0mm
Potential probability adjusted	\$0.1mm	\$0.6mm	\$ -	\$0.7mm

LEH's Recently Restructured High Yield Deals

 IntelSAT Caa1/B	<ul style="list-style-type: none"> ◆ Funded \$600mm unsecured bridge; partial execution of bond offering. ◆ Price talk widened from 10.75%-11%.
 IRIDIUM B3/Caa	<ul style="list-style-type: none"> ◆ Downsized \$235mm credit facility by \$25mm; restructured tranches. ◆ Increased pricing by 100 bps on 1st Lien and 175 bps on 2nd Lien. ◆ Sold at a discount to par; the Firm expects to lose \$100k.
 numericable Unrated	<ul style="list-style-type: none"> ◆ Flexed pricing 38bps on €500mm mezz. ◆ Shifted €125mm of Term Loan A to Term Loan B; cancelled €125mm of Capital Investment Facility. ◆ Institutional syndicated; pro rata hold of €16.8 million.
 Rexnord B3/CCC+ / Caa1/CCC+	<ul style="list-style-type: none"> ◆ Flexed \$100mm from sr. subs into seniors and term loan. ◆ Priced 50 bps outside of the cap.

a) Source: Bloomberg as of 7/28/06. For Global HY Bonds, LEH ranked #7 with 6.1% share, For Global LevLoans, LEH ranked #12 with 2.8% share.

b) Pipeline as of 7/18/06. Includes HG (>\$100mm, non-FRL), Real Estate and Structured Finance deals.

c) As of 7/28/06.

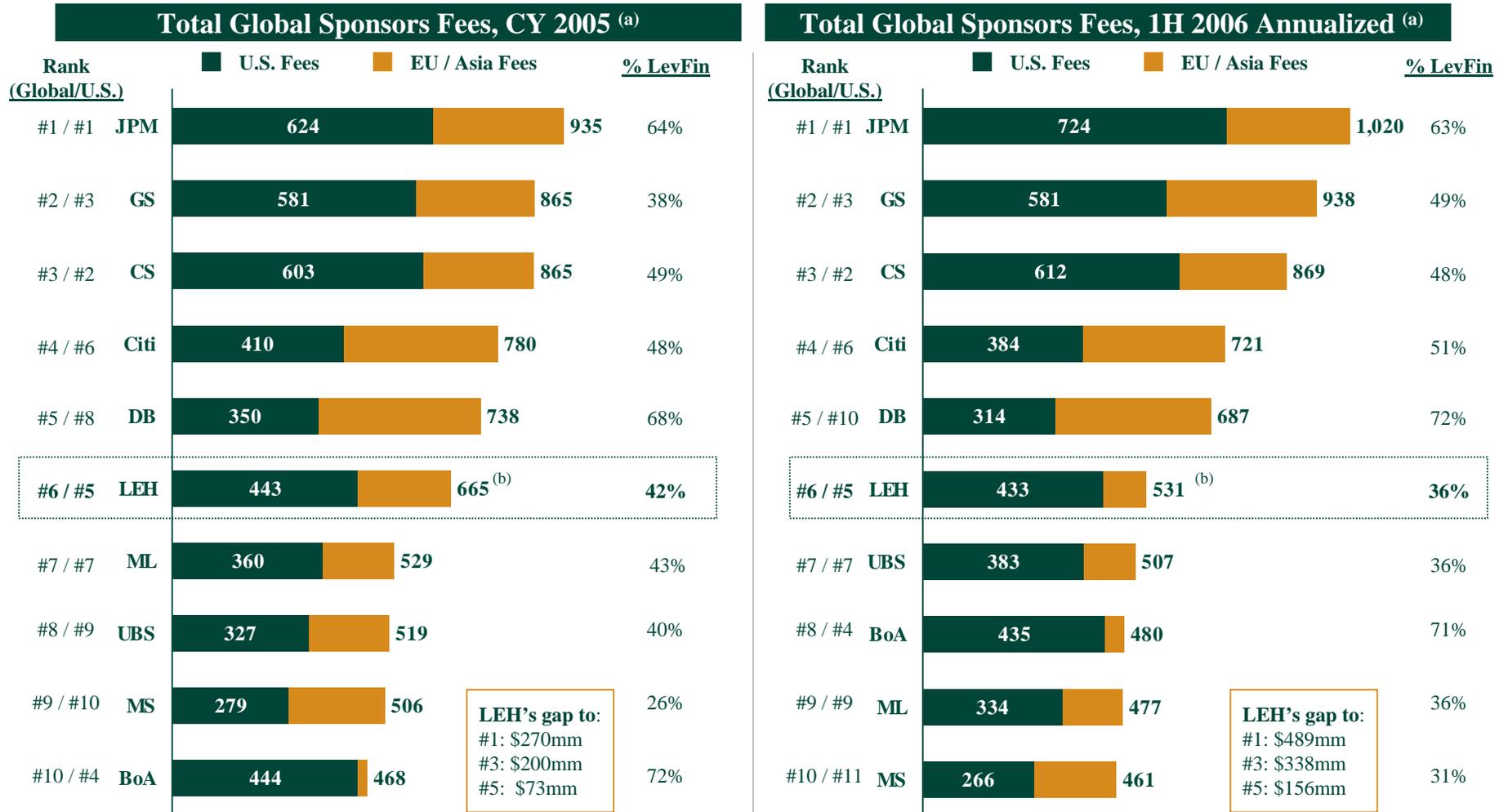
d) Risk Appetite ("RA") through 7/20/06. Regional RAs sum to greater than global total due to diversification benefit. RA has increased significantly due to large EU transactions, e.g., Eno France, Stahl and Altis.

LEHMAN BROTHERS

C. Competitive Landscape – Market Position with Sponsors

\$ in millions

I. Context for Discussion



(a) Source: Dealogic.

(b) LEH's actual revenues in FY05 were \$745mm vs. Dealogic CY05 modeled fees of \$665mm. LEH's actual revenues in 1H FY06 were \$398mm vs. Dealogic modeled fees of \$266mm.

However, aside from the slightly different timeframes (FY vs. CY), LEH actual revenue includes items that would not be captured by Dealogic: investments in Sponsor funds, FRLs and derivatives.

LEHMAN BROTHERS

C. Competitive Landscape – Competitors’ Strategies

- ◆ In light of these market dynamics, two strategies have emerged:
 - Leading with balance sheet, which is a necessity on large financings.
 - Developing proprietary ideas which capitalize on corporate relationships.
- ◆ Lehman has been able to become more proprietary by leading with ideas on transactions like Hertz and Dunkin’ Donuts and by winning middle market sell side transactions. (Recent examples: Avio, J. Alix, Royalty Carpet.)
- ◆ However, the Firm has been less successful in leveraging proprietary ideas and relationships to win mandates for larger transactions (i.e., over \$3bn in debt financing), which often are being awarded based solely on terms and pricing.
 - As a result, the Firm lost several mandates when competitors were willing to be more aggressive and were able to leverage corporate relationships.
 - If the Firm wants to consistently be awarded mandates for the largest LBOs, the Firm needs to further develop our proprietary ideas and relationships, to become more aggressive in proposing terms, and to get to winning terms faster.
 - The Firm needs to decide if we should start taking a more aggressive stance on pricing and terms to win more large mandates.
 - By pursuing this strategy, the Firm will risk letting syndication losses erode fees.



	Balance Sheet	Proprietary Ideas and Relationships
Sponsor Client View	<ul style="list-style-type: none"> ◆ Financial leverage required to drive equity returns. ◆ Commitment size becoming more relevant as deals grow. ◆ Wants underwriter with “confidence.” 	<ul style="list-style-type: none"> ◆ Ideas and “control of asset” most valued. ◆ Rewards business for proprietary idea flow. ◆ Still respectful of “staples” if backed by M&A influence / strong banker.
Competitor Response	<ul style="list-style-type: none"> ◆ Greater willingness to sacrifice discipline regarding terms/leverage. ◆ Greater willingness to do “unnatural acts” to gain client favor/entry. ◆ Establishment of “dedicated” sources of capital reduce reliance on syndication. 	<ul style="list-style-type: none"> ◆ Creating opportunities through Private Equity business, client relationships and M&A influence. ◆ Greater willingness to use leverage with Sponsor clients.
LEH Position / Conclusion	<ul style="list-style-type: none"> ◆ Confidence in distribution critical to underwriting comfort. ◆ Heightened need to “trust” client relationship and lead banker. ◆ Losses possible with market swings – very little cushion. 	<ul style="list-style-type: none"> ◆ Not capitalizing on existing corporate relationships. ◆ Need to increase investment banking coverage footprint. ◆ Sell-side flow has improved due to Middle Market coverage effort.

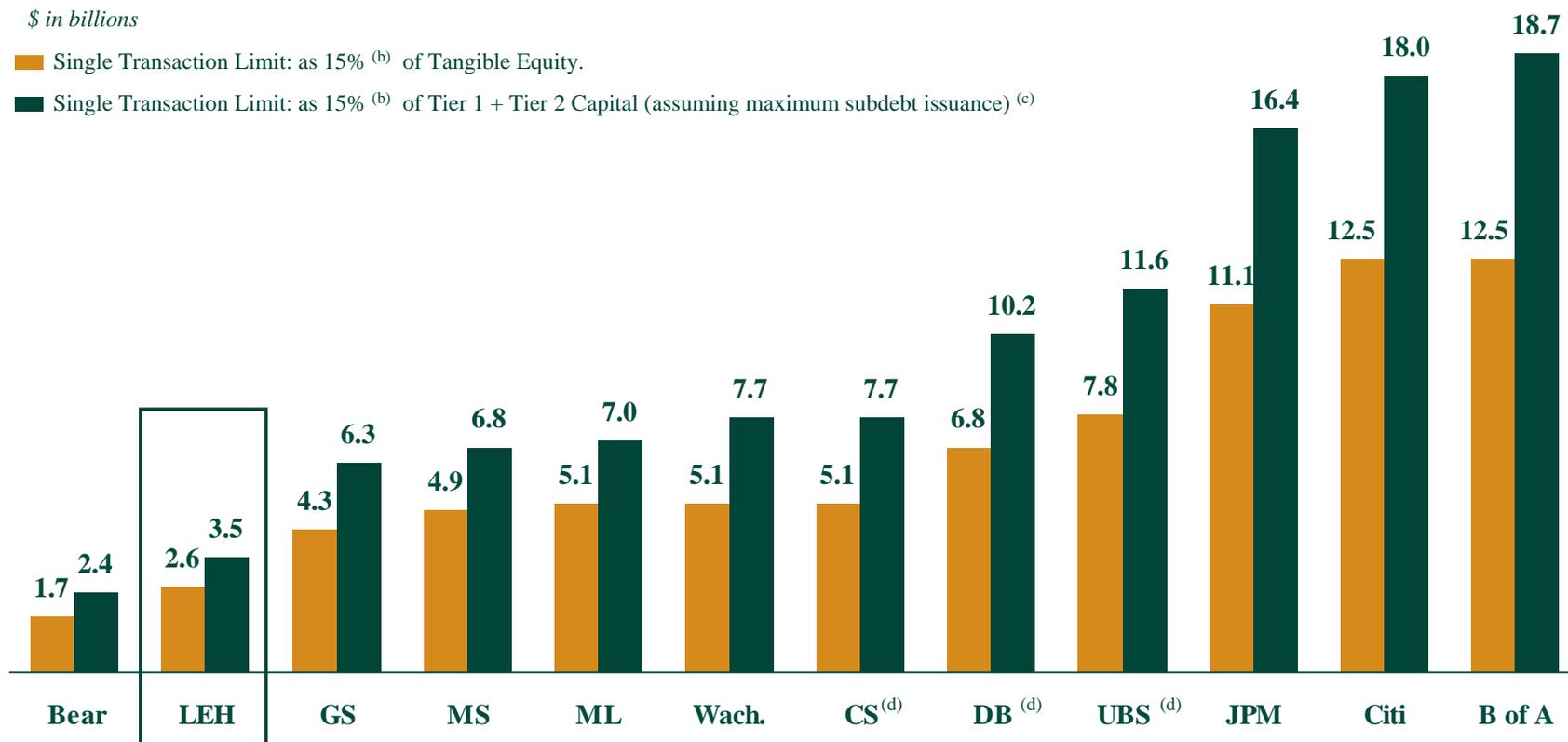
C. Competitive Landscape – Comparison of Risk Limits

Nominal Commitment Limit: Competitor Comparison 2Q 2006 ^(a)

\$ in billions

Single Transaction Limit: as 15% ^(b) of Tangible Equity.

Single Transaction Limit: as 15% ^(b) of Tier 1 + Tier 2 Capital (assuming maximum subdebt issuance) ^(c)



(a) LEH, GS, MS and BSC as of 2Q 2006. All others as of 1Q 2006. Tier 1 and 2 data for competitors not disclosed; estimate from GAAP data and recent subordinated issuances. Competitor tangible equity is estimated as Tier 1 Capital + Deferred Tax Assets.

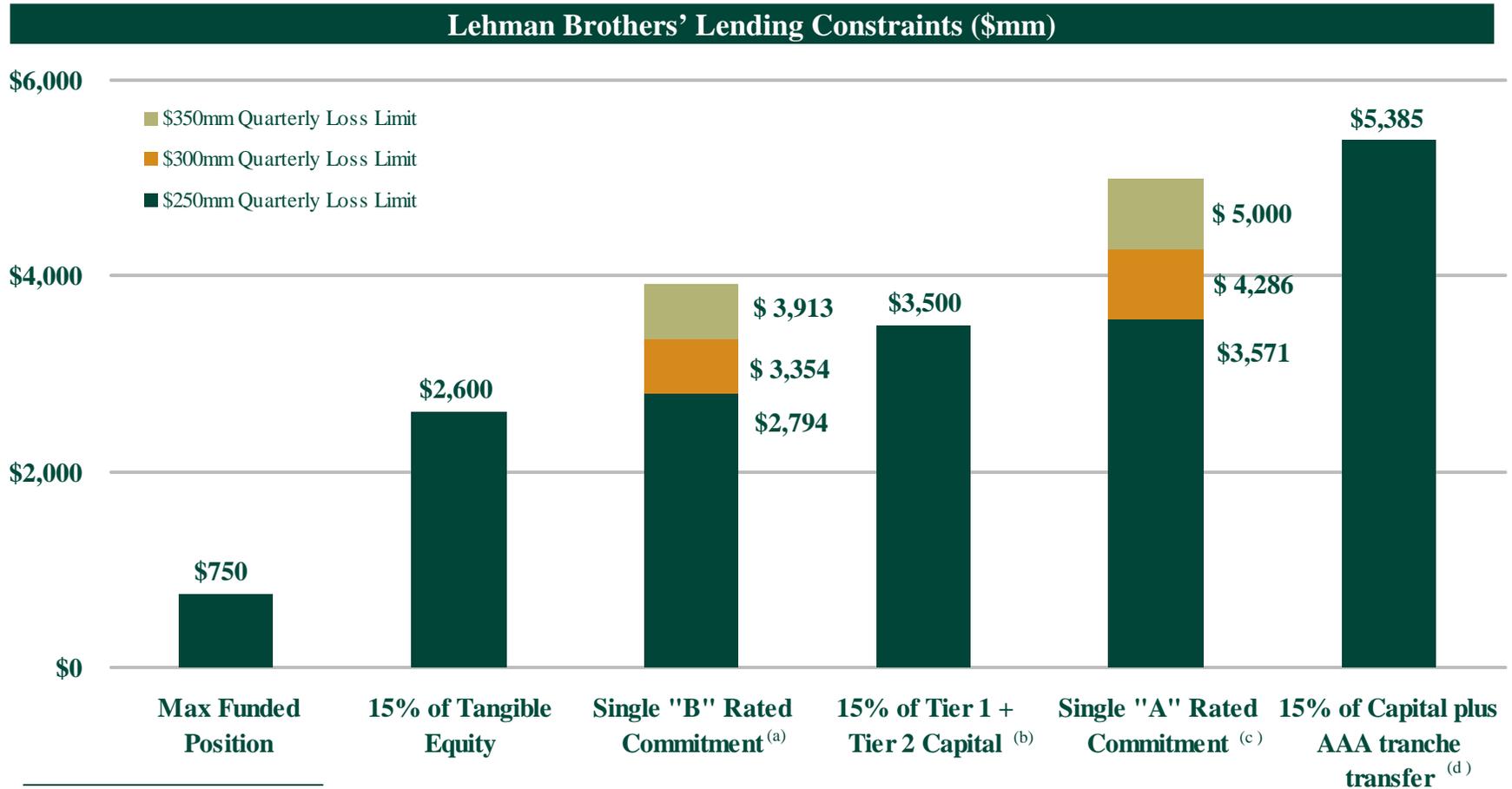
(b) Difference between Tang. Eq. and Tier 1 Capital is primarily due to deferred tax assets > 1 year. Tier 1 Capital does not include deferred tax assets, however, Tangible Equity does.

(c) SEC allows qualifying LT debt to be included in Tier 2 capital for 3 years (through YE '08). This allows securities firms to gradually replace LT debt with sub debt without causing market disruptions. LEH currently includes the maximum LTD allowed (50% of Tier 1). For competitors, Tier 2 capital assumes maximum subordinated debt issuance - 50% of Tier 1.

(d) U.S. banking rules allow a maximum limit of 15% for single name exposure. European banking rules allow a maximum limit of 25% for single name exposure, and that limit may be exceeded without immediate notification to the regulatory body as long as the excess over the limit is covered completely by freely eligible equity resources. **The 25% limit has been applied to CS, DB and UBS.**

C. Risk Limits Which Apply to Lending Commitments

I. Context for Discussion



(a) Single "B" Rated Commitment: expected closing in less than 2 months, Business MAC, 75% Secured, 25% Unsecured. If the Single Transaction Limit model were to allow a max loss in a quarter of \$300mm, limit would increase to \$3,354mm. If the limit were raised to \$350mm, this limit would increase to \$3,913mm.

(b) 15% of Capital: under new definition of Tier 1 plus Tier 2 Capital, including credit for long term debt until 2008.

(c) Single "A" Rated Commitment: expected Closing in less than 2 months, Business MAC. If the Single Transaction Limit model were to allow a max loss in a quarter of \$300mm, this limit would increase to \$4,286mm. If the max loss were to be raised to \$350mm, this limit would increase to \$5,000mm.

(d) 15% of Capital plus Aaa tranche transfer: tranching top 35% of Capital Structure into Aaa participation using Moody's Loss Given Default Methodology.

C. Competitive Landscape – Competitors’ Strategies

- ◆ Commercial banks are (i) less constrained by nominal commitment limits and single transaction limits, (ii) have a lower cost of capital and (iii) generally do not need to mark-to-market loans and do not incur losses until credit impairment.
 - As a result, they have used their balance sheets and risk appetite aggressively to win mandates for large Corp. Acq. and LBOs.
- ◆ In response to fierce competition from commercial banks, pure-play investment banks have developed several strategies to win mandates for large Corporate Acquisitions and LBOs while still managing single name exposure and mark-to-market risk.

■ Indicates strategy in place
 ■ Indicates in process of putting strategy in place

		Pure-Play Investment Banks				Commercial Banks							
		LEH	GS	ML	MS	BoA	Citi	CS	DB	JPM	UBS	Wach.	
Competitors’ Strategies in Winning Mandates for Corporate Acquisition Finance and Leveraged Finance													
Strategies predominantly used by Pure-Play Investment Banks	◆ Issuing sub debt to boost nominal commitment limits.	■	■	■	■								
	◆ Forming partnership with commercial bank or other lending source.	■	■										
	◆ Co-investing in equity or mezz tranches of LBOs.	■	■	■	■	■	■	■		■		■	
	◆ Raising a Private High Yield / Mezzanine Fund.	■	■	■									
	◆ Enhanced exclusive sale practice to secure stapled financing.	■	■	■	■	■	■	■	■	■			
	◆ Leveraging strength in coverage banking in specific industries.	■	■	■	■		■	■	■	■	■		
Strategies predominantly used by Commercial Banks	◆ Signing commitment letters for 100% of large LBOs.	■	■	■	■	■	■	■	■	■	■	■	
	◆ Providing full financing for large corporate acquisitions.	■	■	■	■	■	■	■	■	■		■	
	◆ Offering aggressive financing terms to secure lead positions.			■		■	■	■	■	■		■	
	◆ Holding securities on balance sheet pending market clearance.			■		■	■	■	■	■		■	
	◆ Using balance sheet to win equity mandates.	■	■	■		■	■	■	■	■		■	

(b)

(a) LEH often inserts mitigating language in the legal documentation stating that while we are committing to the full 100%, we are requiring that we have partners to reduce our commitment.
 (b) LEH has only used balance sheet to win equity mandates in several select situations, e.g., Hertz, Hexion.

II. Issues to be Addressed and Potential Solutions

A. Increasing Lending Capacity for Corporate Acquisitions

Issues to be Addressed

- ◆ The financing required to support some corporate acquisitions is beyond the capacity of the Firm.
- ◆ In addition, because the Firm's tangible equity base is smaller than those of our principal competitors, the amount to which we can commit on any single transaction (without taking undue concentration risk) is lower.
 - This puts the Firm at a competitive disadvantage and forces our clients to bring in a competitor to provide the remainder of financing.
 - This also marginalizes the Firm's ability to dominate an account because the competitor providing financing will share in future ancillary revenues (e.g., M&A and Equity).
- ◆ The Firm's concentration limit is set at 15% of Tier 1 and Tier 2 capital, so we can currently commit \$3.5 billion.
 - Estimated that this limit could be triggered 10-15 times a year.
 - Recent examples: GlaxoSmithKline, Tesoro, STMicroelectronics.

Potential Solutions

- ◆ The limit on single name concentration for corporate acquisitions can be addressed in two ways:
 - 1) Raise the limit.
 - 2) Source additional capacity.
- ◆ Even if the Firm decided to manage risk unconstrained by the externally imposed commitment limit, having a single transaction limit is necessary and desirable.
 - Regardless of how good the Firm's credit work is, there is always a small chance that the credit could be severely impaired and we do not want to "bet the Firm" on one transaction, even if that outcome is a very low probability event.
 - However, the Firm can re-evaluate the \$250 million quarterly loss limit inherent in our Single Transaction Limit model.
- ◆ Alternately, and attainable at reasonable cost, are partnership arrangements with other financial institutions, Sumitomo in particular, which provide the capacity to make commitments of \$7 billion or more without exposing the Firm to an undue amount of risk.

A. Increasing Lending Capacity for Corporate Acquisitions

Lending Capacity Partner Evaluation – Sumitomo

II. Issues to be Addressed and Potential Solutions

Lehman has completed 12 loan transfers to Sumitomo over the past 24 months.

- ◆ Sumitomo has not yet turned down an opportunity to buy a portion of any loan from Lehman Brothers.
- ◆ The LEH/SMBC Bulk Portfolio currently exceeds \$5 billion in notional exposure of which \$775 million are bridge commitments.
- ◆ Over the last two weeks, Lehman has met with Sumitomo several times to discuss expanding the lending partnership.
 - Sumitomo has expressed willingness to expand the relationship and also expressed interest in participating in high yield credits.
- ◆ Lehman and Sumitomo are presently working to further formalize their large loan relationship by developing a more institutionalized process that will enable the distribution of confidential information to Sumitomo at an early stage to enhance their credit review.

Detail of Transactions with Sumitomo ^(a)

Trade Date	Deal Name	Rating	Commitment (\$mm)		Upfront (bps)	Associated Fees Paid		
			LEH	SMFG		Upfront (\$k)	Add'l (bps)	Add'l (\$k)
6/26/06	TXU ^(b)	Baa2 / BBB-	750	300	20.0	600	6 bp/qtr past 12/15	-
6/6/06	GlaxoSmithKline	Aa2 / AA	7,000	3,500	3.0	1,050		-
5/26/06	CVS ^(b)	Baa2 / BBB+	700	200	10.0	200		-
3/9/06	Southern Union ^(b)	Baa3 / BBB	550	275	25.0	688		-
10/17/05	Mohawk Industries	Baa3 / BBB-	100	50	8.0	40		-
9/20/05	Consolidated Natural Gas	Baa1 / BBB	650	250	24.0	600		-
7/28/05	Omnicare	Ba2 / BBB-	550	250	15.0	375	\$125k post 12/15	125
5/24/05	Kerr-McGee	Ba2 / BB+	250	75	20.0	150		-
3/24/05	EPCO	/ BB+	800	150	15.6	234		-
8/25/04	BellSouth	A2 / A	3,000	1,000	7.5	750	2.5 bp/qtr	126
8/25/04	Gulf Power	A2 / A	100	90	15.0	135		-
8/24/04	Magellan Midstream Partners	Baa3 / BBB	130	65	12.5	81		-
	Total		14,580	6,205		4,903		251
	Average		1,215	517	14.6 straight/ 7.9 weighted ^(c)	409		21

(a) Note: LEH has never offered capital markets economics as payment to take risk. Offering economics on bond/equity deals is likely to be more costly than negotiating an upfront fee on each loan situation.

(b) Shading indicates deals to which Sumitomo currently has exposure.

(c) The fees LEH negotiates with Sumitomo vary deal-by-deal based on the following factors: size of commitment, borrower's credit rating, expected time bridge taken out, overall market conditions and credit-specific spreads observed in capital markets, how much time we give Sumitomo to approve the situation, whether other dealers are showing out the bridge and whether Sumitomo is familiar with the credit.

LEHMAN BROTHERS

B. Increasing Lending Capacity for Sponsors LBOs

Issues to be Addressed

- ◆ Although limits on the size of commitments for Sponsors LBOs are also an issue for our competitors, the Firm cannot commit as much at the initial stages as our competitors can because of the relatively smaller size of our tangible equity base.
- ◆ Accordingly, the Firm is not as capable as our competitors of responding to Sponsors' needs by (i) making an initial commitment of sufficient size (even though we know that we will be partnered up and our final commitment will almost always be significantly smaller) or (ii) retaining a final commitment comparable in size to our competitors.
- ◆ These constraints make us less relevant to top Sponsors on large transactions and less likely to get the upfront call.
 - Recent examples: HCA, Univision, Kinder Morgan.
- ◆ To be competitive with Sponsors like KKR and Blackstone, the Firm needs to be able to name the level at which we can play.
- ◆ The Firm expects to be combined with other banks later in the process, but we need to be able to go in “big” with confidence to be relevant to top tier Sponsors.

Potential Solutions

- ◆ The Firm needs to be able to be more responsive to Sponsors' needs by initially committing to 100% of the financing.
 - Initial commitment letter capacity should be at least \$5 billion to be relevant on large transactions.
 - Estimated to be needed 10-15 times a year. Recent examples: Univision, Pages Jaunes, Travelport.
- ◆ To create initial commitment level capacity, the Firm can establish a structured solution which can shift the most senior 35% of exposure (the “Aaa risk”) to third parties at an estimated cost of \$6-7 million per year.
 - However, this solution does not achieve risk transference for Lehman.
- ◆ In addition, on occasion, the Firm may need to be able to have a “final” commitment on LBO transactions or high yield corporate acquisitions in an amount in excess of our internal single transaction limit and would want extra capacity for those transactions.
 - Estimated to be needed 6-9 times a year. Recent examples: Hertz, Gala, Coral Eurobet, Univision.
- ◆ To create this additional commitment capacity, the Firm is pursuing partnership arrangements with other financial institutions to assume a portion of the risk on specific transactions on a pari passu basis.
- ◆ In conjunction with these strategies, the Firm could also re-evaluate the \$250mm quarterly loss limit inherent in our Single Transaction Limit model. ^(a)

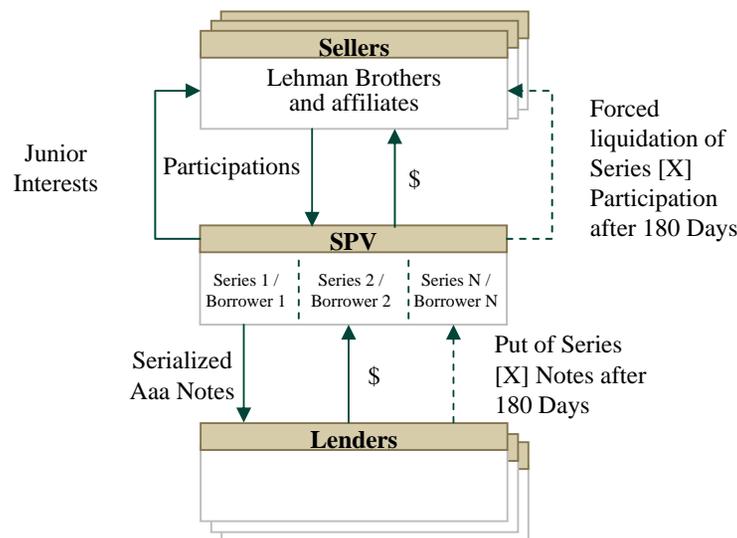
*a) If the Firm were to increase the quarterly loss limit inherent in the Single Transaction Limit model from \$250mm to \$300mm, then the limits on commitments would increase by approximately 20%.
If the loss limit were to be increased from \$250mm to \$350mm, then the limits on commitments would increase by approximately 40%.*

B. Increasing Lending Capacity for Sponsors' LBOs Structured Solution Overview

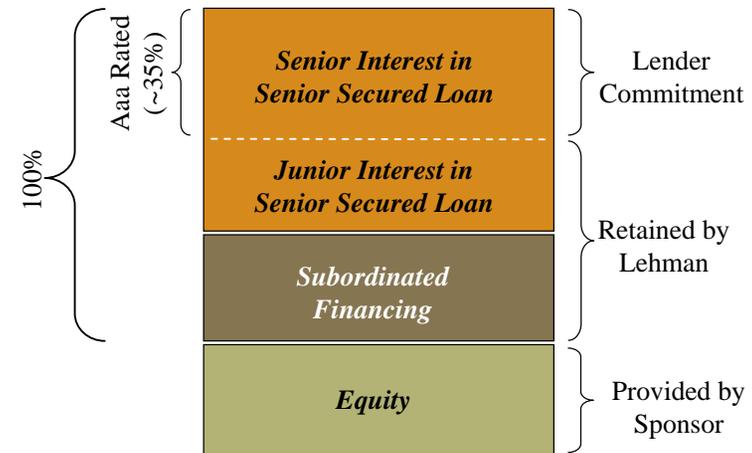
Lehman Brothers Can Increase Notional Commitment Capacity II. Issues to be Addressed and Potential Solutions by Participating a Senior Risk Tranche to Lending Partners on a Pre-Committed Basis

- ◆ Lehman Brothers will establish an ongoing financing facility that will increase our ability to commit a larger notional amount up front by relying on partners for amounts in excess of our external nominal commitment limit.
 - This excess capacity is not expected to be required once Lehman's final hold position in the underwriting group has been determined.
- ◆ Lenders will commit in advance to acquire on a revolving basis without prior credit review notes explicitly rated Aaa, each of which represents the senior 25-35% of the total debt financing provided by Lehman to an individual borrower.
 - Moody's is unlikely to allow the creation of a tranching exposure within a single corporate credit that is rated below Aaa. ^(a)
- ◆ While "headline" capacity will increase, there will be limited risk transfer because Lehman will retain the majority of each borrower exposure as a junior interest subordinated to the interests of the lenders.
- ◆ Total fees payable per annum for the facility are expected to be approximately \$6-7 million including fees to lenders and rating agency and legal fees. ^(b)

The Facility Utilizes Structured Finance Technology



Lenders Acquire Aaa-Rated Senior Tranches of Borrowers' Debt Financing



a) Moody's methodology for tranching single-name corporate exposures, including reasons for its unwillingness to rate Notes to a level other than Aaa, are described in section II of appendix.
 b) Assumptions utilized in calculating aggregate fees are described in detail in section II of appendix.

B. Increasing Lending Capacity for Sponsors' LBOs Structured Solution Partner Evaluation

Potential Partner	Status of Discussions
	<ul style="list-style-type: none"> ◆ Initiated discussions on the high yield structured solution with Lloyds' Head of Structured Finance. <ul style="list-style-type: none"> – Lloyds understands the structure, and is both intrigued and supportive. ◆ Detailed follow up with subject experts from both sides scheduled for August 4th. ◆ Have already partnered with Lloyds on a liquidity facility (Aegis) supporting High Grade loans. ◆ Potential roadblock: Lloyds is a conservative (Aaa), bureaucratic organization that is known for slow decision-making. This could be a source of frustration if we were to pursue a partnership with Lloyds.
	<ul style="list-style-type: none"> ◆ RBC reacted positively to the proposal: found it interesting and appreciated the early look. ◆ Raised a desire to make this more than just a balance sheet for fee discussion. <ul style="list-style-type: none"> – Interested in having additional roles (e.g., in the syndicate). <ul style="list-style-type: none"> • Agreed to postpone those discussions until they determine whether the proposal is otherwise viable.
	<ul style="list-style-type: none"> ◆ Held preliminary conversation with contact in Danske's London office. ◆ Danske reacted fairly positively, but they want to discuss the proposal internally before providing substantive feedback.
	<ul style="list-style-type: none"> ◆ Held preliminary conversation with contacts in Helaba's New York office. ◆ Helaba expressed some interest in the structure and will provide feedback back to us. <ul style="list-style-type: none"> – However, it is not clear where the transaction would be housed internally at Helaba.
	<ul style="list-style-type: none"> ◆ Contacted Rabo; have not yet scheduled a meeting. <ul style="list-style-type: none"> – Currently waiting for Rabo to come back to us with the appropriate contact for a preliminary call.
	<ul style="list-style-type: none"> ◆ Meeting scheduled for early August. <ul style="list-style-type: none"> – Updates to be provided.
	<ul style="list-style-type: none"> ◆ Held preliminary conversation and they expressed potential interest in U.S. partnership as they have interest in expanding their LBO exposure, but cannot do so alone owing to structural constraints. <ul style="list-style-type: none"> – However they view us as a direct competitor in Europe and are unlikely to participate there. ◆ We need to determine if U.S.-only capacity is helpful.

B. Increasing Lending Capacity for Sponsors' LBOs

Lending Capacity Partner Evaluation (Deal-by-Deal Solution)

II. Issues to be Addressed and Potential Solutions

Potential Partner	Status of Discussions
	<ul style="list-style-type: none"> ◆ Have existing ad hoc lending partnership for high grade credit. <ul style="list-style-type: none"> – Over the past two years, completed 12 loan transfers to Sumitomo. ◆ Want to expand and formalize lending partnership. <ul style="list-style-type: none"> – Sumitomo has expressed interest in becoming more involved with Lehman and taking a more aggressive approach to high yield credit exposure.
	<ul style="list-style-type: none"> ◆ Calyon expressed interest in partnering on high grade and high yield acquisition facilities. <ul style="list-style-type: none"> – However, Calyon would want a portion of the fees from future investment banking business. – In addition, Calyon is a competitor in the European Leveraged Loan market.
	<ul style="list-style-type: none"> ◆ WaMu expressed preliminary interest in exploring leveraged lending partnership opportunities. <ul style="list-style-type: none"> – However, WaMu expressed concern regarding the degree of concentrated risk inherent in financing multi-billion dollar LBOs. – Furthermore, WaMu indicated they were more interested in partnering across a broad range of assets (e.g., Real Estate, FRLs, etc.). ◆ Discussions are ongoing to form a broad financing relationship that would include acquisition finance.
	<ul style="list-style-type: none"> ◆ Potential interest in U.S. partnership, but view us as a direct competitor in Europe and are unlikely to partner there. ◆ We need to determine if U.S.-only capacity is helpful. ◆ Not an ideal partner given the extended amount of time Mizuho takes to make credit decisions.
	<ul style="list-style-type: none"> ◆ Interested in pursuing lending partnership in size for EU deals, and beginning with smaller size in U.S. <ul style="list-style-type: none"> – Have participated in similar deals (up to \$2-3bn), but only in Europe. – Have participated in some U.S. deals, but in smaller size (\$300-400mm). ◆ HVB is currently discussing the opportunity internally and will get back to the Firm to discuss the proposal in greater depth.

LEHMAN BROTHERS

C. Becoming More Aggressive in Proposing Terms

Issues to be Addressed

- ◆ There is a real, and generally healthy, tension between IBD and FID on Financial Sponsor LBO transactions.
 - IBD originates the revenue opportunity; FID assesses and manages the risk.
 - The Firm also generally has a low tolerance approach to risk on these transactions, seeking to minimize losses to the full extent possible.
 - The best outcome for the Firm – winning the business but mitigating the risk to the maximum extent possible – usually results.
- ◆ However, this dynamic can prevent the Firm from being in a position to propose the most aggressive (and winning) terms on a transaction, particularly in volatile and uncertain markets like those of today.
- ◆ Additional consequences of the Firm’s risk management approach are that it:
 - Consumes enormous internal resources and time to reach a “resolution” that all of the Firm supports.
 - Makes the Firm too slow to agree to terms being proposed by clients.
 - As a result, the Firm appears reluctant to clients, losing the ability to lead the discussion of terms.
 - Recent example: Pages Jaunes.

Potential Solutions

- ◆ A potential solution, analogous to what we do with Firm Relationship Loans, is to agree to create an annual Sponsor FRL reserve budget to cover losses resulting from matching or proposing terms that may be regarded as too aggressive, but which are necessary to win business (primarily lead roles on large cap buyouts with top tier Sponsors), improve our league table position and capture the ancillary benefits.
- ◆ The Sponsor FRL reserve budget will serve as a statement to the organization that (i) the Firm is willing to take syndication risk in order to aggressively pursue select mandates on transactions with our most important Sponsor relationships and (ii) there is a recognition that we can lose money on some transactions in order to expand our Sponsor franchise.
 - However, senior-level accountability from Sponsors, Leveraged Finance and High Yield groups is critical to minimize actual losses and maximize the benefits of this commitment to Sponsor relationships.
- ◆ Having a Sponsor FRL reserve budget also might accelerate the internal approval process so that the Firm can agree to “final terms” faster and be more responsive to clients.
- ◆ Proposal is to create a Sponsor FRL reserve budget of \$100 million.

C. Becoming More Aggressive in Proposing Terms Sponsor FRL Reserve Budget

II. Issues to be Addressed and Potential Solutions

- ◆ Create an annual, evergreen Sponsor FRL reserve budget of \$100 million to cover syndication losses on Leveraged Finance transactions.
 - ◆ The objective is to selectively take calculated syndication risk when a determination is made not to allow terms to stand in the way of winning business, so that we can better position ourselves to be the lead on these financings and leverage our incumbency to win mandates for follow up business.
 - Makes a statement internally that the Firm is willing to take risk in order to aggressively pursue select mandates.
 - ◆ Although the idea would not be to intentionally lose money on transactions, the reserve budget would represent a recognition by the Firm that there is the potential for the Firm to lose money on some transactions due to market volatility and a desire to be aggressive with top Sponsors on specific transactions.
 - However, should be clear that the losses we are willing to incur are syndication losses, not credit losses.
 - Not willing to make compromises on credit underwriting standards.
 - ◆ On select transactions, price financing and set terms aggressively.
 - Modify low tolerance approach to risk on these transactions.
 - Align risk more closely to current market distribution rather than a willingness to hold assessment.
 - Weather balance sheet holds through market volatility.
 - Be willing to deviate from “moving not storage” philosophy in selected circumstances.
 - ◆ Allocate budget based on Sponsor client priority and credibility (i.e., ability to “trust” Sponsors).
 - ◆ FRL reserve budget to be managed through a committee process like Corporate FRLs.
 - Suggested committee members: Steven Berkenfeld, Alex Kirk, Mike Konigsberg, Fred Orlan, Ros Stephenson, Jeff Weiss, and TBD representatives from the London office.
-
- ◆ Charge for mark-to-market losses on financing packages by netting costs against fees.
 - Costs will be split equally between Investment Banking, Fixed Income and Equities.
 - ◆ Expect to allocate the reserve to 6-12 transactions a year.

C. Becoming More Aggressive in Proposing Terms Lehman Private High Yield / Mezzanine Fund

II. Issues to be Addressed and Potential Solutions

Create third party fund which would invest in riskiest part of financing to be underwritten by Lehman (i.e., the last half turn of debt currently being marketed to hedge funds). (a)

Target Fund Size	<ul style="list-style-type: none"> ◆ \$1.0 to \$1.5 billion target equity commitments. ◆ Leverage of 35%-45% debt / total capital resulting in additional investable funds \$500 million - \$1.0 billion. ◆ Total fund size including leverage of \$1.5 - \$2.5 billion.
Target Investments	<ul style="list-style-type: none"> ◆ \$50mm - \$125mm in size; too large for small mezz providers and too small for high yield market. ◆ High Yield Alternative – deals large enough for high yield market but require additional features not in standard high yield issues. ◆ 20-30 U.S. investments resulting in an average of \$75 - \$100mm per investment.
Target Returns	<ul style="list-style-type: none"> ◆ Unlevered gross returns of 12%-16%; levered gross returns of 17%-22%. ◆ Fund returns generated by interest (cash and PIK), upfront closing payments, prepayment penalties, warrants, and equity co-investments.
Investors	<ul style="list-style-type: none"> ◆ Lehman Brothers and Employees to potentially contribute 20% of funding (up to ~\$250mm). ◆ Strategic, institutional and high net worth investors. <ul style="list-style-type: none"> – E.g., BOTM, AIG, All State, Babson, John Hancock, Met Life, Northwestern Mutual, TIAA. ◆ 5 year investment period.
Advantages	<ul style="list-style-type: none"> ◆ Fits naturally in the credit-related funds asset class of Private Equity. ◆ Attractive investment vehicle for investors. ◆ Provides a tool for Lehman to commit to all of the financing required for an LBO. <ul style="list-style-type: none"> – Allows the Firm to pre-syndicate the most challenging debt tranche and lead with confidence.
Next Steps	<ul style="list-style-type: none"> ◆ Identify a qualified investment team and demonstrate fund independence for a successful fund raise. ◆ Begin fundraising initiatives. ◆ Establish Firm's ability to source transactions from premier Sponsors and to make good credit decisions. ◆ Develop "rules of the road" to ensure the Firm's Mezz Fund is primary vehicle for this type of activity. ◆ Review alternative structures (CDO and BDC) and discuss potential sources of leverage. ◆ Warehouse deals on the balance sheet prior to fundraising.
Competitor Benchmark	<ul style="list-style-type: none"> ◆ Goldman raised a \$5 billion Private High Yield / Mezzanine Fund; ML is rumored to be doing so as well. ◆ Majority of investors were High Net Worth clients. ◆ GS has placed the HoldCo PIK piece of Pages Jaunes in its fund.

a) The last half turn of debt is the bottom part of the capital structure.

D. Add'l Strategies to Become More Proprietary with Sponsors

Issues to be Addressed

- ◆ Banks, because of their size, low cost of funding and low cost of equity dominate the leveraged lending business.
- ◆ The Firm needs to have a competitive model where our advantages (ideas, structuring skills, relationships, etc.) are critical.
- ◆ Almost certainly, for the foreseeable future, the Firm will need to do a blend of (1) low margin, but high revenue, large transactions along with (2) higher margin, better return on risk, proprietary transactions.

Potential Solutions

- ◆ The Firm should continue to pursue strategies to enhance our proprietary relationships with Sponsors and to differentiate ourselves with our proprietary ideas:
 - Capitalizing on our existing corporate relationships to create proprietary LBO ideas.
 - Co-investing with Sponsors on selected transactions.
 - Building-out the Whole Business Securitization capability.
 - Expanding and targeting Wealth Management coverage of Sponsors' partners.
 - Expanding Middle Markets Sponsor coverage.
 - Expanding Investment Banking footprint.
 - In particular, developing a better sell-side / divestiture business.
 - Having broader inter-divisional relationships with top Sponsors accounts.
 - Offering additional products to Sponsors (such as monetizing GP positions and providing cash flow loans on GP interests).

III. Summary of Specific Recommendations

III. Specific Recommendations / Next Steps – Overview

Objectives: Maintain Top 5 Market Position with Financial Sponsors and Increase Revenue Share in Corporate Acquisition Finance.

Problem	Potential Solutions	Issues Solved, Examples
Corporate Acq. Finance	<ul style="list-style-type: none"> ◆ Form Relationships and Partnerships to Increase Corporate Acquisition Finance Lending Capacity. 	<ul style="list-style-type: none"> ◆ Maintain control of transaction longer. ◆ Retain more of overall fee pool by better controlling the addition of other bookrunners, ex. – GlaxoSmithKline, Tesoro.
Sponsor LBOs	<ul style="list-style-type: none"> ◆ Establish Structured Vehicles or Form Relationships and Partnerships to Increase LBO / Leveraged Finance Lending Capacity. 	<ul style="list-style-type: none"> ◆ Gain flexibility to be more responsive to Sponsors’ needs. ◆ Become more relevant to top Sponsors in large transactions. ◆ Increase ability to win lead mandates and control terms on large buyouts.
Becoming More Aggressive on Terms	<ul style="list-style-type: none"> ◆ Create a Sponsor FRL Reserve Budget. ◆ Raise Private High Yield / Mezzanine Fund. 	<ul style="list-style-type: none"> ◆ Increase the Firm’s willingness to take risk on select transactions. ◆ Gain flexibility to be more responsive to Sponsors’ needs. ◆ Allows the Firm to be more aggressive in proposing terms. ◆ Allows the Firm to be more aggressive in proposing terms. ◆ Provides the Firm with an attractive investment opportunity.
Proprietary Ideas and Relationships	<ul style="list-style-type: none"> ◆ Co-Invest with Sponsors on Selected Transactions. ◆ Build-out Whole Business Securitization. ◆ Expand and Target Wealth Management Coverage of Sponsors’ Partners. ◆ Expansion of Middle Market Sponsor coverage (fund size: \$ 2-5 billion). ◆ Expansion of Investment Banking Footprint. – In particular, expand exclusive sale practice. ◆ Offer Additional Products to Sponsors. 	<ul style="list-style-type: none"> ◆ Enhances the Firm’s proprietary relationships with Sponsors. ◆ Improves the Firm’s risk / return profile on these transactions. ◆ Become more relevant to top Sponsors in large transactions. ◆ Allows the Firm to be more aggressive in proposing terms, ex. – Univision. ◆ Deepens relationships with Sponsors, ex. – Cox Cable. ◆ Enhances the Firm’s proprietary relationships with Sponsors, ex. – Hertz, Dunkin’. ◆ Allows the Firm to be more aggressive in proposing terms. ◆ Enhances the Firm’s proprietary relationships with Sponsors. ◆ Deepens relationships with Sponsors, ex. – Carlyle. ◆ Enhances Firm’s proprietary relationships with Sponsors. ◆ Broadens revenue footprint. ◆ Enhances the Firm’s proprietary relationships with Sponsors. ◆ Become more relevant to top Sponsors. ◆ Enhances the Firm’s proprietary relationships with Sponsors. ◆ Deepens relationships with Sponsors.

III. Specific Recommendations / Next Steps – Economic Impact

Objectives: Maintain Top 5 Market Position with Financial Sponsors and Increase Revenue Share in Corporate Acquisition Finance.

III. Summary of Specific Recommendations

Problem	Potential Solutions	Costs	Benefits	Net
Corporate Acq. Finance	<ul style="list-style-type: none"> Form Relationships and Partnerships to Increase Corporate Acquisition Finance Lending Capacity. 	<ul style="list-style-type: none"> Dependent on specifics of each transaction <ul style="list-style-type: none"> – Upfront fee range: ~3-25 bps 	<ul style="list-style-type: none"> 30-50% additional financing fees per transaction Plus incremental revenue retention 	Incremental revenue should exceed cost on completed deals
Sponsor LBOs	<ul style="list-style-type: none"> Establish Structured Vehicles or Form Relationships and Partnerships to Increase LBO / Lev. Finance Lending Capacity. 	<ul style="list-style-type: none"> ~\$6mm per year for ~\$3.5bn of capacity 	<ul style="list-style-type: none"> \$10mm revenue from each additional transaction 	One additional mandate per year should exceed cost
Becoming More Aggressive on Terms	<ul style="list-style-type: none"> Create a Sponsor FRL Reserve Budget. 	<ul style="list-style-type: none"> \$100mm per year 	<ul style="list-style-type: none"> \$5mm additional revenue from each mandated transaction \$10mm rev from each add'l transaction 	TBD
	<ul style="list-style-type: none"> Raise Private High Yield / Mezzanine Fund. 	<ul style="list-style-type: none"> \$250mm in Firm capital, committed over 4 years 	<ul style="list-style-type: none"> ~17-22% levered IRR \$10mm revenue from each additional transaction 	Supportable on stand-alone risk / return basis
Proprietary Ideas and Relationships	<ul style="list-style-type: none"> Co-Invest with Sponsors on Selected Transactions. 	<ul style="list-style-type: none"> \$400mm in Firm capital per year <ul style="list-style-type: none"> – Up to \$100mm per transaction 	<ul style="list-style-type: none"> ~20-25% IRR Assume no additional transactions won 	Supportable on stand-alone risk / return basis
	<ul style="list-style-type: none"> Build-out Whole Business Securitization. 	<ul style="list-style-type: none"> Estimate ~\$5mm in annual comp expense 	<ul style="list-style-type: none"> \$30mm in revenue from 2-3 add'l transactions per year 	Incremental Firm revenue should support cost
	<ul style="list-style-type: none"> Expand and Target Wealth Management Coverage of Sponsors' Partners. 	<ul style="list-style-type: none"> Estimate ~\$2mm in annual comp expense 	TBD	Incremental IMD revenue should support cost
	<ul style="list-style-type: none"> Expansion of Middle Market Sponsor coverage (fund size: \$ 2-5 billion). 	<ul style="list-style-type: none"> Estimate ~\$5mm in annual comp expense 	<ul style="list-style-type: none"> \$50-75mm in revenue p.a. from 15-25 additional clients 	Incremental Firm revenue should support cost
	<ul style="list-style-type: none"> Expansion of Banking Footprint. <ul style="list-style-type: none"> –E.g., expand exclusive sale practice. 	<ul style="list-style-type: none"> \$50mm in '06 New Initiative dollars spent on new hires 	TBD	Incremental Firm revenue should support cost
	<ul style="list-style-type: none"> Offer Additional Products to Sponsors. 	<ul style="list-style-type: none"> No cost separate from underwriting each transaction 	<ul style="list-style-type: none"> Separate risk/return analysis for each transaction 	