

Confidential Presentation to:

Executive Committee

Financial Sponsors Strategies (Including Lending Capacity Solutions) Appendix

August 3, 2006

LEHMAN BROTHERS

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I. Risk Limits Which Apply to Lending Commitments

Risk Limits Which Apply to Lending Commitments

- ◆ The Firm manages High Grade and High Yield risk against four main parameters.
- ◆ The most relevant constraint the Firm faces in financing Corporate Acquisitions and LBOs is S&P's nominal commitment limit.
 - As a result of the limit, the Firm cannot commit to funding financings >\$3.5 billion.
 - The Firm must reduce its commitment by either finding a balance sheet partner or by giving up economics to a competitor who splits the commitment.
- ◆ The Firm has a great track-record in distributing risk, so once a deal syndicates, our hold position is quickly managed down.

Nominal Commitment Limit

- ◆ S&P mandated that a single commitment cannot exceed 15% of tangible equity.
 - LEH's limit is \$2.6bn. ^(a)
- ◆ Alternately, Consolidated Supervisory Entities may calculate the limit as 15% of Tier 1 + Tier 2 Capital.
 - Using this methodology, LEH's limit is \$3.5bn. ^(a)

Single Transaction Limit

- ◆ Absolute size of financing for which LEH can make a legally binding commitment determined by LEH's internal model.
 - STL HY loss must be <\$250mm in quarter.
 - STL HG loss must be <\$250mm in quarter.
 - Both STLs calculated as quarterly loss at 99.5% confidence level.
- ◆ Calculation based on amount "expected" to be committed to in the final loan documents rather than amount actually committed to in preliminary papers.

Aggregate HG and HY Contingent Commitments

- ◆ Total amount of contingent High Grade and High Yield commitments reportable in external filings.
 - Includes only commitments where LEH has signed legally binding papers.
- ◆ No official limit, but the Street monitors the quarterly disclosures closely.
 - Maximum HY reported to date: \$7.9bn in Q3 2004.
 - Maximum HG reported to date: \$6.4bn in Q3 2004.

Risk Appetite

- ◆ Total amount of portfolio risk that origination business is permitted to take; measures market volatility and default risk.
 - \$300mm annual High Yield origination limit.
 - Allocated: U.S.: \$150mm; EU: \$185mm; Asia: \$0mm. ^(b)
 - \$150mm annual High Grade origination limit.
 - Allocated: U.S.: \$125mm; EU: \$50mm; Asia: \$0mm. ^(b)
 - Both calculated as annualized potential loss at 95% confidence interval.

^(a) Limit calculation as of 1H 2006.

^(b) Regional risk appetites sum to greater than the global total due to the diversification benefit.

Risk Limits – Competitor Comparison

I. Risk Limits

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

\$ in billions

	Tangible Equity	Tier 1 + 2 Capital ^(b)	Tier 1 + 2 Capital: w/ Max Subdebt ^(c)	Single Transaction Limit			
				% Limit ^(d)	% Tangible Equity	% Tier 1+2 Capital	% Tier 1+2 Capital (w/Max Subdebt)
Bear	11.6	10.7	16.0	15%	1.7	1.6	2.4
LEH	17.4	16.3	23.3	15%	2.6	2.4	3.5
GS	28.8	29.4	41.8	15%	4.3	4.4	6.3
MS	32.6	34.3	45.4	15%	4.9	5.1	6.8
ML	33.7	33.2	46.8	15%	5.1	5.0	7.0
Wachovia	34.0	49.5	51.0	15%	5.1	7.4	7.7
CS	20.6	25.9	30.9	25%	5.1	6.5	7.7
DB	27.1	41.2	40.7	25%	6.8	10.3	10.2
UBS	31.0	33.8	46.5	25%	7.8	8.5	11.6
JPM	74.3	103.8	109.6	15%	11.1	15.6	16.4
Citi	83.5	109.7	119.9	15%	12.5	16.4	18.0
B of A	83.2	111.4	124.8	15%	12.5	16.7	18.7

(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.

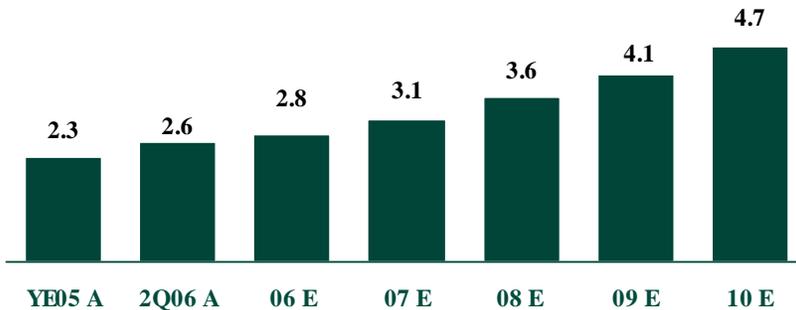
(d) U.S. banking rules allow a maximum limit of 15% for single name exposure. European banking rules allow a maximum limit of 25% for single name exposure, and that limit may be exceeded without immediate notification to the regulatory body as long as the excess over the limit is covered completely by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

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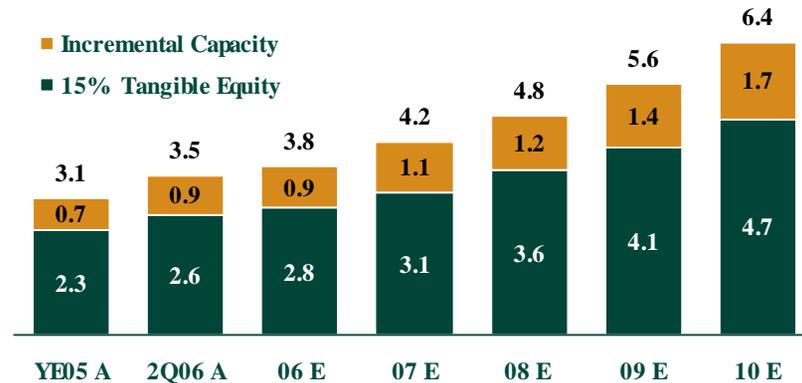
Risk Limits – Lehman’s Limits Going Forward

Nominal Commitment Limit Calculation (\$bn)

Original Limit: 15% of Tangible Equity ^(a)



Revised Limit: 15% of Tier 1 + 2 Capital ^(b,c)

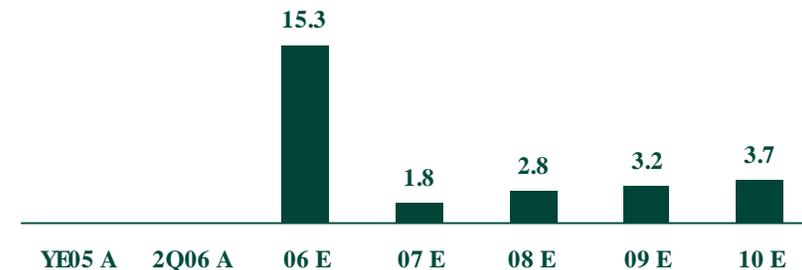


Incremental Capacity

Subordinated Debt Issuance (\$bn) ^(c)



Incremental Cost of Sub Debt Issuance (\$mm) ^(d)



- a) Leverage equity forecasts for 2007 to 2010 are from March to \$150 analysis conducted in Mar-06. Estimate for 2006 year end is from mid-year business review.
- b) Major difference between tangible equity and Tier 1 capital is deferred tax assets > 1 year (Tier 1 deducts DTA). Assumes DTA grows at 10% annually.
- c) Currently under CSE framework, SEC allows qualifying long-term debt to be included in Tier 2 capital for a period of 3 years (through end of 2008). This essentially is to allow securities firms to gradually replace long-term debt with sub debt without causing market disruptions. The Firm currently includes the max LTD allowed (50% of Tier 1). For 2006 onwards, Tier 2 shown assumes the Firm will issue max amount of sub debt to replace LTD (50% of Tier 1).
- d) Assumes subordinated debt costs 20 bps more than long term debt.

Risk Limits – Internal Single Transaction Limit Model (a)

	Visibility	Maturity / Secured	MACs		Credit Rating					I. Risk Limits	
			Business	Market	Aa+	A	Baa	Ba	B		Caa
Bought Deals	Market Visibility ~2 Weeks	0-2 Years			25,000	14,000	7,500				
		2-5 Years			17,500	9,000	4,500				
		5+ Years			11,500	6,000	4,000				
		Unsecured						3,125	1,650	800	
Credit Facilities	Market Visibility ~1 Month	0-2 Years			12,500	7,000	3,750				
		2-5 Years			8,750	4,500	2,250				
		5+ Years			5,750	3,000	2,000				
		Secured						4,250	1,875	700	
		Unsecured						1,563	825	400	
Acquisition Finance	Expected Closing Less Than 2 Months	Secured	✓	✓				6,250	4,650	NA	
		Unsecured	✓	✓	10,500	5,000	3,500	2,500	1,700	1,050	
		Secured	✓	X				4,464	3,321	NA	
		Unsecured	✓	X	7,500	3,571	2,500	1,786	1,214	750	
		Secured	X	✓				3,472	2,583	NA	
		Unsecured	X	✓	5,833	2,778	1,944	1,389	944	583	
		Secured	X	X				3,125	2,325	NA	
		Unsecured	X	X	5,250	2,500	1,750	1,250	850	525	
	Expected Closing More Than 2 Months	Secured	✓	✓				4,420	3,290	NA	
		Unsecured	✓	✓	7,400	3,500	2,500	1,770	1,200	740	
		Secured	✓	X				3,160	2,350	NA	
		Unsecured	✓	X	5,300	2,500	1,800	1,260	860	530	
		Secured	X	✓				2,460	1,830	NA	
		Unsecured	X	✓	4,100	2,000	1,400	980	670	410	
Secured		X	X				2,210	1,640	NA		
Unsecured		X	X	3,700	1,800	1,200	880	600	350		

a) Assumes max quarterly loss of \$250mm. If the max loss were to be raised to \$300mm, then limits would increase by ~20%. If it were raised to \$350mm, then limits would increase by ~40%.

Risk Limits – Resulting Fees Left on the Table

Lehman scaled down its involvement or did not participate in certain High Yield financings due to balance sheet constraints or risk concerns.

- ◆ Group (1): Did not approve the full commitment size due to B/S constraints or concerns regarding aggressiveness of terms.
- ◆ Group (2): Eroded economics to reduce risk exposure using hedges, e.g., purchase of credit default swaps.
- ◆ Group (3): Chose not to participate because of concerns about the credit. However, these transactions succeeded in the market.
- ◆ Group (4): Chose not to participate because of concerns about the credit. However, this transaction failed in the market (hung bridge).

	Total Financing Size \$mm	Lehman Brothers' Financing Fees ^(a)				Impact on Competitors' Fees				Competitor	Reason for Miss
		Booked		Unrealized Fees		Total Potential Fees		Additional Fees			
		\$mm	% Deal	\$mm	% Deal	\$mm	% Deal	\$mm	% Deal		
(1) Full Commitment Size / Terms Not Approved											
Hertz	\$6,520	\$34.1	22.0%	\$9.3	6.0%	\$43.4	28.0%	\$9.3	6.0%	DB & Others	Commitment Size Cap
Worldspan	\$300	\$2.6	20.0%	\$1.3	10.0%	\$3.9	30.0%	\$1.3	10.0%	JPM, UBS, DB, GS	Business MAC & Flex
Hanley Wood	\$302	\$0.0	0.0%	\$4.0	50.0%	\$4.0	50.0%	\$4.0	50.0%	CSFB & JPM	Leverage Cap
Gala	\$1,638	\$35.0	40.0%	\$8.0	10.0%	\$43.0	50.0%	\$8.0	10.0%	RBS	Commitment Size Cap
SBS Broadcasting	\$2,628	\$12.7	33.3%	\$2.5	10.0%	\$15.2	40.0%	\$2.5	10.0%	RBS	Commitment Size Cap
Total	\$11,388	\$84.4		\$25.1		\$109.5		\$25.1			
(2) Internal Hedging Activity											
Gala (CDS + Sub-UW)	\$4,438	\$35.0	40.0%	\$5.5		\$40.5	40.0%				Reduce Exp. by \$900M
Coral Eurobet (CDS + Sub-UW)	\$1,525	\$23.3	50.0%	\$2.6		\$25.9	50.0%				Hedging and Sub-UW
Total	\$5,962	\$58.3		\$8.1		\$66.4					
(3) Transaction Not Approved (Market Success)											
Activant Solutions	\$305	-	-	\$2.5	33.3%	\$2.5	33.3%	\$2.5	33.3%	DB & JPM	Credit Issues
Centennial Communications	\$1,142	-	-	\$6.9	50.0%	\$6.9	50.0%	\$6.9	50.0%	CSFB	HoldCo Terms & Exec.
Sorenson Communications	\$565	-	-	\$3.8	33.3%	\$3.8	33.3%	\$3.8	33.3%	BOA & RBS	Leverage Too High
Double-Click	\$405	-	-	\$2.7	33.3%	\$2.7	33.3%	\$2.7	33.3%	BS & CSFB	Leverage Too High
Infor Global (Latest Acquisition)	\$550	-	-	\$9.4	50.0%	\$9.4	50.0%	\$9.4	50.0%	JPM, CSFB, ML	Inadequate Financials
N&W	\$529	-	-	\$3.4	33.3%	\$3.4	33.3%	\$3.4	33.3%	CIBC/SG	Leverage Too High
Total	\$3,496	\$0.0		\$28.7		\$28.7		\$28.7			
(4) Transaction Not Approved (Market Failure)											
Affinion ^(b)	\$1,126	-	-	\$11.5	33.3%	\$11.5	33.3%	\$11.5	33.3%	DB & CSFB	Leverage Too High
Total	\$1,126	\$0.0		\$11.5		\$11.5		\$11.5			
Grand Total		\$142.7		\$73.4		\$193.1		\$42.2			

(a) This analysis excludes M&A fees

(b) Affinion cleared the market in 6 months.

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Risk Limits – Resulting Fees Left on the Table

\$ in millions

I. Risk Limits

Deal Size						
Deal Size	\$4,000	\$8,000	\$12,000	\$16,000	\$20,000	\$24,000
Equity Contribution ^(a)	1,000	2,000	3,000	4,000	5,000	6,000
Total Financing (total deal less equity)	3,000	6,000	9,000	12,000	15,000	18,000
% of total financing to which Lehman can commit ^(c)	100%	58%	39%	29%	23%	19%
Upfront Commitment (50% of total) ^(b)	1,500	3,000	4,500	6,000	7,500	9,000
Lehman's ability to commit to 50% under current parameters ^(c)	✓	✓	X	X	X	X
Ultimate Expected Commitment (33% of total) ^(d)	990	1,980	2,970	3,960	4,950	5,940
Lehman's ability to commit to 33% under current parameters ^(c)	✓	✓	✓	X	X	X
% of ultimate expected commitment to which Lehman can commit ^(c)	100%	100%	100%	88%	71%	59%
Potential Fees to Lehman Brothers						
Financing Fee ^(e)	12	25	37	50	62	74
M&A Fee ^(f)	8	11	14	16	18	19
Total Potential Fees	20	36	51	65	79	93
Lehman's Fees Under Current Constraints						
Financing Fee	12	25	37	44	44	44
M&A Fee ^(g)	8	11	14	0	0	0
Total Lehman Fees Under Current Constraints	\$20	\$36	\$51	\$44	\$44	\$44
Fees Left on the Table						
Financing Fee	0	0	0	6	18	31
M&A Fee	0	0	0	16	18	19
Total Fees Left on the Table	\$0	\$0	\$0	\$21	\$36	\$50

(a) Assume 25% equity contribution.

(b) Assume 50% upfront commitment.

(c) Given Lehman's current nominal commitment limit of \$3.5bn (15% of Tier 1+ 2 Capital, assuming maximum sub debt issuance).

(d) Assume 33% ultimate hold.

(e) Assume 33% ultimate hold and 1.25% fee, including mark on revolver.

(f) Assumes M&A fees per the fee card, discounted 50%. For example, the fee card dictates a fee of 0.23%, or \$28mm, on a \$12bn M&A advisory assignment. For Sponsors, we assume this fee is discounted to \$14mm.

(g) Assumes Lehman cannot earn an advisory fee if the Firm cannot commit to more than 30% of the financing.

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II. Recommendations for Increasing Lending Capacity

Corporate Acquisition / LBO Lending Partnership – Overview

Objective

- ◆ **Increase Firm's capacity to provide acquisition financing for corporate clients and LBO financing for Sponsors clients.**
 - Form relationships or even formal partnerships with 1-2 banks that are each willing to commit at least \$1 billion to financings as Lehman's partner.
 - Potentially foster secondary relationships with 1-2 additional banks that are willing to commit at least \$500 million to financings as Lehman's partners.

Partner Characteristics

- ◆ Needs this kind of asset to diversify and to expand exposure to the region or to this type of risk.
- ◆ Has excess balance sheet capacity and broad risk appetite.
- ◆ Understands these credits and risk/reward trade-off.
- ◆ Maintains investment grade credit rating.
- ◆ Is not expected to become (in 3-5 years) direct investment banking competitor in U.S. or EU.
- ◆ Is considered strategically important to the Firm.
- ◆ **Potential partners:**



Next Steps

- ◆ Assess each partners' interest in partnering.
- ◆ Establish how much each partner is willing to lend on a single transaction.
- ◆ Gauge willingness to lend to non-investment grade borrowers.
- ◆ Develop view on economics partner will require to participate, both in terms of fees and risk sharing (e.g., first loss).
- ◆ Understand partner's credit process - how much time and information needed to make credit decisions.
- ◆ Discuss several case studies to determine how venture will work in real-time with each partner.

Lending Partnership – Proposed Term Sheet

II. Increasing Lending Capacity

Structure

- ◆ Financing origination partnership between Lehman and several banks.
 - Designed to provide additional capacity for High Grade Corporate Acquisitions, High Yield Loans, Bridge Loans and FRLs.
- ◆ Contractual relationship in which Lehman and partner commit to and ultimately fund revolvers, term loans, and bridge loans with aggregate value over ~\$2 billion.
 - Back-to-back arrangement in which the partner will support Lehman’s financing proposals and co-invest in Lehman’s financing commitments.

Eligible Financings

- ◆ All High Grade Corporate Acquisition Loans, High Yield Loans, Bridge Loans and FRLs originated by Lehman with aggregate amounts (across all parts of the debt capital structure) of over ~\$2 billion.

Commitment Exposure

- ◆ Lehman Brothers and the partner will split the senior financing on a pro rata basis.
- ◆ Lehman will provide all of the subordinated and mezzanine financing, effectively creating first loss protection for the partner.

Credit Process

- ◆ The partner will be asked to commit when Lehman first sends signed commitment papers to the borrower.
- ◆ The partner will have access to all due diligence materials (including Lehman credit committee documents) through a virtual data room.
- ◆ The partner will not have direct access to the borrower.
 - All interactions with the borrower will be conducted by Lehman.
- ◆ Lehman and the partner will run parallel credit processes with the partner able to fully participate in Lehman’s credit process.
- ◆ Credit decisions (by both parties) must be substantially completed before the deadline to submit a signed commitment letter.

Economics

- ◆ Lehman Brothers and the partner will split the senior financing economics on a pro rata basis.
 - Senior financing economics include: commitment fees, funding fees, agent fees and coupon payments.
- ◆ Lehman will receive the full economics of the subordinated and mezzanine financing.^(a)
- ◆ Lehman will receive the full economics of any subsequent capital markets activity or other investment banking activity.

Other Benefits

- ◆ The partner will have the opportunity to elect to participate in the subordinated financing on a pari passu basis.
- ◆ Lehman will give the partner allocations of all parts of the capital structure in syndication on a preferred basis.

a) Assumes the partner only participates in senior financing commitments.

Structured Solution – Overview

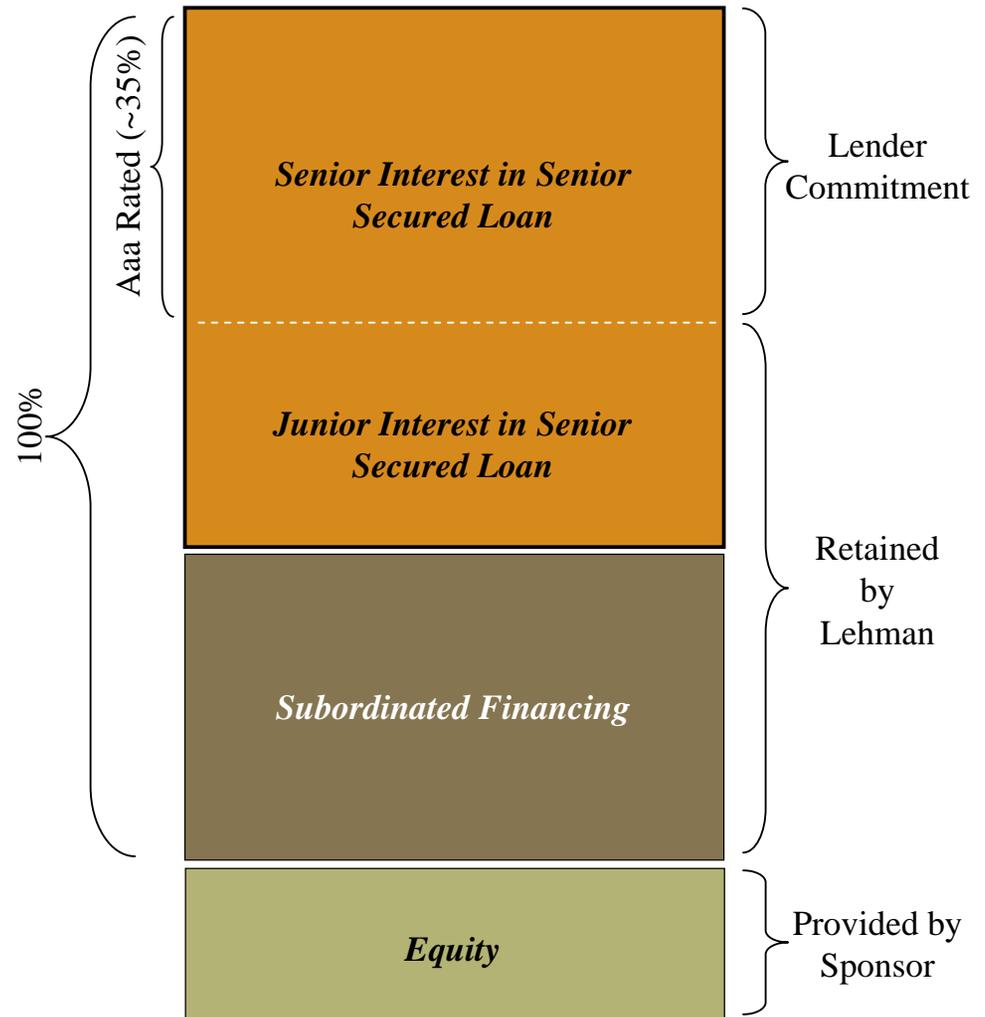
Expanding Notional Capacity by Aggregating with Committed Lender Balance Sheet

- ◆ Lehman Brothers will establish a revolving committed facility involving one or at most a few lending partners which will support us in committing larger notional amounts than are permitted under our nominal commitment limit.
 - The larger notional risk limit will not provide the Firm with effective risk transfer as we will retain a junior interest in each credit equal to approximately 65% of the total financing package.
- ◆ The senior portion of our notional risk under any lending commitment is transferred to one or more lenders on a pre-committed basis to the extent we need the additional capacity.
- ◆ Lehman will remain lender of record to each borrower, with the ability to fund the amount of any required advance that exceeds our nominal commitment limit by selling a participation in that advance to a bankruptcy-remote special purpose entity (Issuer).
 - Lenders will purchase rated notes issued by the Issuer, the proceeds of which will be used to purchase the participation.
 - Lehman will retain a junior interest in each commitment sized to provide lenders an explicitly rated Aaa exposure.
- ◆ Each lender's commitment to purchase notes will be subject only to satisfaction of pre-agreed eligibility criteria and will not allow for prior credit review of transactions.
- ◆ A lender's funded exposure to any borrower is expected to be limited in a variety of ways including:
 - The lender's capacity contribution to a transaction is required only for the period during which our binding commitment exceeds our nominal commitment limit.
 - Since our expected hold position will generally be well below our nominal commitment limit, the lender's exposure period per credit should be brief and the lender's capacity will be freed up for subsequent opportunities.
 - In the event lender capacity continues to be required through syndication, the likelihood (in the U.S.) and duration (in Europe) of actual funding is expected to be limited.
 - If funding is required, lenders will have the right to put notes back to the Issuer after <180> days causing Lehman to have to refinance or sell the related borrower financing.
 - Single obligor and industry exposure limits, if practical, may also be included in the eligibility criteria.

Structured Solution – Lender Commits to Aaa Risk

A Lender’s Investment Represents a “Aaa” Tranche of the Senior Secured Loan Financing Made Available to Borrowers

- ◆ Lenders commit in advance for a one-year period to acquire rated notes representing a senior interest in the senior secured loan tranche of the debt financing provided to borrowers.
 - Lehman retains a subordinated interest equal to the remainder of the borrower debt financing.
- ◆ In the event that funding is required, the Issuer will sell a segregated series of Aaa-rated notes to one or more lenders in order to finance the purchase from Lehman of a participation in the advance to the borrower.
 - Each series of notes will be secured by and benefit from a senior claim on payments owed to Lehman by the related borrower.
- ◆ Notes are repaid with the proceeds of syndication, with any market losses for the account of Lehman.
- ◆ The lenders in each series may put their notes back to the Issuer after <180> days, thereby triggering a refinancing or market sale (with a last look by Lehman) of the related participation.
 - Any losses on liquidation are absorbed first by Lehman through its retention of the junior interest.



Structured Solution – Costs to Grow Notional Capacity

Costs Are Estimated Assuming Increased Transaction Flow

- ◆ We calculate costs of transferring risk assuming a total of 9 transactions per year, of which at the most 2 are in progress at any one time.
- ◆ We assume that each transaction includes a Aaa tranche equal to 35% of the total debt financing package or \$1.885 billion such that Lehman's retained 65% junior interest meets our current \$3.5 billion nominal commitment limit.
 - To accommodate 2 transactions at one time, total lender commitments of \$3.77 billion are required.
 - As Tier 2 capital issuance and retained earnings grow, the \$3.5 billion notional limit and maximum Aaa tranche amount will also increase, but for purposes of this analysis we have assumed a static Aaa tranche size.
- ◆ In order to determine the cost of the facility, we make a number of assumptions as detailed below:
 - Lender's exposure is rated Aaa by Moody's.
 - Targeted RAROC^(a) is 17.5%, which the Firm believes is sufficient for banks even for a pre-committed blind pool facility.
 - RAROC is calculated based on a conservative Loss Given Default assumption of 45%.
 - Risk-adjusted Basel II regulatory capital requirements are determined assuming lenders are using the IRB approach.
 - Required capital as a percentage of lender's commitment assuming a one-year Aaa exposure period is 0.62%.
- ◆ Moody's fees to achieve a Aaa private rating will be payable on each transaction rated.
 - We assume nine transactions per year globally will require commitments in excess of \$3.5 billion.
 - Per-transaction fees are estimated to be between \$100,000 and \$250,000, for total annual fees of \$900,000 to \$ 2,250,000.
 - Legal fees for establishing the program and initial transaction documentation are estimated to be \$500,000 to \$750,000 up front with small per-transaction fees on an ongoing basis.
- ◆ Total fees for year one are estimated to be \$6.4 million including \$4.1 million fees to lenders, \$1.6 million rating agency fees, and \$750,000 legal fees (year one only).
 - Fees for subsequent years are \$5.7 million per annum.
- ◆ Costs may be lower if banks accept a lower RAROC target or calculate their exposure on a mark to market basis; costs may be higher for banks following the standardized approach under Basel II or treating their exposure as a securitization exposure, as required capital in each case will be 1.6% on commitment amount rather than 0.62%.

a) RAROC = Risk Adjusted Return on Capital.

Moody's CDO / Structured Credit Methodology

Methodology For Tranching Single-Name Corporate Obligations Is Practical Solely for the Creation of a Aaa Rated Exposure

- ◆ Moody's will rate a tranching individual corporate exposure through the analysis of default probability and the application of a recovery rate assumption based on the seniority of the obligation within the borrower's capital structure.
 - For a senior secured loan rated up to two notches above the corporate family rating, the applicable recovery rate on that loan is expected to be between 40% and 60%, depending on the particular circumstances of the related borrower.
 - As a result, assuming a worst case probability of default of 100%, the holder of the senior secured loan would be expected to recover 40% to 60% of its investment to a Aaa level of certainty.
- ◆ A lender acquiring notes representing the senior 40% to 60% of the senior secured loan would therefore acquire a Aaa rated asset.
- ◆ In order to create a multi-tranching exposure with tranche ratings that are in each case higher than the related corporate family rating, Moody's would need to analyze stressed default probability and recovery distributions to determine the size of the various non-Aaa tranches.
- ◆ While this type of analysis is theoretically possible, Moody's is unlikely to issue ratings other than Aaa on tranches of single name corporate exposure for two reasons:
 - The use of a probability analysis for default and recovery exposes Moody's to significant reputational risk in the event that it applies the incorrect probability analysis and an asset underperforms, resulting in losses for investors.
 - The tranching methodology was developed by Moody's assuming a broadly diversified asset portfolio, not a single credit.
 - Moody's would be required to re-examine the stress levels and default probabilities it applies in its analysis and would likely impose more stringent levels.
- ◆ Because of the significant reputational risk to Moody's and the difficulty in determining appropriate stresses for use in its probability analysis, Moody's is unlikely to allow the creation of a tranching exposure within a single corporate credit that is rated below Aaa.

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 direct competitor in Europe and are unlikely to participate there. ◆ We need to determine if U.S.-only capacity is helpful.

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

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 direct competitor in Europe and are unlikely to participate 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.

III. Recommendations for Becoming More Aggressive in Proposing Terms

Lehman Private High Yield / Mezzanine Fund

III. Becoming More Aggressive on Terms

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

- ◆ \$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

- ◆ \$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

- ◆ 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

- ◆ Lehman Brothers and Employees to potentially contribute 20% of funding (up to ~\$250mm).
- ◆ Strategic, institutional and high net worth investors.
 - E.g., BOTM, AIG, All State, Babson, John Hancock, Met Life, Northwestern Mutual, TIAA.
- ◆ 5 year investment period.

Advantages

- ◆ 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.
 - Allows the Firm to pre-syndicate the most challenging debt tranche and lead with confidence.

Next Steps

- ◆ 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

- ◆ 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.

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Lehman Private High Yield / Mezzanine Fund – Case Study

Illustrative Case Study

- ◆ Lehman Private High Yield / Mezzanine Fund invests \$100 million in ABC Company to help XYZ Financial Sponsor’s acquisition of the Company.
 - The investment takes the form of \$100 million 8-year Senior Subordinated Notes.
- ◆ The terms of the Senior Subordinated Notes are as follows:
 - The coupon is 13.0% (11.0% cash, 2.0% PIK).
 - Non-callable for 3 years and then callable at par plus ½ of the coupon in year 4 declining ratably to par by year 7.
 - 1% upfront closing payment.
 - Warrants for 1% of the fully diluted equity value of the Company.
- ◆ XYZ Financial Sponsor monetizes its position at the end of year 5 through a sale to a strategic buyer.
 - Lehman Private High Yield / Mezzanine Fund will realize gross IRRs of 15.4% and 21.6%, unlevered and levered, respectively and 1.8x multiple of invested capital.

Illustrative Case Study

	<u>Year 0</u>	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Year 5</u>	
Lehman Private High Yield	\$100.0	\$102.0	\$104.0	\$106.1	\$108.2	\$110.4	Principal PIKs at 2.0% annually.
<u>Cash Flow:</u>							
Principal	(\$100.0)					\$110.4	
Cash Interest		11.1	11.3	11.6	11.8	12.0	Annual cash interest of 11.0%.
Upfront Fee	1.0						1.0% upfront fees payable on close.
Prepayment Penalty						4.8	Redemption at 104.3% in Year 5.
Warrants						9.0	Warrants for 1.00% of the Company.
Total Cash Flow	(\$99.0)	\$11.1	\$11.3	\$11.6	\$11.8	\$136.2	
Unlevered Gross IRR	15.4%						
Levered Gross IRR ^(a)	21.6%						
Multiple of Invested Capital	1.8 x						

(a) Assuming 40% leverage and obtaining banking financing at 5.0%.

Lehman Private High Yield / Mezzanine Fund – Fundraising

III. Becoming More Aggressive on Terms

There are several sources we can access to raise funding.

Sources of Funding for the High Yield / Mezzanine Fund

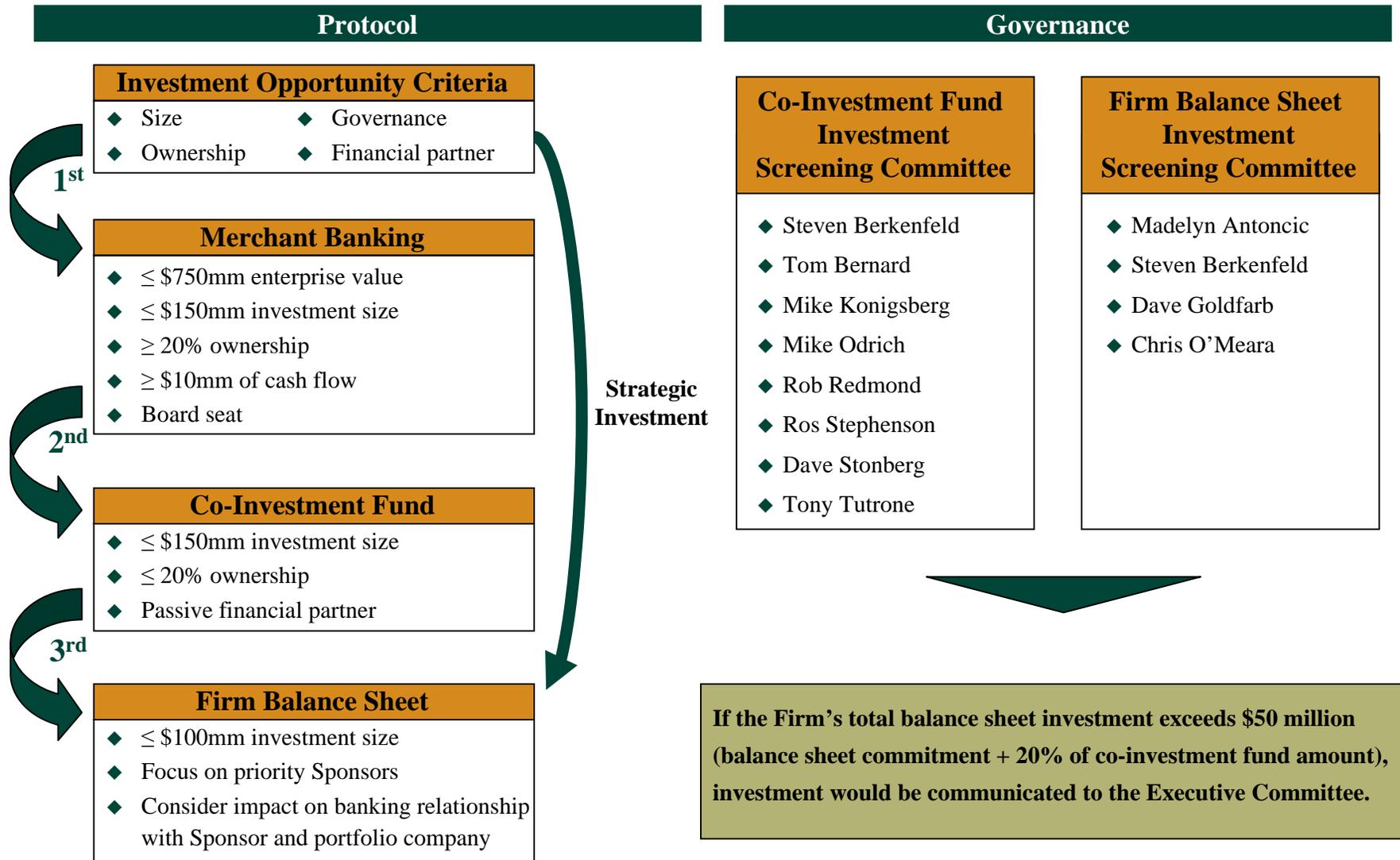
<u>Sources:</u>	<u>Estimated Amount</u>
Lehman Brothers and Employees	\$200 - \$250 million
Strategic Investors	\$400 - \$600 million
Institutional Investors	\$200 - \$300 million
High Net Worth Individuals	\$200 million
	<hr/>
Total Size Before Leverage	\$1,000 - \$1,350 million
Bank Financing (35%-45% of total capital)	\$500 - \$1,000 million
	<hr/>
Total Size	\$1,500 - \$2,350 million

IV. Recommendations for Developing Additional Strategies to Become More Proprietary with Sponsors

Co-Investing with Sponsors

- ◆ Co-investing would strengthen and deepen our relationship with our Sponsors clients, while also making the risk/return equation on leveraged finance transactions more attractive to the Firm and earning a substantial return on our balance sheet capital.
- ◆ Our competitors, notably Goldman Sachs and Merrill Lynch, have aggressively used their own capital to secure the pole position on key transactions. Several competitors, including Morgan Stanley, CSFB and Citibank, are currently in the market raising Co-Investment Funds.
- ◆ Lehman is closing a \$1.5 billion Co-Investment Fund by the end of August.
 - Warehoused ten investments (aggregate equity investment of \$300 million) to be transferred into the fund.
- ◆ To be truly relevant to our Sponsors clients, we need to be capable of investing at least \$250 million in a deal:
 - Our Co-Investment Fund will be able to invest up to \$150 million per deal.
 - Lehman could potentially invest up to \$100 million per deal from our balance sheet.
 - Through a strategic relationship with another firm, Lehman could potentially source substantial additional investment per deal (e.g., up to \$200 million per deal from Caisse de Dépôt).
- ◆ We anticipate that the use of direct balance sheet for co-investment would only be executed in select situations, likely no more than once a quarter. We would look to commit \$1 billion in aggregate over the next 10 quarters to these co-investments.
- ◆ Given continued increase in the size of private equity transactions, we anticipate that ongoing demand for co-investment will increase.
- ◆ Private Equity has proposed a deal review protocol to ensure that the Firm does not “cherry pick” the best opportunities. We would establish separate teams to make Private Equity Co-Investment and Firm Co-Investment decisions.

Protocol for and Governance of Co-Investment Activity



Whole Business Securitization Opportunity

Advantages for Lehman Brothers	<ul style="list-style-type: none"> ◆ Provides opportunity to lead with creative, high value added solutions. ◆ Harnesses the Firm's intellectual capital. ◆ Creates a unique competitive advantage for the Firm.
Advantages for Client	<ul style="list-style-type: none"> ◆ Lower cost financing. ◆ Higher leverage. ◆ Greater operating flexibility. ◆ Scaleable financing structure.
Applicability	<ul style="list-style-type: none"> ◆ Steady, predictable EBITDA. ◆ Transferable asset with significant market value. ◆ Low or stable capital expenditures. ◆ High barriers to entry. ◆ Long track record. ◆ Simple, straightforward operating model. ◆ Potential industries include: franchised businesses; wireless towers; transportation; music, film and television libraries; directory publishing; outdoor advertising; pharmaceutical royalties; satellites; stadiums and theme parks; and infrastructure (toll roads, bridges, tunnels, ports, parking garages).
Recent Transactions	<p>Hertz \$15.1 billion LBO by Clayton Dubilier, Carlyle and Merrill Lynch Private Equity from Ford.</p> <ul style="list-style-type: none"> ◆ Lehman was lead structuring advisor and lead bookrunning manager (left) on \$5.8 billion ABS package. ◆ Lehman acted as lead financial advisor to the Consortium and structuring advisor and joint bookrunner on an additional \$6.5 billion of corporate debt financings. ◆ ~\$63 million in fees to the Firm. <p>DUNKIN' BRANDS [eatdrinkthink] \$2.4 billion LBO by Bain Capital, Carlyle and Thomas H. Lee Partners from Allied Domecq.</p> <ul style="list-style-type: none"> ◆ Lehman was sole structuring advisor and joint-lead bookrunning manager (left) on \$1.7 billion of ABS financing. ◆ ~\$28 million in fees to the Firm. <p>AERCAP \$2.2 billion LBO by Cerberus from DaimlerChrysler and a consortium of German banks.</p> <ul style="list-style-type: none"> ◆ Lehman acted as sole M&A advisor and sole structuring advisor and sole bookrunning manager on \$1 billion of ABS financing and a \$125 million term loan. ◆ ~\$32 million in fees to the Firm.
Resources Required	<p>Current Resources:</p> <ul style="list-style-type: none"> ◆ New York: 2 MD, 3 SVPs, 4 associates and 3 analysts. ◆ London: 1 MD. <p>Resources Required to Grow the Business:</p> <ul style="list-style-type: none"> ◆ New York: 3-4 additional associates and 3-4 additional analysts. ◆ London: 1 SVP, 1 VP, 2-3 additional associates, 2 additional analysts.

Sponsors Wealth Management Coverage

Objective

- ◆ Deepen investment banking relationship with Sponsors clients by delivering the Firm.
- ◆ Bolster the Firm's AUM by targeting ultra high net worth individuals who are Partners at Private Equity Firms or executives at portfolio companies.
- ◆ Increase asset management revenue by forging enduring relationships with lucrative clients who have unique wealth management needs.

Phase I: Launch Pilot

- ◆ **Leadership:** hire a MD-level manager to coordinate effort on a full time basis.
- ◆ **Clients:** Focus on a small group (2-5) of inner circle priority Sponsors.
 - IMD and IBD jointly select Private Equity firms and determine which partners to target.
- ◆ **IMD Coverage:** IMD and IBD will pre-screen several existing IR teams.
- ◆ **Coverage Banker Involvement:** Educate bankers covering targeted clients on IMD capabilities and facilitate introductions to IMD contacts.
- ◆ **Monitoring:** Progress to be continuously monitored by IBD and Capital Advisory.

Phase II: Dedicated Coverage

- ◆ **Clients:** Focus on larger group (10-20) of inner circle priority Sponsors.
 - IMD and IBD jointly select Private Equity firms and determine which partners to target.
- ◆ **IMD Coverage:** Hire additional IRs to provide dedicated Sponsors coverage.
- ◆ **Coverage Banker Involvement:** Launch education campaign targeting all Sponsors bankers. Provide information on IMD capabilities and facilitate introductions to IMD contacts.
- ◆ **Monitoring:** Progress to be continuously monitored by IBD and Capital Advisory. Utilize tools such as banker scorecards to encourage bankers to make IMD referrals.

Product Offering: Sponsors GPs

- ◆ Strategic Tax and Estate Planning (Holly Isdale).
- ◆ Asset Allocation and Manager Selection (Alison Deans).
- ◆ Investment Solutions (proprietary and third party products).

Product Offering: Portfolio Companies

- ◆ Wealth and Cash Management.
- ◆ Equity Compensation and Retirement Plans.
- ◆ Insider Investment Policy Guidance.
- ◆ Directed Share Programs.

Middle Market Sponsors Overview

- ◆ The middle market Sponsors effort is co-headed by Tom Flanagan and Doug Cruikshank.
 - There are currently two mostly-dedicated VPs as well as two other VPs who cover several middle market accounts.
 - 1-2 dedicated associates and 1-2 dedicated analysts will support the middle market group.
 - In order to grow this business, we will likely need additional resources in Lev Fin to handle increased volume.

 - ◆ Sponsors IBD's overall revenue target for 2006 is \$800 million, and revenue from middle market Sponsors should comprise ~15-20% of group revenues by 2008.
 - This assumes that we fully cover approximately 25 high-touch middle market Sponsors.
 - Revenue target for the high-touch middle market Sponsors is \$5-10 million per year.
 - Also provide light/opportunistic coverage to an additional 15+ middle market Sponsors.
 - Lower average fees per year but portfolio effect will augment overall revenues.

 - ◆ Estimate that 25% of this revenue will be generated by loans, with an average size of \$200 million (but potentially could be larger).
 - Assumes 15-20 deals per year.

 - ◆ We currently focus on deals with >\$250 million of funded debt (loans + bonds). If Lehman chose to build out a middle market lending effort, we would be able to refer smaller deals to the middle market lending group, enabling us to build better relationships with these Sponsors and with portfolio companies who will often, over time, become sizable companies of interest to us.
-

Middle Market Sponsors: Target Clients and Selected Deals

IV. Becoming More Proprietary with Sponsors

Target Clients

Existing Coverage



Transitioned Coverage



Newly Created Funds



Selected Deals



- ◆ \$300-\$400 million exclusive sale and stapled financing.
- ◆ Anticipated Fees
 - Financing Fees: \$4 million.
 - Advisory Fee: \$3.5 million.

ELEVATION PARTNERS

- ◆ Acquisition of Bioware / Pandemic Studios.
 - Advisory fee of \$1mm.
- ◆ Mandated on Project Titan with \$2mm advisory fee.
 - Will lead to secondary offerings in 2007/2008.
- ◆ Mandated on Project Granite; expected fee of \$3mm.



- ◆ Led \$150 million loan for Primary Energy in 2005 with fees of \$2 million.
- ◆ Now handling sale of Primary Energy with expected advisory fee of \$4 million and stapled financing fees of \$7 million.



- ◆ Secondary sale of PVH stock in 2005 with fees of \$6 million.
- ◆ Secondary sale of remaining PVH stock in 2006 with fees of \$8 million.

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Additional Product Opportunities

Opportunity

Next Steps

- | Opportunity | Next Steps |
|--|--|
| 1. Finance dividend re-caps of portfolio companies to provide Sponsor with pre-IPO liquidity. | 1. Product already exists; begin offering product more aggressively; need to be more proactive in covering Sponsor asset managers and capital markets staff with regard to portfolio company products. |
| 2. Offer margin loans to Sponsors to monetize their minority positions in an investment pre-IPO. | 2. Complete pre-IPO minority share financing for Olympus Capital/Arysta deal and use as a template to offer product to clients. ^(a) |
| 3. Extend cash-flow loans to entire GP group, collateralized by receivables (management fees and promote) from the GP interest in current and previously-raised funds. | 3. Develop marketing pitch (manage cash flow requirements for Partners) and preferred structure and begin offering product to clients in appropriate situations. |
| 4. Assist clients in structuring public offerings of Private Equity Investment Funds. | 4. Product already exists and should be offered more aggressively to clients. |
| 5. Provide equity bridge loans to Sponsors to bridge the syndication of co-investment to LPs and other investors in a particular transaction. | 5. Product should not be regularly offered to Sponsors given expected poor risk/reward trade-off. |

(a) Lehman arranged a pre-IPO minority share financing for Olympus Capital secured by a 40% stake in Arysta LifeScience Corp. The syndication was ~2x oversubscribed, split between Japanese banks and Asia focused hedge funds.