

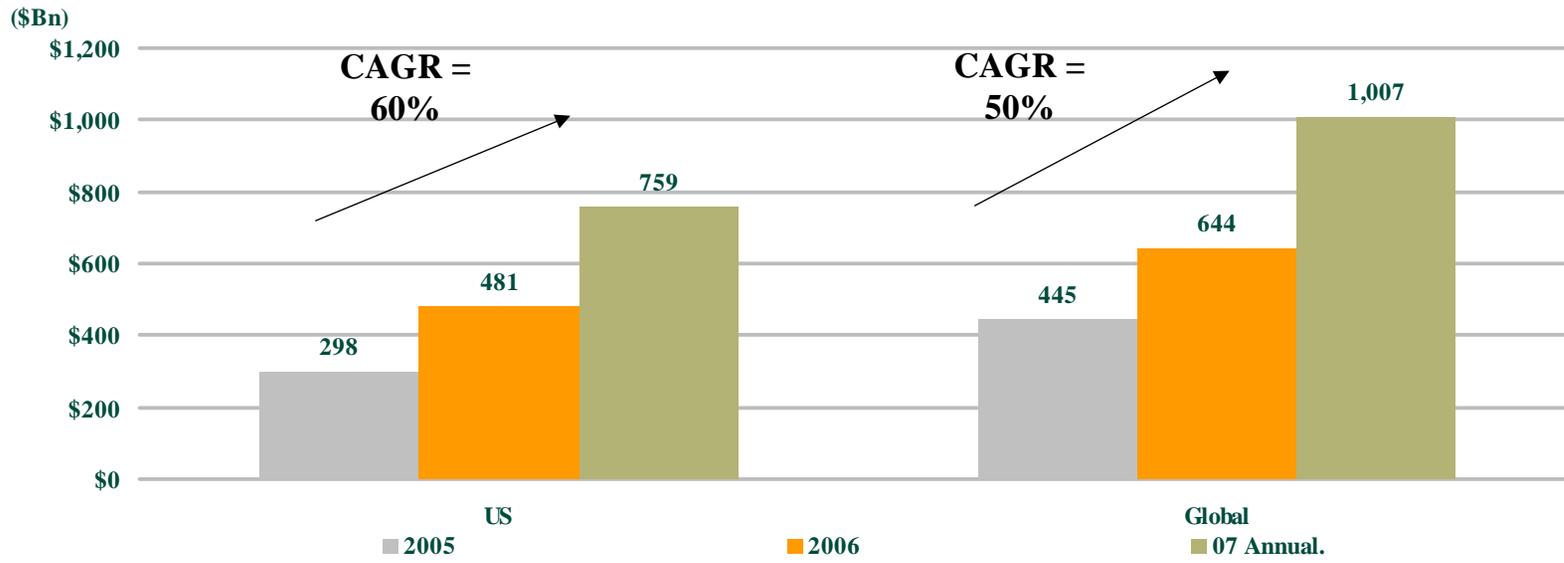
# Leveraged Finance Risk

*June 2007*

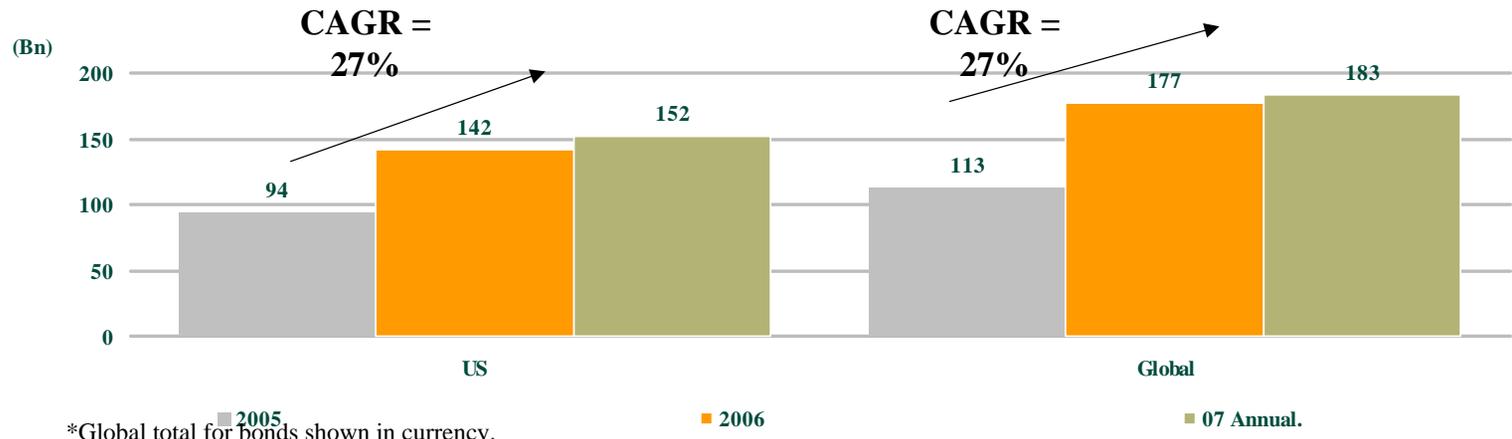
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# The leverage finance market has been growing rapidly

## Leverage Loans



## Bonds



# Our Market Share and rank have improved this year both in the U.S. and Globally for Leveraged Finance

## Leverage Loans

	2007*			2006			Δ		
	Amount (\$mm)	Share	Rank	Amount (\$mm)	Share	Rank	Amount (\$mm)	Share	Rank
Global Leveraged Loans	\$52,771.6	3.8%	8	\$34,282.7	2.9%	12	\$18,488.90	↑0.9%	↑4
US Leveraged Loans	\$37,618.6	4.0%	8	\$23,424.3	3.0%	9	\$14,194.30	↑1.0%	↑1

## Bonds

	2007*			2006			Δ		
	Amount (\$mm)	Share	Rank	Amount (\$mm)	Share	Rank	Amount (\$mm)	Share	Rank
Global HY	\$11,820.4	6.5%	7	\$9,654.5	5.5%	9	\$2,165.90	↑1.0%	↑2
HY US	\$11,482.4	7.6%	5	\$9,020.3	6.4%	7	\$2,462.10	↑1.2%	↑2

\*Annualized 2007

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# Our Market Share and rank have improved this year both in the U.S. and Globally for Financial Sponsors

## Leverage Loans

	2007*			2006			Δ		
	Amount (\$mm)	Share	Rank	Amount (\$mm)	Share	Rank	Amount (\$mm)	Share	Rank
Global Leveraged Loans	\$34,166.0	5.9%	6	\$22,511.0	4.5%	11	\$11,655.00	↑1.4%	↑5
US Leveraged Loans	\$16,564.6	6.4%	7	\$10,228.0	4.1%	10	\$6,336.60	↑2.3%	↑3

## Bonds

	2007*			2006			Δ		
	Amount (\$mm)	Share	Rank	Amount (\$mm)	Share	Rank	Amount (\$mm)	Share	Rank
Global HY	\$6,157.0	11.0%	4	\$3,831.6	7.7%	7	\$2,325.40	↑3.3%	↑3
HY US	\$6,013.6	13.0%	1	\$4,465.7	6.8%	6	\$1,547.90	↑6.2%	↑5

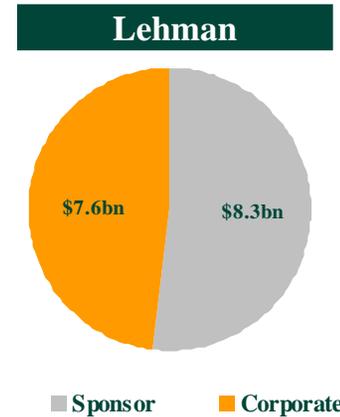
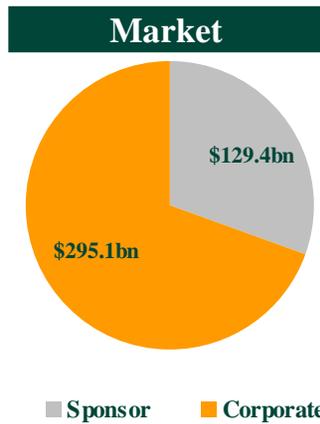
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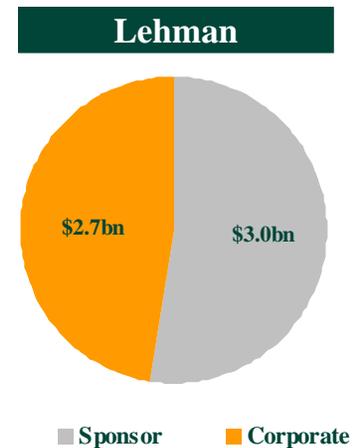
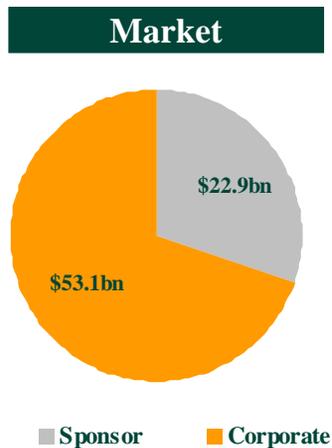
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# We have been much stronger with Sponsors than Corporates

Financial sponsor transactions make up 30% of all U.S. Leveraged loans. It is 52% of Lehman Brothers' business.

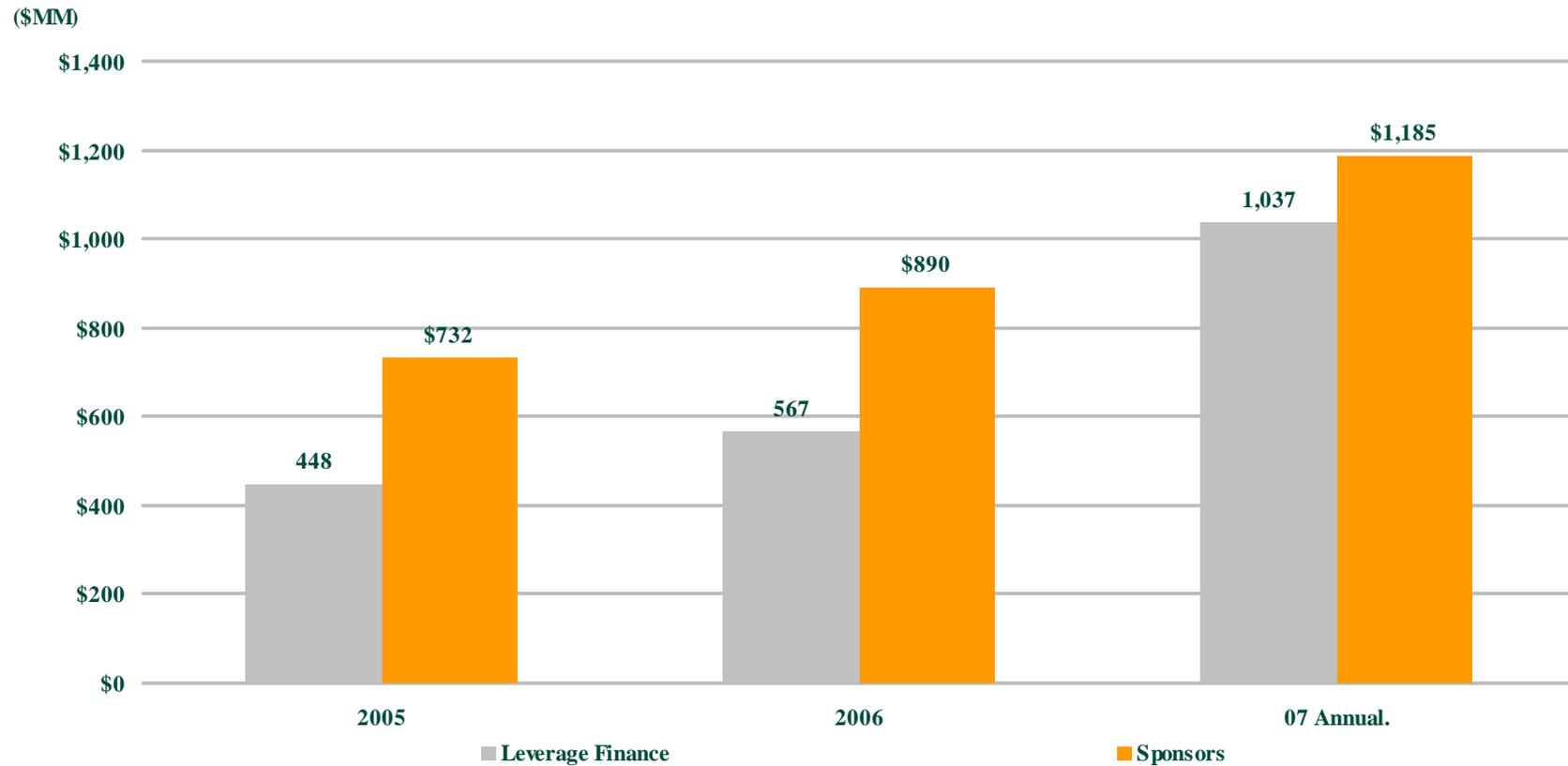


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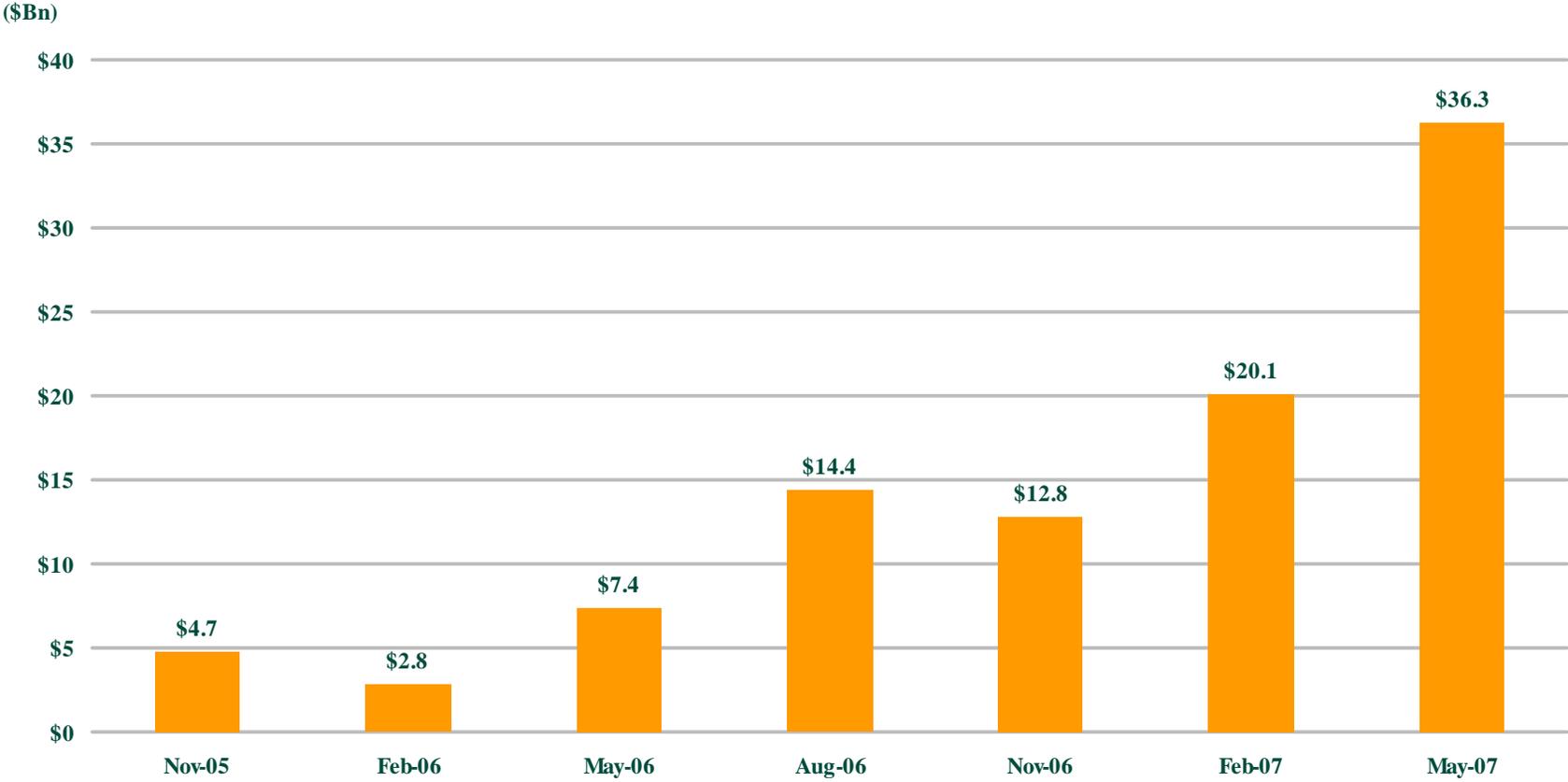
# Our Leverage Finance and Financial Sponsor revenues have been growing rapidly

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As a consequence, our commitment risk has also grown rapidly

### High Yield Contingent Commitments



# Stressing the Portfolio

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- ◆ We used our mandated commitments as of 5/31/07 plus Home Depot Supply (Staple)
- ◆ We have estimated the losses under three distinct scenarios.
- ◆ Our average cushion on our loan commitments before fees is 70 bps.
- ◆ Our average cushion on our bond commitments before fees is 60 bps.
- ◆ Our fee pool is \$ 579mm.
- ◆ Our losses are calculated net of the fees being earned.
- ◆ These are not expected cases.
- ◆ This does not account for an idiosyncratic loss, just severe market move.
- ◆ These are mark to market estimates not expected realized losses.

# Fall 2000

US Loans	(\$80) (Positive P&L)
US Bridges	\$441
Europe	\$22
Equity	<u>\$210</u>
<b>Mandated Commitments Loss</b>	<b>\$593</b>
HY Loan Holds	\$78
<b>Total Loss</b>	<u><u><b>\$671</b></u></u>

**Market perceives heightened risk of recession/slow down due to threat of rising interest rates, commodity pricing pressures or growth slow down to point where investors fears EBITDA decline.**

## Assumptions

### US Loans

RC	Current Clearing Spread for TLB + 100bps + 50 to 100 (depending on ABL, rating and other qualitative factors)
TLB	Current Clearing Spread for TLB + 50 (Average, including RC, 65bps)
2d Lien	Current Clearing Spread for 2d liens + 75 to 150 (depending on rating and other qualitative factors)

### US Bridges

Senior Debt	Put Bond Cap +150bps (on average)
Sub Debt	Put Bond Cap +275bps (on average)

### Europe Loans

Drawn 1L Debt	Current clearing spread +50bps
Undrawn 1L Debt	Current clearing spread +100bps
Second Lien Debt	Current clearing spread +100bps
Mezzanine Debt	11% (except for Lloyds, which is at 12%)

### Equity

20% drop

### HY Loan Holds

RC	Widening 50-100bps
TL	Widening 50bps

# 1998

US Loans	\$292
US Bridges	\$918
Europe	\$124
Equity	\$347
<b>Mandated Commitments Loss</b>	<b>\$1,680</b>
HY Loan Holds	\$124
<b>Total Loss</b>	<b>\$1,804</b>

**1998 type market due to some sort of external shock or extreme fears causing leverage and liquidity unwind.**

## Assumptions

### US Loans

RC	Current Clearing Spread for TLB + 100 (+) 50 to 250 (depending on rating and other qualitative factors)
TLB	Current Clearing Spread for TLB + 75 to 200 (Average, including RC, 130bps)
2d Lien	Current Clearing Spread for 2d liens + 150-300

### US Bridges

Senior Debt	Put Bond Cap +200bps (on average)
Sub Debt	Put Bond Cap +400bps (on average)

### Europe Loans

Drawn 1L Debt	Current clearing spread +100bps
Undrawn 1L Debt	Current clearing spread +150bps
Second Lien Debt	6.50%
Mezzanine Debt	12% (except for Lloyds, which is at 13%)

### Equity

33% drop

### HY Loan Holds

RC	Widening 50-250bps
TL	Widening 75bps-200bps

# 2002

US Loans	\$551
US Bridges	\$1,650
Europe	\$269
Equity	\$525
<b>Mandated Commitments Loss</b>	<b>\$2,995</b>
HY Loan Holds	\$245
<b>Total Loss</b>	<b>\$3,240</b>

**Full blown 2002 recession with EBITDA and multiple contraction. Significant pick-up in defaults.**

## Assumptions

### US Loans

RC	Current Clearing Spread for TLB + 100bps + 150 to 275 (depending on rating and other quantitative factors)
TLB	Current Clearing Spread for TLB + 125-250 (Average, including RC, 170bps)
2d Lien	Current Clearing Spread for 2d liens + 275-450

### US Bridges

Senior Debt	Bond price = 82% (on average)
Sub Debt	Bond price = 60% (on average)

### Europe Loans

Drawn 1L Debt	Current clearing spread +200bps
Undrawn 1L Debt	Current clearing spread +250bps
Second Lien Debt	8.00%
Mezzanine Debt	13% (except for Lloyds, which is at 14.5%)

### Equity

50% drop

### HY Loan Holds

RC	Widening 150-275bps
TL	Widening 125-250bps

# Possible Solutions

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## 1) Tighten up existing credit standards

**Current competitive market has driven standards to new highs not seen since the late 1980's.**

- ◆ Debt/EBITDA > 8X
- ◆ FOF 2007-2008 : Negative to 0
- ◆ Average Corp Rating : B3

**Structure is skewed towards equity.**

- ◆ Covenant lite loans
- ◆ PIK toggle bonds

**Outcome: We will do a lot less business until the market turns.**

## 2) Make strategic decision to limit Bridge Equity

Limits

- ◆ Portfolio
- ◆ Single Name
- ◆ Participation

**Outcome: We will limit our participation in large deals.**

## 3) Lower \$/Percentage of deals we will underwrite

**Outcome: We will not be driving the underwriting , will end up as Jt. Book runner on the Right.**

# Possible Solutions (cont'd.)

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## 4) Massive macro hedges

**Outcome: Uncertain taking on massive basis risk. The options market is not big enough to accommodate.**

## 5) Be more selective on Sponsor/Deals on Economics/Roles

- ◆ Focus on deals where we have a leading M&A /Strategic role
- ◆ Deemphasize the tag along financing role in auctions
- ◆ Focus on fewer sponsors

**Outcome: Tough choices for firm around business concentration.**

## 6) Sell risk down through non traditional methods

- ◆ Blind pool efforts have failed
- ◆ Structured solution has been blocked by Moodys
- ◆ Possible silent participation on a name by name basis. Sumitomo is engaged

**Outcome: Lower fees and limited ability to execute strategy.**

## 7) Keep firing on all cylinders and continue to increase risk

**Outcome: High Beta.**

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