

*Confidential Presentation to:*

# Executive Committee

## Leveraged Finance Risk

*October 16, 2007*

LEHMAN BROTHERS

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# Executive Summary

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- ◆ In 2006, the Firm committed to achieving a top 5 market position with Financial Sponsors and succeeded in increasing global fee rank from #7 in 2006 to #5 for 2007 YTD (HY Global Bond rank increased from #9 to #5)
- ◆ The Private Equity market was extremely active during this period – 15 deals over \$10 billion in size were announced in the last 12 months alone
  - Many of these deals were with aggressive structures and priced at then-current market levels without any cushion
- ◆ As a result of the Firm’s market share gains and the expansion of the Private Equity Market, the Firm’s Balance Sheet was burdened with much higher levels of commitments
  - Contingent Commitments: up 205% from \$14.4B in 8/06 to \$43.9B as of 5/07
- ◆ The significant correction in the credit market led to substantial losses across Wall Street
  - The Firm took mark-to-market losses of \$1.3B (\$703M net of fees and hedges) which was in line with many of our competitors, but is material to Lehman, given our relative size
    - Given the improvement in the market, the Firm is likely to recoup some losses in Q4
- ◆ As a result of the recent downturn, the Firm learned valuable lessons about our approach to leveraged loans:
  - Importance of maintaining flexibility on financing commitments and terms
  - Need to mitigate risk whenever possible
  - Need to drive a better economic return on committed capital
- ◆ Going forward, the Firm must modify our policies and practices to better manage capital commitments
  - Limit our HY capital commitments (including funded positions to be syndicated) to \$20-25 billion in aggregate in order to right-size our risk exposure (based on the size of our balance sheet today)
  - Make better decisions on capital allocation; tighten underwriting standards; limit commitments of longer duration
- ◆ We have formulated guidelines to limit the aggregate size of our exposure in the future, and the velocity at which we allow it to grow, through better allocation of capital. However, the implications to the Firm of this approach need to be fully discussed as well.
  - These guidelines represent a shift in the Firm’s business strategy - from maximizing revenue generation and gains in market share / league table rankings towards greater emphasis on risk management and return on risk

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## **I. Update on the Firm's Leveraged Finance Pipeline and its Comparative Size**

■ Lehman Brothers involved  
■ Lehman determination not to finance

# Market Update – Corporate Acquisitions and Sponsor LBOs

## Largest Announced LBOs ≥ \$4B: 2007 (\$B) <sup>(1)</sup>

Ann. Date	Company	Sponsor(s)	Enterprise Value	EV/LTM EBITDA	PF Debt	PF Debt / LTM EBITDA
6/30/07	BCE	MDP, Teachers'	\$48.9	7.0x	\$32.0	4.6x
2/26/07	TXU	KKR, TPG, GS	43.8	7.9x	39.0	7.0x
4/2/07	First Data <sup>(2)</sup>	KKR	27.9	10.1x	22.4	8.1x
5/20/07	Alltel	TPG, GS	27.1	9.6x	23.2	8.5x
7/3/07	Hilton Hotels	Blackstone	26.4	15.2x	21.0	12.1x
4/16/07	SLM	JC Flowers, Friedman Fleischer & Lowe	25.6	NA	NA	NA
3/9/07	Alliance Boots plc	KKR (+ Stefano Pessina)	24.0	11.9x	14.5	7.2x
5/29/07	Archstone-Smith	Lehman Real Estate, Tishman Speyer	21.3	26.4x	17.2	21.3x
6/19/07	Intelsat	BC Partners	16.4	NA	14.8	NA
4/2/07	Tribune	Existing Management (ESOP), Sam Zell	13.4	9.53	9.5	6.72
12/14/06	ProSieben Sat.1 Media / SBS	KKR, Permira	12.5	12.0x	8.8	8.5x
3/15/07	Saga - Automobile Association	Charterhouse, CVC, Permira	11.9	14.3x	9.3	8.8x
6/19/07	Home Depot Supply	Bain, CD&R, Carlyle	10.3	10.4x	8.6	8.7x
2/4/07	Mills	Simon Property Group, Farallon	9.2	NA	NA	NA
6/15/07	Penn National Gaming	Centerbridge, Fortress	8.7	13.8x	NA	NA
3/20/07	Affiliated Computer Services	Cerberus	8.6	14.0x	6.6	10.6x
6/4/07	Avaya	Silver Lake, TPG	8.2	12.1x	NA	NA
9/21/06	Nycomed	Nordic Capital, DLJ, Blackstone, Alpinvest	8.1	6.7x	7.3	4.9x
5/11/07	Thomson Learning <sup>(3)</sup>	Apax, OMERS Capital Partners	7.8	NA	5.4	NA
5/17/07	Alliance Data Systems <sup>(2)</sup>	Blackstone	7.7	11.2x	6.1	8.8x
5/14/07	Chrysler <sup>(3)</sup>	Cerberus	7.4	NA	NA	NA
3/12/07	Dollar General	KKR	7.3	13.0x	5.0	8.8x
7/23/07	United Rentals	Cerberus	7.2	6.0x	5.6	4.7x
5/2/07	US Foodservice <sup>(3)</sup>	CD&R, KKR	7.1	NA	3.7	NA
5/29/07	CDW	MDP	6.5	13.1x	4.6	9.3x
5/21/07	EMI Group plc	Terra Firma	6.3	NA	6.9	NA
10/11/06	Telediffusion de France (TDF)	Charterhouse, CDC, CDC EEC	6.0	10.8x	4.5	8.0x
7/2/07	Manor Care	Carlyle Group	6.0	12.4x	NA	NA
NA	Formula 1	CVC Capital Partners	5.9	11.2x	2.8	5.3x
6/28/07	Allison Transmission	Onex, Carlyle	5.6	NA	4.2	NA
5/11/07	Pegasus Aviation Finance <sup>(3)</sup>	Terra Firma	5.2	NA	NA	NA
3/19/07	ServiceMaster	CD&R	5.2	11.8x	4.5	10.2x
10/11/06	PagesJaunes	KKR, GS	5.1	8.4x	4.1	9.1x
5/30/07	Ceridian	Fidelity National, TH Lee	5.0	13.7x	3.7	10.1x
3/14/07	Beacon Capital Partners III <sup>(3)</sup>	Broadway Real Estate Partners	5.0	NA	NA	NA
4/20/07	BAWAG	Cerberus	4.9	NA	2.6	NA
5/14/07	Endemol	GS, Cyril Funds II and other	4.9	13.9x	3.0	8.5x
11/5/06	Kion	KKR, GS	4.7	6.4x	3.6	4.9x
5/16/07	Bausch & Lomb	Warburg Pincus	4.5	17.5x	NA	NA
10/2/06	AWG plc (Anglian Water)	3i, CPPIB, CFSGAM, IFM	4.3	10.2x	8.1	7.8x
6/27/07	Tank & Rast	RREEF	NA	NA	3.0	11.0x
<b>TOTAL</b>			<b>\$481.7</b>		<b>\$312.2</b>	

1. Source: Bank books, offering memoranda, proxy statements, SDC, CapitalIQ, Dealogic, Merger Market.

2. Represents a Lehman Brothers deal which contains information that is not publicly available.

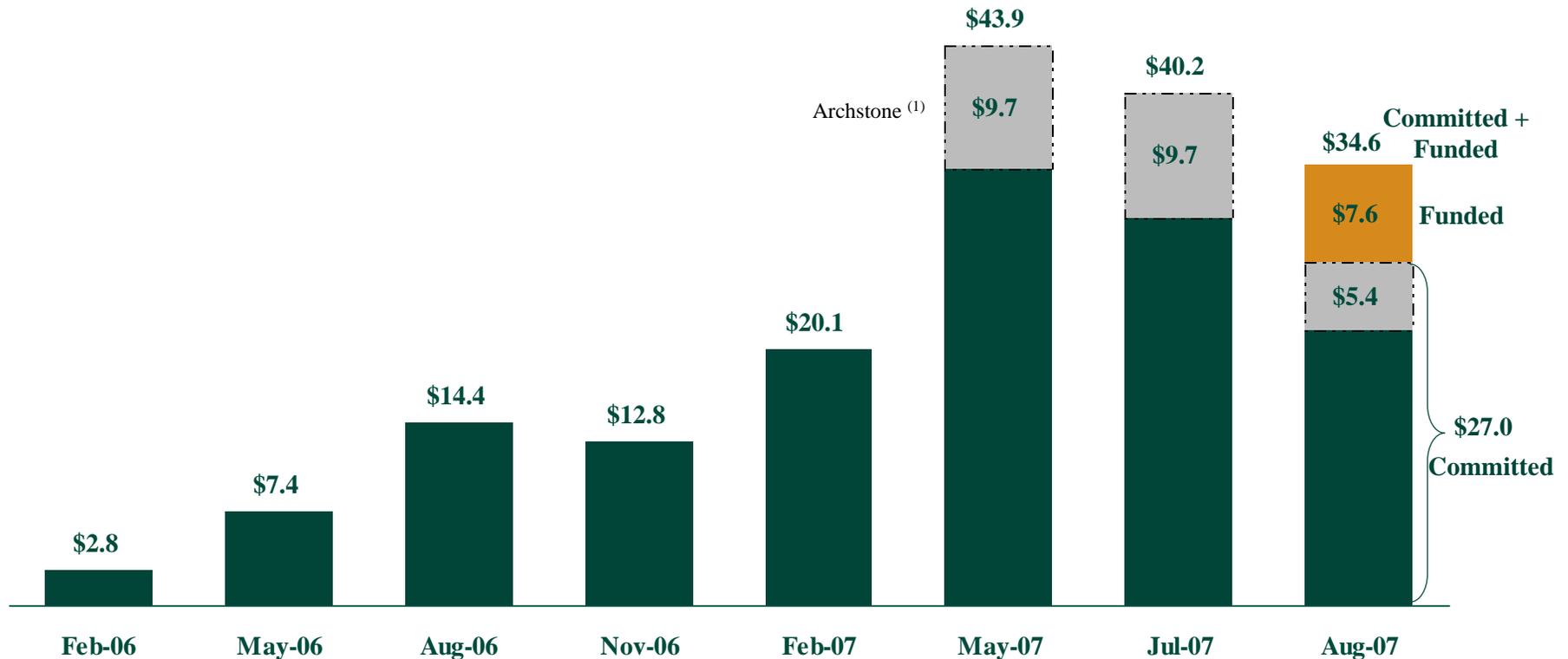
3. EBITDA is not publicly disclosed because company is privately-held or a division within a larger company.

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# High Yield Commitments – Lehman Brothers 10Q

Reported a record \$43.9 billion in High Yield contingent commitments in 2Q 2007

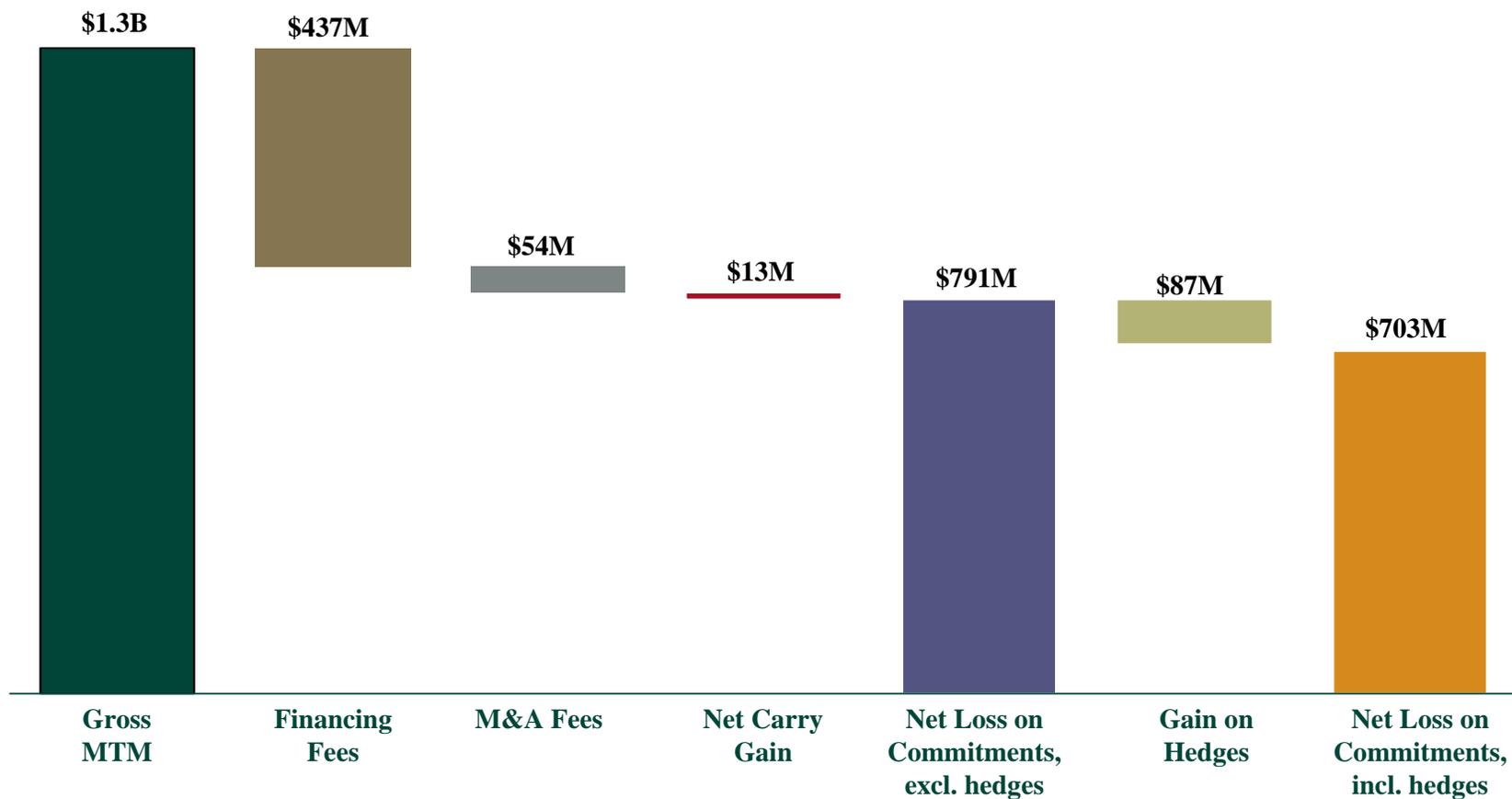
## High Yield Contingent Acquisitions Commitments as Reported in 10Qs (\$B)



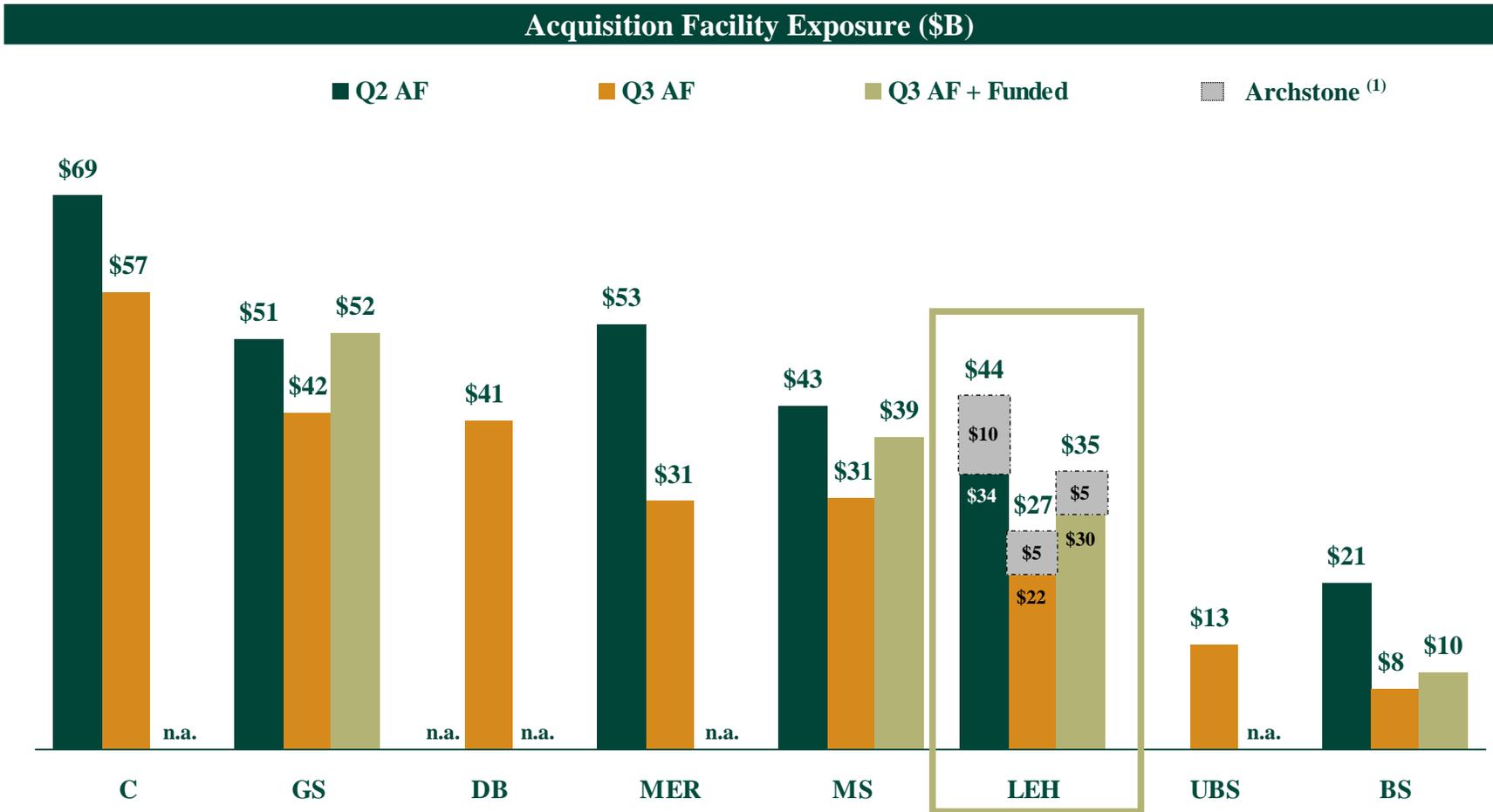
(1) Archstone commitment totaled \$11.1B, of which \$9.7B was debt (\$8.55B debt + \$1.15B junior mezzanine), \$1.15B was Bridge Equity and \$0.25B is permanent equity

# P&L Impact of HY Facilities – Lehman Brothers

## Overview of MTM Losses through August 31



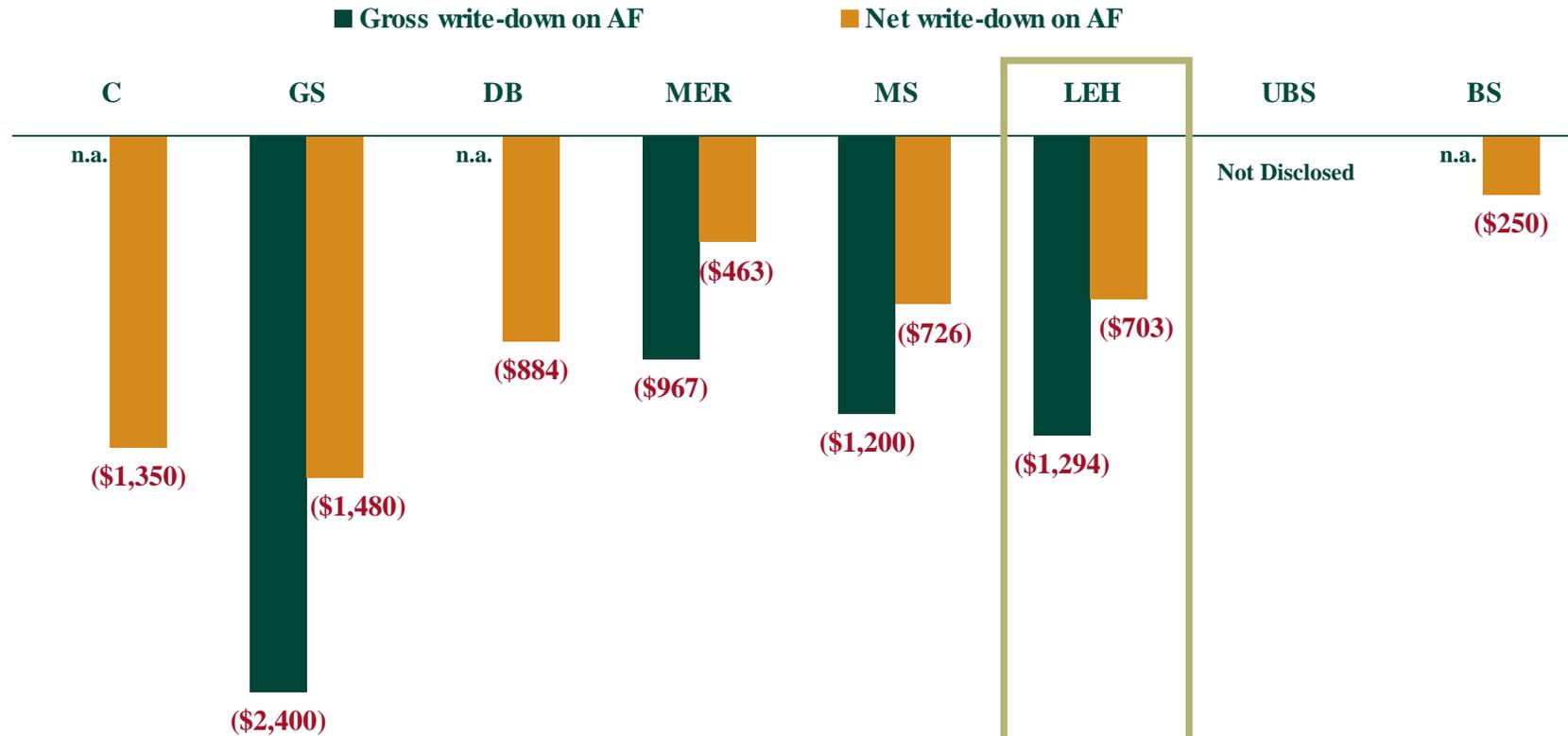
# High Yield Commitments – Competitor Comparison



(1) Archstone commitment totaled \$11.1B, of which \$9.7B was debt (\$8.55B debt + \$1.15B junior mezzanine), \$1.15B was Bridge Equity and \$0.25B is permanent equity  
 Note: UBS' figures were taken from press releases prior to official 3Q earnings announcements; as a result, it is unclear whether AF portfolio contains exactly the same inputs as the other firms

# P&L Impact of HY Acq. Facilities – Competitor Comparison

## Write-Down on Acquisition Facilities (\$M)



### Net Write-Down as % of Outstanding Commitment:

C	2.4%	GS	3.5%	DB	2.2%	MER	1.5%	MS	2.3% <sup>(1)</sup>	LEH	2.6% <sup>(1)</sup>	UBS	N/A	BS	3.3%
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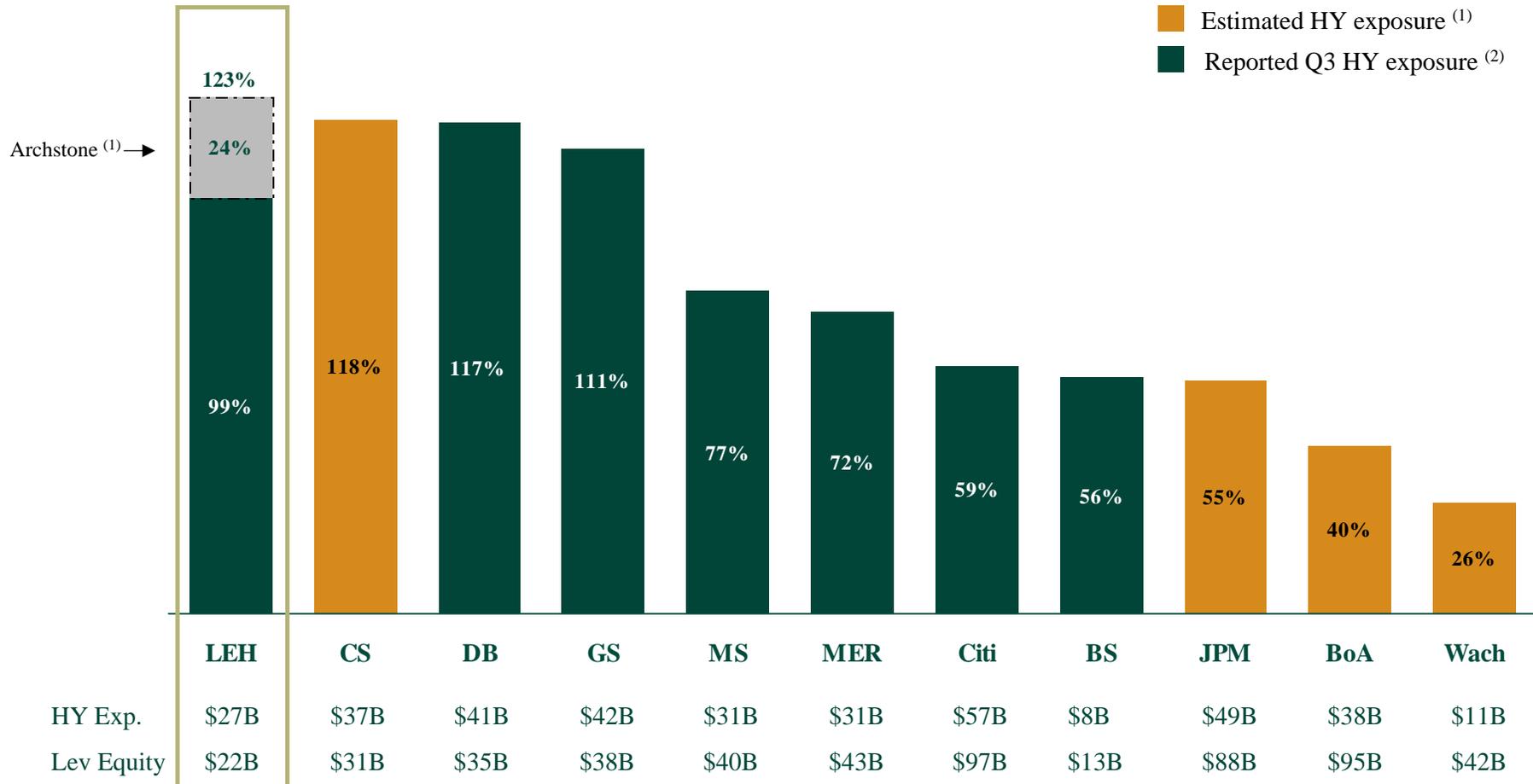
Note: UBS' figures were taken from press releases prior to official 3Q earnings announcements; as a result, it is unclear whether AF portfolio and write-down figures contain exactly the same inputs as the other firms

(1) Net number for LEH included Archstone commitment; excluding Archstone, write-downs as a % of outstanding increase to 3.3%

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# High Yield Commitments as Percentage of Leverage Equity

Estimated Amount of Bridge and Loan Risk Exposure as a Percentage of Leverage Equity <sup>(3)</sup>

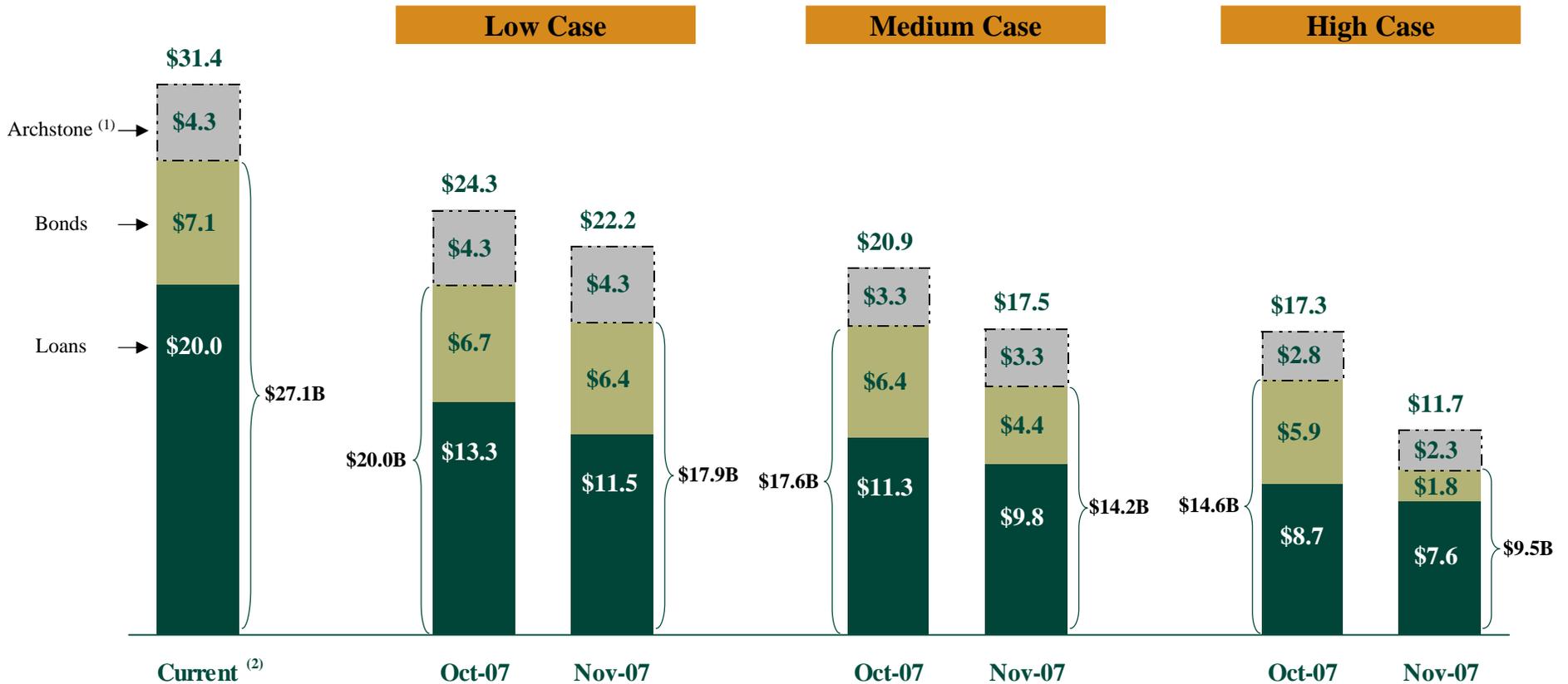


1. Loans estimated based on reported public forward calendar as of mid-July. Does not account for total forward calendar where deal size or underwriter information was not available.  
 2. Reported AF for Q3.  
 3. Leverage Equity defined as Tier 1 + 2 capital. Q2 data for all competitors.

# Lehman Brothers Projected High Yield Syndication

## Projected High Yield Contingent Acquisitions Commitments and Funded Positions (\$B)

\$ in billions, assumes no new commitments



(1) Archstone commitment totaled \$11.1B, of which \$9.7B was debt (\$8.55B debt + \$1.15B junior mezzanine), \$1.15B was Bridge Equity and \$0.25B is permanent equity  
 (2) Current as of 10/3/07, may include some positions that have already been sold.

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## **II. Lessons Learned in the Leveraged Finance Market**

# Results from Restructured Commitments

	Issuer	Sponsor	Size	Deal Terminated	Added / Improved Covenant(s)	Eliminated / Altered PIK Toggle	Commitment Size Altered	Rate Relief	Increase Fee	Retranching	Underwriter's Principal Leverage for Renegotiation	Estimated Savings	
												Overall	To Lehman
Deal Included Levers to Restructure	Home Depot Supply	Bain, Carlyle, CD&R	\$9.8B			✓	✓	✓	✓	✓	Renegotiation of Purchase Agreement	\$700M	\$233M
	TXU	KKR, TPG, Citi, Goldman	\$30.7B		✓	✓		✓			Credit Agreement	\$1,200M	\$150M
	Harman	KKR, Goldman	\$5.2B	✓							Business MAC	\$450M	\$98M
	Alliance Data Systems	Blackstone	\$6.6B		✓	✓		✓			Credit Agreement	\$400M	\$80M
	First Data	KKR	\$24.0B		✓	✓				✓	Credit Agreement	\$500M	\$60M
	PHH	Blackstone, GE Capital	\$6.1B	TBD							Condition Precedent Yet Not Met	\$140M	\$41M
	USIS	Providence	\$1.3B		✓	✓					Credit Agreement	\$25M	\$16M
	Metavante	Warburg	\$2.0B		✓			✓			Credit Agreement	\$80M	\$16M
	Allison	Carlyle, Onex	\$4.6B		✓			✓			Prior Verbal Agreement	\$25M	\$6M
	Alliance Atlantis CW Media	GS Capital, Canwest	\$950M		✓	✓		✓			Condition Precedent Not Met	\$15M	\$6M
Vertrue	One Equity	\$660M		✓			✓			Credit Agreement	\$5M	\$3M	
No Levers	Targa	Warburg	\$2.5B				✓	✓		✓	Limited	\$80M	\$18M
	Goodyear EPD	Carlyle	\$1.3B		✓					✓	Limited	\$25M	\$8M
	Asurion	MDP, WCAS, Providence	\$2.4B					✓	✓		Limited	\$25M	\$8M
	Syniverse	GTCR	\$500M		✓			✓	✓	✓	Limited	\$10M	\$6M
	Jarden	Warburg	\$900M		✓				✓	✓	Limited	-	-
	R.J. O'Brien	Spectrum, Tech Crossover Ventures	\$685M		✓	✓					Limited	-	-

# Lessons Learned

## Financing Commitments and Terms

- ◆ Need contractual protections in commitment letters
  - Sponsors can and generally will hold us to the document and deal terms
  - Sponsors were not always able / willing to follow through on verbal agreements
  - Concessions from Sponsors correlated with the degree of leverage underwriters have and the unity of the underwriting group
  - We should only speak for what we're willing to take
- ◆ Unprecedented terms (i.e. covenant lite, PIK toggle) bring disproportionate risk
- ◆ Credit agreement negotiations are our last line of defense
  - Maximum flex in credit agreement terms is critical
- ◆ Business MAC provisions matter: pay attention to wording and negotiate to get as expansive an out as possible
  - Rely on specific financial conditions whenever possible (i.e., minimum EBITDA and maximum leverage)
- ◆ Staples can be dangerous
  - If not handled correctly, can force the Firm into unwanted financing commitments
  - Conflicts are difficult to manage in adverse scenarios
- ◆ Difficult to negotiate terms of financings when we are not the lead manager
  - If we're going to be on the right side, should try to minimize commitment on larger transactions

## Risk Transfer and Syndication

- ◆ Outside of normal course syndication, it is very difficult to get other firms to take some of our risk on a transaction on acceptable terms
- ◆ SMA round commitments may not transfer risk – need to tighten up agreements and make them more enforceable
- ◆ The market has limited capacity: deals can be too big
- ◆ Don't underestimate:
  - Significance of supply / demand dynamics for the overall market
  - Dependence on leveraged buyers relying on short-term financing
- ◆ Bridge Equity market not nearly as deep as expected
- ◆ Importance of having enough liquidity, balance sheet & risk appetite so as not to be required to liquidate positions in a distressed market

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### **III. Future Management of Capital Commitments**

# Future Management of Capital Commitments

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## Better Allocation of Capital and Return on Risk

1. Institute limits for single transactions and total portfolio exposure
2. Insist on bookrunner and M&A roles
3. Commit to lower percentages and amounts on large deals
4. Limit commitments of longer duration
5. Evaluate and prioritize Financial Sponsor relationships
6. Tighten underwriting standards by establishing specific guidelines
7. Do not manage staple financings as aggressively
8. Limit Bridge Equity
9. Emphasize principal opportunities
10. Sell-down risk through non-traditional means



**Impact on  
Current  
Business Plan**

# 1. Single Transaction and Total Portfolio Limits

## *Institute limits for single transactions and total portfolio exposure*

- ◆ Institute appropriate limits for the following: Single Transaction Limit (STL), portfolio limits and funded position limit
- ◆ Transactions must be the lower of the following limits:
  - Recommended STL for notional value of High Yield transactions: **\$2.5 billion**
    - Notional value subject to STL is expected commitment, not amount for which the Firm originally signs
  - Recommended new STL for modeled losses resulting from any High Yield or High Grade transaction: **\$400 million** <sup>(1)</sup>
    - Equivalent to approximately \$2.3 billion ‘B’ rated LBO commitment <sup>(2)</sup>
- ◆ Proposed Notional Portfolio Limit: **\$20-25 billion** for HY Contingent Commitments + HY Funded Positions
  - Once the Firm reaches a steady state, allows for addition of \$5 billion of new commitments per month, assuming average tenor of commitment of 4 months, plus \$5 billion of funded positions
  - Limit based on “headline” exposure
  - Expect modeled loss limit on the portfolio to be approximately \$1 billion
    - Size estimated loss for each position in the portfolio using STL framework
    - Apply diversification benefit
- ◆ Proposed Expected High Yield Funded Position Limit: **\$1 - \$1.5 billion**
  - Ensure that the Firm is not exposed to any one credit rated below BBB for >\$1 billion
  - Funded limit only applies in situations where the Firm does not expect to syndicate, but anticipates funding
  - Must address issues arising from the disparity between \$2.5 billion notional limit and \$1 billion funded limit

### Implications

- ◆ Limits our ability to participate in certain transactions, especially very large ones and big European LBOs with funding prior to syndication
- ◆ May make the Firm less relevant to major Sponsors, especially to top ten Diamond accounts

(1) Assumes STL model includes the new risk factors that Risk Division has proposed. The new factors are roughly half of the old, implying a spread widening of 50 bps to 900 bps depending on the riskiness of the deals. These scenarios are in line with '98 and '02 type of widening in the course of a few months.

(2) Assumes standard terms on the commitment: B rated loan, Caa bridge, no Bridge Equity, no put bond, 2/3 are loans and 1/3 are bonds, and long time horizon for deal to get approved, and no MAC. With a 150 bps put bond cushion, the limit moves up to \$2.5B.

## 2. Insist on Bookrunner and M&A Roles

## 3. Commit to Lower Percentages / Amounts on Large Deals

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### *Focus on deals where Lehman has a leading M&A / strategic role*

- ◆ Limit capital commitments where Lehman is not receiving a meaningful M&A fee and a lead role in the transaction
  - Exceptions will depend on the nature and extent of the relationship with the Financial Sponsor / Borrower
- ◆ De-emphasize tag-along financing roles in auctions
- ◆ Not prepared to participate in credits where Lehman previously indicated that we would not be a lead underwriter at the proposed terms

### *Sign for lower percentages and amounts on any single large deal*

- ◆ Do not insist on equal participation
- ◆ Reduce financing percentages and forego additional revenue to manage risk
- ◆ When we do not have a lead role, reduce percentage committed

### Implications

- ◆ Limits our ability to participate in certain transactions, especially very large ones – impact on league table standings
- ◆ Will drive us to more mid-sized transactions

- ◆ No longer driving the discussion on terms or leading the syndication of financing
- ◆ Risk of getting eliminated altogether from the deal, rather than ending up with a smaller share
- ◆ Impact on the Firm's revenues and league table position

# 4. Limit Commitments of Longer Duration

## 5. Financial Sponsor Relationships

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### *Manage commitment inventory down by limiting commitments of longer duration*

- ◆ Be mindful of expected life of each commitment
  - Cost of a commitment increases as it remains in our inventory for a longer period, especially since longer commitments rarely generate higher fees
  - Need to keep turning inventory to maximize return on capital and make room for new commitments
- ◆ Apply higher standards for longer-duration commitments
  - Demand more pricing flex and higher put bond rates
  - Require higher fees
- ◆ Limit commitments in transactions requiring long regulatory approval processes

### *Evaluate and prioritize Sponsor relationships*

- ◆ Need to maintain a record of Financial Sponsors' actions on each transaction
  - Track which Financial Sponsors have shown pricing and structural flexibility, thereby helping the Firm syndicate the risk, instead of sticking with the specific terms laid out in the documents and forcing the Firm into funded Bridge Loans
- ◆ Emphasize relationships with Financial Sponsors who treat the Firm as a valued advisor / partner (including with respect to principal investment opportunities), rather than as a provider of commodity financing
- ◆ Re-evaluate contractual commitment standards (including protection provided by fee letter stipulations)

### **Implications**

- ◆ Reduce Leveraged Finance activity in regulated industries, such as Media and Power

- ◆ Allocate financial and human capital to our best Financial Sponsor relationships
- ◆ Limit business with Sponsors with bad track records, which may reduce involvement in larger transactions and thereby impact revenues / league table standing

# 6. Tighter Underwriting Standards

## 7. Staple Financings

### *Tighten underwriting standards through establishment of specific guidelines*

- ◆ Boundaries will change based on then-current market conditions and demands
- ◆ Relevant considerations:
  - Use of proceeds
  - Leverage multiples and Free Cash Flow
  - Ratings
  - Covenants
  - PIK Toggle
  - Put Bond Cushion and flex
  - Delayed draw facilities
  - Conditions Precedent

### *Don't manage staple financings as aggressively*

- ◆ Be cautious about providing staple when acting as lead M&A advisor for sale of a public company
- ◆ Do not stretch on terms and structure to pre-empt competitive financing proposals when providing staple
  - Make M&A advisory role our top priority, but retain option to participate in financing if comfortable with terms
- ◆ Do not limit bidder's ability to bring in other financing sources
- ◆ Do not allow sell-side M&A client to push the Firm into financings with which we are not comfortable
- ◆ Address conflict of interest issues
- ◆ Utilize objective minimum EBITDA requirements to avoid Business MAC debates

### Implications

- ◆ Will lose out on deals when other banks are more aggressive on terms
- ◆ Potentially develop a reputation as “off market” on terms
- ◆ Makes the Firm less relevant to Financial Sponsors
- ◆ Limit the Firm's ability to “lock-up” a financing role when acting as sell-side advisor
- ◆ Lose exclusive sale mandates when seller demands staple financing and indicative staple terms are key factor in awarding mandate (e.g., for Sponsor portfolio companies)
- ◆ Potentially reduce the Firm's revenues and league table position in Leveraged Finance and Sponsors M&A

# 8. Limit Bridge Equity

## 9. Principal Opportunities

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### *Make a strategic decision to limit Bridge Equity*

- ◆ Only provide Bridge Equity when the Firm is comfortable enough with the credit to co-invest in the equity and then only for an incremental amount beyond the co-investment commitment
- ◆ Insist on priority sell-down on marketable terms (no promote)

### *Emphasize Principal Investment Opportunities with Sponsors*

- ◆ Factor in principal investment opportunities in evaluating potential financing commitments
- ◆ Create opportunities to improve economics of debt commitments through equity upside – better use of capital and return on risk
- ◆ Further align our interests with Financial Sponsors who are willing to partner with us in co-investment

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### Implications

- ◆ Could limit our participation in larger transactions
- ◆ Could impact our access to co-invest opportunities
- ◆ May create conflicts with other clients involved in the transaction
- ◆ Will result in competing interests of the Firm as lender and investor

# 10. Sell-Down Risk Through Non-Traditional Means

## *Continue Efforts to Sell Risk Through Non-Traditional Means*

- ◆ Continue silent participation sales with Sumitomo and Commerzbank; seek to develop additional silent partners such as Bank of Scotland
  - Confidentiality essential to preserving banking relationships
  - Challenging to silently move risk for credits rated below BB
  
- ◆ Attempts to develop a transparent underwriting program with partners unsuccessful to date
  - Discussions with Sumitomo, GECC, RBC are continuing, but prior to market dislocation did not yield a below investment grade deal
  - Objective is to establish a regular program of commitments to develop confidence that the Firm can regularly reduce our High Yield commitment exposure
    - Commit to 25%+ of gross initial commitment shortly after the Lehman commitment
    - Require transfer of a portion of the acquisition financing related fees
    - Also working on blind pool strategy with ABP to sell them 10% of all of our High Yield commitments up to a cap

### Implications

- ◆ Must bear cost of risk mitigation by transferring a meaningful portion of projected fees
- ◆ Natural negative selection bias reduces the credit quality of the remaining portfolio
- ◆ Strategy runs client risk for the following reasons:
  - Runs counter to Sponsors' preference to have their lead lenders maintain full exposure
  - Facilitates a new lending relationship for our Sponsor clients

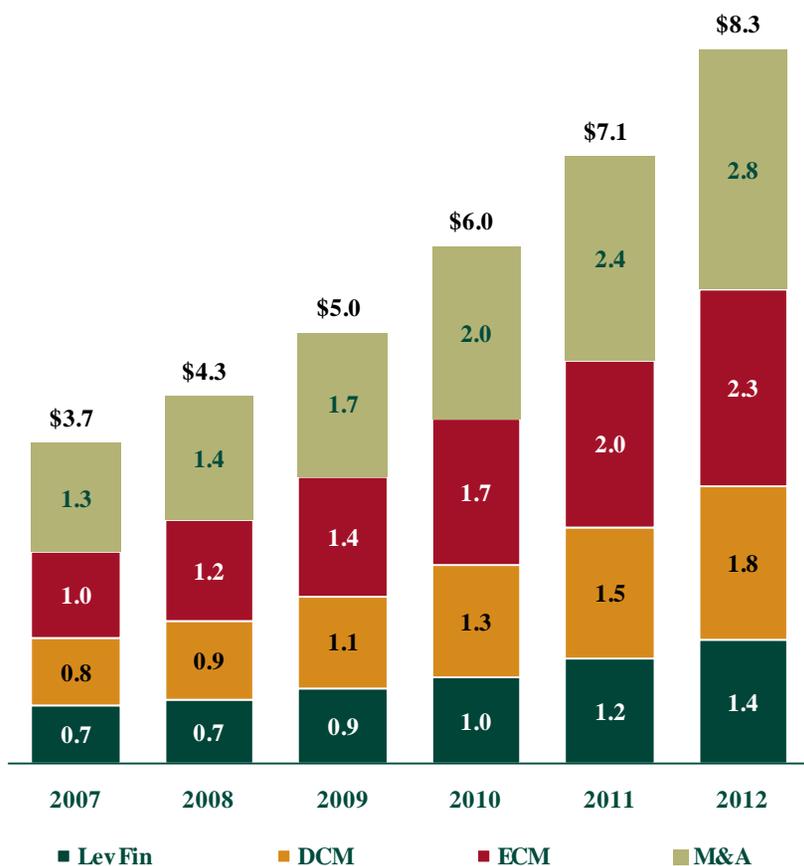
# Summary of Implications

'06 SV Recommendation	'07 Modifications	Implication
<ul style="list-style-type: none"> <li>◆ Increase lending capacity to “speak for” \$5B</li> <li>◆ Become more aggressive on terms                             <ul style="list-style-type: none"> <li>– Sponsor “reserve budget”</li> </ul> </li> <li>◆ Capture higher percentage of economics for Sponsors transactions                             <ul style="list-style-type: none"> <li>– Win sell side mandates / provide staple financing</li> <li>– Co-Invest</li> <li>– HY / Mezz Fund</li> </ul> </li> <li>◆ Become more proprietary with Sponsors                             <ul style="list-style-type: none"> <li>– Offer innovative financing structures</li> <li>– Market new products</li> </ul> </li> <li>◆ <b>Achieve top 5 rank in Leveraged Finance and with Sponsors</b></li> </ul>	<ul style="list-style-type: none"> <li>◆ Set \$2.5B single transaction limit</li> <li>◆ Set \$20-\$25B total portfolio exposure limit</li> <li>◆ Adhere to tighter underwriting standards</li> <li>◆ Insist on bookrunner and M&amp;A roles to ensure seat at table for terms negotiation</li> <li>◆ Commit to lower percentages and amounts on large deals</li> <li>◆ Manage staple financings less aggressively</li> <li>◆ Limit commitments of longer duration</li> <li>◆ Prioritize Sponsor relationships</li> <li>◆ Limit bridge equity</li> <li>◆ Emphasize principal opportunities</li> </ul>	<ul style="list-style-type: none"> <li>◆ May limit our ability to win mandates for / participate in certain transactions, including:                             <ul style="list-style-type: none"> <li>– Very large transactions</li> <li>– Transactions with aggressive financing terms</li> <li>– Transactions we are not leading</li> <li>– Exclusive sale mandates for which indicative staple terms are a key factor in awarding mandate</li> <li>– Transactions in regulated industries (e.g., Media, Power)</li> <li>– Transactions for Sponsors with bad track records</li> </ul> </li> <li>◆ Potential to lose relevance with major Sponsors                             <ul style="list-style-type: none"> <li>– Develop a reputation as not aggressive enough on terms</li> <li>– Not able to lead very large transactions</li> <li>– Lose incumbency for future mandates (IPOs, M&amp;A)</li> </ul> </li> <li>◆ Greater importance of proprietary ideas and controlling the deal</li> <li>◆ More emphasis on middle market Financial Sponsor coverage</li> <li>◆ More emphasis on Corporate coverage</li> <li>◆ May reduce gross amount of Sponsors revenue, but should yield better return on capital</li> <li>◆ May lower league table standing in Leveraged Finance and market share with Financial Sponsors</li> </ul>

# Revenue Implications

## Investment Banking Budget Targets

\$ in billions



## Assumptions

### Revenue Growth Rates

	2007	2010	CAGR	Share '07 / '10
M&A	\$1.25	\$2.00	17.0%	4.8% / 6.6%
Equity	\$1.00	\$1.70	19.3%	3.2% / 4.4%
Lev Fin	\$0.67	\$1.00	14.6%	5.7% / 7.0%
IG	\$0.79	\$1.30	18.3%	4.7% / 6.4%

### Analysis

- ◆ Sponsors currently contribute following percentage of the Firm's IBD product group revenues:

M&A	25.1%	Lev Fin	65.2%
ECM	17.5%	DCM	1.7%

- ◆ Under this strategy, market share with Financial Sponsors may decline with corresponding revenue impact
- ◆ Market share and revenue growth with Corporates will need to significantly exceed the average product growth rates outlined above

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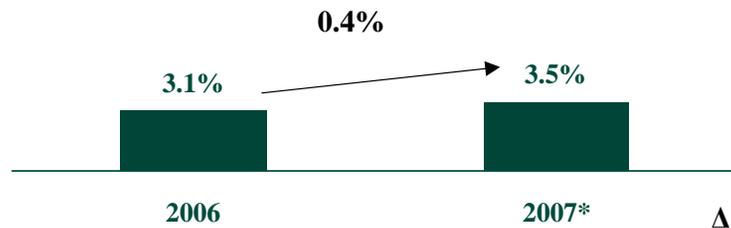
## Appendices

# Significant Improvement in Lehman Brothers' Share

Gained share in Leveraged Finance and achieved top 5 in Financial Sponsors overall

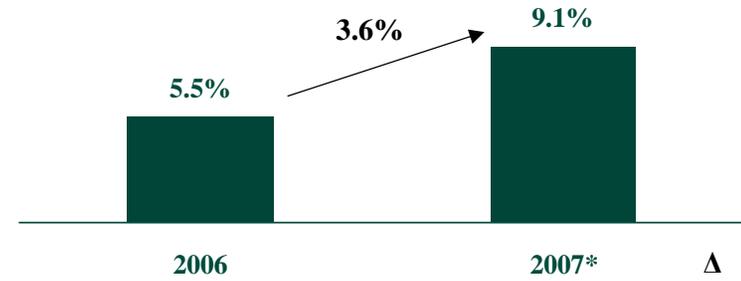
## Lehman's Global Leveraged Finance Share

### Leveraged Loans (Volume)



	2006	2007*	$\Delta$
Rank	11	8	3
Volume	\$37.8B	\$58.7B	56%

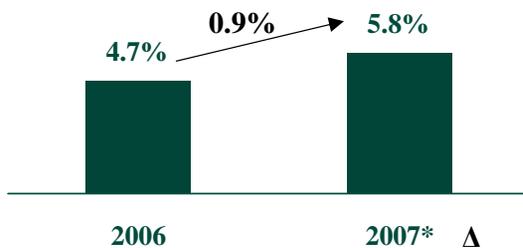
### High Yield Bonds (Volume)



	2006	2007*	$\Delta$
Rank	9	5	4
Volume	\$9.7B	\$11.0B	14%

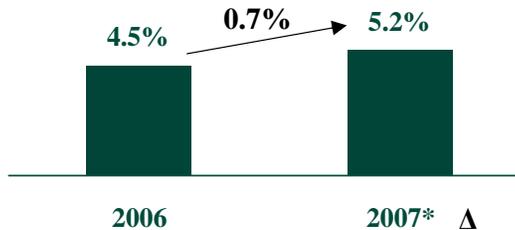
## Lehman's Global Financial Sponsor Share

### Overall (Fees)



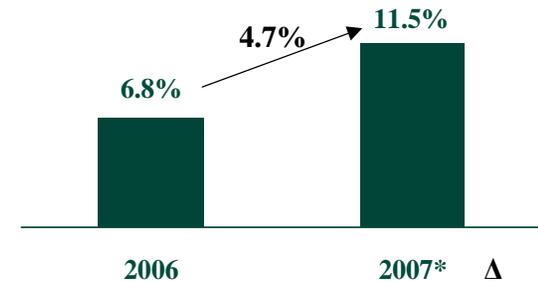
	2006	2007*	$\Delta$
Rank	7	5	2
Fees	\$847M	\$959M	13%

### Leveraged Loans (Volume)



	2006	2007*	$\Delta$
Rank	11	7	4
Vol.	\$22.5B	\$35.9B	60%

### High Yield Bonds (Volume)



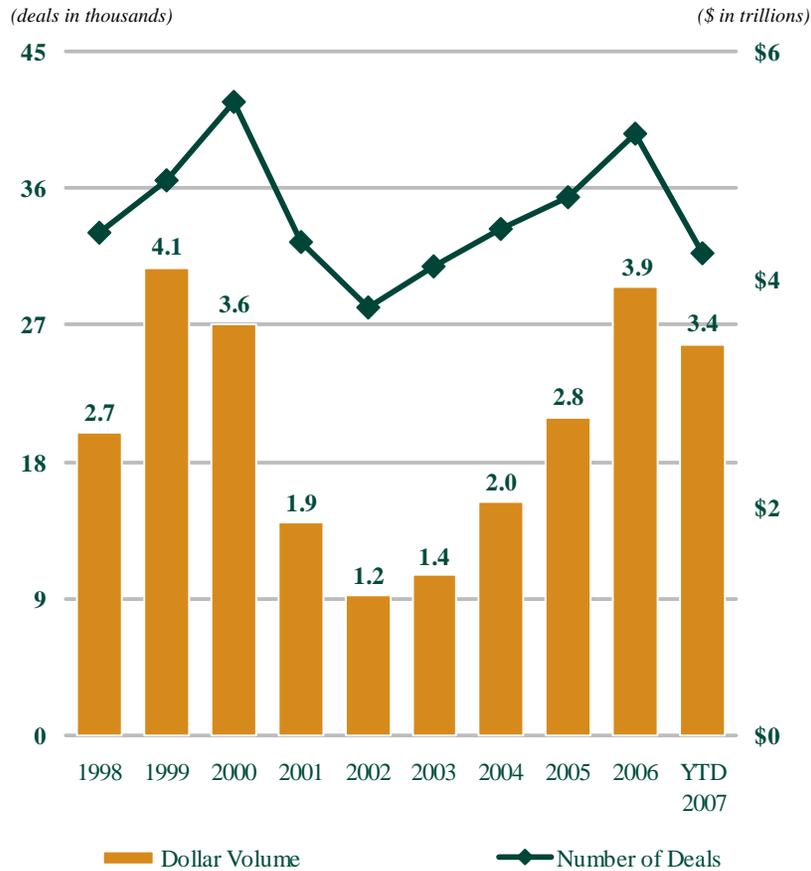
	2006	2007*	$\Delta$
Rank	6	1	5
Vol.	\$4.5B	\$6.5	45%

\* 2007 data for Leveraged Loans and HY Bonds through September 25<sup>th</sup>. Overall Sponsor fee data through September 28<sup>th</sup>. Volumes and fees are annualized through 2007.

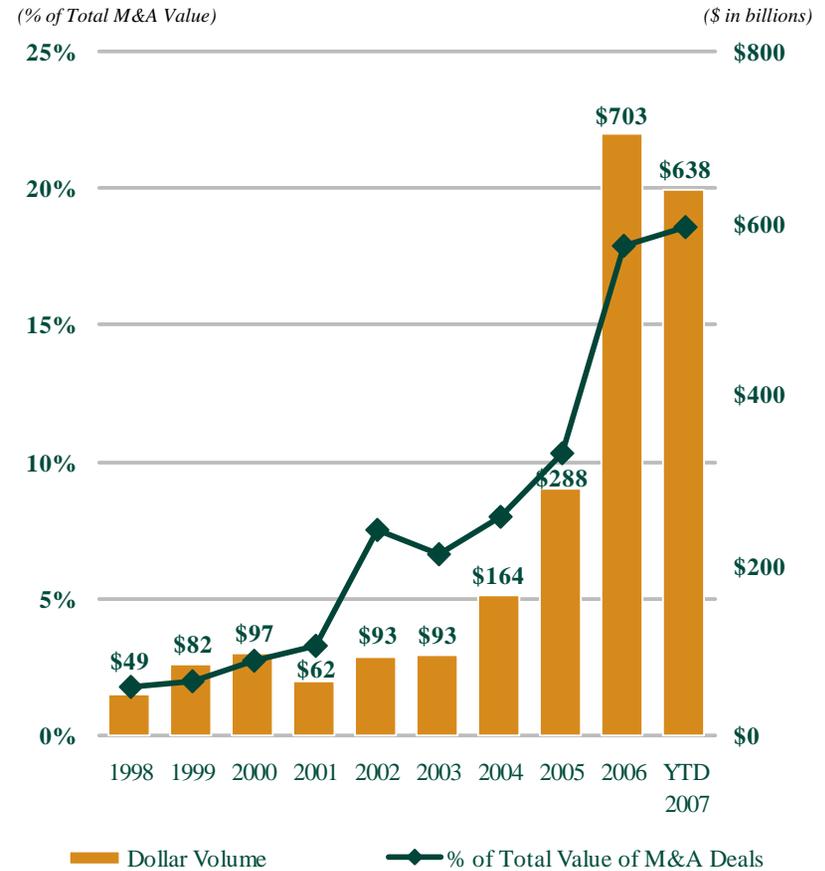
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# Market Update – Corporate Acquisitions and Sponsor LBOs

## 1998-YTD 2007 Global Announced M&A Activity



## 1998-YTD 2007 Global Sponsor M&A Activity



Source: SDC Database, YTD 2007 through 9/26/07.

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# Competitor Comparison – HY Contingent Acquisition Facilities

	LEH		MER	MS	GS	BS	DB <sup>(2)</sup>	Citi	UBS	
	Actual	Adj. <sup>(1)</sup>								
<b>Contingent Acquisition Facility Exposure (\$B)</b>	Q2 Contingent Acquisition Facility	43.9	53.0	42.8	51.0	20.8		69.0		
	Closed deals	9.7			3.9					
	Withdrawn / lost deals	2.1			10.9					
	Paired down	9.3			7.1					
	3rd party buyer / LLF	6.1			0.0					
	Closed / dead / etc.					28.0				
	New Q3 commitments	10.3			10.1	19.0	N/S			
	<b>Q3 CAF</b>	<b>27.0</b>	<b>21.6</b>	<b>31.0</b>	<b>31.0</b>	<b>42.0</b>	<b>7.6</b>	<b>41.0</b>	<b>57.0</b>	<b>13.0</b>
	Funded CAF at August 31	7.6	7.6	n.a.	n.a.	10.0	2.0	n.a.		
	<b>Total Acquisition Financing Commitments</b>	<b>34.6</b>	<b>29.2</b>	<b>31.0</b>	<b>31.0</b>	<b>52.0</b>	<b>9.6</b>	<b>41.0</b>		
<b>P&amp;L Impact (\$M)</b>	<b>Q3 P&amp;L Impact</b>									
	<b>Gross write-down</b>	<b>(1,294)</b>	<b>(1,294)</b>	<b>(967)</b>	<b>(1,200)</b>	<b>(2,400)</b>				
	Fees, carry	504	504		474	690				
	Hedges	87	87		–	230				
	<b>Net write-down on CAF</b>	<b>(703)</b>	<b>(703)</b>	<b>(463)</b>	<b>(726)</b>	<b>(1,480)</b>	<b>(250)</b>	<b>(884)</b>	<b>(1,350)</b>	
<b>Comparison</b>	Gross-write-down as a % of Total Acq Fin Cmtmt	3.7%	4.4%	3.1%	3.9%	4.6%	n.a.	n.a.		
	Net-write-down as a % of Total Acq Fin Cmtmt	2.0%	2.4%	1.5%	2.3%	2.8%	2.6%	2.2%		
	Gross-write-down as a % of CAF	4.8%	6.0%	3.1%	3.9%	5.7%	n.a.	n.a.	n.a.	
	Net-write-down as a % of CAF	2.6%	3.3%	1.5%	2.3%	3.5%	3.3%	2.2%	2.4%	

Note: N/S = Not Significant.

- Adjusted for Archstone commitment (\$5.4B), which was marked at par.
- As of September 4th, disclosed as part of their recent debt issuance.

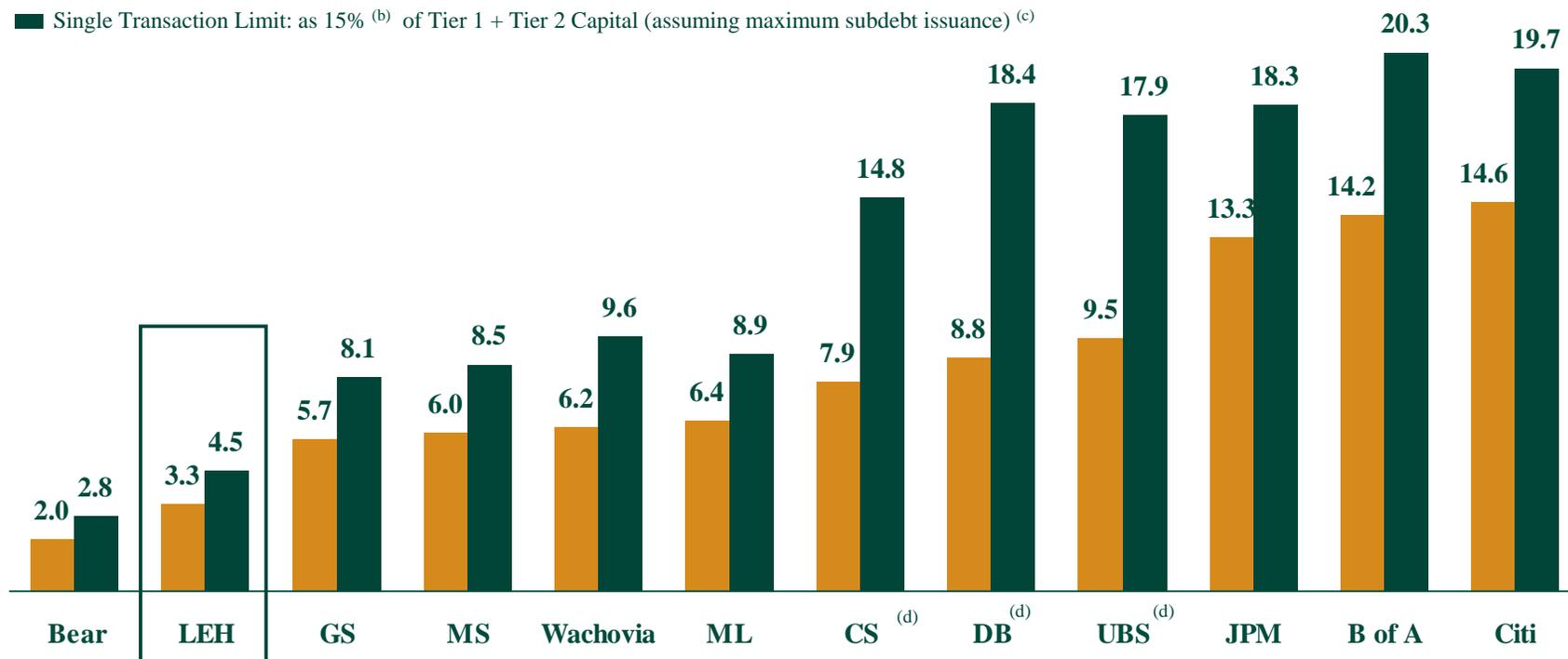
# Competitor Comparison – Nominal Commitment Limit

## Nominal Commitment Limit: Competitor Comparison 2Q 2007 <sup>(a)</sup>

\$ in billions

■ Single Transaction Limit: as 15% <sup>(b)</sup> of Tangible Equity.

■ Single Transaction Limit: as 15% <sup>(b)</sup> of Tier 1 + Tier 2 Capital (assuming maximum subdebt issuance) <sup>(c)</sup>



- (a) 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 subdebt 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.
- (e) All competitors currently displaying 2Q data, except ML, CS, DB, and UBS – Q1 was the latest available data for these companies.

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# Competitor Comparison – Nominal Commitment Limit

## Nominal Commitment Limit: Competitor Comparison 2Q 2007 <sup>(a)</sup>

\$ in billions

	Tangible Equity	Tier 1 + 2 Capital: w/ Max Subdebt <sup>(b)</sup>	Single Transaction Limit		
			% Limit <sup>(c)</sup>	% Tangible Equity	% Tier 1+2 Capital (w/Max Subdebt)
Bear	13.5	18.5	15%	2.0	2.8
<b>LEH</b>	<b>21.9</b>	<b>30.0</b>	<b>15%</b>	<b>3.3</b>	<b>4.5</b>
GS	38.0	54.1	15%	5.7	8.1
MS	40.3	56.6	15%	6.0	8.5
Wachovia	41.5	63.7	15%	6.2	9.6
ML	42.5	59.0	15%	6.4	8.9
CS	31.4	39.4	25%	7.9	14.8
DB	35.0	49.0	25%	8.8	18.4
UBS	38.0	47.8	25%	9.5	17.9
JPM	88.4	122.3	15%	13.3	18.3
B of A	95.0	135.1	15%	14.2	20.3
Citi	97.1	131.3	15%	14.6	19.7

(a) 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 subdebt 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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# Lehman Brothers Leveraged Finance Pipeline – Detail<sup>(1)</sup>

\$ in millions

Deal	Lehman Commit.	Unfunded Commitments				Funding Timeline				P&L			
		Sep-07	Oct-07	Nov-07	Dec-07	Sep-07	Oct-07	Nov-07	Dec-07	Mark	UW	M&A	Net
T XU	\$4,738	\$4,738	\$3,175	\$3,175	\$3,175	\$0	\$1,563	\$1,563	\$1,563	(\$270)	\$60	\$20	(\$190)
Archstone-Smith (3)	4,281	4,281	626	626	626	0	3,655	3,655	3,655	0	77	0	77
Riverdeep/ Houghton-Mifflin	2,398	2,398	2,398	2,398	2,398	0	0	0	0	(39)	47	12	20
Applebee's/IHOP (2)	2,139	2,139	2,139	100	100	0	0	2,039	2,039	0	50	0	50
PHH Corp. (2)	1,703	1,703	493	493	493	0	1,210	1,210	1,210	(6)	10	10	15
CDW Corp.	1,494	1,494	102	102	102	0	1,392	1,392	1,392	(89)	33	15	(41)
Alliance Data	1,322	1,322	1,322	100	100	0	0	1,222	1,222	(101)	25	16	(60)
Harman International	1,146	1,146	1,146	1,146	1,146	0	0	0	0	(119)	21	4	(94)
United Rentals	975	975	975	143	143	0	0	833	833	(26)	20	0	(6)
FairPoint Comm.	832	832	832	832	832	0	0	0	0	(30)	10	10	(9)
Sequa Corp	820	820	820	60	60	0	0	760	760	(29)	16	4	(9)
ACTS (Air Canada)	724	50	50	50	50	674	674	674	674	(24)	13	1	(10)
TRW Auto (4)	650	650	650	50	50	0	0	600	600	--	--	--	--
Endemol (Edam Acquisition)	586	193	193	193	193	393	393	393	393	(18)	7	11	(1)
McJunkin Corp.	578	578	578	76	76	0	0	502	502	(10)	9	0	(1)
LKQ Corp.	545	545	50	50	50	0	495	495	495	(32)	7	0	(25)
PHS Group	545	72	72	72	72	473	473	473	473	(16)	8	0	(8)
Hawaiian Telecom Yellow Pages (2)	455	455	455	5	5	0	0	450	450	(3)	7	4	9
Lloyds TSB	453	0	0	0	0	453	453	453	453	(17)	11	0	(6)
Metavante Corp.	400	400	50	50	50	0	350	350	350	(14)	5	0	(9)
ARINC Inc.	365	365	38	38	38	0	328	328	328	(18)	7	0	(11)
Debitel Group	299	35	35	35	35	264	264	264	264	(7)	4	0	(3)
Chevron Global (Delek)	283	51	51	51	51	232	232	232	232	(11)	10	0	(1)
Icopal A/S	279	33	33	33	33	245	245	245	245	(9)	7	0	(2)
Territory Res. / Consol. Minerals	277	277	0	0	0	0	277	277	277	0	4	0	4
Varel Holdings	230	230	15	15	15	0	215	215	215	0	2	0	2
Sisal SpA	208	19	19	19	19	189	189	189	189	0	0	0	0
Plains Exploration & Production (FRL)	207	207	207	100	100	0	0	107	107	--	--	--	--
Regent Seven Seas Cruises	200	200	200	200	0	0	0	0	200	0	--	--	--
Merlin Entertainment	195	23	23	23	23	172	172	172	172	(3)	5	0	2
PQ Corp. (CPQ Holdings)	145	145	145	0	0	0	0	145	145	(8)	--	--	--
El Paso Corp. / El Paso Pipeline Partners (FRL)	125	125	73	73	73	0	53	53	53	0	--	--	--
A&P	118	118	118	0	0	0	0	118	118	0	3	0	3
Tenaska (TPF II LC)	90	90	0	0	0	0	90	90	90	0	3	4	7
Chronic Care Solutions (CCS Medical) (FRL)	86	86	86	86	86	0	0	0	0	0	--	--	--
American Standard	75	75	75	75	75	0	0	0	0	--	--	--	--
Windstream Regatta	59	59	4	4	4	0	55	55	55	(3)	2	0	(2)
Tribune Co.	52	52	52	20	20	0	0	32	32	--	--	--	--
Regency Gas Services (FRL)	35	35	35	35	35	0	0	0	0	--	--	--	--
Pregis Corp.	20	20	0	0	0	0	20	20	20	--	--	--	--
Avago Technologies Finance Pte. (FRL)	15	15	15	15	15	0	0	0	0	--	--	--	--
<b>Total HY</b>	<b>\$30,145</b>	<b>\$26,346</b>	<b>\$16,921</b>	<b>\$10,115</b>	<b>\$9,915</b>	<b>\$3,095</b>	<b>\$12,797</b>	<b>\$19,604</b>	<b>\$19,804</b>	<b>(\$893)</b>	<b>\$482</b>	<b>\$111</b>	<b>(\$301)</b>

Pipeline as of September 25, 2007.

• Excludes fronting for agent deals.

(2)

(3)

Risk shared with Structured Finance.

Real Estate deal. Funding is based on a hold of \$1.175 bn and 100% funding.

4)

5)

Not yet mandated.

\$333 mm bank commitment guaranteed by Home Depot, Inc.

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# Key Updates on Sun Valley 2006

## Recommendations for Financial Sponsors Franchise

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

Issue	Recommendation	Update
<b>Lending Capacity</b>	Organic Lending Capacity	<ul style="list-style-type: none"> <li>◆ Issued \$3.7B of Tier 2 capital; and with retained earnings increased nominal commitment limit from \$3.5B to \$4.5B</li> <li>◆ Educated Rating Agencies on nature of acquisition finance commitments to focus on amount at time of mandated commitment, not at time of commitment letter</li> </ul>
	Lending Partnerships or Structured Vehicles	<ul style="list-style-type: none"> <li>◆ Deepened relationships with silent partners: Sumitomo, Commerzbank, also developing relationships with GECC and RBC</li> <li>◆ Developed structured vehicle and initiated conversations with potential partners. However Moody's rejected methodology</li> <li>◆ Formed Hudson Castle funding vehicle in 3/07 with \$4B of capacity, upsized to \$6B in 6/07, upsized capacity to \$7.5B in 7/07               <ul style="list-style-type: none"> <li>– Since inception, used vehicle for 5 credits, including TXU and several High Grade credits (IBM, Alcoa, Imperial Tobacco, Global Santa Fe)</li> <li>– Currently using \$6.1B of capacity</li> <li>– Does not transfer risk, it only provides funding relief and increases the amount the Firm can lend in any transaction</li> </ul> </li> </ul>
<b>Becoming More Aggressive on Terms</b>	Create a Sponsor FRL Reserve Budget	<ul style="list-style-type: none"> <li>◆ Maintained credit standards, but participated in certain transactions with potential syndication losses, e.g.,               <ul style="list-style-type: none"> <li>– Claire's, Dollar General, Harmon, Home Depot Supply</li> </ul> </li> </ul>
	Raise Private High Yield / Mezz Fund	<ul style="list-style-type: none"> <li>◆ In fundraising for \$3.0B Global Mezz Partners Fund led by Mike Guarnieri</li> <li>◆ Investments being warehoused</li> </ul>
<b>Proprietary Ideas and Relationships</b>	Co-Invest with Sponsors on Select Transactions	<ul style="list-style-type: none"> <li>◆ Co-invested \$2.2B alongside our clients in the last 12 months</li> <li>◆ Notable transactions: TXU (\$400M), BAWAG (\$270M) First Data (\$250M), Chrysler (\$230M), Freescale (\$143M), Tokyo Star (\$125M), GMAC (\$100M), CDW (\$50M), Firth Rixson (\$16M)</li> </ul>
	Build out Whole Business Securitization	<ul style="list-style-type: none"> <li>◆ Key mandates: Dunkin' Donuts, Wendy's, Warner Music, Applebee's</li> <li>◆ Team expanded</li> </ul>
	Expand/Target Wealth Management Coverage of Sponsors' Partners	<ul style="list-style-type: none"> <li>◆ Initiated internal discussions, and had several meetings with Sponsors clients; however have made limited progress to date</li> <li>◆ Plan to pursue in tandem with Middle Markets Sponsors effort this fall</li> </ul>
	Expansion of Middle Market Sponsor Coverage	<ul style="list-style-type: none"> <li>◆ P.J. Moses to be appointed Head of Middle Markets Banking</li> <li>◆ New Leveraged Finance and Financial Sponsors Middle Markets hires</li> </ul>
	Expansion of Investment Banking Footprint	<ul style="list-style-type: none"> <li>◆ Hired 113 senior bankers (58 in 2006, 55 in 2007) for \$250M in comp expense               <ul style="list-style-type: none"> <li>– Total impact on revenue in excess of \$250M</li> </ul> </li> </ul>