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LEH Will Survive

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I could have written a multi-chapter treatise on **Lehman Brothers** (LEH) based on the long call and Q&A, but I wanted to keep to the highlights. Clearly, the company has taken significant hits in its credit business, but something else bears mentioning -- its other businesses performed quite well. The asset management business is growing nicely and management should be complemented on its timely and well priced acquisition of Neuberger Berman several years ago.

Lehman's focus on the balance sheet is beginning to pay off, although there is still some uncertainty as to level three assets. Today's conference call was quite informative and well prepared. There is no way that former CFO Erin Callan could have conducted such a controlled and informative conference call.

I think that Lehman is going to be a survivor despite rumors or fears to the contrary over the past few weeks. I was actually looking at some Lehman Preferred Stock, which could make an interesting purchase.

Now let's see what **Goldman Sachs** (GS) and **Morgan Stanley** (MS) have to say later this week.

Lehman Brothers reiterated last week's preliminary quarterly outcome when issuing final second-quarter 2008 financial results. The company lost $2.8 billion for the quarter, equating to a loss of $5.14 per share. This was Lehman's first even quarterly loss since being reincarnated as a public corporation after many years of ownership by **American Express** (AXP) . (Does anyone remember Slamex -- Shearson Lehman American Express?)

According to Richard Fuld, residential and commercial mortgage origination and securitization revenue opportunities are significantly diminished, while secondary trading is still good. He went on to say that sponsor and leveraged originations will remain weak, though the company is doing deals on better terms. In 2007, a record year, those businesses contributed less than 10% of total net revenue.

Net revenue for the quarter was a loss of $668 million. Mark-to-market losses in the credit markets totaled $3.6 billion and hedges added another $100 million in losses. In the past, hedges provided "significant benefits." Total asset re-pricing losses totaled $4.9 billion. Thus, by simple mathematics, all of the other Lehman businesses generated net revenue of $4.2 billion.

Headcount declined by 1,900, and the company incurred severance costs of $140 million.

The conference call (rightfully so) was a detailed overview of the balance sheet. For the purposes of brevity, here are some of the significant items worth taking away:

- the company raised $10 billion of tangible equity since the beginning of second quarter 2008, bringing the total tangible equity balance to $33 billion, and management believes that the funding plan for 2008 is complete;
- reduced gross assets by $147 billion during the quarter, to a level of $639 billion;

- reduced net assets by $70 billion sequentially, to $327 billion;
- reduced gross leverage from 31.7 times to 24.3 times and net leverage from 15.4 times to 12 times;
- reduced residential mortgage assets to $24.9 billion from $31.8 billion sequentially;
- reduced whole loans to $8.3 billion from $11.9 billion sequentially;
- sold $11 billion of residential mortgage assets and purchased about $6 billion;
- reduced Alt-A assets from $14.6 billion to $10.2 billion sequentially;
- reduced subprime assets from $4.0 billion to $2.8 billion sequentially;
- exposure to commercial mortgages and real estate held for sale declined sequentially from $49 billion to $39.8 billion;
- sold $4.2 billion of loans (45% mezzanine and 55% senior loans);
- in acquisition finance, exposure was reduced to $18 billion from $28.7 billion sequentially, with the largest reduction coming from the successful closing of **IHOP's** (IHP) Applebee's acquisition; and
- Lehman's bank entities have excess liquidity of $17 billion have total collateral of $87 billion.

Level three assets are still under review, and the current expectation is that they will decline from least $40.2 billion at the end of the first quarter. In the second quarter, Lehman sold approximately $3.5 billion of level three assets and also had additional writedowns of approximately $2 billion, bringing the total down to approximately $35 billion. This reduction will be offset, however, by net transfers and other activity of approximately $3.5 billion. Therefore, the company expects to end the quarter at approximately $38 billion of level three assets.

For Rothbort's preview heading into the Leman Brothers conference call, please click here.

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At the time of publication, Rothbort was long Goldman Sachs and a single legacy position in Morgan Stanley, although positions can change at any time.

Scott Rothbort has over 20 years of experience in the financial services industry. In 2002, Rothbort founded LakeView Asset Management, LLC, a registered investment advisor based in Millburn, N.J., which offers customized individually managed separate accounts, including proprietary long/short strategies to its high net worth clientele. He also is the founder and manager of the social networking educational Web site TheFinanceProfessor.com.

Immediately prior to that, Rothbort worked at Merrill Lynch for 10 years, where he was instrumental in building the global equity derivative business and managed the global equity swap business from its inception. Rothbort previously held international assignments in Tokyo, Hong Kong and London while working for Morgan Stanley and County NatWest Securities.

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