

**The Valukas Report:
Examination of the Chapter 11
Proceedings of Lehman Brothers
Holdings Inc.**

**William C. Harvey, II, CCIM, MAI
Wm. C. Harvey & Associates, Inc.**

A few more words about Examiner Anton Valukas...



- Appointed examiner on 1/19/09 with a self-imposed target date for his report of 2/1/10.
- Reviewed three petabytes of data, equivalent to 350 billion pages, and conducted 250 interviews.

Scope of Examination

- Examiner evaluated the reasonableness of Lehman's mark-to-market valuations under SFAS 157
- Examination concentrated on Lehman's U.S. assets
- Focus on 2nd & 3rd Quarters of 2008

Scope of Examination

- Examiner attempted to determine any fraud, dishonesty, incompetence, misconduct, mismanagement, or irregularity in the management of the affairs of the debtor
- Identified colorable claims against senior officers and third parties

SFAS 157

- Establishes a framework for measuring fair value in GAAP
- Creates a broad, three-level, fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value

SFAS 157

- **highest priority to quoted prices in active markets for identical assets or liabilities (Level 1)**
- **followed by observable inputs other than quoted prices (Level 2)**
- **lowest priority to unobservable inputs (Level 3)**

Primary Assets Examined

- **Commercial real estate (CRE)**
- **Residential whole loans (RWLs)**
- **Residential mortgage-backed securities (RMBS)**
- **Collateralized debt obligations (CDOs)**

Lehman's Valuations

- Reported asset values determined by Lehman's various business desks
- Product Control Group responsible for price testing and revisions and served as standardized check
- E&Y conducted quarterly reviews

Key Statistics – 1/29/08

- Revenues - \$60 billion
- Earnings - \$4 billion
- 52-Week High - \$65.73/Share
- Market Capitalization - \$30 billion

Key Statistics – 9/12/08

- **52-Week Low – \$3.65/Share**
(95% decline from January)
- **Market Capitalization - \$19.2 billion**
(\$7 Billion Below Book Value)
- **Lehman prepares for bankruptcy**

What Happened in 2008?

- **Market lost confidence in Lehman's reported asset values**
- **Clearing banks demanded additional collateral**
- **Lehman employed accounting gimmicks (Repo 105) to cover \$50 billion hole**

Lehman's CRE Values

- Historically, Lehman used its “Cap * 105” method to value CRE (multiplied the capitalization of the development by 105% to determine the collateral value, which produced conservative valuations in appreciating markets)
- Lehman switched to an internal rate of return (IRR) method after determining that the down-market of late 2007 and 2008 caused it to produce overstated collateral values

Lehman's CRE Values

- Switch from Cap * 105 method to IRR method produced significant write downs
- Write downs were phased in on a rolling basis
- Senior management pushed back against recommended write downs and imposed quarterly caps

Lehman's Commercial Book

- Historically, Lehman was able to sell its positions shortly after origination
- Market conditions in 2007 and 2008 caused it to retain most of its commercial book
- Marks to Lehman's commercial book were based on a number of methods

Lehman's Commercial Book

- **Conduits – mock securitization models**
- **Mezzanine loans – net present value models**
- **CMBS – third party pricing data**
- **Limited market data resulted in variances with PCG testing results**

Lehman's PTG Portfolio

- **Principal Transaction Group (PTG) invested in debt and equity positions in developmental projects**
- **Typical investments included condo conversions, construction of hotels and offices and land development**
- **PTG investments were “high-risk, high-return”**

Lehman's PTG Portfolio

- Constant from 2002 to 2005, the PTG balance sheet grew 57% between 2005 and 2007
- Composition of PTG portfolio also changed in ways that made it more risky (focus on boom markets, equity investments and land deals)
- Mark-to-market valuations more difficult

Lehman's PTG Portfolio

- Values based on Cap * 105 method were replaced with values from DCF and IRR models in 2008
- PTG relied on third party asset manager (TriMont) but valuations became delayed
- Target yield rates v. market yield rates were often employed

Lehman's Largest Investment

- Acquired Archstone REIT for \$23.6 billion on 10/5/07 (154 apartment projects)
- Business plan was to quickly sell certain properties for \$8.9 billion, reduce debt load from 80% to 70% and syndicate 50% of Lehman's debt
- Break up fee was \$1.5 billion

Lehman's Largest Investment

- *Barron's* January 2008 article suggested Lehman's equity had evaporated
- Key elements of business plan were not realized
- Lehman's DCF models were overly optimistic, especially in light of observable changes in the market

Why Did Lehman Fail?

- **The Examiner concluded that Lehman failed because it was unable to retain the confidence of its lenders and counterparties and because it did not have sufficient liquidity to meet its current obligations.**
- **The business decisions that brought Lehman to its crisis of confidence may have been in error but were largely within the business judgment rule.**

Why Did Lehman Fail?

- **Decision not to disclose the effects of those judgments does give rise to colorable claims against some senior officers (CEO & CFOs) and the outside auditor (E&Y).**

Were Lehman's Valuations Fair and Reasonable?

- **The Examiner explored this subject because it is central to the question of Lehman's solvency and to whether Lehman's financial statements were accurately stated.**
- **The Examiner concluded that Lehman's valuation procedures may have been wanting and that certain valuations may have been unreasonable for purposes of a bankruptcy solvency analysis.**

Were Lehman's Valuations Fair and Reasonable?

- **The Examiner's conclusion that valuations were unreasonable for solvency analysis does not necessarily mean that individuals acted with sufficient scienter to support claims for breach of fiduciary duty.**
- **Thus, the Examiner did not find sufficient credible evidence to support colorable claims concerning valuations.**

Lessons Learned

- **The economic crisis in 2007 and 2008 created the “perfect storm” for real estate devaluation and illiquidity.**
- **Limited market data that resulted gave rise to theoretical valuation methods that could not be verified.**

Lessons Learned

- **Determining the fair value of any asset, especially illiquid assets, requires the party performing the valuation to exercise judgment as to a variety of criteria that a potential purchaser would consider, especially in light of the inherent risk.**

Lessons Learned

- These criteria are reflected in the two components of the “mark-to-market” valuation process: “marking to credit” and “marking to yield.”
- Marking to credit refers to recognition of changes in the amount and/or timing of the future expected cash flows from the properties underlying positions (the “collateral”).

Lessons Learned

- **Marking to yield takes into account changes in broader market conditions affecting the value of an asset even if the circumstances of the asset itself have not changed.**
- **Failure to consider both components generally results in an unreasonable valuation.**

Contact

**William C. Harvey, II, CCIM, MAI
President**

**William C. Harvey & Associates, Inc.
1146-H Walker Rd.**

Great Falls, VA 22066-1838

Tel (703) 759-6644, ext. 108

Email wcha@verizon.net

Web site www.wchainc.com