GATOR CAPITAL MANAGEMENT

Overlooked by the Market:
Goldman Sachs's New CEO as a Catalyst to Unlock Value

David Solomon became Goldman's CEO in October of 2018. We have read several articles about his disc jockeying at night clubs.[1] These articles make for fun reading especially since this unusual hobby seems so out-of-character for an executive at a company like Goldman. However, none of these articles focus on the opportunity Solomon has to reshape the firm away from the capital-intensive institutional trading Fixed Income, Currency & Commodities ("FICC") business unit and whether Solomon will act on this opportunity. Based on his public comments since taking on the role of CEO, we believe Solomon will be a catalyst to unlock value in Goldman's stock by shrinking FICC and expanding investment banking and wealth management. Given that Goldman's stock trades at tangible book value per share ("TBVPS" or "tangible book value"), we do not think this view is widely held by other investors.

With the stock trading at tangible book value and an 8x Price-to-Earnings ratio ("P/E"), we believe Goldman presents an interesting turnaround story that we don't hear other investors discussing. The company has the premiere investment banking franchise. New CEO Solomon is in the early stages of a significant restructuring, is open to new ideas, and seems willing to change the current business structure to improve returns. Additionally, he has started comprehensive "front-to-back" reviews of each business to improve returns through both revenue opportunities and cost-cutting. He has an opportunity to expand the investment banking franchise by leveraging the Goldman brand to cover clients who had not previously been serviced by a Goldman banker and to introduce new products into the existing client base.

Goldman's stock has lagged peers over the last few years. Since December 2016, Goldman's stock has declined 15.71% while the S&P 500 Index is up 33.60%. During this same time, JP Morgan Chase's stock has slightly outperformed the S&P 500 Index. We think Goldman's long-term underperformance has been due to mediocre results in its FICC business unit.

FICC DRAGS DOWN GOLDMAN'S RETURN

Why has the FICC business unit underperformed? We believe there are several reasons:

- The market opportunity in FICC has declined over the past 10 years. Low interest rates and an active presence by global central banks in the bond market has reduced fixed income volatility. Potential revenue from making markets in fixed income has declined as bond trading has moved to electronic venues. Finally, the Volcker Rule has reduced the ability of commercial banks to take risks in their trading operations.

- Prior management at Goldman mistook a secular decline in the fixed income trading for a cyclical decline. This prevented them from taking more serious strategic actions to reduce the capital allocated to the FICC businesses and to reduce the expense base.

- Goldman has had a variety of business strategies within the FICC business. Some of these strategies, such as making markets in bonds, did not require much capital and historically produced high returns on equity ("ROE"). Other strategies, such as long-term physical commodity delivery contracts, require an enormous amount of capital and produce low a ROE. When looking at the business as a whole 10 years ago, the mix of high ROE

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[1] https://www.nytimes.com/2017/07/13/business/dealbook/goldman-sachs-david-solomon-dj-d-sol.html

opportunities and low ROE opportunities produced an overall ROE that was respectable. Over the past 10 years, the high ROE opportunities have been shrunk due to competition, low fixed income volatility, and technological change, but the low-ROE opportunities have been long duration and remained on Goldman's balance sheet.

With a little work, we can see how low the return Goldman earns from its FICC business and how much capital Goldman has invested in the business. From Goldman's 2018 10-K, the company discloses the pre-tax income from each business segment and the amount of assets devoted to each business. We can use this information to estimate a ROE for each business segment. But, first, we have to estimate the amount of capital Goldman allocates to each business segment based on the assets it assigns to each unit. We made the following assumptions to estimate the amount of capital allocated to each business: 1) in Investment Banking, we assumed the business segment is only levered 2.4x because this is the amount of leverage that investment banking advisory boutique Moelis and Company uses, 2) in Institutional Client Services, we assume the assets are levered 16x, 3) in Investing & Lending, we assume the equity investments are not leveraged and the debt investments are leveraged 16x, and 4) in Investment Management, we assume the assets are leveraged 16x because they are mainly loans to private wealth clients.

	2018 Pre-tax Net Income[2]	2018 Assets[2]	2018 Capital[3]	2018 ROE[4]
Investment Banking	3,516	1,748	728	401%
Institutional Clients Services	3,131	656,920	41,058	6%
Investing & Lending	4,211	259,104	36,285	10%
Investment Management	1,755	14,024	877	166%

As you can see in the table, Goldman earns only 6% in the Institutional Clients Services, which is composed of FICC and Equities. Yet, Goldman devotes over 50% of all of its capital to this low return segment. We think Goldman should shrink this segment as fast as practically possible and use the capital to repurchase shares at tangible book value.

NEW CEO IS A CATALYST FOR CHANGE

Our analysis of the last half-dozen transcripts of conference presentations and earnings conference calls reveals the areas where Goldman executives have said they are going to make changes. Management has stressed that the review is ongoing, and a more detailed strategy will be released by Q1 of 2020. All of their disclosed changes are consistent with expanding the client footprint or operating more efficiently.

[2]From Goldman Sachs 2018 10-K https://www.sec.gov/Archives/edgar/data/886982/000119312519050198/d669877d10k.htm
[3]Gator Capital Management calculation using assumptions above.
[4]Assumes 17% corporate tax rate across all business units.

Here is a list of the main initiatives that we've heard Goldman executives mention in public forums over the last 6 months:

1. INCREASE INVESTMENT BANKING CLIENT COVERAGE

Goldman plans to hire 100 additional investment bankers to cover an additional 1,700 corporate clients. Most of these companies will have enterprise values below $2 billion. Goldman has a 10% market share on companies with enterprise values greater than $2 billion, but only a 6% market share on smaller companies. Historically, Goldman has not focused on smaller companies because the fee size was perceived as too small. This change to hire more investment bankers, so they can focus on smaller clients, seems promising.

2. BRING "ONE GOLDMAN SACHS" TO CLIENTS

Goldman has started a test effort to bring one point of contact to its top 30 clients. With a culture of strong risk management and an increased compliance burden, clients are finding it difficult to do business with Goldman. Clients have given Goldman this feedback. An example of this difficulty in doing business is reports of Goldman attorneys pushing for unreasonably strong contract language. This focus on top clients is aimed at keeping these lucrative clients happy and meeting their needs. One side benefit is the effort is leading to additional revenue.

3. REDUCE CAPITAL INTENSITY IN INSTITUTIONAL CLIENT SERVICES SEGMENT

The Institutional Client Services segment houses Goldman's FICC and Equities businesses. Goldman's FICC business has the largest drag on its returns. We estimate the Institutional Securities business at Goldman only has a 6% ROE, but it accounts for 52% of the company's capital. We believe a major reason for this is some long-term positions that are capital intensive but low-return. These are long-term derivative trades that Goldman must hold to maturity but will earn low returns in the meantime. Solomon has an opportunity to take a fresh approach to staffing and expenses in this division. We believe the market opportunity has declined in this segment for several reasons including lower and less volatile interest rates, trading moving to electronic venues, the Volcker rule, and shifting of industry assets into passive products. We believe Goldman's prior CEO did not address the secular change in this business.

4. INTRODUCE CORPORATE TREASURY MANAGEMENT COMMERCIAL BANKING PRODUCT

Goldman is building a Corporate Treasury Management product to offer to its clients. Goldman believes this lucrative segment of commercial banking has not seen innovation in years, so they are introducing a product that will take advantage of current technology to improve the client experience. By using the new product internally, they believe they will save $100 million annually. Corporations typically use several commercial banks for Treasury management. Goldman believes that they will be able to get their solution added to a fair number of their existing corporate clients.

Internal new product benefits include:

a. Use changes in technology to introduce a better product cash management product;

b. Save $100 million by using the product internally;

c. Increase commercial banking deposits;

d. Increase foreign exchange trading revenue;

e. Additional product for bankers to sell to existing clients; and

f. Create strong ties with existing clients

5. BUILDING THE WEALTH MANAGEMENT BUSINESS

Although Goldman has long had a wealth management business aimed at ultra-high net worth clients, the business has been subscale and they have not shown much interest in expanding the business. Fifteen years ago we asked the then head of GSAM whether he was interested in hiring additional advisors for this business. His response was a flippant, "If you know any $1 billion teams, I'd be interested in talking to them." The message was clear that significant expansion of this business by hiring many medium sized advisors was not desired.

Conversely, we believe Morgan Stanley's stock has outperformed Goldman's due to its significant wealth management franchise. In the three years ending March 31st, Morgan Stanley has a compounded return of 21.8% versus Goldman's 8.4%. However, during this time, both companies have grown TBVPS by about the same 7%. Almost all of the difference in the two companies' stock returns can be explained by the change in price to tangible book value ("PTBV") multiples the market has placed on the two stocks. Morgan Stanley's stock price went from trading at a discount to tangible book value to a premium while Goldman's lost its premium to tangible book value. We think the main driver of this valuation change is investor acceptance of Morgan Stanley's wealth management business as a strong franchise with high returns that is not capital intensive.

We see evidence that Solomon is changing Goldman's view of wealth management within the organization. First, he is expanding Goldman's Ayco franchise. This franchise had provided financial planning services for the top 10-20 executives at Goldman's investment banking clients. Now, they are expanding this service by offering it to the top 200 executives at their investment banking clients. Second, Goldman recently announced the purchase of United Capital, which is a $50 billion assets under management ("AUM") registered investment advisor ("RIA"). We think the wealth management business is a good, non-capital intensive business where Goldman should be able to grow.

6. REDUCE ON-BALANCE SHEET EQUITY INVESTMENTS

Since its IPO, Goldman moved into investing its equity capital in equity investments. Many of these investments have been into their merchant banking/private equity funds. The problem with these investments is they are capital intensive and stock market investors penalize the entire valuation of Goldman's stock by not placing a multiple on these investments. Solomon has stated he wants to monetize existing equity investments on the balance sheet to reduce capital intensity.[5] He also wants to raise third party capital for Goldman's private equity platform to increase fees from this business. Although, based on our experience investing in private equity firms, raising more third party funds will take 10-20 years before we see a materially impact on Goldman's bottom-line.

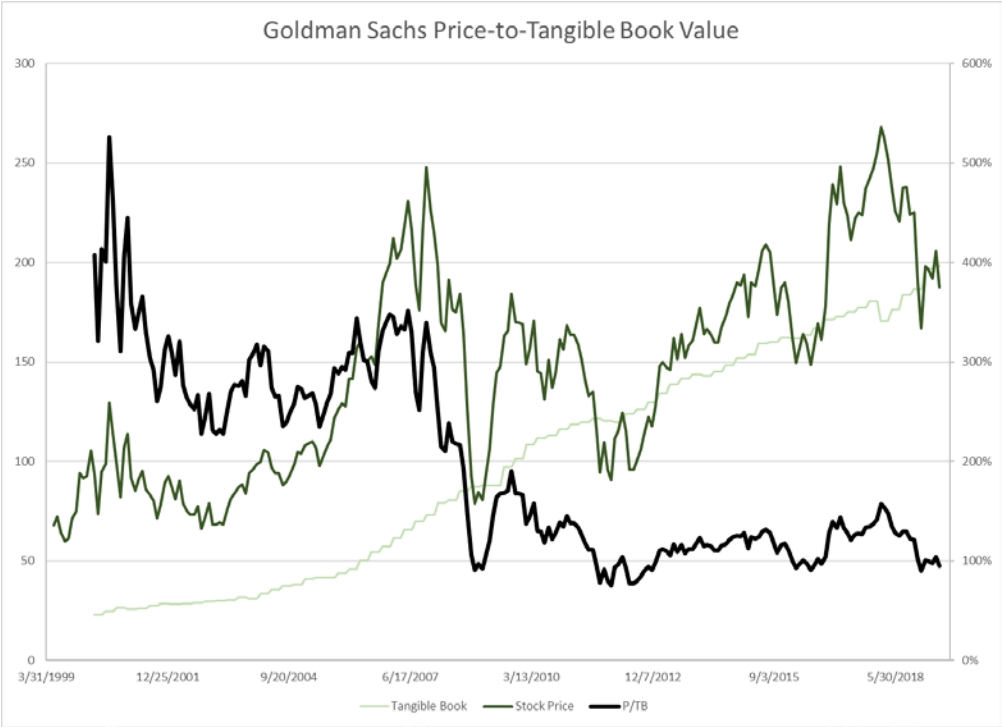
[5]https://www.wsj.com/articles/goldman-sachs-to-combine-private-investing-arms-11560715048

7. REPLACE WHOLESALE FUNDING WITH CONSUMER BANK DEPOSITS

Goldman purchased GE Capital's online consumer bank a few years ago and has raised $35 billion in US-based deposits. For every $10 billion of additional bank deposits raised, Goldman saves $100 million or $0.20 per share in earnings per share ("EPS") by using the deposits to replace high-cost wholesale funding. Over 5 years, we believe Goldman can raise $100 billion of additional consumer deposits, which would improve EPS by $2.

VALUATION

Goldman's stock trades around tangible book value. Here's a chart showing Goldman's PTBV (black line) since the company's IPO in 1999.



Source: Company reports and Bloomberg

The dark green line shows Goldman's stock price. The light green line shows Goldman's tangible book value per share ("TBVPS"). Goldman's stock is trading at the same level it did 12.5 years ago (i.e., the stock is unchanged since November 2006!), but TBVPS has grown over these 12.5 years at 10% annualized. The PTBV multiple has compressed from 350% to 95%. We think there is a relative floor at 100% especially since Goldman's new CEO is focused on improving returns. With these coming changes, we think Goldman's stock can recover a modest premium to tangible book value. With continued growth in book value and a modest expansion in the multiple, we think Goldman's stock has attractive potential return going forward.

RISKS

1. 1MDB MATTER

Goldman has a well-publicized, pending legal matter. The Malaysian sovereign wealth fund ("1MDB") was defrauded of $7 billion when a con man caused 1MDB to issue bonds, but the con man received the proceeds. Goldman was the underwriter on the bonds. Goldman has reserved $1 billion for the matter, but 1MDB is asking for $7 billion. The potential $6 billion of legal exposure is worth between $12 and $15 per share to Goldman depending on whether a settlement will be tax deductible. While this will be a painful hit to tangible book value, this is a one-time matter and management may be able to settle the matter for a lower amount.

2. INVESTOR DISINTEREST DUE TO TIMING

We don't see much interest among other investors in the capital markets firms like Goldman due to the length of the current bull market and the sentiment about the economic environment. While the idea may not seem timely, we believe that Goldman will achieve a premium to tangible book value over the next 24 to 36 months. As this premium is priced in, we believe investors will earn excess returns by owning Goldman's stock. If Goldman's stock does not regain a premium to tangible book value, investors will still earn an attractive return based on book value and earnings growth.

3. ENTRY INTO CONSUMER LENDING

We have heard from several portfolio manager peers that they don't like Goldman's entry into consumer lending via Marcus. We agree. If we wanted to own a consumer lender, we could buy shares in pure play consumer lenders like Discover Financial or Capital One and pay the same 8x P/E that we pay for to purchase Goldman. Plus, both these companies have 30+ years of institutional experience in the consumer lending space. With Goldman, we get an inexperienced consumer lender full of big egos who think they can figure things out better than others. It seems like a recipe for disaster. However, we are able to overcome this issue and still buy Goldman's stock because the consumer lending portfolio is only $4 billion and is less than 1% of its balance sheet.

A reasonable question that our peers ask us when discussing our investment thesis on Goldman is, "Goldman executives have been consistent in their message about making changes to the business, why hasn't the stock reacted?" We believe there are three issues here:

- The amount of time that it is going to take to implement all of these changes and see results is 2 to 5 years, with the average institutional portfolio manager asking, "Why bother if we don't get paid this year?";
- While Goldman executives have repeated the restructuring story on quarterly earnings conference calls and at investment conference presentations, they have not quantified the potential financial benefit of the restructuring; and
- The Goldman executives have given themselves a long timeframe to update the market on the whole scope of the restructuring. Here's the quote from the Q1 Earnings Conference Call:

> "Today we discuss the initial takeaways from our front-to-back reviews, which will continue. Next, over the coming quarters, and on the basis of our work, we expect to define publicly the performance targets to which we will hold ourselves accountable. As we move toward the back half of the year, we will pursue opportunities for improved disclosure to align with any changes in our business or organizational structure. Lastly, we expect to provide a more comprehensive strategic update through the lens of any enhanced disclosure by the first quarter of next year."[6]

With investor's not giving Goldman's stock credit for the restructuring, we see an opportunity to build a position and wait for the company's results to reflect the benefits of the restructuring. We think with a few positive quarters and more transparency around the restructuring program, investors will begin to appreciate that CEO Solomon is acting as a catalyst for unlocking value.

In the short-term, Goldman's stock is going to trade with the market and on every Presidential tweet about tariffs. Over the longer-term, the market will recognize the coming improvements in efficiency and capital allocation. We expect Goldman to regain a premium to its tangible book value that its investment banking franchise deserves.

[6]https://seekingalpha.com/article/4254571-goldman-sachs-group-inc-gs-ceo-david-solomon-q1-2019-results-earnings-call-transcript?page=5