Goldman Sachs (GS)

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Full Steam Ahead – Upgrading To Buy

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- **Upgrading GS to Buy.** The rating revision is reflective of five factors. Our revised price target is $210 or 1.8x estimated Q4 book value of $116. We are also raising our 2009 and 2010 EPS estimates to $18.06 and $18.47 from $17.45 and $17.16, previously. Our Q3'09 est. is unchanged at $3.37.

- **FICC Still Looks Solid**. A growing debt market (due to corporates and governments), the likeliness of increasing volatility soon (when rates begin to rise) and a lack of competition continue to make FICC a solid story. We estimate that GS's FICC realization rate (fixed income revenues as a percentage of average debt trading inventory) is trending at 2.2%, its highest level in at least 3 years. Accordingly, flow trading revenues are currently ample to generate meaningful returns. This is in sharp contrast to trends in 2007 and the first part of 2008. In addition, positive disintermediation trends also support growth in European debt capital markets.

- **Banking Backlogs Imply Post Labor Day Activity.** The industry M&A backlog is up 6% since the end of 2008 and the IPO backlog is up 13% from the end of Q2'09. GS's backlogs are up 20% and 32%, respectively. Steady improvements in both the equity and debt market throughout the year and into the summer will likely provide the needed confidence post-summer.

- **Hedge Fund Business Is Stabilizing.** Mgmt noted on the Q2'09 conference call that the prime brokerage business is improving as they believe the bulk of redemptions have occurred. This is consistent with industry trends we have seen, which saw both net outflow and liquidations decrease materially in Q2'09.

- **Compensation "Complaining" May Drive Material Returns In Q4**. Political pressure around compensation may force GS to pay lower than normal levels. GS typically accrues compensation at a 48-49% rate through the first three quarters of the year. The Q4 compensation ratio is usually 25-30% below the average for the first three quarters. Given political pressure, we believe the Q4 rate has the potential to be 40-50% lower this year. As a result, upside potential in Q4 could be substantial. Currently, the Q4 consensus is $4.33; we are est. $6.37 with a comp rate of 28%.

- **Valuation Could Move Higher**. Current ROE and ROA levels of 20% and 120bps are historically more consistent with GS multiples in the 2x range. Given our constructive outlook on asset returns, we believe multiple expansion is very probable. At 1.8x our estimated Q4 book value est., we believe a $210 price target is reasonable implying 34% upside from current levels.

GS: BUY [was Neutral]

Price $157.25
Target: $210

52 Week Range:	**$172.45 - $47.41**
Market Cap. (mm):	**$83,194**
Avg. Daily Volume (100 day):	**16,740,677**

FY (Dec)	2008	2009	2010
Q1	$3.23 A	$3.39 A	$4.60 E
Q2	$4.58 A	$4.93 A	$4.25 E
Q3	$1.81 A	$3.37 E	$3.23 E
Q4	($4.97) A	$6.37 E	$6.39 E
FY	$4.47 A	$18.06 E	$18.47 E
P/E	NM	8.7x	8.5x
P/BV	NM	1.48x	NM
Prior FY	NM	$17.45	$17.16
Consensus FY	NM	$15.65	$16.19
Revenues ($mm)	$22,222	$43,031	$43,634

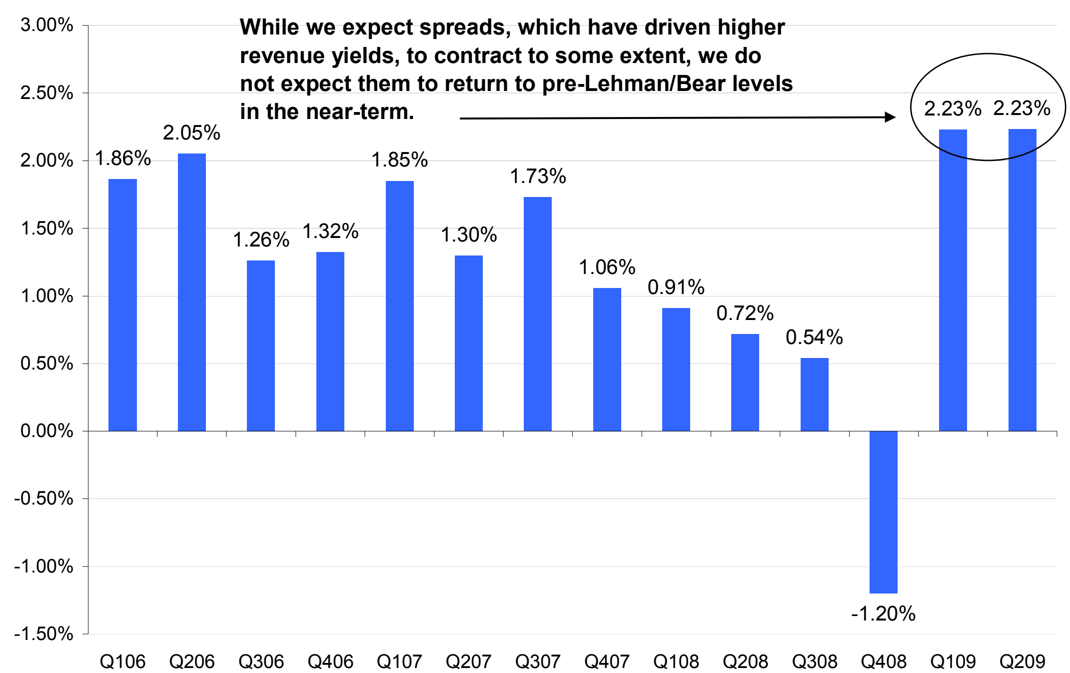
Source: Pali Research Estimates and Company Documents
Note: P/BV is based on reported BV

Please Read: Important disclosures and analyst's certification appear in Appendix

Upgrading GS To BUY. We are upgrading shares of GS to BUY from Neutral for five reasons. First, FICC, while not expected to outperform 1H'09 results, should remain strong though the seasonally slow second half. Second, it appears as though redemptions for hedge funds have stabilized; this should bode well for GS's prime brokerage business, especially in light of reduced competition. Third, both the M&A and IPO backlog have shown signs of improvement; we are further encouraged by indications that the macro backdrop for both M&A and equity issuance has improved as well. Fourth, we expect that GS will have a significantly lower comp rate in Q4. Finally, GS currently trades at 1.4x our Q4'09 book value estimate. Based on historical valuation and both current and forecasted profitability ratios (ROE & ROA), we believe that shares should trade at 1.8x our Q4'09 book value estimate or $210.

We Expect FICC Strength To Continue. 1H'09 results were largely driven by record FICC results. While we expect revenues to decline in the seasonally slow third and fourth quarters, activity and spreads continue to be relatively favorable. As we demonstrate below, in the first half of 2009, revenue as a percent of average long FICC inventory, which we believe offers a rough gauge for spreads across the FICC business, retuned to levels not seen since at least 2005 (likely longer). GS's higher return (revenue not income) on FICC related assets suggest that the capacity that has come out of the industry in recent quarters is translating into greater pricing power. While we would not expect spreads to remain at recent historically high levels, we do not see them reverting to pre-Bear/Lehman levels either. Accordingly, flow trading revenues are currently ample to generate meaningful returns, in our view.

Exhibit 1: Revenue Yields On FICC-related Inventory Rebounded In 1H'09

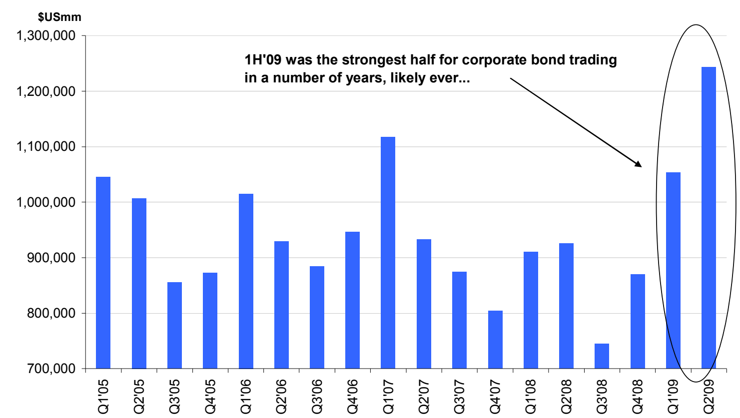


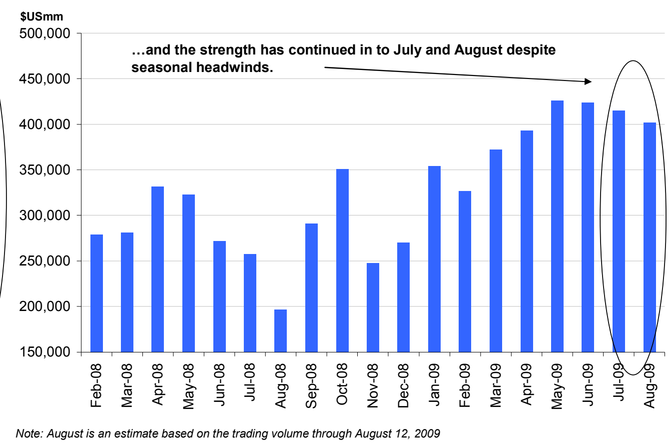
Note: Revenue yield is calculated as FICC revenue divided by estimated average FICC related long inventory
Note: FICC-related inventory includes US Govt, Agency Sovereign and Corporate Debt, Derivatives and Physical Commodities

Source: Company data and Pali Research estimates

We expect that corporate bond trading activity will continue to be strong. According to FINRA Trace data, corporate bond dollar volumes in July were down only 2% from June and 3% from May (includes high grade, high yield and converts). We note that May was the strongest month since at least 2005 (likely much longer) and that June was the second strongest month. Although we are only half way through August, trends have been resilient. Dollar trading volume has averaged $19bn per day in August, in-line with July activity and slightly below the June average of $21bn per day

Exhibit 2: Strong Corporate Bond Dollar Volume Trends Appear Poised To Continue

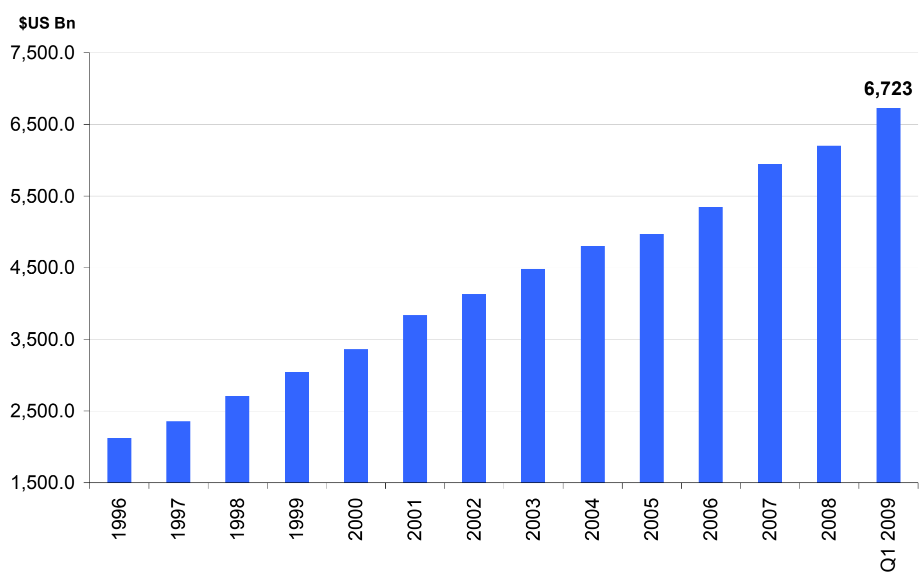




Source: FINRA TRACE, Bloomberg and Pali Research estimates

We expect this trend to continue, as the corporate bond market overall appears poised for further growth. As we note below the corporate bond market has more than doubled from $3.3T in 2000 to $6.7T at the end of March 31, 2009. At the same time, the reduction in capacity with the bankruptcy of Lehman and the absorption of Bear Stearns by JPM should continue to be favorable.

Exhibit 3: Corporate Bonds Outstanding



Source: SIFMA

As indicated by Fed Funds futures, the Fed appears poised to raise rates over the next few qtrs; Bloomberg consensus estimates predict that rates will increase to 50bps by Q2'10. We would expect GS's rates business to benefit from client repositioning as rates move higher. As we note below, CME open interest trends, which we view as a good gauge for future trading activity, have shown improvement, particularly in equities and interest rates. As of August 12, 2009, open interest for interest rates is up 6.4% vs. July 31, 2009 and 13% since the end of Q2'09. In addition, we would also expect the Treasury's relatively large issuance calendar to bode well for GS's rates business.

Exhibit 4: CME Open Interest Trends

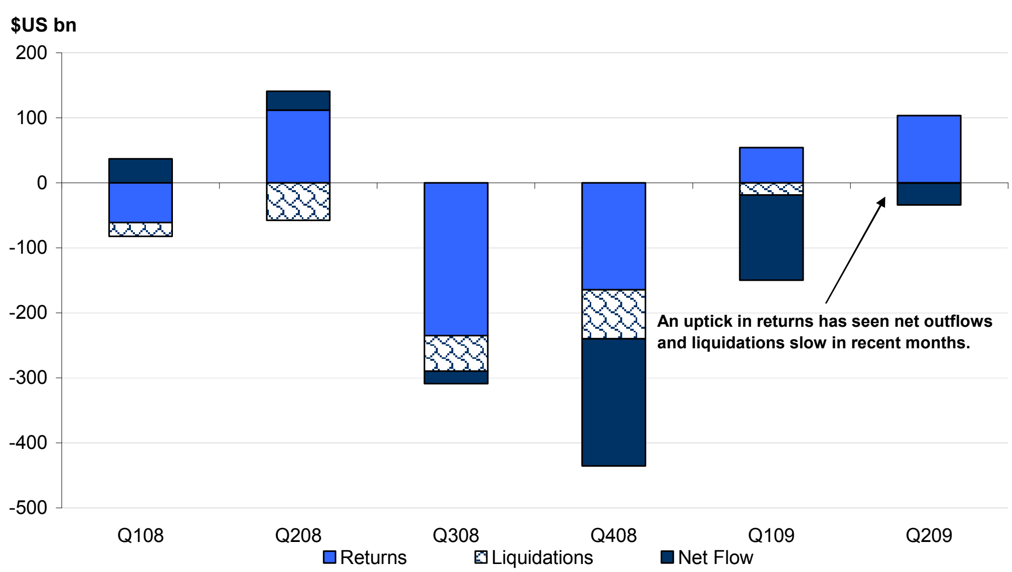
Number of Contracts

	Dec-08	Jan-09	Feb-09	Mar-09	Apr-09	May-09	Jun-09	Jul-09	8/12/2009	% chg. Vs. Jun'09	% chg. Vs. Jul'09
CME Comm & Alt Invst	4,628,237	5,040,448	4,258,472	4,921,647	4,645,970	5,549,584	5,098,644	5,347,662	5,475,400	7.4%	2.4%
CME Equities	4,502,824	5,266,562	6,010,078	4,834,501	5,056,904	5,235,997	4,284,079	4,695,544	5,172,441	20.7%	10.2%
CME Foreign Exchange	762,486	930,585	1,046,909	876,658	923,683	1,074,414	924,324	1,015,505	993,084	7.4%	(2.2%)
CME Interest Rates	**26,138,135**	**29,105,739**	**30,134,636**	**25,799,918**	**27,879,895**	**29,125,103**	**27,367,846**	**29,054,502**	**30,924,999**	**13.0%**	**6.4%**
Total:	36,031,682	40,343,334	41,450,095	36,432,724	38,506,452	40,985,098	37,674,893	40,113,213	42,565,924	13.0%	6.1%

Source: CME Filings

Hedge Fund Business Is Stabilizing. Management noted on the Q2'09 conference call that the prime brokerage business is improving as they believe the bulk of redemptions have occurred. This is consistent with industry trends we have seen, which saw both net outflow and liquidations decrease materially in Q2. Recent market performance and flow trends suggest that Q3 will prove to be a continuation of these trends. We think that GS is positioned to benefit from capacity shrinkage, future rate increases and stabilization in balances.

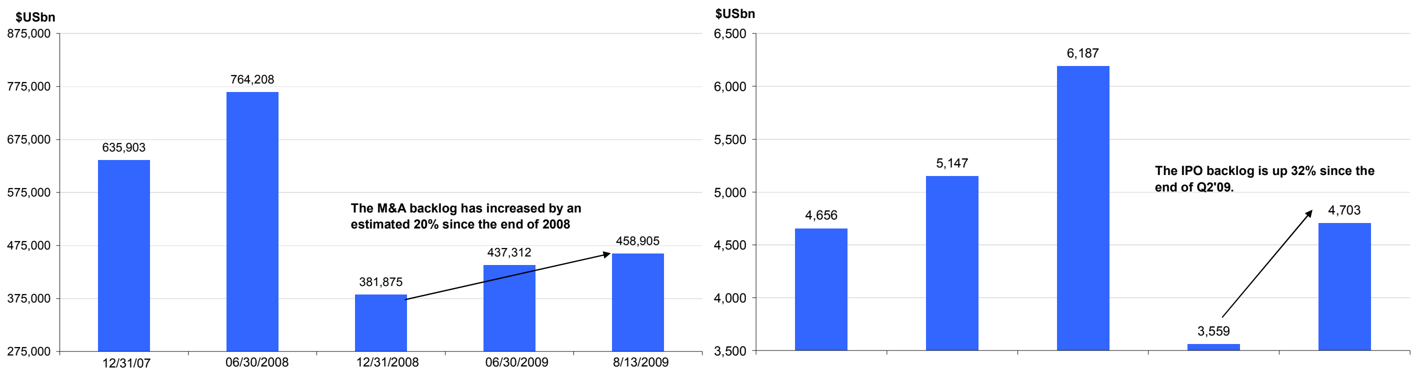
Exhibit 5: Breakdown Of Change In Hedge Fund AUM



Source: Barclays

M&A And IPO Backlogs Are Rebounding. M&A and IPO backlogs have rebounded from the lows seen in Q1'09. GS's M&A backlog is now 20% higher than where it ended 2008 while the IPO backlog has increased 32% since the end of Q1'09. Coupled with a contraction in debt spreads, what appears to be a stabilizing equity market and an improvement in CEO confidence, we suspect that GS may be able to begin monetizing the improved backlog.

Exhibit 6: GS M&A and IPO Backlog

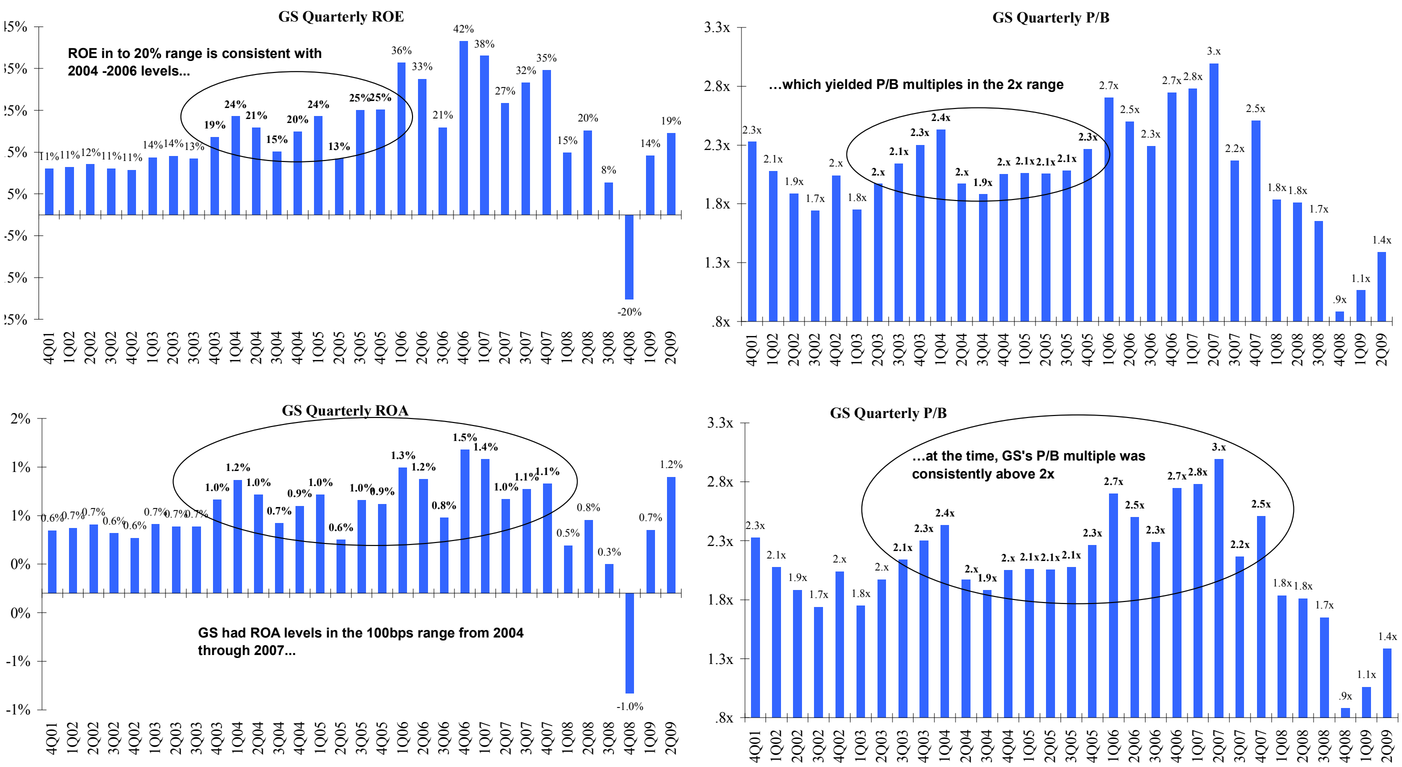


Source: Thomson One

Compensation "Complaining" May Drive Material Returns In Q4. Political pressure around compensation may force GS to pay lower than normal levels. GS typically accrues compensation at a 48-49% rate through the first three quarters of the year. In Q4, management then finalizes compensation levels and adjusts the fourth quarter rate accordingly. The Q4 compensation ratio is usually 25-30% below the average for the first three quarters. Given political pressure, we believe the Q4 rate has the potential to be 40-50% lower this year. As a result, upside potential in Q4 could be substantial. Currently, the Q4 consensus is $4.33; we are estimating $6.37 given newfound compensation considerations. Our comp. ratio is 28% in Q4'09.

Historical Valuation Trends Support A Better Multiple. We think shares are fairly valued at 1.8x our Q4'09 book value estimate of $117. GS had an annualized ROE of 19.46% and ROA of 120bps in Q2'09. Our ROE and ROA estimates average 17% and 113bps over the next four quarters. The last time GS had profitability metrics in that range, shares traded well above 2.0x reported book value.

Exhibit 7: GS Profitability Ratios Vs. Price To Book Value Multiple



Source: Company data, FactSet and Pali Research estimates

Appendix: Important regulatory disclosures on subject companies

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I, Douglas Sipkin, in my role as Research Analyst, hereby certify that the views about the companies and their securities discussed in this report are accurately expressed and that I have not received and will not receive direct or indirect compensation in exchange for expressing specific recommendations or views in this report.

I, Warren Gardiner, in my role as Research Analyst, hereby certify that the views about the companies and their securities discussed in this report are accurately expressed and that I have not received and will not receive direct or indirect compensation in exchange for expressing specific recommendations or views in this report.

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BUY – A stock that is expected at initiation to produce a positive total return of 15% or greater over the 12 months following the initial recommendation. The BUY rating may be maintained following initiation as long as it is deemed appropriate, notwithstanding price fluctuations that would cause the target to fall outside of the 15% return.

SELL – A stock that is expected at initiation to produce a negative total return of 15% or greater over the next 12 months following the initial recommendation. The SELL rating may be maintained following initiation as long as it is deemed appropriate, notwithstanding price fluctuations that would cause the target to fall outside of the 15% return.

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Valuation

We assign Goldman Sachs a Buy rating. Our target price is $210 or 1.8x our Q4'09 book value estimate of $116.

Risks

1. **Goldman is reliant on strong global growth.** The bulk of Goldman's businesses are tied to a healthy economic environment. Prolonged economic weakness will weigh on the business regardless of execution.

2. **Regulatory Environment Could Curtail Profitability.** Regulation surrounding OTC instruments could potentially weigh on profitability if enacted.

3. **Long-term debt markets remain expensive**. Long-term debt market spreads make it challenging to raise money.

4. **Less predictable derivative markets make it harder to take prudent risks and generate profits.** The derivative market has become less reliable due to de-leveraging and a contraction of capital. Derivatives have served banks well in that they are vehicles used to hedge risk. Less reliable derivative markets have made it harder to take risk and generate capital. We suspect the role of derivatives as a hedging vehicle will be scaled for a long period of time.

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