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The Goldman Guide

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Key Takeaways

- ⇒ Financials may drive the market
- The industry has gone through hell and so have investors
- Recent transaction may portend return to growth
- ⇒ M&A target could be a 30% gainer

Financial Future is Bright

Tomorrow, Americans (who have not already) will cast their ballots for the next President of the United States of America. These votes, in hindsight, will either be good decisions or bad decisions, depending upon future circumstances and the interpretations and analysis associated with policies, successes, and failures.

As a self-described right wing nut job, my choice is clear, despite my lack of enthusiasm on the subject.

Regardless of who wins, this country has a lot of challenges ahead. I am not smart enough to propose any answers with any meat, nor do you really care for me to spout off rhetoric and ideas. Still, the winner of the election will have an impact on the stock market.

One segment of the market rarely profiled in these pages is the financial services sector. Truth be told, there isn't a lot to get excited about in this space for investors seeking near term high growth potential. Nonetheless, today we are profiling one stock that is a surefire M&A candidate that is a penny stock, despite its large revenue base.

Before we describe the situation, it is imperative that we highlight the lay of the land and recent activity.

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Financial Future is Bright (cont'd)

We have mentioned often about how the low volume in the stock market has impacted stocks. What we haven't mentioned is how the low volume has affected investment firms. In order to provide a quick analysis, let us look at a little bit of history.

In the mid-1990's, with the repeal of the Glass-Steagal Act (under the Clinton Administration), banks went on a spending spree and began buying up investment banks and investment management companies. This also led to mergers among equals. Volumes leapt higher, the Internet bubble and the early parts of the housing bubble was formed, and people in the business made tons of money, as did investors.

The most aggressive firms, particularly in tech and health care equity investment banking and M&A, had the greatest success while the more conservative firms did ok. Ditto for the largest firms, for the most part.

Then came the first of the triple whammys. The market peaked in 2000 and the companies began to lose some steam. Next came 9/11 and with it came the shuttering of venerable names and lower stock prices and volumes. This was followed by the war in Iraq and another rally in housing and stocks together. Then we endured the subsequent housing bubble, triggered at the same time by the collapse of Bear Stearns, where the industry got hammered once again.

This is where it gets interesting. Although a number of firms were gutted and hurt, somehow, what goes down must come up and in 2010 that is what happened. Volumes picked up, as did interest, activity, etc. (We are simplifying this history, of course.)

Today, the larger firms are de-leveraging their assets (divisions and units), and continuously reducing headcount. The small stock market, which really began to take it on the chin 10 years ago, has been whipsawed in the past 2 years, and the past year especially, as investment funds have disappeared and the associated risks have ruled as a deterrent.

Risk is not assumed by large investors and the small investor has no funds for risky ventures. So small business, on which the country's economy is largely based, has suffered, as have the stocks.

You know this. This is not new news. It is hard to make money in this business.

Nonetheless, I believe that we may be reaching an inflection point.

In the late 1990's, growth stock investment banks flourished. In the past year, key names have closed up shop (Rodman, ThinkEquity). The largest firms (UBS, Morgan Stanley, HSBC) have become smaller. Hedge funds are no longer the return-making entities they once were. It is a whole new ballgame.

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<u>Index</u>	Close	YTD
DJIA	13093	7.1%
S&P 500	1414	12.2%
NASDAQ	2982	14.6%
Russell 2K	814	9.6%

(figures are rounded)



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Future, cont'd....An M&A Candidate

The entire financial services industry, which is supposed to be stodgy, and unchanging has been transformed several times in less than 20 years. Right now, institutional investors are less than sanguine regarding their prospects. From an investment perspective, the S&P 500 Index typically had financial services accounting for more than 20% of the composite, on a sector basis. When financials do we well, so does the market.

The rally we have enjoyed has not be broad-based and a lot of things do not make sense. We have proffered that cyclically, we should do well for the balance of the year and possibly next year. If financials turn, that will help.

Case in point. Stifel Financial (NYSE –SF) a formerly sleep firm in St. Louis of a middle market size and no real national reach, has been on an M&A spree. It has acquired small firms, brokers, bankers, etc., the past several years, taking advantage of the current market. It has acquired Legg Mason's institutional business, Ryan Beck's small regional retail force, Thomas Weisel's bankers, and is now buying Keefe Bruyette & Woods (NYSE—KBW). KBW is arguably the most well-regarded investment bank and research firm focused on the financial services market.

This small deal (\$575M) could well portend a return to greater activity in the space which bodes well for the market in general. So far, Stifel, a name you are probably not familiar with, has made the right moves. Unlike cutbacks, and headcount reductions, this is a positive for the space. We think we will see more, and see small bank M&A flourish in 2013.

As for our little teaser...Gleacher (NASDAQ—GLCH—\$0.70), an investment bank with a great deal of expertise in credit market, including mortgages, recently announced it is "seeking strategic alternatives", which basically means it put itself up for sale. Stifel was rumored to be the buyer. The Company generates over \$200M in revenue and has a market cap of around \$80M. The stock is near its year-low and is down now that Stifel has made another purchase and the Street may think it is less attractive.

Still, it appears that there are other suitors for the Company, including a rumor that my old shop, Piper Jaffray (NYSE –PJC) has an interest. A buyer would instantly have a major presence in an area that while our of favor now, could be lucrative a year from now. We would buy it on dips as we believe that it could be sold for a nice 30% premium by year-end.

Until next week...

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