Goldman SMALL CAP RESEARCH

The Goldman Guide

VOLUME 4 | ISSUE 15 | AUGUST 18, 2013

INSIDE THIS ISSUE:

KEY TAKEAWAYS

- ⇒ *Stocks off 3.7% in past 10 days, just like 3.7% drop in June*
- ⇒ *Monetary easing to taper and so-so earnings are drag on stocks*
- ⇒ *We need a correction which is a good thing...ignore the panic*
- ⇒ *Valuations are too high relative to historical multiples and EPS growth*
- ⇒ *Buy these tortoise stocks, small cap undervalued boring stocks that investors will migrate into, looking for value*

KEY STATISTICS

Index	Close	2013
DJIA	15081	15.1%
S&P 500	1656	16.1%
NASDAQ	3603	19.3%
Russell 2K	1024	20.6%

(figures are rounded)

Screw the Pundits

The past two weeks have made me want to just flat out exit the investment business altogether. I can almost guarantee that if you listen to the talking heads and major columnists and pundits, they will set you on a road to financial ruin. This is not to say that we have a monopoly on information and opinions. But, cooler heads have prevailed in these pages whereas ridiculous prognostications and the absence of any logic have replaced true investment advice all in the name of web traffic. Allow me to explain.

During the month of June we noted that with word of monetary easing in the U.S. would be reduced, the stock market took a dive. In fact, it dropped by 3.7% in 2 weeks, mid-month and at one point was down over 6% from its year-high, achieved just 3 weeks earlier. Everyone was in a panic. We pointed out that we felt the market was on its way to a correction (10% from peak or more) and that earnings were also at risk, along with poor economic numbers, so that the next few months could be rocky at best.

Lo, and behold, July was kick-ass and we were wrong. Why? Magically the same people that said the end of the world was here retracted and believed that the monetary tapering was further out and would not have as much of an impact. We ourselves got lulled into believing that we had been premature in our call and that the market would go incrementally higher.

We should have stuck to our guns instead of giving a mea culpa. Still, we maintained a cautious stance because of what is exactly happening right now.

Since the market high on Aug 5th (our most recent alarm bell) stocks have dropped 3.7% in 10 days on monetary easing concerns, poorer economic figures and less than so-so earnings reports. Deja vu? So in hindsight , the 5 week rally was a false one, as we had feared, driven by bond flights and over-exuberance. Nothing has really changed aside from the fact that earnings season is over. So, the same people that strongly supported the rally are claiming we are headed for a 1987-style crash, which has exacerbated an already delicate situation.

Folks, these big declines are normal and have been on low volume. So it is ok.

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Valuations Too High

The drop in seasonal trading volume in conjunction with the market drop is good news indeed, This is not like 2 years ago when the U.S. credit rating was reduced and panic ensued. Volume was huge then and we did not recover for months as even more pain set in.

We need the market to retreat in order to right itself. We have been spouting on/off for months that P/E valuations were potentially out of whack as we were at the high historical heights yet we are counting on a big move in 2H13 to justify the valuation. If that fails to occur, it's "Bad News Bulls". To that end, Barron's cover story now preaches what we have been saying for 2 months, and that as profit estimates are too high, which has been evidenced by Company comments and guidance over the course of this 2Q13 earnings season. Expect that to have a material impact—-without spreading panic.

Given the current situation, we probably need to correct at least another 6-7% to normalize the valuations. This will mean more pain for a few months. The good news is that we do not think the drops will be too terribly dramatic and that as companies and the market get their bearings, we will have a repeat performance at year-end, just as in 2012.

I hate to say it, but the numbers just bear it out. These multiple are at the high end of the range but EPS growth is not. Hence, the problem. Here is a graph from the most recent edition of *The Wall Street Journal.*

Friday, August 16, 2013

	P/E RATIO			DIV YIELD			
	8/16/2013†	Year ago†	Estimate^	8/16/2013†	Year ago†		
Russell 2000	47.70	31.47	18.67	1.67	1.57		
Nasdaq 100	20.14	11.90	16.81	1.50	1.08		
S&P 500	18.17	16.13	15.05	2.10	2.07		

† Trailing 12 months
^ Forward 12 months from Birinyi Associates; updated weekly on Friday.
P/E data based on as-reported earnings; estimate data based on operating earnings.
Source: Birinyi Associates

So, how do we play it? First, we would recommend buying calls on oil ETFs if there is a drop in price, due to the continued unrest in the Middle East. Although we are producing our on oil more now than we have in decades, expect our foreign policy (or lack thereof) to screw up a good thing. Bear in mind, it is a short term play only. As to equities, do not fear. Much like our ugly duckling stocks which have been unscathed during the downturn, here are 2 boring, undervalued small cap stocks we refer to as tortoise stocks, that will persevere in this environment.

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Buy These Tortoise Stocks

Given the concerns about the market, there is typically a flight to safety into stocks that may rise in response to the fall of the rest of the market. For example, some investors may seek to exit high-flying stocks with outsized valuations in favor of what may be construed as more stable, slow-growth profitable businesses, trading at a reasonable valuation.

Primo Water Corporation (NASDAQ – PRMW - $2.37) provides multi-gallon purified bottled water, self-serve filtered drinking water, and water dispensers in the United States and Canada. The Company's products and services are offered at approximately 24,500 retail locations.

With the sharp decline in soft drinks such as sodas and an increasing shift toward water, including bottled water, Primo is in a great position to enjoy top-line and bottom-line growth. In fact, the Company estimates that consumers average 35 five-gallon bottles of water consumption per year.

Earlier this week, management released 2Q13 results and raised guidance. In response, the stock recently hit a new 52-week high and appears primed to move 30-40% higher. Primo recorded sales of $24.2M and adjusted EBITDA of $2.3M versus $1.3M in 2Q12. The Company increased its full year 2013 adjusted EBITDA guidance, which is now expected to range between $9.3 and $9.5 million or an increase of over 71% from 2012. For the full year, Primo reiterated its net sales guidance at an expected range of $93.3 to $95.2 million. Considering that the stock has a market cap of under $60M, and it is trading around 6x FY13 EBITDA and .5x revenue, there is a lot of room to move higher. We believe PRMW can ultimately trade 10x EBITDA, or 1x revenue, which would take it to nearly $4.00 per share.

Wireless Telecom Group, Inc. (NYSEAMEX – WTT - $1.76). WTT designs and manufactures radio frequency (RF) and microwave-based products for wireless and advanced communications industries and markets its products and services worldwide.

Last week, WTT announced 2Q13 results that were stellar and it appears as if this trend will continue for the balance of the year. Revenue grew 22% from $7.1M to $8.7M while net income jumped 61% from $655,000 to $1.06 million, aided by a $1.1M contract from the FAA. The Company is on track to generate more than $30M in revenue and around $0.15 or so per share in earnings due to margin expansion. On a valuation basis, WTT trades less than 12x EPS and 1.3x revenue for 2013. Moreover, with $0.32 in net cash per share, the real FY13 P/E is less than 10x this year's EPS.

WTT was founded in 1985 and has slowly and methodically grown its business. The stock is trading around 17% below its 52-week high which we believe will be surpassed as the Company continues to perform at a high level on an operating basis. In fact, we believe that the stock can support a multiple of 15x earnings, which would take it to the $2.25 level, a 29% increase, with little downside due to the high net cash per share and already low valuation.

Until next week...

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