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Cadence Bancorp. shares attractive in a transitioning market

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It was late summer 2010 when an executive at Guggenheim Securities Holdings LLC, where I then worked, asked me to meet with a couple of individuals from Sageview Capital LP to talk about bank M&A and Southeast banks. At the time, Sageview had made a sizable capital commitment to Paul Murphy's Community Bancorp LLC (now Cadence Bancorp LLC). Murphy has a great name among bank investors as a money maker, having overseen the growth as a co-founder and eventual sale of Houston-based Amegy Corp. to Zions Bancorp. in 2005 for $1.7 billion. Pricing by precrisis standards was great at about 4.0x tangible book value and 23x core earnings.

I walked out of the meeting thinking Sageview was going to commit a lot of capital to the industry, but my admittedly very limited insight into the game plan led me to conclude it was a fishing expedition. Within a month or so, Starkville, Mississippi-based Cadence Financial Corp. terminated a pending merger with Trustmark Corp. and agreed to be acquired by Community Bancorp in a deal that would pay Cadence shareholders $2.50 per share in cash (about $30 million) compared to Trustmark's deal that entailed about $2.00 per share of Trustmark common stock at the time of announcement.

During the meeting, no one mentioned any interest in Cadence, which I believe had not yet announced its intention to merge with Trustmark. Although it was unusual that Cadence would terminate a merger agreement that was signed a couple of weeks earlier, it made sense from the perspective of the PE investors and Community. Cadence represented a platform acquisition. Both Community Bancorp and Trustmark were proposing to acquire Cadence for a sharp discount to tangible book value (though not so much after application of marks to the loan portfolio and ORE), and the purchase price for the common shares was nominal at around $30 million. The enterprise value was higher, however, including $44 million of TARP preferred that was purchased from the U.S. Department of the Treasury for $38 million (Trustmark proposed $30 million) and the assumption of $30 million of trust preferred securities that were part of Cadence's parent company's capital structure. Trustmark's $2 million termination fee that Community had to pay was a rounding error relative to the opportunity.

Nearly seven years later, Cadence Bancorp priced the IPO on April 12 that I thought would have occurred before energy prices tanked in 2015. I assume bankers took the temperature of potential acquirers to gauge an acquisition value for Cadence to compare it with an IPO value and subsequent future value based upon whatever forecast management developed.

The company raised $150 million in the IPO, before fees, by selling 7.5 million shares for $20.00 per share. Management and private equity shareholders are decidedly in control because Cadence Bancorp LLC, previously Community Bancorp LLC, through which private capital was invested in Cadence, owns 75 million shares. I do not think that will matter to investors. Periodic flotations of shares by the control group should be welcome given the positive implications for liquidity even if a pending offer creates some short-term pressure.

Maybe it is the evolving narrative around how much banks' fortunes have changed since Nov. 8, 2016, but I thought the offering would price above the targeted $19 to $21 range. My back-of-the-envelope calculation for earning power is upwards of $100 million, which equates to about $1.20 per share based upon 83 million post-raise shares. The implied P/E is about 15x, while the price/TBV multiple is around 180% of my March 31 tangible book value rough estimate of about $11 per share. Perhaps investors agree. The shares traded up nearly 8% the first day (it is a bank, not a tech IPO), though I am surprised at how many shares were flipped (5.3 million shares traded) if the underwriters' goal was to place the shares with long-term investors.

First-day performance aside, I think Cadence will prove to be a good stock over time. It represents an interesting combination of a small, regional-bank growth story with a wholesale overlay, in which 37% of the loan portfolio as of year-end represented participations and shared national credits in which Cadence was not the lead bank. National Commerce Corp. meets Comerica Inc. might not be an unreasonable tagline.

Unless I have misjudged earning power, the company does not yet have a premium valuation, but may in time. Growth companies have to feed investors growth to obtain (or maintain) a premium valuation. Although not a pure play on Texas, the company's Texas and Southeast footprint provides a very good backdrop to drive organic growth, and there will be no shortage of would-be sellers who will look to Cadence as a possible acquirer.

Returns can improve, too. The efficiency ratio approximated 60% in 2016, which probably can be improved with more scale and help from rising short-term rates that should push the 3.30% NIM higher. Also, credit costs were elevated in 2016 due to low energy prices. Absent an acquisition, it will take time to leverage the new capital, but the 2016 ROE and ROTCE of 6% and 9%, respectively, should trend higher. I am not sure investors will care so much about top-notch ROE for the time being, as long as revenue growth combined with operating leverage drive EPS growth.

Like any bank, there are always things that can go wrong that will matter. Management will have to avoid overpaying for acquisitions. Unlike the 2011 deals for Cadence Financial Corp. and Superior Bank, M&A today does not offer the tailwinds that existed then of modest pricing and asset quality that was stressed but directionally getting better. Oil prices could dive again (about 13% of the year-end portfolio consisted of energy-related loans). CRE could crash. Russian operatives could hack the core processing system.

But a lot can go right, too. Texas and the Southeast are great banking markets. Comerica moved to Dallas from Detroit for a reason. Banking is about stringing together base hits, or making money by the handful year after year and avoiding bucketful losses in the down years. Management's history has been very good on both counts, although, as always, price paid matters a lot when calculating returns from the investor's perspective.

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