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Growth vs. value in Nashville's pending bank IPOs

By Jeff K. Davis

Nashville is not a huge market, but it is booming. Not surprisingly, area banks here are performing well, exceedingly low interest rates and regulatory burdens notwithstanding. Long awaited S-1s were recently filed for Nashville-based FB Financial Corp and CapStar Financial Holdings Inc. Assuming the IPOs price, they will represent the third and fourth bank IPOs since the first quarter 2015 when Avenue Financial Holdings Inc. and Franklin Financial Network Inc. went public. I do not intend to jinx the underwriters or dismiss their distribution capabilities, but I will be surprised if both IPOs are not well-received by investors.

In the case of FB Financial an IPO has been expected for some time to allow Jim Ayers, the company's sole shareholder, to liquidate some of his investment and to have publicly traded shares to facilitate M&A. Ayers is highly regarded in Tennessee as a philanthropist and money maker among various business ventures, including FB Financial. IPO marketing will be helped in that CEO Chris Holmes and CFO James Gordon are known among bank investors from past stints at other publicly-traded banks.

CapStar's IPO has been expected, too, though the company has also been the subject of periodic speculation as a possible seller or merger-of-equals partner. An IPO or acquisition has been expected because private equity firm Corsair Capital LLC was a sizable investor in the company's initial, and to date only, capital raise, which occurred in 2007. Presumably Corsair will exit some or all of its position. Earlier this year Corsair sold a 7.3 million-share position in United Community Banks Inc. CapStar's Chairman is Dennis Bottorff, whose long banking career includes serving as chairman and CEO of First American National Corporation when it was acquired by AmSouth Bancorporation (now Regions Financial Corp.) in 1999. Not that it matters to IPO pricing, but there are notable lineages. Bottorff at First American was the boss of executives Robert McCabe and Terry Turner, who today are chairman and CEO, respectively, of Pinnacle Financial Partners Inc. Also, CapStar's CEO Claire Tucker previously was an executive with FB Financial's primary banking unit, FirstBank, and before that with First American.

Although both companies are based in Nashville, they have different profiles. CapStar is a pure play on Nashville, where all of its deposits are domiciled. It also has a specialty lending focus in healthcare (Nashville has a huge for-profit healthcare sector) and correspondent banking. Year-to-date ROE through June 30 was 7.8%. The challenge will be to leverage the cost structure to push the 69% efficiency ratio lower and ROE higher, or to offset higher credit costs whenever the inevitable turn in the credit cycle occurs.

FB Financial is based in Nashville, but it is a nearly statewide bank with offices in five of the six largest MSAs and a legacy West Tennessee market that produces higher loan yields and excess deposits that are lent in Nashville and elsewhere. I doubt investors will have any hang-ups that the company is not a pure MSA play. The company presents an interesting combination of growth and high ROE, which was 16% year-to-date on a C-corporation basis. Although year-to-date returns were helped by a negative loan loss provision compared to provision expense for CapStar, the key difference in profitability is the 4.20% year-to-date NIM compared to 3.13% for CapStar. Nashville is a high growth market, but it is highly competitive, too.

The underwriters also will be working with two good data points: the 2015 IPOs of Avenue and Franklin Financial. Ironically, both IPOs proved to be great money makers, in part because IPO pricing was deemed disappointing. Avenue's shares priced at the low end of the $11 to $13 per-share expected pricing range, at $11 per share on February 9, 2015. On January 28, 2016, Avenue agreed to be acquired by Pinnacle Financial Partners in a deal that valued the shares at $20.50 per share at announcement. The non-annualized return was 86%.

Franklin Financial priced March 25, 2015, at $21.00 per share, which inexplicably was below the $24.00 to $27.00 per-share target range. Whether Bank of America/Merrill Lynch as the lead underwriter over-promised, misjudged the market, or did not know the community bank market is moot. Investors who bought the IPO have a 66% gain with the shares closing at $34.95 per share August 30. Price paid is the one variable investors control with certainty. Lower is better in terms of prospective returns, as seen with Franklin Financial and Avenue.

Other IPO comps that I think investors will focus on are Birmingham-based National Commerce Corp. and ServisFirst Bancshares Inc. Both are viewed as Southeast growth stories among small cap banks. Ironically, ServisFirst priced at the low end of the expected range as a growth stock and later "broke price" by trading below the IPO price. Since then the shares have proven to be a huge winner in a triumph of growth over value, in my opinion.

My assumption is that the underwriters will price FB Financial and CapStar at 14-17x whatever the buy-side thinks each bank can earn in 2017. If investors give the companies really long leashes, then perhaps the multiples will be based upon 2018 earnings expectations. Capital cannot be instantly leveraged absent acquisitions, and the banking model is predicated upon leveraging capital and collecting loans. So perhaps my 2017 assumption is asking too much. Regardless, while pricing will be quoted in terms of each company's pro forma tangible book value per share, investors are going to price the shares based upon earning expectations and whatever they deem an appropriate P/E based upon the growth outlook and risk profile of each company.

Both companies' management teams will get a lot of questions during the roadshows about Nashville real estate and how long it can keep going, since it periodically implodes. I am in the camp that it will run for a while given strong population and job growth and a Fed that will struggle to hike rates beyond one more token increase. I've heard less talk lately about concerns that overbuilding in multi-family will result in ridiculous rents. Also, office supply does not seem to be growing fast enough to meet demand. Net absorption last year and year-to-date annualized is approaching 1.3 million square feet, where it peaked in 2007 before the collapse. One key difference between then and now is vacancy at 5.1% compared to 13.5% in 2007.

Amid my optimism, I'll offer a word of caution, without resorting to a "glass half-empty" view of our world. A few months ago a friend at a local bank offered his take on when things begin to overheat in Nashville. He said a roll-over occurs about 18 months after builders tap investors to finance incremental inventory. I do not know how actively investors are financing builders here, but a few weeks ago my realtor wife asked me if I wanted to finance a lot for a builder who was tapped out with his bank. I passed, but it was a moot point, because the lot sold the next day, 24 hours after it hit the market.

Article amended on Aug. 31, 2016, at 7:36 p.m. ET to correct a reference to First American National Corporation.

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