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What does Corsair want to do with its United Community Banks stake?

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United Community Banks Inc. June 26 announcement that it sold $171 million of classified assets closes the credit chapter for the Blairsville, Ga.-based bank.

It was a rough period.

Net charge-offs during 2008 through June 30, 2012, approximated $1.1 billion, including $71 million incurred in the second quarter of 2013 to unload the classified assets. ORE-related expenses exceeded $200 million. At year-end 2007, loans were $5.9 billion. The accompanying announcement of the reversal of the $266 million DTA allowance was expected by year-end. Economically, what will matter rather than the reversal is generating taxable income to utilize $659 million of Federal and $32 million of NOLs as quickly as possible. With credit losses for tax purposes presumably poised to be minimal going forward, it appears to me usage will take six to seven years.

SNL's Robb Soukup had an article recently that looked at Street expectations with the return to normalized credit and reversal of the DTA may mean. The Street's expectations are important with the shares trading around 1.2x projected June 30 tangible book value per share ($6.78 per share at March 31), based upon management's statement that TBVPS will increase by about $4.00 per share in the quarter. Last fall, I thought the shares had a good risk-reward proposition for investors with the shares trading in a range of $8.00 to $9.00 per share given improving credit quality, the likelihood of an eventual DTA reversal and the funding of a maturing parent debt obligation through the issuance of new debt.

Then, as now, I think the more important expectation is not that of the Street, but rather that of private equity investor Corsair Capital LLC. It holds 10.3 million shares, or 18% of the company's voting and nonvoting common shares. Corsair's investment dates to March 2011 when it was a lead investor in a recapitalization that brought $380 million of new capital. Its basis is $9.50 per share. The shares traded below the investment price almost from the day the investment was made until late 2012 due to a couple of late cycle credit stumbles. Also, the market cratered in the third quarter of 2011 and spent the ensuing six months in recovery mode.

> **"The return driver for Corsair going forward may be pushing for a sale in 2014 or 2015 if the economic environment does not change much. A sale, which presumably would be at a premium to the current valuation, should produce a much better IRR for Corsair than would a near-term spot secondary."**

Corsair now has an approximate 30% unrealized gain with no interim dividends. I am sure the investment team's proposal to Corsair's investment committee envisioned a much larger return. The realized return is dependent upon the exit price, timing and how the exit occurs: secondary offering, flow-sales or lean on the board to sell the company. With the improvement in the Atlanta real estate market gradually expanding outward, I doubt Corsair feels a need to rush. Downside risks to the position are now primarily tied to broad sector moves since most problem assets have been purged. Readers of Nashville Notes know that I am bearish on the commercial banking industry's NIM prospects — recent curve steepening notwithstanding — if short rates do not increase and loan demand does not improve. But for Corsair and all investors, the NIM issue is not a new phenomenon as it progresses very gradually in an uneven fashion.

I suspect Corsair's and the board's view is to see what the next year or two may entail. Most likely, I think it will be more of the same for United Community with modest loan demand and incremental yield pressure. Having survived a near-death experience that required a six-fold increase in the share count, I doubt the modus operandi is going to entail a rapid ramp in lending to the home building sector in the outer realm of the Atlanta MSA. Efforts to broaden the portfolio mix and expand into Greenville, S.C., via an LPO should be helpful in time.

Also, $180 million of series B preferred that was issued to U.S. Treasury Department and resold to private investors earlier this year presumably will be redeemed given the resetting of the coupon to 9.0% from 5.0% in late December. This will require some form of a noncommon capital raise given just $51 million of parent cash at March 31, though I assume regulators will allow the subsidiary bank to pay a meaningful upstream dividend to contribute with the resolution of most problem credits and a bank-level leverage ratio of 10.0% at March 31.

The net is that absent near-term M&A speculation and/or material market moves, the shares may tread water for now given the valuation of about 14x consensus 2014 EPS and 1.2x pro forma June 30 tangible book value per share. That said, 2014 may be a time of increasing pressure to sell the company if the operating environment does not change. The boards of Arlington, Va.-based Virginia Commerce Bancorp Inc., Flint, Mich.-based Citizens Republic

Bancorp Inc. and Kosciusko, Miss.-based First M&F Corp., among others, all elected to sell after getting through their credit issues and thereby produced big returns for shareholders who were late-cycle investors.

United Community conceivably could attract interest from Winston-Salem, N.C.-based BB&T Corp., Cincinnati-based Fifth Third Bancorp, Birmingham, Ala.-based Regions Financial Corp. and Coral Gables, Fla.-based Capital Bank Financial Corp. given its position between Atlanta, Knoxville, Tenn., Chattanooga, Tenn., and Charlotte, N.C., with some presence in Savannah, Ga., too. Columbus, Ga.-based Synovus Financial Corp. should be a natural interested party too, though Synovus' board and regulators may want more time to elapse from its own dreadful crisis performance before making a material acquisition.

But the most interesting partners maybe two smaller regionals that are in the process of digesting significant deals: Tupelo, Miss.-based Renasant Corp. and Columbia, S.C.-based SCBT Financial Corp. United Community has 18 offices with $1.0 billion of deposits within 10 miles of an SCBT office, while Renasant has 13 offices with $633 million of deposits, according to SNL Financial.

Memphis, Tenn.-based First Horizon National Corp. could have a high level of interest, too, because United Community has 24 offices with $1.3 billion of deposits within 10 miles of a First Horizon office.

Investing in banks based solely upon an M&A thesis is tough unless an investor has leverage over the board. Deals are hard to time, assuming one ever occurs as investors in Atlanta-based Fidelity Southern Corp. ($2.53 billion) can attest. It is better to invest based upon a combination of fundamentals and valuation. Corsair presumably thought it was investing near the bottom of both the credit and valuation cycle for United Community in March 2011. The return driver for Corsair going forward may be pushing for a sale in 2014 or 2015 if the economic environment does not change much. A sale, which presumably would be at a premium to the current valuation, should produce a much better IRR for Corsair than would a near-term spot secondary.

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