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NASHVILLE NOTES

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Nashville's next crop of bank IPOs

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Nashville, Tenn., has and has had a number of tag lines. Music City is the one that has taken hold as the anchor of the city's booming entertainment and tourism industries. Although there is no tagline associated with health care, Nashville is (or near) the epicenter of for-profit health care that was spawned by the formation of Hospital Corporation of America decades ago. The city was also known as the "Athens of the South" in the 19th century because of the number of educational institutions.

But the name that is no longer remembered and will draw a smirk from some of you reading this is "Wall Street of the South." Today, that tagline belongs to Atlanta or Charlotte, N.C. During the 20th century Nashville became a regional financial center with multiple banks, broker-dealers and insurance companies whose reach extended beyond Middle Tennessee. Acquisitions gradually eliminated most of the companies, the last being First American Corp., which was acquired in 1999 by AmSouth Bancorp. (now Regions Financial Corp.), and J.C. Bradford & Co., which was acquired by Paine Webber Group Inc. (now UBS Group AG) in 2000.

There are a few financial companies around town that are the spawn from the bygone era. The most successful is Pinnacle Financial Partners Inc., which was organized by former executives of First American in 2000. The shares have risen 764% since the IPO was priced during August 2000 at $5.00 per share based upon its January 22 closing price of $38.19 per share. The success of Pinnacle combined with a hot economy here should provide a good backdrop for pending IPOs by Avenue Financial Holdings Inc. and Franklin Financial Network Inc., which recently filed S-1s to raise $30 million and $50 million. Nashville-based CapStar Bank may file an S-1 in the next year based upon management's statements that it too is looking to execute an IPO.

I think both deals will be well received by small cap institutional investors assuming the underwriters do not over-reach on pricing as appeared to occur with the ServisFirst Bancshares Inc. IPO last May 2014. Why? Investors want growth and value, but usually get one or the other with the degree depending upon where the industry stands in its business cycle and where the market cycle stands; however, in the case of most banks today, investors get neither. There is little, if any, revenue-driven earnings growth for many banks, and I do not think regional bank stocks represent value when trading around 15x LTM earnings when credit costs are very low.

Organic growth is hard to find in the industry, but it is not impossible. Better is long-term organic growth with below average credit costs. Usually banks in this mold have one or more common characteristics: (a) small market share in growing markets; (b) operations in markets that are dominated by behemoths that tend to leak market share; and (c) management that came from a well-established company that one of the behemoths acquired. New York-based Signature Bank and Pinnacle are good existing examples. Prior to its February 2008 acquisition by Royal Bank of Canada, Alabama National BanCorp. had a near cult following among institutional investors due to its footprint in growth markets, low credit costs and diverse revenue base. Members of Alabama National's management team now run Birmingham, Ala.-based National Commerce Corp., which filed an S-1 early this year to raise $50 million.

Pinnacle has benefited from moving market share the past 14 years. As of June 30, the company had 9.4% deposit share of the Nashville MSA, a $44 billion deposit market. I do not expect Avenue or Franklin Financial to garner the same share in 14 years (absent merging), but both (and CapStar) can grow modest market share bases of about 2% each.

Plus, it is hard for me to convey the growth that is occurring in the area that does not seem to be captured in such statistics as projected MSA population growth of 6.2% for 2014 through 2019, though Franklin Financial's core markets of Williamson and Rutherford Counties are higher at 8.6% and 7.5%. Unlike much of the country, housing is not in the doldrums here, with a 7.6% gain in 2014 closings. All of my friends in commercial real estate are wildly bullish, though maybe that should be a cause for concern. SNL's Ken McCarthy and Vipra Vora had a profile piece on CRE lending here that touched on this.

Investors will find a few issues to quibble over. Franklin Financial has a high amount of C&D loans (29%), and the retirement of two long-time Williamson County lenders last year has led to some speculation if the two could come out of retirement with another institution. Avenue Financial's year-to-date ROA through Sept. 30, 2014, was only 0.62%, according to SNL regulatory data, though the trend the past few years has been one of improving. Also, I offer the glass-is-half-full observation that the 3.35% YTD NIM for Avenue and 3.67%, based on SNL regulatory data, for Franklin Financial have less downside risk in our zero-interest rate world than those of most community and many regional banks. In effect, loan growth should more or less drive net interest income growth for these banks versus many banks that need loan growth to hold net interest income steady as loan and bond yields grind lower.

Investors may also ask the question: why an IPO? Being public has its downside such as the addition of another regulator (SEC) and the 90-day earnings treadmill. Capital ratios look okay for both banks, though sustained loan growth can change that. Avenue is not raising much money with some amount of the $30 million coming from selling shareholders rather than the company. Avenue recently raised $20 million of sub debt. Proceeds from the offerings will be used to retire $19 million of SBLF preferred. Franklin will net $40 million before expenses assuming $10 million of the proceeds are used to retire its SBLF preferred. Maybe it is a combination of reasons. Avenue has private equity investors that may want liquidity now or the option to tap the market later. Both may have acquisition targets. Also, the boards presumably do not want to sell (yet), perhaps because more value can be realized by growing for several years before reconsidering the question.

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