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# CapStar Financial Holdings, Inc.

## Nashville, TN



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- **It's a great time to be a private bank in Nashville...**
  - **The Pinnacle-Avenue deal should benefit CapStar in several important ways...**
  - **This company will almost certainly come public...The question is when, and how much?**
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**The recent announced acquisition of Avenue Financial Holdings, Inc. (AVNU) by Pinnacle Financial Partners, Inc. (PNFP) has provided further confirmation that Nashville is the absolute right place to be in banking now...and it's a particularly good time to be a private bank there.**

Nashville may be the hottest banking market in the U.S. right now – due to location, beneficial state tax policies, enlightened governmental planning, and the existence of large and important industries (healthcare and entertainment, most notably) in the region. Not surprisingly, the banking market in Nashville is healthy, it's dynamic, and it continues to provide ample lending opportunities for the community banking sector. It is also providing great opportunities for community banking consolidation, as the recently announced acquisition of Avenue by Pinnacle – at a hefty 2.2x Avenue's year-end TBV and 23x its projected 2016 earnings – shows.

**There is finally a scarcity value for good community banking franchises – thanks to the well-chronicled regulatory difficulties of chartering new banks – and that's where CapStar Bank comes in.**

CapStar Bank – at \$1.2 billion in year-end assets – is among the largest of the remaining franchises in the Nashville market, and it is growing strongly through its focus on the business market in the region. The bank was founded in 2008 by banking industry veterans Dennis Bottorff (of C&S Sovran fame before being CEO of First American and Chairman of AmSouth) and Claire Tucker (a First American National alumna) when they saw a lack of banks offering truly customized service to business owners at the smaller end of the size spectrum – and thus a successful growth strategy was born. The bank's holding company – CapStar Financial Holdings, Inc. – was approved by the Federal Reserve in late January.

**Is this a “private” bank? Well – yes and no.**

While CapStar is privately owned, it does not seem to us to be a private bank in the traditional sense, as it does not operate a “concierge” banking model like competitor Avenue. Rather, the company operates a bank focused on commercial companies and their owners, to which it offers both traditional commercial lending expertise (for the companies) and private banking capabilities (for the business owners). It also is strongly focused on technological delivery of its services, as 75% of its deposits presently come into the bank through mobile sources. In the words of President and CEO Claire Tucker, the bank aims to be a “customized tailored solutions company” rather than a more traditional bank with extensive deposit-gathering infrastructure.

**The company sees its future growth in continuing this commercially oriented focus, although it also foresees the addition of both products and services for its business-owning customers.**

The bank added mortgage banking capabilities (essential for private banking clients) in 2014 through the acquisition of Farmington Mortgage, and will continue to hone its wealth management skills in coming years as it adds wealth management teams and personnel. But management here is adamant that this growth focus will remain centered on the company's traditional “verticals” of commercial, healthcare and commercial real estate, where they see their “sweet spot” of product and expertise converge.

**CapStar is really still in its adolescence in some ways... While this company is fully formed and fully invested in its technological platforms, risk management systems, and physical infrastructure, it still is focused on improving profitability and building its core businesses.**

CapStar has encountered many of the challenges common to smaller community banks as it has grown toward achieving scale and greater profitability. It is presently returning 73 bps on average assets and 7.61% on average equity, and it has near-term targets of 1% and 10% respectively (Note – with a 10.4% Tier 1 Risk-based Capital Ratio and only 0.34% of loans non-performing at year-end, soundness and asset quality are not issues for this company).

**The issue most impacting CapStar’s present profitability is the need to invest for future growth.**

CapStar’s 68% efficiency ratio for 4Q15 reflects the dilemma for community banks of its size and ambition – there is a more or less constant need to invest in revenue-producing personnel, but the costs of adding these highly-prized people always predate the incremental revenue produced. CapStar hired six new bankers in 2015, and it will take roughly 12-16 months for these new hires to be fully producing and profitable. But CFO Rob Anderson does see these costs trending down in 2016 and sees the achievement of a sustainable 65% overhead ratio by the end of this year.

**But there is one issue that is unique to CapStar – and it’s a problem that may call for an innovative solution.**

When we spoke with Chairman Denny Bottorff on his views of the banking industry generally and on CapStar’s future specifically, he professed both pride in his company’s growth and optimism for the future of Nashville commercial banking. However, he also pointed out an interesting challenge for CapStar – one that he would like to overcome – and that is a “volatility of liquidity” issue that is a unique by-product of CapStar’s commercial business mix and upscale customer base.

**When we looked at CapStar’s year-end balance sheet, we immediately saw what he meant.**

Between September 30 and year-end, CapStar’s balance sheet added roughly \$36 million in cash and Fed funds sold on a \$64 million 3Q15 base – a cash pile that predictably wreaked havoc on the net interest margin, which accordingly fell from 3.45% in the third quarter to 3.22% in the fourth (a normalized NIM for the bank is generally in the 3.15%-3.25% range). The reason for this abundance of short-term cash is one to be envied, frankly – within CapStar’s ownership and customer base are a lot of rich people, and those people have “liquidity events” (sales of companies, tax issues, etc.) that may lead them to have large cash balances that they need to park on the bank’s balance sheet for short periods of time.

**CapStar’s management does not bemoan the problem, but more predictable Net Interest Income trends might be necessary for a bank looking to eventually go public.**

Wall Street loves and values predictable earnings streams, so what to do to smooth out these temporary blips in liquid assets? The answer might be to add more predictable core deposits into the funding mix, but these deposits must come without the need to add a heavy expense base as well. Perhaps a well-established, well-functioning and efficient community bank with an older and less-demanding core deposit base? (We're thinking back to the pronouncement of **South State Corp. (SSB)** management that they like to buy banking franchises that are "dense and old".) Such rural banks do exist throughout Tennessee, and a merger with a larger and more sophisticated Nashville player might be just the ticket for some of these smaller, revenue-challenged companies.

**That's a good segue into how the PNF- AVNU deal might add to CapStar's growth... The Avenue deal might be just the ticket to accelerate CapStar's growth.**

While we have the greatest regard for the managements of both Pinnacle and Avenue, we still must nonetheless look back at 34 years of observing bank deals and say – a few eggs always get broken, especially in an in-market deal. And given that Avenue has based its operating model on high-touch service and that Pinnacle CEO Terry Turner has promised that he will cut 40% of AVNU's cost base, we can only say that that will be a tall order to fulfill. We think that it is highly likely that some of Avenue's customers will want to continue to bank with a smaller company where the banker-customer relationship is closer and more specialized, and the overlap of CapStar's verticals (especially healthcare) with those of Avenue is especially auspicious for CapStar's picking up incremental business.

**And then there is the issue of revenue producers.** There's no way around it – when material cost saves are announced in a deal, head-hunters start getting calls. While we're sure that the PNF- and AVNU management teams are moving quickly to tie up their best producers, we would also note that CapStar's management is not sitting on its hands, but is moving quickly to attract those Avenue producers who are nervous about their future prospects. While there would inevitably be short-term costs for adding these experienced lenders and the company's 65% efficiency target might slide a quarter or so as a result, we believe that the long-term benefits of enhanced growth would be worth it.

**Bottom Line: We believe that CapStar will inevitably become a public company... It's great to be a privately held bank, but growth in the banking industry almost always requires a publicly traded currency.**

While remaining private certainly has its attractions – greater latitude for growth plans, the avoidance of a lot of pesky paperwork, not having to deal with short-sighted and whiny Wall Street analysts, etc. – it's also admittedly tougher to attract top employees and do meaningfully sized deals without a currency whose value is confirmed in the market on a daily basis. While we cannot predict the timing of such an event for CapStar, the company does have issues – like the attainment of its profitability goals and the taming of its funding quirks – that need to be addressed, we nonetheless think that CapStar's focused approach to its businesses and its

potential for growth in Nashville and beyond will lend themselves to a healthy valuation that management will want to see recognized and realized in a public stock.

**And that's another place where the Pinnacle-Avenue deal helps – there's a firm (and healthy) valuation yardstick out there.**

Avenue Bank, which became a public company in early 2015, was already trading at a healthy 1.5X TBV shortly before it was acquired by PNFP at a 50% (roughly) premium to its market value (CapStar's pro-forma TBV was \$10.18 at December 31, for comparative purposes, versus \$8.91 for AVNU). We would also note that while AVNU had some very high-growth potential in its entertainment business, we think that CapStar's more prosaic mix of specialties – C&I, healthcare, and CRE – have equally attractive long-term prospects in the middle Tennessee market, and that investors would reward the company's disciplined approach and well-evolved strategies.

**Will this happen in 2016? Who knows – the bank may want to wait until a less-volatile market for bank stocks takes hold – but we do know that this company should be on the radar screen of all community bank investors who are waiting for more good "stories" to emerge.**

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CapStar Bank Historical Balance Sheet (Call Report)	2011Y	2012Y	2013Y	2014Y	2015Y
<i>Figures in thousands of dollars</i>					
Cash & Balances Due	36,843	105,701	41,975	69,775	93,455
Securities	233,820	275,291	300,396	280,449	216,476
Fed Funds & Reverse Repos	7,200	7,665	2,818	4,159	6,730
HFS Loans	-	-	-	15,386	35,729
HFI Loans	430,329	624,328	626,382	713,077	808,396
Loan Loss Reserve	6,226	8,213	8,459	11,282	10,132
Other Assets	9,217	27,067	46,373	56,831	55,773
<b>Total Assets</b>	<b>711,183</b>	<b>1,031,839</b>	<b>1,009,485</b>	<b>1,128,395</b>	<b>1,206,427</b>
Noninterest-bearing Deposits	66,641	102,875	135,524	157,355	190,580
Interest-bearing Deposits	554,571	817,037	743,641	823,702	847,880
Fed Funds & Repos	12,622	7,452	9,494	14,837	3,755
Borrowings	-	-	20,000	20,000	45,000
Other Liabilities	2,779	3,997	4,635	9,850	10,626
<b>Total Liabilities</b>	<b>636,613</b>	<b>931,361</b>	<b>913,294</b>	<b>1,025,744</b>	<b>1,097,841</b>
Preferred Stock	16,500	16,500	16,500	16,500	16,500
Common Stock	58,070	83,978	79,691	86,151	92,086
<b>Total Equity</b>	<b>74,570</b>	<b>100,478</b>	<b>96,191</b>	<b>102,651</b>	<b>108,586</b>

CapStar Bank Historical Income Statement (Call Report)	2011Y	2012Y	2013Y	2014Y	2015Y
<i>Figures in thousands of dollars</i>					
Interest Income	23,453	33,966	41,156	38,287	40,503
Interest Expense	7,146	6,682	6,575	5,871	5,731
<b>Net Interest Income</b>	<b>16,307</b>	<b>27,284</b>	<b>34,581</b>	<b>32,416</b>	<b>34,772</b>
Loan Loss Provision	1,897	3,968	938	3,869	1,651
Noninterest Income	817	1,351	1,703	7,228	8,826
Gain on Securities	57	482	73	13	55
Noninterest Expense	13,211	18,920	25,261	28,384	30,973
<b>Pre-Tax Income</b>	<b>2,073</b>	<b>6,229</b>	<b>10,158</b>	<b>7,404</b>	<b>11,029</b>
Income Taxes	-	(3,168)	3,749	2,412	3,470
<b>Net Income</b>	<b>2,073</b>	<b>9,397</b>	<b>6,409</b>	<b>4,992</b>	<b>7,559</b>

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