January 11, 2016

South State Corporation

NASDAQ: SSB | Columbia, SC

SOUTH STATE CORPORATION

Price:	$67.14	**Tangible Book Value:**	$27.26
52-week price range:	$58.84-$81.80	**Price/TBV:**	2.46X
EPS Estimates:	2014A: $3.75	**Dividend/Yield:**	$1.04/1.50%
	2015E: $4.33	**Market Capitalization:**	$1.63 billion
	2016E: $4.52		
	Q415E: $1.12 (vs. $1.01 in 4Q14)		
	Note: All estimates are based on operating results.		

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- **This high-quality company—the largest bank headquartered in South Carolina with $8.5 billion in assets—will soon become a "mega-community" bank...**
- **The bank's South Carolina base is a great place in which—and from which—to grow...**
- **This management's acquisition strategy is well-defined and rational...And the stock's valuation reflects the Street's high regard…**

Welcome to the new world of the "mega-community" banks…

We'll soon see a whole new category of community banks—bigger than $10 billion in assets, smaller than $50 billion, and different from their larger competitors. While the argument might be made that such companies already exist—**Synovus**

(SNV) already fits within those asset size parameters—we would assert that Synovus and its like-sized peers have historically competed more with the large banks and in the process have shed much of their community banking identity.

Not so for this new generation of larger community banks—**South State**, **Ameris Bancorp (ABCB)**, **Bank of the Ozarks (OZRK)**, **BNC Bancorp (BNCN)**, **Pinnacle Financial Partners (PNFP)**, **TowneBank (TOWN)**, **Union Bankshares (UBSH)**, **United Community Banks (UCBI)**, and **Yadkin Financial (YDKN)** are the Southern banks that come most immediately to mind—as these companies continue to grow both through acquisitions and organically toward and beyond that magic $10 billion milestone.

At that point, these banks will cease to be "community banks" for the purposes of regulatory classification ONLY. While South State and its peers will indeed suffer some earnings impacts from this attainment of mega-community status—the most significant being the loss of debit card revenues as mandated by the Durbin Amendment, which reduced "swipe" fees from roughly $0.44 to $0.21 per transaction for larger banks, as well as some increased expenses for regulatory compliance—the geographic diversification and the ability to offer more services to a base of larger commercial customers will eventually offset these up-front hits. The reality is that South State will continue to fund itself through core deposits, maintain its close relationships with both retail and commercial customers, and will continue its close identification with its communities—but will simply have a larger platform from which to do all of this.

We believe that investors are closely attuned to the changes coming in the community banking space—and that they welcome them. The reality is that many institutional investors are tired of the increasingly dreary earnings prospects of the nation's largest banks, with their ever-increasing capital requirements and their seemingly endless legal and regulatory headwinds. But investing in the community banking sector has been challenging for the larger hedge funds and mutual funds, due both to the low trading liquidity of many small-bank stocks as well as the multitude of community bank names and the need to have a greater knowledge of regional economies and local competitive factors. The emergence of this new larger-bank segment should go some way toward making investment in these banks easier and should also encourage a broader constituency for these names, thus engendering more Wall Street research coverage and a greater public knowledge of these unique companies.

South State ticks the "geographic growth" box for investors. The bank, headquartered in Columbia, SC, operates 127 branches in some prime real estate—coastal and upstate South Carolina, northern and coastal Georgia, and coastal North Carolina. Both the upstate South Carolina and coastal operating areas are seeing strong growth as both Charleston and Savannah continue to attract manufacturing businesses that need ready access to ports, and the presence of BMW and Michelin (among others) in the Greenville-Spartanburg area continue to serve as a strong magnet for attracting both businesses and people into that region. And it goes without saying that the pull of areas like Hilton Head, Charleston, Savannah, and Wilmington, NC on the retiree populations in the U.S. is strong, and will continue to be so as the migration of people from the high-tax states of the Northeast and Midwest into the Southeast continues apace.

South State has another growth area that we admire—investment management. It's something of a rarity to see a $4 billion (roughly) assets-under-management trust and investment management company appended onto an $8 billion community bank, but here they are. The failure of Wachovia (and its subsequent absorption into Wells Fargo) was a big factor in allowing South State's management to lift out two teams of money managers from that shop and to begin to transform their legacy trust business into a much more dynamic entity. Subsequent acquisitions have added money management expertise and assets, and the bank now offers a full product set of asset management, wealth management, private banking, institutional services, etc. (under the South State, Minis & Co., and American Pensions flags) with 800-plus relationships and 19,000 retail investors (and $18 million in 2014 revenues).

South State goes into this new banking world order with the benefit of an important intangible asset—an identification with the old Wachovia…

No, we're not talking about the Wachovia that overdosed on residential real estate in California, built up a capital markets presence with illiquid credit default swaps, and then quietly went out of business one Friday afternoon. We're talking about the REAL Wachovia—the iconic North Carolina bank renowned for pristine credit quality, strong client relationships, and an industry-leading reputation. And the identification of South State with Wachovia is not a coincidence, as both CEO Robert Hill, Jr. and CFO John Pollok are alumni of that august institution, and have brought Wachovia's best practices to their South Carolina franchise—a heritage that should give new investors in the community banking space an extra degree of confidence in this company.

South State management has brought this inherent conservatism to their acquisition strategy as well. The atmosphere around bank consolidation in the Southeast in recent months has been frenetic, to say the least. A week seldom goes by that there is not at least one—or two, or three—bank deals, mostly involving $1 billion-in-assets and-under banks deciding to turn the keys over to larger competitors, most recently at some gravity-defying prices. While South State has been a participant in recent consolidation trends, they have pursued a more measured pace of deals and have been mostly on hiatus from larger deals for the last two years.

South State was able to participate strongly in the consolidation of failed franchises in the wake of the financial crisis. In 2010 and 2011, SCBT (as it was then known) acquired three failed banks (two in Georgia, one in South Carolina) and in the process added about $1.6 billion in assets to its existing $2.7 billion asset base. And as was often the case in the community banking world, the positive economics of those failed-bank deals then enabled SCBT to use its new balance sheet size and strength to embark upon a path of more conventional, high-quality acquisitions, as the bank added **Peoples Bancorporation** (upstate South Carolina) and **Savannah Bancorp** (coastal Georgia), adding another $1.5 billion in footings in the process. Then in 2013 came the "transformational" deal—the acquisition of **First Financial Holdings**, a $3.2 billion bank with 65 branches in North and South Carolina (primarily in the attractive coastal counties), a deal that catapulted SCBT into the #5 deposit market share spot in South Carolina and added to wealth management revenues as well. So over a 4-year period this large-ish community bank had transformed itself into a much larger multi-state presence, and the company cemented that change in February 2014 by combining five separate banking brands into one, South State Bank—a brand that will allow for further expansion in the Southeast should the opportunity arise.

They have not exactly been sitting on their hands in the last two years. When the company took a breather from deals after First Financial, it was clear to SSB's management that they needed to do "major surgery" on the new franchise in order to get onto one deposit system and to clean up other operational issues. It was also clear that their (roughly) $8 billion asset size would put them squarely in the sights of regulators as a bank that would eventually grow beyond community banking size and thus would be subject to the new regulatory regime of DFAST (the Dodd-Frank Act Stress test, for anyone who may have forgotten), which—while a company-run process—requires banks to stress their balance sheets under scenarios of increasing adversity. In any case, whether the move past the magic $10 billion mark is accomplished through organic growth or through another large acquisition, SSB's management sees their company as fully ready for the transition, and this merger hiatus has been an important factor in that process.

There is one important differentiating factor in SSB's deal strategy that may make future deal activity more episodic—and perhaps might make the prices for future acquired banks higher. CEO Robert Hill is firmly on the record as saying that the company is not interested in acquiring those smaller banks that have been chartered and grown with an eye to being quickly acquired and producing a big payday for senior management. They are interested only in those franchises that are "dense and old"—that is, those community banks that have been operating in their communities for many years, have material market shares and thus have developed a loyal customer following. Not only do they see these types of banks as being less likely to produce excessive depositor attrition during the merger consolidation process, but they also see them as less likely to lose depositors to competitors in the period of steadily increasing deposit rates that is facing the industry. We see this as an admirable strategy, and also see it as likely to continue to produce merger activity at SSB that is more episodic and measured than in the Southeastern community banking group as a whole.

There was one deal worthy of mention in 2015. In August, 2015, South State completed the acquisition of 13 branches of **Bank of America** (12 in South Carolina, one in Georgia), six of which were in markets new to the bank. The company had modeled 15% deposit runoff from the $438 million acquired deposit base, and the actual loss came in at 24%, taking the modeled deal value from $31.6 million down to $25 million. We have spoken to several sources in the industry who have said that this shortfall is not unique to SSB—whether it be the ubiquity of Bank of America's branches (there's usually another one nearby) or the preference of some part of the acquired customer base for BAC's larger suite of mobile products, the deposit loss in these deals has often turned out to be larger than anticipated. In any event, SSB management still expects "mid-single digits" earnings accretion in 2016 from the BAC branch acquisition.

And that's a good segue into South State's earnings trends…

One need only look at page 7 of SSB's 3Q15 Investor Presentation (available on the company's IR web page under "News and Market Data") to see where earnings are headed—toward their $5.00 annual targeted number. And if our model is correct, the company should be at that $1.25 quarterly run rate in the second half of 2016, without any heroic measures needed to get them there. Earnings at SSB are powered by an enviable combination of double-digit organic loan growth, continuing improvements in credit quality, and progress in reducing the company's decent-but-not-stellar (62%, roughly) operating efficiency ratio through a process of basic expense blocking-and-tackling.

There is one thing that anyone new to SSB's earnings report should realize—that reported earnings and operating earnings can diverge by a material amount due to the impact of past deals. That was the case in 3Q15, when $3.1 million in branch consolidation expenses knocked the $1.12 operating result down to $1.04 reported. There is also one other unique factor that makes projecting net interest margin trends somewhat frustrating—the existence of the "FDIC indemnification asset" that is the result of loss sharing agreements with the FDIC in the failed bank deals that were done in the 2010-2011 time frame. As these assets come off the books (either through release of credit provisions or amortization), the "amortizing" NIM can be impacted positively or negatively in a somewhat lumpy way. The good news is that this asset is small presently ($4 million-$5 million) and has a smaller impact on the net interest margin each quarter. In any case, the company presents both operating and "amortizing" net interest margin results, so that clarity in underlying trends is not lacking.

The biggest impact on the NIM (of both types) in 3Q15 results was the liquidity of the acquired BAC branches—thus a big inflow of cash last August that will be gradually put to work in a rising rate environment. The company experienced a 23-basis-point drop in operating NIM (from 4.75% down to 4.52%) as the $400+ million of deposits (and a negligible amount of loans) flowed onto the balance sheet with limited reinvestment opportunities, as the company simultaneously experienced an 11 bps decline in loan yields. The opportunities for reinvestment should become increasingly attractive as we go through 2016, and we would expect a move back toward a 4.60%-4.65% NIM by mid-2016.

Bottom Line: South State's stock was not one of the community banking industry's biggest winners in 2015…

But that may be a good thing. Now that the 2015 numbers are in, it's easy to see some trends in the performance of the Southeastern community bank stocks. Within the burgeoning "mega-community" bank group, it was a good year to be an active acquirer—as shown by the stock of BNC Bancorp, one of the industry's most noteworthy and active acquirers, which was up 49% for the year. While SSB's stock certainly registered a more-than-respectable gain for its holders—up 9% versus a flat market—it was clear that last year was one in which the market was excited by the prospects for those community banks that were growing rapidly through deals, and had voiced their expectations of more to come in 2016.

We expect continued active deal-doing in 2016 as many community banks grapple with a growth environment that is less than hospitable. While both banks and their investors have long awaited the beginning of the Federal Reserve's move off its zero-rate policy, the reality is that not much will change in the process. Asset-sensitive banks will all see measured improvement in their net interest revenues, but the reality is still that market presence, good customer relationships, and the ability to take advantage of market disruption (whether it comes from the travails of the large banks or the disruption at the smaller end) will in the end be the determinants of revenue growth. In that regard, we think that companies like

South State that have "cleared the decks" operationally and have demonstrated the ability to continue to both integrate acquired companies and grow organically will likely have ample opportunities for more appreciable growth through mergers in the next few years.

One thing that we have learned over 30-plus years of bank analysis—quality always wins in the end. To that end, we would note that South State is already earning 1.3% on operating assets and close to 17% on average tangible equity—and what's not to like about that? And while we would note that—at roughly 15X our 2016 estimate of $4.52 and 2.6X its tangible book value of $27.26—this stock's valuation may present sticker shock to those investors who have grown accustomed to the less-lofty multiples of the nation's largest banks, there's a whole new banking world out there. And in this new banking world, banks actually grow, they actually are able to increase their dividends at a strong pace, and their customers actually do business with them because they prefer to—not because they have to. South State will continue to claim an outsized place in this group of quality banks and in the positive investor psychology that surrounds it—and the stock's performance will take care of itself in that process.

South State Corporation
Average Balance Sheet & Capital Ratios

	2014Q3	2014Q4	2015Q1	2015Q2	2015Q3	2015Q4E	2014Y	Est. 2015Y	Est. 2016Y
Securities	809	806	803	815	851	875	799	823	864
Real Estate Loans	4,443	4,608	4,619	4,622	4,684	4,725	4,509	4,642	4,874
Agricultural Loans	6	6	6	7	7	7	5	7	7
Commercial and Industrial Loans	368	378	419	432	460	500	363	437	459
Other Loans	481	470	464	463	462	465	482	463	486
Average Loans and Leases	5,713	5,740	5,768	5,785	5,868	5,900	5,694	5,807	6,097
Other Earning Assets	21	21	20	20	19	19	23	19	20
Earning Assets	6,936	6,948	6,962	7,028	7,378	7,490	6,882	7,215	7,576
Total Assets	**7,952**	**7,903**	**7,897**	**8,034**	**8,332**	**8,415**	**7,941**	**8,170**	**8,579**
Interest Bearing Deposits	4,900	4,838	4,816	4,826	4,972	5,200	4,939	4,954	5,202
Federal Funds Purchased	256	239	280	306	296	300	254	267	280
Other Borrowed Money	1	1	1	1	1	1	1	1	1
Interest Bearing Liabilities	**5,257**	**5,178**	**5,173**	**5,187**	**5,323**	**5,500**	**5,295**	**5,560**	**5,838**
Preferred Equity	0	0	0	0	0	0	0	0	0
Common Equity	960	976	996	1,016	1,036	1,050	951	1,025	1,076
Total Equity	**960**	**976**	**997**	**1,020**	**1,037**	**1,050**	**968**	**1,025**	**1,076**
Net Interest Margin	4.64%	4.71%	4.67%	4.69%	4.52%	4.55%	4.75%	4.58%	4.60%
Equity/Assets	12.27%	12.58%	12.56%	12.66%	12.32%	NA	12.67%	NA	NA
Common Equity Tier 1 (CET1)	11.43%	11.76%	12.25%	12.15%	11.82%	NA	11.76%	NA	NA
Tier 1 Capital Ratio	13.29%	13.62%	13.17%	13.03%	12.68%	NA	13.62%	NA	NA
Total Risk Based Capital Ratio	14.12%	14.43%	13.87%	13.72%	13.36%	NA	14.43%	NA	NA
Tier 1 Leverage Ratio	9.16%	9.47%	9.53%	9.68%	9.32%	NA	9.47%	NA	NA

South State Corporation
Earnings Estimates

	2014Q3	2014Q4	2015Q1	2015Q2	2015Q3	2015Q4E	2014Y	2015Y	2016Y
							- -		
Net Interest Income	80.37	81.55	81.05	82.28	83.02	84.26	326.36	330.63	345.00
Tax Equiv. Adjustment	-	-	-	-	-	-	-	-	-
Net Interest Income	80.37	81.55	81.05	82.28	83.02	84.26	326.36	330.63	345.00
Provision	2.09	1.48	0.82	3.14	1.08	1.20	6.59	6.26	7.50
Noninterest Income	24.54	25.30	26.51	30.08	29.77	30.4	94.70	116.76	120.0
Noninterest Expense	68.21	70.08	70.13	69.29	70.10	71.5	279.10	281.05	290.0
Pre-Tax Operating Income	34.61	35.29	36.61	39.92	41.61	41.92	135.37	160.08	167.50
Nonrecurring Expense	6.85	4.60	0.36	2.24	3.09	-	23.94	3.69	-
Nonrecurring Revenue	-	-	-	-	0.00	-	-	-	-
Realized Gain on Securities	(0.09)	-	-	-	0.00	-	(0.00)	(0.0)	(0.0)
Pre-Tax Net Income	27.67	30.69	36.25	37.69	38.52	41.92	111.43	156.39	167.50
Tax Expense	8.35	9.45	12.33	12.81	13.38	14.7	35.99	53.8	57.8
Tax Rate	30.2%	30.8%	34.0%	34.0%	34.70%	35.00%	32.3%	34.40%	34.50%
Net Income	19.33	21.25	23.93	24.87	25.14	27.25	75.44	102.59	109.71
Operating Net Income	24.17	24.43	24.16	26.35	27.17	27.25	91.65	105.01	109.71
Preferred Dividends	-	-	-	-	0.00	-	1.07	-	-
Net Operating To Common	24.17	24.43	24.16	26.35	27.17	27.25	90.57	105.01	109.71
Net To Common	19.33	21.25	23.93	24.87	25.14	27.25	74.36	102.59	109.71
Other Comprehensive Income	(1.55)	0.76	3.38	(4.93)	3.81		9.35		
Average Earnings Assets	6,936	6,948	6,962	7,028	7,378	7,500	6,882	7,217	7,500
NIM	**4.65%**	**4.72%**	**4.78%**	**4.75%**	**4.52%**	**4.55%**	**4.75%**	**4.58%**	**4.60%**
Common Shares Outstanding (mn	24.14	24.15	24.16	24.20	24.20	24.20	24.15	24.20	24.20
Average Diluted Shares (mm)	24.16	24.19	24.20	24.26	24.26	24.26	24.15	24.26	24.26
EPS	$0.80	$0.88	$0.99	$1.03	$1.04	$1.12	$3.08	$4.23	$4.52
Operating EPS	$1.00	$1.01	$1.00	$1.09	$1.12	$1.12	$3.75	$4.33	$4.52

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