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North Carolina Banking: It's Complicated…

By: Nancy A. Bush, CFA
NAB Research, LLC
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We must admit up front—it's tough to go back to Charlotte. As an analyst who has followed the major banks for three decades-plus, the "Queen City" carries more than its share of bad karma, mostly in memories of past research visits to Bank of America and First Union (and then the short-lived "new Wachovia"). We can only recall the grandiose growth plans, the botched and overpriced deals, the feeling that there was some kind of new American banking manifest destiny that would flow from the towers on South College and North Tryon—First Union would take over the country, while Bank of America would conquer the world. And we know how it all ended—in disarray, and in tears.

Fast forward to the present day, and it's a whole new banking world out there. For one thing, the Charlotte MSA has recovered from the swoon that was felt after Wachovia fell into the arms of **Wells Fargo (WFC)** and **Bank of America (BAC)** embarked on a massive and multi-year restructuring, with the loss of thousands of jobs. The acquisition of Wachovia by Wells Fargo—perhaps the best of all possible outcomes for the company and for the city—has resulted in more jobs than initially existed there and has buffered some of Bank of America's negative personnel impacts, with the net result that the town is well back on its feet again and showing some of the best employment and income growth metrics in the state.

From a growth perspective, North Carolina's economy is showing strong trends not only in Charlotte—which still tends to lead the state in many important growth categories—but in several other important markets as well, such as Raleigh/Durham/Chapel Hill (the Research Triangle), Greensboro/High Point/Winston-Salem (the Triad), Wilmington and Asheville. While growth in Charlotte still tends to be powered by the financial services industry, North Carolina has long had a reputation for excellence in secondary education and for growing jobs in the high-tech industries that often coexist with good universities. And healthcare in North

Carolina is a growth sector as well, both as a result of the excellence of its university-affiliated hospitals (Duke University Hospital and UNC Health Care, to name just two) and as a consequence of the state's growing attractiveness to retirees fleeing taxes and cold winters.

And where there is growth—there are banks, and in North Carolina, there are a lot of banks. Not only are there some of the nation's largest banks—and we would be remiss in not mentioning **BB&T (BBT)**, one of the banking industry's largest and most acquisitive regional players, headquartered in Winston-Salem, as well as **PNC Financial (PNC)** (in the guise of the old RBC Centura)—but there are a number of community banks, both within the growing $5 billion-$10 billion in assets category (where the performance metrics are particularly attractive) and within the ranks of the smaller ($1 billion-plus) community banks that are planning growth toward the $3 billion-$5 billion milestone.

On a recent swing through the state, we were able to visit with several community banks in both the Charlotte and Raleigh/Durham markets, and we can only say that the banking scene there is dynamic, in every sense of the word. Not only has the turmoil that afflicted the large banks in Charlotte in the wake of the financial crisis given the community banks in North Carolina ample opportunities to pick up disaffected customers and their business, but they have also given these banks a very desirable pool of talented bankers from which to choose. And along with bankers and business has come considerable private equity and other private investor funding, which has given rise to a number of new community banks in the last decade.

We had visited with several of the Nashville community banks back in December, and found the situation in Tennessee to be fairly straightforward, with the presence of Bank of America and **SunTrust (STI)** on the large side and with **Pinnacle Financial (PNFP)** being widely acknowledged as the major aggregator among community banks in the state. Not so in North Carolina—the list of aggregators is much more extensive, with **Yadkin Financial (YDKN)** of Raleigh and **BNC Bancorp (BNCN)** of High Point being widely acknowledged as the state's most acquisitive banks. But also on the hunt are **Capital Bank Financial (CBF)** and **Park Sterling Corp. (PSTB)**, both of Charlotte, and all of these companies are targeting not only growth in North Carolina but in South Carolina and Virginia as well.

We visited with the managements of Yadkin, Park Sterling, and Capital Bank in North Carolina, and with **American National Bankshares (AMNB)** in Danville, VA, and found distinctly different stories among all of these banks. We must also say that it felt like "old home week" when it came to the familiarity of many of the faces that we encountered—from Don Truslow, the brand-new CFO at Park Sterling, whom we knew from his years at Wachovia; to Gene Taylor, now CEO of Capital Bank, but perhaps better known as the long-time head of Consumer and Commercial Banking at Bank of America; to Capital Bank's CFO, Chris Marshall, whom we remember from his days at **Fifth Third Bancorp (FITB)**. (Indeed, when we looked at the names on Capital Bank's board of directors, we realized that we knew almost all of them. Sometimes, at least in banking, it pays to be old.)

We must say that Yadkin—which will have over $7 billion in assets and the #1 North Carolina community bank share after it completes its upcoming merger with **NewBridge Bancorp (NBBC)** of Greensboro—has one of the most interesting acquisition histories that we have ever encountered. This company has essentially formed itself through a series of deals of increasing size and breadth, beginning in the mid-2000s, and has basically accomplished its most recent growth spurt through a series of mergers of equals. Indeed, CEO Scott Custer sees MOEs as essential to the company's growth, saying that "the financial outcomes are so great that they overcome

the social issues." He qualifies that statement by saying that "the MOE construct must go away quickly—it can't be like Noah's Ark, with everything two by two."

He also sees YDKN continuing its emphasis on homebuilder finance, commercial real estate, and SBA lending at the lower end of the middle market, saying that his bank does not strive to "be all things to all people" and will continue to approach deposit gathering in the "old-fashioned way"—i.e., without an overriding emphasis on mobile technology. And once the NewBridge deal is fully integrated and cost saves fully achieved in late 2017, YDKN management foresees some very healthy metrics—10% earnings accretion, an overhead ratio in the low 50s percentage, and an ROA approaching 1.20%. The question is—what then? Will Mr. Custer and his team choose to do another MOE that takes them well beyond the $10 billion-in-assets mark—and if so, will they be the buyers, or will they choose to be sellers?

That was an interesting question to contemplate as we meandered through the backroads, up to Danville, VA, where we had a very interesting visit with Jeff Haley, the CEO of American National Bankshares. After speaking with Mr. Haley, we can say that we have encountered a community banker in the truest sense of the word, as he sees the fortunes of his bank intimately connected with and defined by the area around Danville, and has no grand growth plans that would change that fact. Indeed, the bank, which was founded in 1909, only began to expand from Danville proper in 1994, and now has roughly one-third of its assets in North Carolina.

Perhaps AMNB's most remarkable achievement was the maintenance of its dividend and its refusal to take TARP funds during the financial crisis, and indeed Jeff Haley's operating mode is one of innate conservatism and caution. (That's how he can maintain and grow a $0.96 dividend.) The bank trails its peers in service charges, due mostly to the fact that it did not allow overdrafts—of any kind—way before the "opt-in" issue came to the regulatory forefront, and he does not see mortgage banking—which lends itself to earnings volatility—as a "valuation kicker." In short, the growth of AMNB's earnings will be mostly dependent on the growth of Danville and its surrounding areas, and indeed the favorable prices of real estate there and the city's proximity to growth areas of North Carolina are attracting both new businesses and an in-migration of professionals.

It's as we looked at the Charlotte banking scene that things got a bit more complex. We met first there with the management of Park Sterling, a bank that has grown in the wake of the Charlotte banking turmoil to present a full suite of sophisticated products to commercial customers, and with roughly $3 billion in assets, it bills itself as the "largest community bank headquartered in the Charlotte area." The company now operates 60 offices in Charlotte, upper South Carolina, northeast Georgia and Richmond, and will be looking for more in the Carolinas and Virginia to round out the franchise.

But as Park Sterling CEO Jim Cherry readily admits, his company's operating model is "still in its adolescence," and the company has not yet reached full scale or maturity. The development of its capital markets activities (including hedging and foreign exchange capabilities), its treasury management products, its mobile and online platform, and its wealth management and trust products has resulted in a 70% (roughly) overhead ratio, and this expense base obviously needs to be leveraged over a bigger asset base. Mr. Cherry sees another "one to one-and-a-half" deals over the next 12-18 months to get his bank to the "$4 billion-$7 billion sweet spot" at which he hopes to eventually reside, and sees the existence of a number of small banks with "broken models" in the industry as being conducive to the bank's longer-term expansion plans.

Park Sterling's departing CFO, David Gaines, also clarified his Net Interest Margin guidance for 2016—guidance that had raised some concern at the time of the 4Q15 earnings call in late January. The company does indeed see the NIM declining roughly 20 basis points from the 3.54% level during the course of 2016, and we spoke about this issue. While the guidance incorporates some loss of purchase accounting accretion, it is mostly just management's conservative view of where industry margins are headed this year, and of the reality of the ongoing intense price competition in lending. We look forward to the market getting more guidance from PSTB on this issue in April, and if their outlook on this important revenue "headwind" is correct, then they may end up getting even more than their share of acquisition opportunities in coming quarters.

We ended our North Carolina jaunt with the management of Capital Bank in Charlotte, and we must say that the meeting there was a lot of fun. Gene Taylor continues to be a "character" (in Southern parlance), and his views on industry trends (and on banking industry players) were both funny and insightful. Although the company has certainly reached the "sweet spot" of community banking assets with footings of $7.5 billion at year-end 2015, there is certainly more upside in profitability to come. As a product of the consolidation of several failed banks and several more operational ones, there has been a lot of "churn" (to put it mildly) in Capital Bank's evolution since its formation with $900 million of private capital in late 2009.

With 153 branches in North and South Carolina, Florida, Tennessee and Virginia, Capital certainly has desirable geography—with one great gaping hole in central Florida that will need at some point to be filled. The coming combination with **CommunityOne Bancorp (COB)** (to be completed in 2Q16) will add 45 branches and $2.4 billion in assets and get CBF into the Charlotte MSA in a material way (and increase its share in Hickory/Asheville as well)—all with 5% earnings accretion expected this year and with minimal damage (1% or so) to TBV. We see this latest deal as one that "smoothes" the acquisition path and should help them materially move beyond the 1% ROA mark, and should get them more attention from investors as well. (The company acknowledges a need for more liquidity in their stock—at 27,000 shares in daily volume, it's a tough trade.)

So there we are. While we did not get to visit with BNC Bancorp on this trip (timing issues), we nevertheless got some further good insights into banking in the Carolinas, and we came away assured that there is much more yet to come on the merger scene there. While watching the major banks—both in the Southeast and nationally—has become the investor equivalent of watching paint dry, it's quite the opposite for the Southeastern community banks. It's like pouring a whole lot of different colors into the paint can—and not knowing what color will emerge.

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