

To: Eagle Point Capital
From: Matt Franz, President
Subject: Southern Bancorp and Spirit SMTA
Date: June 5, 2019

In the past two weeks Eagle Point Capital bought one new stock and sold another. Rather than waiting for our next seasonal letter to update you, I want to explain the changes now while they are timely.

First, we bought shares of Southern Bancshares for approximately \$3,700 per share. Second, we sold all of our shares of Spirit SMTA for approximately \$8.50 per share. The timing of these two transactions was coincidental; they are completely unrelated.

Southern Bancshares

Southern Bancshares is the holding company for Southern Bank and Trust, a community bank in eastern North Carolina and southeastern Virginia. Southern is owned and operated by the Holding family, which have been profitable bankers for multiple generations. The Holdings have an excellent long-term track record of conservative lending, value-conscious acquisitions, and shareholder friendly capital allocation.

Over the past twenty years Southern has compounded its tangible equity per share at 11% annually and repurchased 32% of its outstanding shares. Today it earns 1.12% on assets and has a 40% efficiency ratio. These are exemplary economics. Nevertheless, Southern trades for just six times pre-tax earnings.

Six times pre-tax earnings is an exceptionally low price for a well-managed and growing bank. It equates to a 17% pre-tax earnings yield, which compares favorably to the 10-year Treasury (2.1%) and S&P 500 (6.0%). Recent M&A transactions suggest Southern would be worth nine or ten times pre-tax earnings in a privately negotiated sale.

We believe Southern's bargain price is due to its structure, not its economics:

1. It is too small (\$300M market cap) and too illiquid for institutional investors.
2. It is not registered with the S.E.C., though it does publish audited financial reports.
3. It is not traded on a national stock exchange, but rather trades over the counter.
4. It owns \$91 million of First Citizens stock, which it does not highlight.

Southern is best valued as two distinct parts: its First Citizens stock and its operating business, Southern Bank and Trust.

Eagle Point Capital LLC

First Citizens, like Southern, is owned and operated by the Holding family. First Citizens is much larger than Southern, having pursued a more aggressive acquisition policy. It sports a \$4.8 billion market cap and is traded on the Nasdaq (symbols FCNCA and FCNCB).

Southern's First Citizens stock is worth \$91 million today and \$73 million net of deferred capital gains taxes. Southern's \$300 million market cap implies its bank is worth \$227 million or six times last years pre-tax earnings of \$39 million.

Another way to think about Southern is to value its look-through earnings. Southern's share of First Citizens pre-tax income is \$9 million. Southern Bank and Trust earned \$39 million itself which makes \$48 million total. At a \$300 million market cap, Southern trades for six times pre-tax look-through earnings.

We think Southern is worth at least 50% more today than our cost and we expect it to compound at a double digit rate for many years. We are excited to be long-term owners of Southern alongside the Holding family.

Spirit SMTA

As I discussed in my last letter, Spirit SMTA was a spinoff with concentrated exposure to Shopko. Spirit SMTA refinanced the Shopko assets with non-recourse debt before Shopko went bankrupt. In March, Spirit SMTA turned the Shopko assets over to its lenders and announced it was exploring the sale of its remaining assets.

The remaining assets consisted of Master Trust A (MTA), along with a distribution center and some other workout assets. We thought that the Master Trust was likely to sell for a 7-8% cap rate, and our best guess was that it was worth 7.2%. The market valued it at 8%, which we saw as the worst-case scenario. We perceived Spirit SMTA to have an asymmetric risk/reward profile: little to potentially lose and lots to potentially gain.

This week Spirit sold MTA for a 7.1-7.3% cap rate, depending on working capital adjustments. Accordingly, shares appreciated to within 85% of our estimate of intrinsic value. We decided to take our profits since our thesis played out. Once the transaction closes Spirit SMTA will be left with only its distribution center and workout assets, which we have no particular insight into.

We are pleased with the results of this investment. We paid \$6.84 per share in late March, received one \$0.33 dividend, and exited at \$8.50 in early June. That amounts to a 30% return in about two months.

As always, please feel free to contact me with any questions. You can reach me by email (matt@eaglepointcap.com) or phone (630-329-3860) anytime.

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