Bank of the Ozarks

Conference Call – July 12, 2017

<u>Transcript – Prepared Remarks</u>

Note: Administrative communications of the operator and other greetings and social exchanges of no substantial import have been omitted from this transcript.

Good morning, I am Tim Hicks, Chief Administrative Officer and Executive Director of Investor Relations for Bank of the Ozarks. The purpose of this call is to discuss the Company's results for the quarter just ended and our outlook for upcoming quarters.

During today's call, and in other disclosures and presentations, we may make certain statements about our plans, estimates, strategies and outlook that are forward-looking statements. These statements are based on management's current expectations concerning future events that, by their nature, are subject to risks and uncertainties. Actual results and future events could differ, possibly materially, from those anticipated in our statements and from historical performance due to a variety of risks and other factors. Information about such factors, as well as GAAP reconciliations and other information on non-GAAP financial measures we discuss, is included in today's earnings press release and in our 10-K, 10-Qs and various other public filings and investor materials. These are all available on our corporate website, www.bankozarks.com, under "Investor Relations." The Company disclaims any obligation to update or revise any forward-looking statement based on the occurrence of future events, the receipt of new information or otherwise.

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Let me turn the call over to our Chairman and Chief Executive Officer, George Gleason.

George Gleason

We are very pleased to report our excellent second quarter results, which include our 7th consecutive quarter of record net income and other favorable financial results, as well as a number of significant strategic accomplishments. My comments today will focus primarily on strategic matters, before Tim, Greg and Tyler speak on the financial results.

First, on June 26th we completed the previously announced merger of our holding company into our bank, with the bank continuing as the surviving corporation. We expect this corporate reorganization to contribute to future efficiency by eliminating redundant corporate infrastructure and the associated administration, accounting and duplicative federal regulatory oversight. Bank of the Ozarks, the surviving entity, continues to use our "OZRK" ticker symbol and the same CUSIP number as previously used by Bank of the Ozarks, Inc.

Second, on May 31st we closed a secondary common stock issuance resulting in net proceeds of $299.7 million. This increased our already robust regulatory capital ratios and provides capital for significant future growth. As most of you know, we expect to file our first Dodd-Frank Act Stress Test, or DFAST, submission in July 2018 based on year-end 2017 financials. As part of DFAST, we will project our expected growth and performance under three scenarios, known as the base case, adverse and severely adverse scenarios, over a period of nine quarters. With limited exceptions, you cannot include projected future capital raises in your DFAST projections. Because we expect significant growth in our base case scenario, we determined that we would need to augment our regulatory capital ratios during 2017 to support the projected growth in 2018, 2019 and the first quarter of 2020. Our May 31st capital raise should provide the needed capital.

Third, for some time now, we have been evaluating holding additional on-balance-sheet liquidity to provide another tool in managing our liquidity position. During the quarter, we increased our investment portfolio by a net $631 million. This resulted from our purchasing approximately $728 million of highly liquid, short-duration government agency mortgage-backed pass through securities. Because of the high quality and short duration of these securities, they yield only about 2%, so their purchase will be dilutive to some of our performance ratios, such as net interest margin and return on average assets. On the other hand, their purchase will be slightly accretive to other performance ratios such as our efficiency ratio. However, this balance sheet adjustment is not so much about the small incremental earnings as it is about the significant liquidity the purchased bonds will provide, including their monthly cash flow. These securities have a 20% risk-weighting for regulatory capital, so their purchase did not utilize significant capital. This gave us a very good liquidity position at June 30, 2017, including cash of $791 million and approximately $5.72 billion in other available secondary sources of liquidity, including unpledged investment securities.

Fourth, our Forms 10-Q and 10-K reports in recent years have discussed two legal actions related to overdraft fees and the posting order of payments. During the quarter just ended, we reached a settlement in principle with Plaintiff's counsel on a settlement amount, and attorneys for both parties are now negotiating final settlement documents. The agreed upon settlement amount has been fully provided for in our financial statements as of June 30, 2017. This accounted for $750,000 of other operating expenses in the quarter just ended, in addition to amounts accrued in prior years. This matter originated in 2011 and has been the subject of numerous hearings and appeals. We look forward to having this resolved in the near future.

Fifth, for years we have been among the nation's top performing banks. As we continue to grow, we are always focused on developing our products and infrastructure to allow us to continue to achieve high performance, even as we become a much larger bank. We have previously discussed our increased focus on developing technology-based products and solutions through our OZRK Labs, which we think will be critical to our success in this rapidly evolving retail banking environment. We have also talked about our focus on expanding and enhancing our infrastructure for information technology, information systems, cybersecurity, business resilience, enterprise risk management, internal audit, compliance, BSA/AML monitoring, training and other important areas, as well as expanding our human and physical infrastructure to serve low-to-moderate income and majority-minority markets and customer segments. All these initiatives are important elements in our preparation for significant further growth, and we have already made significant progress. These initiatives have been and will continue to be an important emphasis for us throughout 2017 and into 2018.

Sixth, as most of you know, Real Estate Specialties Group ("RESG") has been our largest growth engine for earning assets for many years. We expect it will continue to be our largest growth engine and will continue to increase its volume of originations and growth. However, for several years, we have been working on various initiatives to achieve greater contributions to our growth in earning assets from our other lines of business and product types other than commercial real estate. You can see the progress we are making in this regard in the quarter just ended in which 56% of our growth in non-purchased loans and leases came from our other loan and lease teams. We continue to expand these other lines of business.

Finally, on June 23rd, we migrated from the Russell 2000 to the Russell 1000. Some of you probably noticed that this transition created several days of volatility in our stock price and trading volume. We are pleased that our continued growth led to our increased market capitalization which resulted in our graduating to the Russell 1000.

In addition to all this, our second quarter results included some exceptional financial performance. I will let the rest of the team tell you about that.

Let me turn the call back to Tim Hicks, who you may have noticed has a new title: Chief Administrative Officer and Executive Director of Investor Relations. The creation of this new position and Tim's promotion and expanded role reflect both his accomplishments and our efforts to further increase the depth and breadth of our senior management team. Congratulations, Tim!

Tim Hicks:

Thank you, George.

Our $20.1 billion in total assets at June 30, 2017 was a 63% increase from June 30 last year. This balance sheet growth translated into excellent income growth. Our net income for the quarter just ended was a record $90.5 million, a 66% increase from the second quarter of 2016. Our diluted earnings per common share of $0.73 for the quarter just ended were a 22% increase compared to the second quarter of 2016.

In the quarter just ended, the funded balance of our non-purchased loans and leases grew $808 million and our unfunded balance of closed loans grew another $625 million. This unfunded balance of closed loans was a record $11.9 billion at June 30, 2017, which will be instrumental in achieving our loan growth goals in the remainder of 2017, 2018 and early 2019.

RESG accounted for about 44% of our growth in the funded balance of non-purchased loans and leases in the quarter just ended, and our other loan and lease teams accounted for 56% of the growth. As George mentioned earlier, we expect RESG will continue to be our largest growth engine, but we are pleased by the positive contributions and momentum from our various other loan teams.

At June 30, 2017, the RESG portfolio accounted for 68% of the funded balance and 93% of the unfunded balance of our total non-purchased loans and leases. At quarter-end, our average loan-to-cost for the RESG portfolio was a very conservative 49.1% and our average loan-to-appraised-value was even lower at just 42.0%. The extremely low leverage of this portfolio exemplifies our very conservative credit culture and is one of the many reasons we have such confidence in the quality of our loan and lease portfolio.

Given the growth in our customer base, our robust pipeline of transactions currently in underwriting and closing, and our largest ever unfunded balance of closed loans, we continue to expect 2017's growth in the funded balance of non-purchased loans and leases to be between $3.1 billion and $4 billion, although it is not likely to be at the top end of that range. As we said in our January and April calls, we expect growth in non-purchased loans and leases in the second half of 2017 to be better than the $1.4 billion of growth in the first half of 2017.

Let's turn to capital. As George mentioned, during the second quarter, we completed the issuance and sale of common stock for net proceeds of $299.7 million. We will continue to monitor capital markets conditions, capital formation alternatives, and our capital position, including our expectations for growth over the relevant nine-quarter DFAST time horizon, all with the goal of effectively managing our capital position for the maximum benefit of shareholders, while always maintaining well capitalized status.

Organic growth of loans, leases and deposits continues to be our top growth priority, and we have demonstrated our ability to achieve substantial growth apart from acquisitions. With that said, we believe M & A provides significant opportunities to augment our robust organic growth. Our last 15 acquisitions have been "triple accretive," being accretive to book value per share and tangible book value per share at closing and accretive to earnings per share in the first 12 months following closing. We expect to continue to be disciplined in our acquisition strategy and to apply this "triple accretive" test to future opportunities. We remain active in identifying and analyzing M & A opportunities, and we believe this strategy will help us create significant additional shareholder value over time.

Let me turn the call over to our Chief Financial Officer and Chief Accounting Officer, Greg McKinney.

Greg McKinney:

As a Company we have long focused on three disciplines – net interest margin, efficiency and asset quality.

First let me discuss net interest margin. In the quarter just ended, our net interest income was a record $202.1 million and our net interest margin of 4.99% increased 11 basis points from the first quarter. In recent calls we have mentioned that we have recently focused more on our "core spread" than our net interest margin. In the quarter just ended, our yield on non-purchased loans and leases increased 16 basis points to 5.42%, while our cost of interest bearing deposits increased nine basis points to 0.67%, resulting in a seven basis point increase in our "core spread" and continuing an improving trend over the last five quarters. Increases in Libor rates and the Federal Reserve's fed funds target rate have contributed, among other factors, to this improvement.

As a result of our robust level of loan originations in the quarter, we had $47.1 million in net deferred credits at June 30, 2017, meaning we had $47.1 million more in unamortized deferred loan origination fees than unamortized deferred loan origination costs. This, along with the $123.9 million valuation discount on our purchased loans at June 30, 2017, has favorable implications for future earnings.

Let me switch to efficiency. Our efficiency ratio has been among the top decile of the industry every year for 15 consecutive years. In the quarter just ended, our efficiency ratio was an excellent 35.3% and for the first six months of 2017 was 35.2%.

While our efficiency ratio will vary from quarter to quarter, we have stated in recent calls that we expect to see a generally improving trend in our efficiency ratio in the coming years. There are several key factors, among others, needed to accomplish our long-term efficiency goals. First, we expect to ultimately utilize a large amount of the excess capacity of our extensive branch network, tapping billions of dollars of additional deposits through existing offices. This ability to achieve substantial deposit growth with limited additions of overhead has favorable implications for our efficiency ratio. Second, we expect to achieve further efficiencies over time from our ongoing deployment of technology applications from OZRK Labs.

As George previously mentioned, as a larger and growing organization, we are constantly increasing our expenditures building infrastructure in a number of important areas. The increasing costs for such enhanced infrastructure will be a headwind in our efforts to improve our efficiency ratio. However, we believe that our excellent organic growth will generate sufficient additional revenue for us to achieve both our important infrastructure enhancements and our long-term efficiency goals. Our guidance regarding an improving efficiency ratio in future years does not consider the potential impact of any future acquisitions.

Our asset quality metrics during the second quarter are some of our best as a public company. For example, our annualized net charge-off ratios during the quarter just ended were three basis points for non-purchased loans and leases and five basis points for total loans and leases. At quarter-end, excluding purchased loans, our nonperforming loans and leases as a percent of total loans and leases were just 11 basis points, our nonperforming assets as a percent of total assets were just 23 basis points, and our loans and leases past due 30 days or more, including past due non-accrual loans and leases, to total loans and leases were a record low 0.15%. This was our sixth consecutive quarter of reporting a record low past due ratio.

These ratios reflect our longstanding commitment to conservative underwriting standards and excellent asset quality, which has resulted in our having asset quality consistently better than the industry as a whole. In our almost 20 years as a public company, our net charge-off ratio has averaged about 35% of the industry’s net charge-off ratio, and we have beaten the industry’s net charge-off ratio in every year. Our outperformance has been even better recently, as evidenced by the fact that our net charge-off ratio was just 13% of the industry’s net charge-off ratio last year and just 10% of the industry’s net charge-off ratio for the first quarter of this year.

I want to make one final comment regarding our effective tax rate. During the second quarter, our effective tax rate increased due to our true-up of state income tax apportionment factors. These adjustments were somewhat larger than normal due to our increased lending activity in higher income tax-rate states and municipalities, principally New York State and New York City. We have recently enhanced our procedures to ensure our quarterly accruals are more precise going forward. We expect our tax rate for the remainder of this year to be in a more normalized range of 36% to 37%. Of course, significant changes in the mix of taxable and tax exempt earning assets and changes in the mix of assets between states could affect the rate actually incurred.

Let me turn the call over to our Chief Operating Officer and Chief Banking Officer, Tyler Vance.

Tyler Vance:

In regard to liquidity, we have long expected that we could accelerate deposit growth as needed to fund our loan and lease growth. Our experience in recent years has validated that expectation. At least monthly, and more often as needed, we update a comprehensive 36-month projection of our expected loan fundings, loan paydowns and other sources and uses of funds. These detailed monthly projections of needed deposit growth provide the goals for our deposit growth strategies. This has proven to be a very effective process.

Currently we have 41 offices in 28 cities in "spin-up" mode offering various deposit specials along with an enhanced level of marketing activity. Our branch network of approximately 242 deposit offices continues to have substantial untapped capacity, and we believe that capacity is sufficient to fund our expected loan and lease growth over the next several years. Planned *de novo* branch additions and possible future acquisitions should provide additional deposit growth capacity as needed for the future.

At June 30, 2017, our total deposits were $16.2 billion which was a $528 million increase from the previous quarter-end. Because of our significant growth in organic deposits in the quarter just ended, we decreased our volume of brokered deposits by $434 million from $2.00 billion at March 31, 2017 to $1.57 billion at June 30, 2017. That's a decrease from 12.8% of total deposits to 9.7% of total deposits. Of course, we're not subject to any regulatory limitations on our volume of brokered deposits and our internal policy calls for a 15% limit, which we are well below, but we are nonetheless pleased to see our percentage of brokered deposits continue its recent downward trend. As a result of this shift in mix, our non-brokered deposits grew a healthy $962 million in the quarter just ended.

We consider net growth in core checking accounts as one of our most important deposit metrics. We achieved excellent organic growth in our number of net new core checking accounts with a record 6,339 net accounts added in the second quarter of 2017, bringing our total net new core checking accounts to 10,843 for the first six months of 2017. Our excellent checking account growth has been an important contributor to our record service charge income of $11.8 million for the quarter just ended. Let me remind you that the Durbin Amendment started impacting our service charge income as of July 1, and we estimate it will result in a pre-tax reduction in service charge income of about $1.95 million per quarter based on our most recent transaction volume available.

As Greg mentioned, our cost of interest-bearing deposits increased nine basis points in the quarter just ended compared to the first quarter of 2017. Given our expectation that our growth in non-purchased loans and leases in 2017 will range between $3.1 and $4 billion, we expect to continue to grow deposits significantly this year. Based on this, combined with possible further increases in the fed funds target rate during the remainder of 2017, we expect additional increases in our cost of interest bearing deposits this year. Our goal for 2017 is to hold the rate of increase in our cost of interest bearing deposits below, and hopefully well below, the rate of increase in our yield on non-purchased loans and leases. As previously mentioned, we achieved that goal in the quarter just ended as our yield on non-purchased loans and leases increased 16 basis points compared to the nine basis points increase in our cost of interest bearing deposits.

Now, let me turn the call back to George.

George Gleason:

Next Monday we will celebrate our 20th anniversary as a public company. Over those 20 years, we have grown from 13 offices with $309 million in total assets to 251 offices with over $20 billion in total assets. Our shareholders have benefited greatly from our constant pursuit of excellence, as evidenced by our 22.5% compounded annual total return to shareholders over that 20-year period. Such exceptional and sustained results can only be achieved by an exceptional team. I want to thank our 2,459 employees, who I believe are among the very best in the industry, for their hard work and great accomplishments as we celebrate our 20th anniversary as a public company. Well done! We look forward to continuing this success for decades to come.

That concludes our prepared remarks. At this time we will entertain questions. Let me ask our operator to once again remind our listeners how to cue in for questions.

Transcript of Q & A

Joe Gladue – *Merion Capital Group LLC*

First off, I wanted to touch on some of the expense growth, I guess particularly in the other noninterest expense category, which looks like it was up roughly 19% versus the first quarter. Wondering how much of that might be one time related to the holding company activity and what else might be pushing that up.

George Gleason

Well, as we commented, as I commented in my prepared remarks, there was about $750,000 of cost in there related to the agreement on a settlement amount for the long-standing, since 2011, deposit service charge lawsuit. So that was one unusual factor. There were some lesser sums related to the bank holding company merger, but those were not a significant enough amount for us to quantify. As Greg mentioned in his remarks, we're continuing to build out this infrastructure. A good example of that is at March 31, we had 2,343.5 full-time equivalent employees. That number of employees had increased 51 FTEs by June 30, 2017 to 2,394.5 FTEs. And that reflects both a buildout of the various elements of risk management infrastructure we've talked about for several quarters now, as well as a buildout of staff in our revenue-producing units from RESG to community banking to leasing. So it's a broad-based increase in staff there, and that is reflected in that.

Joe Gladue

Okay. Let me, I guess, move on over to the growth in unfunded commitments. I guess that grew about a little over 5%, 5.5-or-so percent from the first quarter, which is a bit of a slowdown from the previous quarters. Is there some seasonality to that growth? And is some of that, I guess, slower pace related to the fact that more of the growth is coming from non-RESG units rather than RESG?

George Gleason

Joe, I don't think, number one, there's any particular seasonality to it. To some extent what we are probably seeing is the fact that two years ago, we had a really large year followed by an almost as large year growth, in percentage terms, in that unfunded balance of loans. And as you and I and others have talked about many times, the loans, the larger loans, sometimes take two or three years to construct the project. And being the very low leverage only senior secured lender in the transaction, it's often a year or two years before we're funding on the loan as all of the subordinated capital elements, equity and mezzanine debt and so forth are getting expended on a project. So I think to some extent, we had expected that, that rate of growth in the unfunded commitments would begin to slow over time as a lot of these big unfunded commitments from two years ago begin to fund up. We had a very robust level of originations at RESG in the quarter just ended, and I don't have that number, but I don't think there was any slowdown from our first quarter pace of originations at all. It was just more of those previously unfunded commitments funded so it tended to minimize the impact of newly originated unfunded commitments. And I think you'll see that to some degree going forward. I would expect the unfunded commitments to continue to grow but at a slower percentage rate of growth then we have seen in the previous couple of years.

Joe Gladue

Okay, thanks, that's very helpful. I'll step back now.

George Gleason

Thank you, Joe.

Jennifer Demba – *SunTrust Robinson Humphrey, Inc.*

I just had some questions on loan growth. You said you expect loan growth this year to be probably not at the top end of your guided range. Can you just talk about the dynamics you've seen in the last few months? Has demand slowed a little bit or higher paydowns or what are we seeing right now?

George Gleason

Well, Jennifer, the first two quarters of growth were very much in line with what we had modeled at the beginning of the year. So we are tracking where we expected to be. There've been movements in a few other parts. Our marine and RV business generated about $185 million growth in the second quarter. That was up from $134 million of growth in the first quarter and a little more than we expected. I anticipate that some of the competitors we've been taking market share from are adjusting some of their marketing and business strategies and I would not be surprised, if that number pulled back a little bit in Q3 and Q4. On the other hand, our funded RESG growth has been a little slower than we modeled at the beginning of the year. But net, we're within about $20 million or $30 million at the end of June of what we modeled for Q1 and Q2 at the beginning of the year. So we're running really close to projection. We have not changed our guidance, although Tim noted that we're probably more likely to be in the bottom half of that guidance I think was the implication of his comment, than the top half of the guidance range. So we feel like we're on track to do what we expected to do at the beginning of the year.

Timur Braziler - *Wells Fargo Securities, LLC*
First question I have is on the purchased loan yields. It seems like they've been bouncing around quite a bit over the last three quarters. Any gauge as to what's driving that increase in the second quarter and maybe help frame where you see expectations going forward, there?

George Gleason
In Greg's remarks, he mentioned we've got -- Greg, what was the number, $125 million?

Greg McKinney
$123 million.

George Gleason
$123 million of remaining credit, noncredit NPV marks on that portfolio. And what causes those loan yields to bounce around, and we’ve talked about this for years since we've had significant purchase loans in the portfolio going back to 2010 now, is when you have prepayments of those loans, those unaccreted contra accounts drop into income as additional accretion income. So that number will be very volatile from quarter-to-quarter and will be largely dependent on and heavily impacted by the rate of prepayments and the mix of prepayments. If you have $100 million of loans pay off, and they were at their natural maturity, and there were no credit marks on them, then you'll have no unusual impact on accretion income from those prepayments. If, on the other hand, you have $100 million of loans pay off that there were meaningful credit marks or significant maturities left, meaning the significant maturity -- meaning that there's substantial unaccreted discount, net present value discount, on it, then those credits will drop into income, and that will cause your margin on that portfolio to increase and your yield on that portfolio to increase. It will be volatile, and that's one of the reasons that we have talked about in the last four or five calls, that core spread, the difference between our yield on non-purchased loans and our cost of interest-bearing deposits has really been a better indicator of the job management is doing and the effectiveness of our business plan in maintaining good margins. And that spread increased -- core spread increased seven basis points in Q2 after increasing six basis points in Q1. We've had a five quarter improving trend in that core spread as Greg alluded to, so our real focus at the management level

is to keep improving that core spread and get our yield on non-purchased loans to go up more than our cost of interest-bearing deposits goes up as the Fed raises rates. And the NIM will bounce around quite a bit from quarter-to-quarter based on the prepayments in that purchased loan portfolio.

Timur Braziler

That's helpful. And then just circling back to the deposit cost conversation. How much of that increase this quarter was driven by promotional rates versus seeing higher deposit betas on your core accounts? And I guess now with three consecutive rate hikes, is your expectation for deposit betas -- is that expectation now moving higher starting here in the third quarter?

George Gleason

I'm going to let Tyler address that.

Tyler Vance

The increasing cost is really driven a lot by the need to fund our growth. And so we have seen some larger customers where we've made rate concessions, we've adjusted their rates in terms of this new rate environment. We've not changed any of our rack rates. Those have all stayed the same. We've adjusted some CD specials anywhere 10 to 15 basis points in those spin-up markets. So again, really the increasing cost is at the margin to fund the growth.

Timur Braziler

Okay, great then one more if I could just for you George. I'd love to hear your update and thoughts on M&A. What are you seeing there as far as deal flow and does the upcoming DFAST preparation – does that at all hinder the ability or the willingness to announce an acquisition at some point throughout the remainder of the year here?

George Gleason

Our work on DFAST which is ongoing, and we're in the process now of doing our second dry run on DFAST, that is having no impact whatsoever on our appetite or our interest in M&A transactions. As Tim mentioned in his remarks, and Tim works most closely with Dennis James, our Director of M&A, on modeling and looking at opportunities out there, we continue to be active and continue to look but we are committed to our long history of doing transactions that are triple accretive; accretive to book value and tangible book value per share on day 1 and earnings per share in the first 12 months following the transaction closing. Obviously, seller pricing has gone up and seller pricing expectations have gone up as a result of deals that have been announced in recent quarters. Our stock is not trading at as high of a multiple as it was a year or two years ago, and frankly I don't understand that, but it is the fact. So that's making the math of transactions less appealing and more challenging. With that said, we have continued to see several transactions in the first half of this year that would have met our triple accretive test, but we looked at those through a lens of another test. And that other test is if we spend the same energy and effort in resources that we would devote to doing that transaction, can we generate more profitability and return for our shareholders spending that same – those same resources on our organic growth. Hence we've not elected to pursue several transactions that would have met that triple accretive test so far this year but we continue to look, we continue to be active and we continue to believe that M&A will be an important part of our future growth strategy, but we will be disciplined about it.

Michael Rose – *Raymond James & Associates, Inc.*
Hey, good morning. I just wanted to start with the other non-interest income. It looks like it was up a little bit, and I just wanted to see if there was any sort of onetime kind of items in there.

Greg McKinney
Michael, it was really just a continuation of what we've seen from just a run rate standpoint. That has a little bit of a tendency to bounce around from quarter-to-quarter, but there's no really unusual onetime items in there that are driving the increase this quarter.

Michael Rose
Okay, so that's a decent run rate going forward then.

Greg McKinney
That is correct.

George Gleason
With a caveat, as Tyler mentioned, that the Durbin Amendment will kick in here in Q3 and as our number of customer transactions and core accounts has grown and we've completed our acquisitions over time, that number has gotten bigger and it's about $1.95 million a quarter.

Tyler Vance

That is correct, George.

George Gleason

So as your starting point, deduct $1.95 million in service charge revenue from Q2 and then project whatever you think that's going to grow out from there, would be a good starting point.

Michael Rose

Perfect, and then maybe as a follow-up, if you guys can touch on post capital raise, where your CRE and construction concentration levels are relative to the guidelines and if the capital raise in any part was contemplated by any sort of regulatory conversations. Thanks.

George Gleason

The capital raise was not a result of any regulatory conversations whatsoever related to CRE or otherwise. And frankly, I don't know -- Tim, do you know what our CRE ratios are afterwards? We haven't looked at that.

Tim Hicks

No, we don't have those available at this time. Although, the capital raise will obviously benefit those ratios, and we'll have to calculate that considering our growth in the quarter as well.

George Gleason

So we haven't even calculated that, and the CRE ratios were not at all a consideration in the capital raise. The capital raise was a result of the fact that under our first dry run of our DFAST stress test and as we extrapolated those first dry run results to our projections for growth in the future, as they've evolved and so forth, we are expecting such significant growth in 2018, '19 and the first quarter of 2020 in the base case that will outrun our ability to generate capital organically. So if you've retained earnings at a 13% or 14% rate of retained earnings, but you're growing the balance sheet at 30% per annum plus or minus, you've got to have more capital. And as I said in my remarks, you can't project those capital raises over your nine quarters of the DFAST stress test with limited exceptions. You got to have it on your balance sheet at the balance sheet measurement date, which in our case here for the first test will be December 31, 2017. So it was all about the DFAST test and the projected base case growth we expect in the DFAST test, and the capital raise had nothing to do with our CRE ratios.

Michael Rose

Okay. Then maybe just one final broad question just on the RESG business. George, you and I talked about your thoughts on what that -- what the industry growth looks like over the next few years. You talked about it potentially slowing and then your pass-through rates increasing a little bit. Can you just give some color on the market pricing and if that's improving for you guys, given competitors have pulled back, and kind of your thoughts and expectations just for that business line over the next few years? Thanks.

George Gleason

Yes, we do have the expectation that construction nationally across all product types and in all markets across the country is likely to pull back a little bit. And whether that number is 10% or 20%, I don't know. But in talking with our customers as our RESG guys do, and they're passing that feedback along to me, cost of labor and materials in some markets are going up significantly. Cost of construction financing is going up. Because the Feds moved interest rates now 4x, and probably spreads on construction financing, at least in our experience, have gone up over the last 18 months to two years.

So it's costing more in labor, materials and capitalized construction period interest for our customers to build things. And we're working against a period of years coming out of the Great Recession where supply did not keep pace with demand, and supply of product and a lot of product types has caught up with demand now in a lot of submarkets. So there are a lot of markets around the country where you might have had five projects coming to market a year ago, but there's really only a need for two more projects coming to market this year, and that is slowing volume to some extent. But as we've talked about, we do a very, very low percentage of the transactions that we see. And historically, that number has kind of been 6% to 8%. And we kind of feel like it’s even a lower percentage now. So if the pie nationally shrinks, we would still expect our volumes to be very good. And as Tim mentioned, and I think I mentioned in my remarks, we expect RESG to continue to be our biggest growth engine and its business to grow over time. So we still expect by just getting a little higher pull-through rate on our transactions we can keep our volume positive even if the industry contracts a little bit. And that contraction is actually a very healthy thing. It's very encouraging to us that developers are paying close attention to supply-demand metrics and are really being careful to only build things where there's a very good reasonable sound expectation that the demand is going to be there for the product being built. So we think all of that is working out in a very healthy and constructive way.

Stephen Scouten - *Sandler O'Neill + Partners, L.P.*

Maybe a follow-up on a growth question if I could. Maybe it's kind of a two part question around growth. You mentioned the RV and marine as a contributor on the non-RESG percentage, but that number was kind of a lot more impressive than I would have expected this quarter. Can you give other color into that? And then as it pertains to the RESG hires that you mentioned, have you added any new whole teams there or where do we fall on the amount of teams you have for RESG?

George Gleason

We have continued to add new team members to RESG, but we never have gone out and hired a team of people. What we do there is very disciplined and very focused and requires a very high level of expertise and competence and understanding. So we've never tried to go out and lift a team out from any place else and put them in RESG. We hire individual team members that we believe have the aptitude, the skill set, the experience, the knowledge, the work ethic, the discipline to be part of RESG and bring them in and one at a time make sure those individuals really are performing in our culture consistent with the high standards of our culture. So we're continuing to add that. I don't know exactly what the headcount is there. I think we're at 100-something now, maybe a high as108 or 107 something like that. So the RESG team is growing but it's not by adding teams. It's one person at a time based on the unique skills and the ability of that person.

The marine and RV team is an excellent team. They were one of the real jewels from a talent and competence and unique skill set perspective in the CSB acquisition that we closed last July. And John Redmond and Dennis Poer, and the guys that work with them in that team, have just continued to do an excellent job. They are veterans in the business and, hence, they have very broad-based contacts and a lot of relationships that go back decades there. Their ability to take their expertise and capitalize on their market knowledge and relationships and bring in business has been the reason that, that line of business has ramped up as effectively as it has for us.

Stephen Scouten

And just from some of the color you've given, I presume you wouldn't expect the same level of contribution from the non-RESG businesses in the next couple of quarters? Is that fair to say?

George Gleason

I would expect, as I said, it may be hard for the indirect marine and RV guys to replicate that $185 million of growth from Q2. That was an outstanding number, and I think they've certainly ruffled feathers among some of our competitors there. And so there's likely to be a little competitive pushback that slows their momentum just a bit in the short run. I do expect them to be a significant positive contributor, I'm just not sure they can hit $185 million again. We expect continued increases in the volume of growth from Community Banking. Our Community Banking Group actually contributed about $210 or $211 million to our Q2 growth, and we had positive growth in Leasing and our Corporate Loan Specialties Group got a little bit of traction with about $57 million of growth in the quarter. So I would expect in future quarters, we would continue to see additional contributions at an accelerating volume from the non-RESG groups with the possible exception we may have a flat to slightly down quarter or two for indirect, and I would expect an accelerating volume of funded growth from RESG starting this quarter.

Stephen Scouten

That makes sense. And if I could jump to the interest-bearing deposit costs again, it seems like the same amount of offices and regions are in spin-up mode as they were last quarter. Would you anticipate the need for any changes there and any major differential in terms of the deposit composition for this quarter versus last?

George Gleason

Well, that's under constant review by Tyler and his team. And the reason we didn't put more offices in spin-up mode or do more adjustments to our rate on the spin-up offices, was simply a result of the fact that if you ignore the runoff and brokered deposits, our non-brokered deposits – Tyler what was that number?

Tyler Vance

$962 million.

George Gleason

Yes, $962 million. So his retail banking teams and the retail banking teams in the community bank that worked for John Carter and the deputy directors of community banking and those market division presidents just did excellent an job growing deposits. And Tyler mentioned we had over 6,000 net new core checking accounts added, by far the largest quarterly total we've ever had. So they just got a really good quarter of deposit growth without having to increase our number of spin-up officer or significantly adjust the rates in the spin-up offices. That's just good, hard handwork in the way we brought in those deposits by our entire team, so real proud of the accomplishments of Tyler and the entire retail banking team and community banking team on that. There was a lot of hard work that went into that and we are pretty optimistic that we will only make probably minor adjustments in the spin-up offices this quarter, if any, and still get some pretty good results. They’ve got a lot of momentum going on the deposit sides. We're feeling very positive about that. But as I said spin-up is under daily review as Tyler contemplates the 36-month forward funding forecast that Tim and his team provide to Tyler based on the constant review and update of loan commitments and closings and fundings and so forth. Tyler is constantly evaluating what is happening competitively and growth-wise, volume-wise on the deposit side and he's matching that. So it's under constant review.

Stephen Scouten

Okay, and maybe just one last question. A little bit of an abstract question, but you mentioned that you're a little frustrated or surprised by where your valuation is today and that could be inhibiting M&A. Do you think there's anything that you guys can do specifically to kind of further demonstrate the core of your franchise, the strength of the quality, the results of the franchise, and maybe dissipate some of these concerns around RESG or the size of those loans? Anything you guys are considering to make things more clear for people that apparently, it's not clear for today?

George Gleason

The answer to that is no. I mean, we've been incredibly transparent regarding our RESG portfolio and really all of our business for that matter. And if people can’t understand that, then I don't know anything else we can do to help them understand that. But the results over the long-term clearly speak to the quality of that portfolio. And the thing that people ought to be able to very easily understand is that our competitors, many of whom have lower CRE ratios, and who do maybe 20 or 30 points or 40 points higher leverage on their CRE than we do, we are at 49% loan-to-cost and 42% loan-to-appraised-value, which is the fully funded LTCs and LTVs for the RESG portfolio, so assuming every loan is fully funded. Those are amazingly low numbers, and we're the most conservative party, the only senior secured party in the cap stack on every transaction we do. And, if you look at our level of leverage versus the industry as a whole, we're probably the most conservative CRE lender in the entire industry. The numbers from our historical loss experience certainly tell a compelling story. The LTV, LTC numbers tell a massively compelling story, and you would think people would be able to understand that. But -- and I think more and more people are understanding it as time goes on, but it's an outstanding quality portfolio, and we have absolute confidence in it.

Matt Olney – *Stephens Inc.*

I wanted to circle back on the acquired loan book. It looks like that the pay downs continue there at a pretty high level. No real slow down from the first quarter. Any commentary you guys can provide as far as the pace of the pay downs on that acquired loan book?

George Gleason

We were a little surprised by that. If you look at Q4 of last year when we would have expected elevated pay downs because the C1 and the CSB acquisitions were fairly freshly minted, we had a $442 million decrease in that loan book in Q4, which was 8.2% of the beginning of Q4 balance of that. That slowed as we expected it would in Q1 to $378 million or 7.6% of the beginning balance of Q1. And we would've expected that number would've gone down from $377 million or $378 million and down from the 7.6%. That would be our normal experiences that the rate of pay downs from these portfolios would slow. But to your point, it's actually reversed the other direction in Q2. We had $421 million in pay downs, which was 9.2% of the beginning of quarter balance. My best guess at this point in time, and when people pay their loans off is a hard thing to predict, but my best guess at this time is that the Q2 increase in pay downs both in dollar and percentage was an anomaly, and I would expect and there is certainly no guarantees on this, but I would expect the dollar amount of those pay downs and the percentage to decrease in Q3 and decrease again in Q4 and decrease again each quarter. It's not going to perfectly go in a straight line, but we would think the trend would be to have lower dollar amounts and lower percentages prepay over time.

Matt Olney

Okay, thank you for that answer. And then circling back on the operating expenses, I appreciate the commentary on the infrastructure build that's required in order to become a larger bank. Is there any more color you can give us on the operating expense growth rate? And how should we be thinking about the -- what percent of the infrastructure build that's required is now in the run rate as of Q2?

Greg McKinney

Matt, let me take a stab at this. George mentioned the high-to-low that had about -- that settlement on that piece of litigation -- had about a $750,000 one-time impact. We did have the merger transactions, special shareholders meetings, there were a little bit of legal fees, some proxy preparation printing, filing, mailing expenses associated with that, so that is a run rate there, a onetime item as well. Our annual directors' stock grants that we grant to non-employee directors every year at the annual shareholders meeting, that hits in Q2. That was about a $700,000 impact to other operating expenses in the quarter. That's a one-time annual charge. That's not in the – would not be part of the run rate. The other couple of items I'll mention, and this is kind of in lieu along the lines of the buildout of the infrastructure, we have engaged some third parties to help us with some of the DFAST model builds that are required to run the various – and prepare the DFAST submission. Those expenses have been in the run rate for the last three, four, five quarters and will probably continue to be there throughout the remainder of this year. My expectation is that those expenses would begin to slow down in 2018 as we have that DFAST, the models entirely built and all those models validated. So I think that probably remains a little bit elevated for the remainder of 2017. George's comment indicated that we would expect those infrastructure costs to continue through 2017 and into, to some extent, 2018. So I think those will begin to ebb as we move into the remainder of this year, particularly in 2018. And then the one final piece, I'll mention is as of March 31, we are now part of the large bank deposit insurance pricing from the FDIC. Those rates are higher for a large bank versus a community bank and that had a little over $1 million impact on our deposit insurance cost in Q2, and that will basically be ongoing as we look into the future.

Matt Olney

Okay, that's helpful, Greg. And then Greg, since you're there, with respect to the accretion income that goes through the NII, I think that was about $9 million in the first quarter, do you have that number for 2Q?

Greg McKinney

Actually, that was, I think it was…

Tim Hicks

Yeah, that was close to $20 million in the first quarter, it was $22.5 million in the second quarter so a little bit elevated in the second quarter. If you're referring to the line item on our cash flow statement that outlines that, it was a little elevated and obviously the denominator was a little bit lower as well on the purchased loans so that did have a little bit of a bigger of an impact this quarter. Again that goes back to George's comments and Greg's comments just on -- from previous calls, on the mix of payoffs and those purchased loan portfolios and how much accretable difference is remaining on those loans that pay off in that particular quarter.

Catherine Mealor – *Keefe, Bruyette & Woods, Inc.*
Just to follow-up on -- maybe first on the expense side. It sounds like if we take out of the $750,000 associated with the Durbin charge, it feels like still directionally linked quarter, or from here to the back half of the year, we should still see an increase in the expense base but perhaps at a less – or perhaps at a slower pace than we saw in the second quarter?

George Gleason
Catherine, I would think as Greg – and Greg you jump in here, but as Greg enumerated on the previous question, there was the $750,000 legal charge in the non-interest expense, and there was a $750,000 or $700,000 roughly directors cost. So those will drop out, but we continue on this infrastructure build. So I think your assumption is probably a reasonable assumption that yes, non-interest expense will go up in future quarters but at a lower rate than the rate of increase from Q1 to Q2. Greg, is that...

Greg McKinney
Yes, I would actually expect that other line item to be down in Q3 versus Q2. I think probably somewhere between Q1 and Q2 is where I would expect that. I mean, I think we've got probably close to a couple of million dollars of onetime type items that hit that line item Catherine, in Q2, so I would expect -- I would expect that line item to be down somewhere between the Q1 and Q2 amounts as we look into the back half of the year, particularly third quarter.

Catherine Mealor
Okay, that's helpful, thank you. And then, one thing to circle back on the margin, just thinking directionally about the margin, in reading, in what you were saying George at the beginning of the call and the impact that you think that the securities build is going to have on the margin directionally, do you still feel like normalization in the purchase accounting and then the impact from the securities build should still be probably enough that we are going to see directionally a lower margin even as your non-purchased loan yields continue to move higher?

George Gleason

I think it's true because we added $700 million plus of mortgage-backed securities that are very short, and they're going to yield right at about 2%. And so that's going to be dilutive to our margin, dilutive to our yield on our securities portfolio and as I said, we're going to have some small incremental amount of earnings from that so it will be positive in a slight sense to net income. But the purpose of that securities portfolio adjustment and strategy is all about giving the funding guys just one more tool in their arsenal of tools to manage balance sheet liquidity. And we've probably got adequate tools already, but those are the sorts of things you'd just like to have multiple tools in the toolbox to use if you ever got in a situation where you need them. So it will be dilutive to our margin to do that. The thing we're focused on though as you alluded to is that core margin, keeping that increasing over time. And if we do that, I think we'll put up very good results for our shareholders.

Peyton Green – *Piper Jaffray*

I was wondering if maybe you could comment with regard to the non-purchased loan yield. Basically, spread started to widen, if I recall correctly, in the second half of 2015 and then the first half of 2016 relative to spreads on prior Real Estate Specialties Group loans. And given the time line of those fundings, would you expect the non-purchased loan yield to get a little benefit as those loans fund in the second half of 2017 and into the first half of 2018?

George Gleason

Yes, we would. We talked about that starting really in probably the April call last year that we were getting better spreads because a lot of folks had vacated the space. So we were able to even push our leverage lower and get our spreads a little wider than they might have previously been, and that we would begin to see the benefits as those loans originated last year and earlier this year began to fund in future quarters. So we're still thinking that, that is some element of positive for us going forward. It's hard to quantify that, but we do think there's some potential there for that to continue to help us boost the core spread.

Peyton Green – *Piper Jaffray*

Okay. And then the June rate hike that should also help, that non-purchased loan yield in the third quarter, which I would expect you to probably have minimal floors that are in the money to move through at the end of June. Is that fair?

George Gleason

Yes. I think we've got about $800 million of loans that are at a floor rate. And you would say, "well gosh, why is that so large with four Fed increases already done?” And the answer to that is some of these loans are annually adjustable or semi-annually adjustable, and they're not all daily immediately adjustable. So we still have some loans that will adjust when they hit their adjustment date and that will help us. And obviously, we got part of the quarter’s impact from the Fed move in Q2. And since so many of our loans are LIBOR-based, our most dominant index is 1 month LIBOR and 90 day -- 3-month LIBOR is the second most dominant index. So those indexes began to anticipate this last Fed increase so we began to get some build up as we got closer to the date of those increases in those margins. But we'll have a full quarter's benefit of that in Q3. So that should help us continue to keep non-purchased loan and lease yields moving in the right direction.

Peyton Green

Okay. Last question for me. Is there overall -- what kind of other earning asset to earning asset mix, I guess everything non-loans, that you would be targeting towards over the next couple of quarters or year or 1.5 years that we should be mindful of?

George Gleason

We're not. Our securities portfolio right now is at a very low percentage of earning assets compared to where we were say 7 years ago or 10 years ago. And we would like to be in an environment where that securities portfolio could become a much higher percentage of our earning assets. We are unfortunately not in an environment today where we feel like we could add a lot of securities for yield purposes. We did add securities last year that we retained a lot of the kind of short, medium term mortgage-backed securities and other short-term securities from the CSB acquisition for liquidity. And then we added securities as we’ve talked about at length on this call in the last quarter for liquidity. So we're keeping the liquidity element of our securities portfolio where we feel like it needs to be, but as far as really investing a much higher percentage of earning assets in securities because we love the risk-reward profile from an interest rate risk perspective, we are a long way from that at this point.

Brian Martin – *FIG Partners, LLC*

Most of my stuff has been answered, George, maybe just a couple of quick things and maybe it's one more for Greg But on the fee income side, just that underlying, and Greg you kind of talked about it's up about 50% since fourth quarter at least kind of the run rate. I'm just curious, and it sounds like it's sustainable. What are the biggest -- or the bigger components in there I guess maybe if you just -- you were talking about the other expenses and kind of breaking things out. Just other fees, are there any larger components in there that you can isolate or just point to on that line item?

George Gleason

Brian, let me clarify. Are you talking about other income or other expense?

Brian Martin

So within the fee income, just the other line.

Greg McKinney

Yes, there's a -- we have some asset servicing fees that RESG charges. That's a decent sized component within that line item, Brian. We have really begun trying to charge customers for the value we bring to the transaction. And so those fees have been increasing in recent quarters so that's part of the driver there. There’s a little bit of underwriting that also end up in that line item. That's not a big number, but it's really those types of fees and income items that we're able to generate. We've been more successful with the ability to – with better pricing, better other fees associated with some of those transactions, so that's a big part of what has driven the increase in that other non-interest income line item in the last two or three quarters.

Brian Martin

Okay, perfect, that's helpful. And then, just on the securities that were purchased this quarter, I guess it’s fair to assume that not much impact on the margin from this quarter from that purchase as they occurred late in the quarter, is that fair?

George Gleason

That entire block of securities, as you know mortgage-backed securities tend to settle on a regular way on a single settlement date, which I think was the 18th or 19th of June. So you're exactly right. There was 11 -- 10 or 11, 12 days of impact on the margin this quarter from those security purchases. They were all settled on that regular way, June settlement date.

Brian Martin

Okay, perfect. And then just the last two things. Maybe if you could talk about just on the RESG growth this quarter geographically, maybe just if you have an idea of where the larger growth was coming from. And then maybe just one other question on the margin on the non-purchased loan yields and just wondering how much of the -- you talked about the better pricing, George. Just wondering how much of the pickup in that non-purchased loan yield in the quarter is driven off of the rates versus the better pricing. I assume it's more of the rate side but some incremental and some piece better pricing. But just those 2 and that's all I have.

George Gleason

I don't know that I can break that out in any meaningful way for you. With the variable rate loans, obviously, a big part of that increase in yield was a result of that. And I can't quantify how much of it is because we got better pricing on the loan than we might have gotten a year ago. But we were pleased with the positive directionality of that.

On the RESG originations, we had about $746 million of net new loans originated in the quarter in the New York MSA. We had about $324 million of net new originations in the Miami, Florida MSA. Los Angeles MSA, we had about $306 million of new originations. And these are funded and unfunded balances. Orlando, we had about $148 million. Metro Atlanta area, about $94 million. Metro Boston area about $80 million. Metro Chicago area about $76 million. Metro Philadelphia area about $56 million And then everything else was below $50 million, and that included: San Francisco MSA; Summit Park, Utah; Madison, Wisconsin; Minneapolis, Minnesota; Dallas, Texas; Portland MSA; Austin MSA; Denver MSA. Yadda, yadda, yadda. A lot of geographies involved.

Brock Vandervliet – *UBS Financial*

Thanks very much for taking my question. A lot of this has already been kind of aired out, but I'm just going to ask on the funding side, your cost of interest-bearing deposits has risen somewhat faster here in the second quarter than it did in the first. Not surprising consistent with industry trends I would imagine we see, but you also had some changes in the component parts. You called out the decline in the broker categories. Do you think the mix savings time, other time, continues to move and shift versus what we saw here in the second quarter? Or do you think that's going to be pretty stable from here?

George Gleason

You know, I was looking at -- Tim, is that a 12-month graph that I was looking at yesterday?

Tim Hicks

It was a 12 quarter graph.

George Gleason

12-quarter graph of that and that number has just not moved very much over the last 12 quarters. I think we were about 29% time and 54% non-time interest bearing and 17% noninterest-bearing in real round numbers at the end of the last quarter. And those numbers I would say are slightly better than they were a quarter or two quarters ago for the most part, if time being a lower percentage is better, but they haven't moved within two basis points -- two points -- two percentage points on any of those numbers really over the last several years. So pretty stable mix and I think that will continue.

Brock Vandervliet

Are you sensing customers are becoming much more sensitive to rates whether it's savings or time? And you're having to fight harder for the deposits that you are pulling in?

George Gleason

I would say, and Tyler may want to comment on this, but I would say yes. There is some increased sensitivity. I mean, obviously, we've had four Fed fund rate increases so most deposit customers sort of fell asleep for years because there was no activity on deposit rates and certainly, four rate increases got folks looking at that, and that's reflected in the increased cost of deposits in the last quarter.

Tyler Vance

Yes, I think, George, on the CD side we have seen that and we made a few adjustments as I mentioned on our deposit CD specials, but that's primarily where we've seen it. It’s on CD side.

Blair Brantley – *Brean Capital, LLC*

Hey guys, just a real quick question. On the fee income side, is there any change in your strategy to maybe add some more on the -- with the Durbin kicking in and obviously the benefits from some of the acquired loans and what not that should be falling. Is there any change in philosophy or maybe adding some other lines in the fee income segment?

Tyler Vance

This is Tyler. For some time, we've been focused on improving debit card usage. Our marketing teams and others, our community banking teams that George referenced earlier. They're all focused on getting cards in customer's hands as they leave the branch and improving usage. But other than that, there are no other efforts underway.

George Gleason

We're not looking at adding any new lines of business. Particularly, we're very focused and engaged on all the things, the initiatives we already have going on. So there are no present plans, Blair, for us to get into any other fee generating lines of business to augment our existing portfolio of products and services.

George Gleason

Thank you guys for joining the call today, we greatly appreciate your participation. There being no further questions, we're done. We look forward to talking with you again in about 90 days. Have a great day, thank you.