Bank OZK

Conference Call – July 19, 2019

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 OZK. Thank you for joining our call this morning and participating in our question and answer session. In today's Q & A discussion, we may make forward-looking statements about our expectations, estimates, and outlook for the future. Please refer to our earnings release, management comments and other public filings for more information on the various factors and risks that may cause actual results or outcomes to vary from those projected in, or implied by, such forward-looking statements.

Joining me on the call to take your questions are: George Gleason, Chairman and CEO and Greg McKinney, Chief Financial Officer and Chief Accounting Officer.

We will now open up the lines for your questions. Let me ask our operator Kevin to remind our listeners how to cue in for questions.

<u>Transcript of Q&A:</u>

Ken Zerbe – *Morgan Stanley*

I was hoping we can start off with expenses. It looks like expenses ticked up a little bit versus what I thought was a seasonally higher quarter back in first quarter. Could you just talk about what drove the higher expenses this quarter? And more specifically, or more importantly, what is the outlook for expenses on a go-forward basis?

Greg McKinney

Ken, this is Greg. Let me start with that, and then George and Tim can chime in, too. We're continuing to build our infrastructure as we've been doing now for a number for quarters. We are in the late innings on that. I think we're getting close to having that built out. We are hiring individuals to really come in and take the place of third-party consultants that we've been using to help us get some of these programs up. There's a little a bit of a transition in some of that if you bring individuals in and then begin to exit consultants out of the Bank. That process is ongoing. We expect that to continue over the next quarter or two. I think you'll probably see a little bit of continued increase in overhead in the next couple of quarters as we continue to make that transition to get the remaining infrastructure in place. Although we think that we can get beyond the seasonally challenging Q1 of 2020, I think, there's a pretty good opportunity for you to keep the overhead I'm going to say a little more in check. That's not to say it's not going to continue to have some increase, but I think you'll see the rate of increase as we get to that point in time much more likely to be muted, at least relative to what you've seen in the last two or three quarters. That's really the biggest driver in overhead, as we think about overhead the last four, five, six quarters, and that continues to be probably one of the biggest drivers as we think about overhead for the next two or three quarters.

Ken Zerbe

Okay. That does help. Maybe, switching gears. In terms of the North Carolina credit. I understand you're trying to sell the South Carolina credit. But with the North Carolina credit, it almost sounds like you're taking on the responsibility of finishing the project, or the build. Can you just expand on that a little bit more? Like what exactly is happening and what's the timeframe of that?

George Gleason

Yes. Good question, Ken. As you are aware from previous calls, the sponsor there developed a lot of houses, and it was ongoing development of lots. Some of those houses were not fully completed. There's a custom home there that's being built for a custom buyer. So we're completing those sort of construction elements in lot development areas -- activities and expect to sell those homes and lots as developed. There is some remaining work to be done on that project, and then the question will come at some point in time of how you continue development. Do you just sell lots? Do we need to develop some more inventory? So we're going to try to operate that in a way to maximize our proceeds and, hopefully, recover some money that we've written off. We're not going to get into a massive development project, but there is work to be completed, and it is an ongoing operating project with amenities that operate and so forth. So we're going to operate it and work our way out of it in an orderly manner.

The South Carolina property is obviously a much simpler project to sell because it's ripe for someone to acquire it, reposition it, redevelop it in a major way. I will comment, a couple of the analysts noted in their writeups commented that we had foreclosed on these properties. We actually did not foreclose on either one of them. We acquired title in deed & lieu transactions, and that took a little while because we had to recheck all of our environmental due diligence and insurance and get certain permits an operating licenses transferred and so forth. So both transactions were transferred to us in a cooperative agreed upon transaction with the cooperation of the sponsor.

Ken Zerbe

I see. And with the North Carolina project, is there any risk of additional write-downs in terms of your exposure if you don't complete the projects and you sell just the lots or any other -- basically, any other risks to you guys?

George Gleason

Well, there's always a risk of additional write-downs. I think that's extremely low in both transactions, given the conservative nature of the appraisals that we've received. In fact, we wrote the assets down when we received those appraisals in the third quarter of last year to 80% of appraised value. And of course, we've previously mentioned on the South Carolina project that in the couple of quarters after we put it on non-accrual, we've captured $0.5 million or so of cash flow that went to reduce the balance on that. So I think write-downs are unlikely, but our practice is to reappraise OREO properties on an annual basis. So as long as they're in foreclosed assets they're subject to reappraisal, and if those appraisals became more adverse than we would have a write-down from that. The reality is, I think, it's very unlikely.

Ken Zerbe

Okay. And then just one more question if I could. I understand how hard it is to forecast repayments on the loan portfolio, the RESG portfolio, but is there a way of kind of quantifying the lower bound of potential loan growth? I did notice that you did reduce your loan growth guidance for the year due to even more elevated payoffs. I'm just wondering how bad could it be within sort of a reasonable expectation, like if you go through loan-by-loan of your portfolio to try to examine what could payoff? Like, where is the lower bound of loan growth this year?

George Gleason

Well, we did go -- we based our projections based on a loan-by-loan analysis. And as you know, in our RESG portfolio we average about 14 loans per asset manager. So our asset managers are very close to those transactions. These tend to be larger complicated transactions. So sometimes, a sponsor says, we expect to pay this off in May, and for some reason or another, negotiations with their partners, or negotiations with the vendor on the other side, that moves back to August or October for some reason. And then as we've experienced quite a bit recently, projects -- we've had a few projects that were pretty sizable that had been pulled forward on the spectrum. And we had at least one pretty sizable project in Q2, and we've got a couple of more coming in the second half of the year that we've been notified or repaid on that have not even reached a CO status. It's historically been very rare for us to get paid off and refinance mid-construction or before project it is TCO-- at least has a temporary certificate of occupancy. But we've got several of those examples where they've accelerated repayments this year. So we're giving the best guidance we can give on that, but there are things that cause those payoffs, repayments to be sometimes delayed, sometimes accelerated, and you can do your very best to predict that, and you're usually right within a quarter or two, but sometimes, you get surprised.

Timur Braziler – *Wells Fargo*

Looking at the deposit side and some of the commentary around cost of interest-bearing deposits, what's being done that gives you guys optimism that you can lower the potential cost of interest-bearing deposits, ex the rate cut in the third quarter?

Tim Hicks

We're actively managing the deposit book. We really started on July 1 with a lot of our institutional and public fund customers talking about the rate we pay on those. Obviously, LIBOR went down 10 basis points in Q2. So rates -- even though Fed hasn't moved, rates have decreased, and we've had these conversations with some of our larger deposit customers. And so we really started that really early in the quarter. So trying to stay ahead of what the Fed's doing. And even though the Fed hasn't moved yet, some of those rates have already come down. And even our promotional CD rates, we brought down in early July as well. You've seen many in the industry also bringing down their deposit rate. So I think between that and the moderated loan growth guidance that we've outlined here allows us some flexibility to help replace some of our higher deposit customers with some lower cost deposit customers, and we're working hard to do that. We feel like we've got the ability to be slightly less, as we said in our management comments, to be slightly down on cost of interest-bearing deposits even in a flat rate environment for this quarter.

Timur Braziler

Okay. And then maybe just looking at broader deposit growth. You guys have historically looked out at loan growth projections and then backfilled that with deposit-gathering objectives. Is the linked quarter decline in deposits an indication of the lending outlook? Or I guess, what's the goal for growing deposits in an environment where loan growth is going to be pressured?

Tim Hicks

Yes. We feel like we have the ability to grow deposits to match our earning asset growth. We do model that and project that on a monthly basis. And so we're really comfortable in that mid-90% loan-to-deposit ratio. Sometimes there are timing differences that move that a percentage point at the end of the quarter one way or the other. So we're very comfortable in mid-90% loan-to-deposit ratio range. We feel like we've done that for the last several quarters, been in that range, and we'd expect to continue to be in that range as we just project out what our deposit-growth needs are based on what our earning asset needs are.

Timur Braziler

Looking at the Indirect RV & Marine portfolio, the number of dealer relationships seems to kind of find a level here between 1,300 and 1,400 and the growth continues to accelerate. There is some seasonality in 2Q, but I guess just looking at the existing dealer footprint, what's the remaining potential out of that footprint? Meaning is there opportunity to continue seeing accelerated growth from that existing footprint? Or do you need to actually grow the dealer network in order to further accelerate that growth?

George Gleason

Well, that's a good question. If you're following the Marine and RV manufacturers' stocks and their reports, you'll notice that Marine and RV manufacturers are shipping less, selling less to dealers than they were a year ago. So there's a bit of a slowdown in the manufacturing side. And that would imply that your average dealer is selling less as well. So we've been able to maintain good volume this year, and that's in part due to the fact that we have had some modest growth in our dealer network over the last year. That's not been a ton. The capability to grow that dealer network is there. And as we continue to monitor this portfolio and the performance of this portfolio and get more and more history with the data on that, we would expect to expand that dealer network. That dealer network could probably go to 1,700 or 1,800 dealers in a more mature state for that unit. Over the last several quarters, we've been adding dealers every quarter, and you remove dealers every quarter. Our program is very focused on monitoring the performance of our dealers and the quality of paper we're getting from our dealers and the various other dealer performance metrics we're monitoring. So we routinely terminate relationships with dealers and routinely add dealers. But the capability is there as we get more seasoning on this portfolio to add another significant tranche of growth in the future.

Stephen Stone – *SunTrust Robinson Humphrey*

There has been a lot of talk about condo sales in New York and Miami. How are your projects there filling up? And are you guys becoming more cautious on the future projects in these areas?

George Gleason

I would tell you we're not changing our underwriting standards at all, and our projects are doing very well. Nine quarters ago, we probably had 13 or 14 active condo construction projects in the greater Miami area. That's probably seven or six now. So we've had I think at least six or seven of those projects that have CO'd and very quickly paid off. We think that number of projects, based on sales that are in place and construction progress, probably by the end of the year is two to three. So our Miami condo exposure is paying down a ton through selling of condos, and we've got a lot of sales and a lot of sales activity on the projects, so we're feeling extremely good about the credit profile of those projects. We're deeply regretting that we've been unable to replace it with new volume. We would love to have 14 more projects of the same credit profile for each, sale/deposit profile of the ones that we had at September 30 last year -- half of them more or less paid off in the interim.

Our New York portfolio continues to perform without any issues. We've gotten paid down on several projects there and paid off on several projects there. In the last quarter, our new originations in New York were not as large as they were a year ago. There's less new product being created. Interestingly, if you look at the 2Q originations for our RESG unit, the Washington, D.C. MSA was #1; the Boston MSA was #2; Philadelphia was #3; and New York was #4, right in line with the Orlando, Florida MSA and San Diego. So New York, Orlando and San Diego were four, five, and six but just separated by a couple of million dollars. So we feel very good about our New York portfolio and the way it's holding up, but you're not seeing as much new product production there. So our New York growth is slowing a bit.

Stephen Stone
Has that been kind of the limiting factor than on portfolio growth? Just not enough product or projects out there? Is it competition? Other things -- structure, pricing?

George Gleason
It's a combination of all of that. We've commented for a number of quarters now that we've seen a lot of competition, and there are lenders that are willing to be more aggressive on credit and leverage than we're willing to be. And there are lenders in certain markets on certain product types that are being very aggressive on price. And I think we've been clear without exception that we are not going to sacrifice our credit standards. We've got credit standards that are high. We expect to continue to be very disciplined and only do transactions that meet our credit standards. We're not going to do transactions that get so cheap that we don't generate appropriate risk-adjusted returns. So we're negotiable to some extent on price but not beyond a limit.

And the result is that growth is the tertiary consideration in the variable that adjusts. So because we're being disciplined without exception on credit and we're being reasonably disciplined on our return standards, we've seen less growth, and that is a result of two things: one is competition; and two is the fact that there are just fewer deals that meet our credit standards today than there were a year or two or three years ago when there was a lot more room to build product in most markets.

Stephen Scouten – *Sandler O'Neill + Partners*

So thanks again for all the color you guys gave in the Management Comments, very helpful. I'm kind of curious how you guys are thinking about average earning assets trends for 2019 and even into 2020, given the lower loan growth outlook and some of the details that you gave like in Figure 8 around RESG potential repayments over the next couple of years. And wondering, if it's possible that average earning assets are relatively flat on a net basis? And if that's too punitive of you in y'all's minds?

George Gleason

It's a great question, Stephen. And what I would tell you in that regard is that the accelerating trend of repayments of loans in our RESG portfolio as well as Community Banking and portfolio -- we're having a lot of repayments and refinancing in the Community Banking portfolio, too -- it's a very competitive environment in that world as well. So that coupled with the ongoing paydowns in our purchased loan portfolio certainly provides a headwind to growth in total loans. And it's a headwind to growth in average earning asset.

We have a strategy that we articulated in the Management Comments document to address that and the impact of that on net interest income, and one is we're working very hard in our Real Estate Specialties Group without sacrificing our credit quality or our pricing standards to work really hard to generate a good volume of new originations. And through the first half of this year we've generated about $3 billion, in round numbers, of originations. So we're running a little bit ahead of the average pace for last year. We would hope that that origination trend would continue through the back half of the year and, hopefully, even accelerate a bit into next year. Secondly, we are getting good volume out of our Indirect Marine and RV business. We hope to continue to get good volume and growth out of that, as I responded to Timur's question there. That is a business that perhaps we can scale up even a little more by adding another meaningful addition of dealers to our relationships there. Thirdly, we hope to get some significant increases in volume from our different verticals, specialty lending verticals in our Community Banking group. And then we hope to also reduce our cost of funds, Tim sort of addressed that, by more effectively managing our mix and pricing of deposits. So it's a battle to grow earning assets when you've got as many repayments as we do, but we've got a strategy to attack that. Hopefully, that strategy will be successful. We also hope that we can get some lift to our net interest income from both growing earning assets some and mitigating our cost of deposits. But it's a work we've got to do, and it's not going to be easy, but our team is very committed, and I think if market conditions will allow us to be successful. I think we will because our team is working hard to do that.

Stephen Scouten

And maybe on that funding side, on the deposit side, obviously, I heard Tim's comments earlier, but I'm curious how you think your deposit betas may react on the way down if we get two or three or four rate cuts here. If you think the first couple of cuts would have a minimal kind of beta, and then it would ramp as we saw in the reverse? Or how we can think about that potential improvement on funding cost with each theoretical rate cut?

Tim Hicks

I think it'll act fairly similar to how it did on the way up. And we had a high deposit beta on the way up, and I think we're going to have a high deposit beta on the way down. We're actively managing it. So as I said earlier, we started out this quarter trying to actively manage it ahead of any move. So hopefully, that will get us ahead of it, but deposits will lag a little bit from LIBOR, specifically, LIBOR moves pretty quickly -- but I think over a several-quarter period, it will catch up and have a little bit of a lag to it, but we're working hard really early on in this quarter to offset any of that and we feel good about the efforts we're making. And I think you pointed out in your note as well, our reduced or moderated loan growth, as I said earlier, it should allow us some flexibility in running away some of our higher cost deposit customers.

Stephen Scouten

Yes. It all makes sense. And maybe one last kind of clarifying question. I noticed the loan-to-cost for the RESG portfolio as a whole went up. Maybe a couple of, 51% from 49.5%, or something like that. Is that possibly due to that $300 million credit that appears to have gone away? Was that a really low loan-to-cost loan and that leaving pulled the average up? Can you give any commentary as to what pulled that number up slightly?

George Gleason

Well, it's a change and a constant change in the mix of that portfolio. One comment I would tell you, probably the lowest loan-to-cost pieces of our portfolio were our Miami condos. Those, if I recall, average about a 37% loan to cost. So when those get paid off, that tends to cause the average to go up.

So it's a change in mix, and there's probably a slight tendency, I would say, for that loan-to-cost number to go up. I don't think it goes up a lot, but it wouldn't surprise me if in a quarter or two, we saw that at 52% or 53%. I think one of the keys is to look at the loan-to-value number, and the loan-to-value number moved very little and pretty flat down there around 43%. So we continue to feel very good about that, and the reality is, most of the guys or a lot of the guys that we compete with are 15 points, plus or minus, higher leverage, or 20 points higher leverage, than we are. So we continue to think we're probably the most conservatively leveraged guys in the space.

Brock Vandervliet – *UBS Investment Bank*
George, I wanted to circle back to that comment you made, which I think could be really telling in terms of the competitive environment. You're seeing some refinancings from pre-CO credits. So I mean, that just seems amazing to me because I would think as a developer at that point – you're on the final approach to a CO, the last thing you're thinking of is refi because you want to get over the line, so you can lock-in the permanent financing. Are these borrowers that are able to just bring that forward and get permanent financing even ahead of a CO?

George Gleason
We have seen some, a few competitors being very aggressive in acquiring some assets. And usually when the sponsors are in the middle of construction, they're focused on completing the projects and selling or leasing and not refinancing, and our typical working premise has been, was the earliest we would get paid off on an asset would be at TCO, Temporary Certificate of Occupancy, or final CO, and that would be the earliest. In most cases, it would be somewhat after that. But what is encouraging our sponsors to pay us off is a combination of lower rates and higher leverage. So we've seen competitors come in and basically refinance out all or a large part of the equity or mezz debt plus us and do it at a compellingly lower cost of capital to the sponsor. So I don't think that's a trend that is going to affect a lot of deals, but it's affecting enough deals that it's moving our prepayment numbers faster than we expected.

The reality is, and Tim put it really nice in the chart on Page 8 of our Management Comments document, it's the Figure 8 in the Management Comments document that shows on an annual basis each year what the repayments have been from the loans we originated and what's still outstanding for those. And we've talked for a long time that our RESG portfolio is construction and development portfolio, and these loans are going to pay off three years, more or less, after they originate. So if it's a really simple, small non-complex project, they may pay off in 24 months. If it's an average deal, they may pay off in three years. If it's a project that's really big, complicated and mixed-use, hard to construct project it may be a four-year timeline. And the reality is our three biggest years of RESG originations ever were '15, '16, and '17. So you jump forward from that '18, '19 and '20 is kind of the natural cadence for those loans to pay off in more or less a year or so. And seeing that natural cadence unfold and get accelerated by the fact that you're getting loans that are paying of even before TCO and CO is creating some headwinds to our growth. We work through that big chunk of payoffs and, hopefully, successfully, diversify our portfolio and get more earning-asset engines and get a reasonable uptrend to what RESG originations were compared to the $4.8 billion or so from last year. We ought to be able to get back into a decent positive growth story, but we've got to work our way through this season of payoffs.

Brock Vandervliet

And in terms of the competition you're seeing, among the banks, it seems like if they haven't backed out of the business years ago, they're tapering down construction. So it can't be coming from there. Are these credit funds that have always been in the space? Or is it new players? What do you see from the deals that you're losing? Or are they refinancing early?

George Gleason

Brock, it's a combination of big banks, foreign banks, debt funds -- there are a lot of players in the space, and those players have been in the space for the last year plus in large numbers. And you go back to '16 and '17, you saw a lot of banks pull out of this space. That created the formation and the raising of a lot of money and a lot of debt funds, credit funds that are targeting the space. And then a lot of the banks did come back into the space. So it's a crowded space right now.

Matt Olney – *Stephens Inc.*

Just to piggyback off that last point about the early payoffs and RESG, I believe, you now have the early prepayment fees in most, if not all, of your RESG projects that then allow the bank to capture at least a portion of the interest income the bank would've received. So given the heavy paydowns in 2Q, are we seeing more fees in 2Q? And should we continue to expect higher fees the next few quarters?

George Gleason

Well, of course, those prepayment features you're alluding to, Matt, come through the interest line item as minimum interest on those loans. So they show up as interest. We commented the last couple of quarters, not in this Management Comments documents; for the last two that we have had some positive lift, a basis point or two or three or four, I don't remember the numbers, to NIM in those quarters from higher levels of loan fees related to prepayments. We didn't specifically comment on that in this Management Comments document. We did have several loans that had minimum interest in them when they paid off. We would expect that to continue. Some of our sponsors are very attentive to that minimum interest number and don't want to pay it, so they will wrap the loan to the day the minimum interest is earned then pay it off very shortly after that. Some sponsors take a broader view of interest savings. They might get it from a lower-rate refinance or savings that they might get from cashing out a much larger loan with another sponsor that would let them cash out much better or higher cost to equity and factor that in. So sometimes we get minimum interest paid. Sometimes, the sponsors wait us out on the transaction. My guess is that the experience we've had the last couple of quarters is probably reasonably likely to be consistent with the experience we would expect the next several quarters, which is why we made no comment about it in the Management Comments document. But those are chunky prepayment minimum interest numbers, and they're hard to predict, but we think there's not a big delta between what we've experienced the last several quarters, in that regard, to what we would experience the next several quarters.

Matt Olney

Okay. That's helpful, George. And then also want to shift over to get your updated thoughts around a stock repurchase plan. I think it's not something you've done previously in the company history. But with the updated loan growth guidance feel a bit softer, I guess capital will just continue to build. So would you reconsider the stance around stock repurchase activity?

Tim Hicks

Matt, this is Tim. It's an active dialogue with the Board at each quarterly meeting. We've obviously given updated guidance on loan growth. But to your point earlier, we have never done a stock buyback in our 22-year history as a public company. We would prefer to utilize and leverage that capital to grow our bank and whether that's in the short term, medium term or long term, we feel really good over the long term about being able to utilize that capital, and I think our Board would prefer us over the long term to utilize and leverage that capital. They'll continue to discuss it. I would guess their next major discussion regarding it would be early next year when they have an updated financial projection and budget and strategic planning process that we do typically in early part of the year. I would not anticipate much more of a change in our stance between now and then. And even then, they're going to have to evaluate what they think our long-term prospects are for a buyback. So that's basically where we are today.

Catherine Mealor – *Keefe Bruyette & Woods*
You mentioned that you've already lowered some of your promotional CD rates. Can you give us any -- can you quantify maybe where promotional rates have peaked and maybe where you are currently?

George Gleason
Catherine, let me address that. I don't think for competitive reasons we're going to want to quantify that. We made a comment in the Management Comments document that competition in regard to deposits and our ability to moderate that pricing just was really not evident in the first quarter and a half of the year as the second quarter wore on, and, particularly as expectations regarding the direction of Fed action really finally began to settle in on the deposit guys, and I guess some of the CEOs probably looked at what was happening with their loan yields with LIBOR and so forth. We began to see some moderation in deposit pricing in the second quarter and, particularly, the back half of the second quarter. So we tried to get right in very actively and aggressively in that and continued that into the start of the quarter. So we're optimistic we're going to be able to get the cost of funds down. But for competitive reasons, I don't want to discuss details of that.

Catherine Mealor
That's fair. That's fair. And then just kind of circling back on the RESG growth, you've talked a lot in the past about where we are in the cycle and that we may be at peak commercial real estate values, which may squeeze your sponsors a little bit from a return perspective. From a first-lien perspective, you're still in a great spot in terms of credit quality and credit risk. But is there anything that you can point to with the higher prepayments or the kind of lower origination volumes that you've had an OZK-driven effort to take the foot off the gas a little bit to avoid certain credits or certain markets? Or is it more that you're seeing less deal flow when it really is kind of just the competitive dynamics that are really driving the

slower growth? I guess I'm trying to figure out how much of it -- is there any part that's OZK-driven versus just really kind of responding to the macro?

George Gleason

Yes. I would tell you, I don't think any of it is OZK-driven. We have always had very conservative credit policy standards and practices. Those continue. We've not tightened them up. We have not liberalized those in the face of increased competition. I think all of the volume impacts that you see are a result of two things as we've said earlier and as you articulated: one is, it's a more competitive environment with more players in the space; and number two, we're in the point in the cycle where there are just less transaction that makes sense to sponsors from an equity point of view to pursue. So there are less opportunities to do business. And the opportunities that are getting done are percolating longer before they get to closing. Sponsors are very cautious. And transactions that three or four years ago might've gotten closed in 60 days after you first saw it, sometimes it might take one and a half years now or a year or three quarters to get that. Sponsors are taking their time and being cautious, appropriately so, in the economic environment we're in. So it's had an impact on our volume, and you don't want to force the volume. A lot of our competitors are doing that. They may get away with it and be richly rewarded for jumping in there and being more aggressive on credit, but that's just not our style of doing business. We keep our discipline all the time.

Catherine Mealor

Got it. And maybe one final question just on loan yields, kind of thinking about the margin, how much of the change in loan yield would you say is driven just by the impact in LIBOR versus the mix shift from going from RESG into the other verticals Indirect Marine and RV and in your other verticals?

George Gleason

Well, I think you can pretty much gauge the LIBOR impact, just take LIBOR at 6/30/19 versus 3/31/19 and look at that difference in 1-month LIBOR and multiply that times the percent of our variable rate loans tied to LIBOR, and you can derive a pretty reasonably tight estimate of the impact of LIBOR being down during the quarter -- and we put up a LIBOR chart in there on the Figure 16, I think it is, in our Management Comments document that shows that downturn in 1-month and 3-month LIBOR during the quarter, and that weighed on our margin.

There is also some impact from the change in mix of our portfolio. As we mentioned in the Management Comments document, our RESG portfolio being all variable rate loans has become our best yielding portfolio. Whereas the Indirect Marine and RV is all fixed rate. The Community Bank's a mixture of fixed and variable rate. Those portfolios have lagged behind in their yield as the Fed fund rate has gone up because of the fixed-rate component of those portfolios. If you go back to the time right before Fed started raising rates, our Community Bank portfolio, the Marine portfolio, the RESG portfolio, all had very similar yields. But obviously, they perform differently because of changing mix of variable fixed-rate loans in those portfolios.

Catherine Mealor
Substandard loan looked like they were down linked quarter, but do you have the direction of what watch list credits get this quarter versus last?

Tim Hicks
I don't know, and I don't envision it changing much. Obviously, we had one watch credit at RESG, that's still a watch credit. That's obviously our largest watch credit. But I don't know the direction of the watch category either. I would not expect it to have a material difference from what it was at 3/31/19. Obviously, our substandard went down because we moved the two substandard loans at RESG to OREO during the quarter.

Catherine Mealor
Great. So it's fair to say, no large RESG watch credits you did in this quarter?

Tim Hicks
Yes. RESG had no new watch credits. RESG still only has that one watch credit that we've talked about extensively for the last several quarters.

Matthew Breese – Piper Jaffray
Just thinking about the variable nature of your loan portfolio juxtaposed with some of the early actions you've taken on the deposit side. With the Fed seemingly likely to cut at the end of the month, or at least by the end of the year, I was hoping for some color or expectations around the margin as we potentially go into a Fed-cutting environment. How do you expect it to behave?

George Gleason

Well, I think Tim included language in the Management Comments document that suggested that over multiple quarters we expect a roughly parallel move in our core spread there, from declining rates. And it points to the fact that in our nine quarters of Fed increases, I think, our cost of interest-bearing deposits were up four basis points more than our yield on non-purchased loans. So we had quarters in there where the loans gain and core spread improved, quarters in there where the deposit costs increased more and core spread decreased. But over that 15-quarter period of time, nine Fed increases, there was about four basis-point difference. So we would expect a similar sort of movement going down that in the long term. Over multiple quarters, they probably move pretty close to tandem. In the short run, you'll see quarters both directions, we would expect. And certainly, we included in the Management Comments this time in Figure 14, all the floor rates and our loans stratification of the floor rates in our loans. And we commented in the paragraph below that that as we have months where older variable rate loans with floors that were set at the times those loans were originated, if those pay off with their lower floors and we replace those with newly originated loans that have floors at or near the current rate, we've built more protection into variable rate loan portfolio. So I suspect the Fed will cut rates, based on recent commentary, at the end of this month. We would prefer that they wait another few months to do that because the evolving defensive nature of our loan portfolio to protect us from down rates improves every month as we roll off older loans and add on newer loans with floors closer to current rate.

Matthew Breese-

Understood. Yes. Just trying to think, and stepping back and thinking about this lower loan growth outlook and the margin combined with the efforts to really increase net interest income growth, just trying to gauge or get an idea of when we can see that inflection point higher on net interest income growth, and if you have an idea of over the next 12 months or 18 months when we can start to see that?

George Gleason

Well, I think that is going to depend really on two things; average earning assets, which will depend on the effectiveness of our programs to increase RESG originations without sacrificing credit quality, to continue to scale up Marine and RV without sacrificing credit quality or pricing, and Community Bank verticals, scaling it up. And then the other important component is, as we said in the Management Comments, is our ability to better manage our cost of funds and get that down. So I think those are the variables that hopefully we've got to solve to get to a positive net interest income number sooner rather than later. If we're very effective at solving those variables, we can generate more average earning assets and get our cost to funds down, I think that will help us get to a positive net interest income scenario much sooner. If we languish in our efforts to achieve those goals, then that's going to push that out further.

Matthew Breese

Okay. And then just to get a better idea of how competitive things are, when you do lose a deal or something is refinanced away from you and you look at the terms of the competitor, do you look at those and say that individual or that funding source is really taking it on the profitability perspective? Or do you see a real building of risk from a credit perspective on behalf of the new borrower?

George Gleason

Well, I don't want to speak for my competitors. I'll just say, we look at a lot of transactions that we lose and a lot of transactions that get refinanced away from us, and we make the comment that we would never do that loan, at that leverage or on those credit terms. And oftentimes, we also make a comment we would never do that loan at that pricing for that duration. So we scratch our heads a lot at how aggressive some of our competitors are on both credit and pricing terms at times. Yet, despite the very competitive environment, our lenders are doing a very good job of generating positive loan growth in a crazy competitive environment.

Matthew Breese

Understood. Thinking about the New York City construction portfolio and the exposure there across the different asset classes -- just wanted to gain a sense for that, given the new multi-family rent laws and whether or not that would or will not have a real impact on you?

George Gleason

We don't think that has any real impact on us at all. We've never been an active lender in that space on rent-regulated, rent-stabilized properties. Now Tim mentioned in the Management Comments document that a lot of our multi-family loans, I think, it's about half dozen of them in the New York area have 421a tax-abatement provisions. So the way that works is a sponsor can enter into a contractual agreement with the city or housing authority, I'm not sure who the counterparty to that agreement is, but a sponsor may be doing a 200- unit apartment project, and they may agree to make 15% of those units available at below- market rate to individuals that are making some percentage of the median market income. It may be 85% of the median income. So in exchange for the contractual agreement to make those units, that part of the project available at below-market rates for 25 years, say, the sponsor may get a 25-year abatement reduction in the taxes on the project. So it's simply a mathematical calculation. From the sponsor's point of view, how much of a saving in taxes versus how much are they giving up in rental income could make a portion of the project available to people who meet a certain percentage of the median income threshold. Our sense is -- and it's not absolutely clear, but our sense is that the new legislation that was passed for the state would limit those rental increases on those below-market-rate units, which again is 10% to 20% of a project typically, would limit that to the 2% annual increase. That has no effect on us because we didn't underwrite any increases in rents, either the below-market rate or the market rate rents in our economic analysis of the projects. We've assumed flat rents with no increases. So we are not really affected by that. And of course, one of the more pernicious provisions of the new law is the fact that a landlord cannot recover capital expenditures more than 2% per annum which makes it infeasible for people who need to renovate these properties to renovate them and will recover the renovation cost. That doesn't come into play at all on our 421-a projects because they're all new construction. There's no renovation at all.

And then we had a tiny handful of loans leftover from our Intervest acquisition, $25 million leftover from our Intervest acquisition, and these are small multi-family projects that have one or more rent-stabilized units. And typically, these have more market-rate units then rent-stabilized, but there is one or more rent-stabilized or rent-subsidized unit in each of these, but we think that's a very old seasoned portfolio, very low leverage, 29% loan to value, and the debt service coverage on them is 2x plus, I think. So the impact of the law on that relatively tiny bit of our portfolio is negligible, and we don't think really there's any impact there given the low leverage and high debt service coverage and seasoned nature of that portfolio.

Brian Martin – *Janney Montgomery Scott*
Just a couple of things from me. Tim or George said that on the deposit side, what percentage of the deposits are kind of rate-sensitive that move without you guys doing anything versus where the opportunity is to take action like Tim mentioned where you've kind of been active already this quarter this far, but what's the rate-sensitive deposits to a day one change?

George Gleason

Well, Brian, the deposit book falls into two categories: one is CDs that have a fixed rate for the duration of the CD contract. Those will move and will move based on rates that we set when they mature. And then the others are administered rate products that we make conscious decisions to change the rate on it such as the savings account or a money market account or whatever and make the rate change on those administered rate products. So, I guess, we have a couple of deposit relationships that actually flow with -- a small number, more than a couple, but a small number that actually flows with Fed funds target rate or Fed funds effective rate or something like that. But the vast majority of our deposits are either administered or fixed CD maturity deposits. And the equation is how much can you adjust the rates and not meaningfully impair your relationship with the depositor.

Brian Martin

And just on the loan side, in the Community Banking verticals, I know that outside of the boat and the indirect portfolio, where is the biggest opportunity to scale up some of the other areas to help maybe offset some of the payoffs in RESG? Which areas are seeing more traction and today are more optimistic about?

George Gleason

We've got several areas there that we're getting some traction in and some will be more meaningful than others. We would really like to expand our government-guaranteed SBA lending business organically in our local markets through our local branches using our GGL team. We think we can do that. One of the increases in our overhead is we've been trying to staff up in that unit to get more volume out of that. We think that helps to serve our communities in a very proactive way and provides good quality, good yielding loans for us at the same time. Our business aviation group, we've added a couple of more origination people there, and we think we've got some good opportunities there. In fact, that group is coming to see me right after this call to discuss a transaction they're working on that they would like me to look at. We're trying to get more traction in affordable housing and in charter schools verticals, our subscription financing specialty line of business. We've got a really good transaction that we're excited about there. That would be almost $100 million transaction that we're working on, have been working on for a number of months, couple of quarters now that seems to be coming to fruition. They've got a couple of other things to close there. So none of these is going to be an RESG or Indirect Marine-RV type of volume business. But collectively, we're hoping that we can get just every quarter a little bit more scale and volume out of these and that, over the course of 2020, they'll become much more significant contributors to our growth and the diversification of our portfolio.

Brian Martin

Okay. That's helpful. And just the last items -- maybe I missed it, I joined a little bit late. I know it sounds like they were talking about the expenses. Is it fair to assume from the comments I heard in the tail-end that the expense growth, the next several quarters, particularly through 1Q, was kind of similar type of pace, give or take, and then it may be moderates a little bit thereafter? Is that kind of what I heard on that?

Greg McKinney

Brian that is what we said earlier. Yes, we do think that we'll still have some growth in that expense line item over the next two or three quarters, but we are hopeful that as we get into 2020 that we can get our build out for some of these areas we've been focused on will allow us to see less increase on a quarter-over-quarter basis than we have seen in the last two or three quarters.

Brian Martin

Okay. Thanks, Greg, and then just -- and the last one was just on the margin and kind of core spread. Is your outlook on the core margin -- so I guess just the margin versus the core spread, I guess those will kind of follow one another, meaning, I guess, maybe there's not a lot of risk towards where the margin's at today over time, similar to what you're seeing on the core spread. I mean those are pretty connected. Is that how you guys are thinking about it? How we should be thinking about it?

Tim Hicks

Yes - they're going to be mostly connected. Obviously, purchased loans is another big component of our margin and securities - so how those move will impact margin. Obviously, today, the loan yield on non-purchased and purchased are fairly similar. So those are the other two variables in the margin.

George Gleason

All right. There being no further questions, we'll conclude the call. Thank you very much. We look forward to talking with you guys about 91 or 92 days, something like that. Have a great quarter. Thank you.