Bank OZK

Transcript of the Second Quarter 2020 Conference Call

July 24, 2020, 10:00 am

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 session, 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;
- Greg McKinney, Chief Financial Officer; and
- Brannon Hamblen, President & COO of our Real Estate Specialties Group.

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

Ken Zerbe – *Morgan Stanley*

I guess, first of all, starting off, I think it's absolutely great that you saw stronger loan growth in the quarter, and I get that is really driven by lower repayments to some extent. I guess given some of the commentary that you made about repayments picking up in fourth quarter and the bridge and permanent lenders coming back into the market, that part seems a bit cautious. Can you just elaborate a little bit about how you see that net loan growth trending over the next few quarters?

George Gleason

Ken, I would tell you, first off, we don't know what the exact numbers are going to be. There are a lot of moving parts to that. We feel pretty positive about our pipeline going forward. Of course, a good pipeline is a good thing, but you've still got to get those loans approved and closed and executed. And we are seeing, as we indicated in the management comments document, some of the bridge lenders and permanent lenders stepping back into the market. That's certainly not a tidal wave, but it is noteworthy that those guys are coming back as we expected they would. They're getting their bearings and figuring out where everything is settling out. So we're seeing that activity. It's hard to know how that plays out. There's uncertainty. So we're cautiously optimistic about our ability to continue to put up some nice growth numbers in our RESG portfolio and not get totally undercut by repayments in the second half of the year. But we still got to get that growth put on the books and recorded and those transactions closed. And we'll see where the repayment numbers settle out over the course of this year and early next year.

We're pleased with the way it's working out so far. We're getting good origination volume on really quality deals with quality sponsorship. And we have, as you and I have talked about for several years, desired to see a slower rate of paydowns on our loans at completion or as they near completion. So that is working out very favorably for us, and we're very pleased about that. And of course, that was one of the critical factors in translating to the improvement in net interest income in Q2 versus Q1.

Ken Zerbe

And then just maybe a different question in terms of NIM compression. So obviously, I like the comments that you made about NIM potentially being -- reflecting -- being stable or flexing higher from here. But given the, I think it was, 92% of all your variable rate loans are already at the floors and fixed rate -- at fixed rate, and then given, I guess, a rather large amount of CD repricing that you have available, it seems almost a given that your NIM should be moving higher from here. Can you talk about are there -- what would be the factors that would actually drive NIM compression given the floors plus CDs?

George Gleason

Well, a couple of things that contributed to our compression in NIM in the quarter just ended is one was our PPP loans that have a 1% coupon and yield under 3%, high 2s when you factor in the amortization of the fees on those, which we're amortizing over the life of the loans. So that knocked a basis point or two off of NIM in the quarter just ended. And then our liquidity build -- we're in an environment where we think it's prudent to build more liquidity. And there's not much yield on any securities you can buy out there that you're excited about owning and want to keep short for liquidity purposes. So that probably took, Tim, what was it, another six, eight basis points off our NIM?

Tim Hicks

I think it was around five or six basis points.

George Gleason

Five or six basis points in the quarter just ended. So a continued liquidity build and having a full quarter of the PPP loans on the books now - when those forgiveness and repayment start coming in is dependent upon the government's programs and timing for that so that's hard to predict. So that could weigh on margin a little bit. The counter of that is what I think is a very constructive thesis for margin going forward. And that is, as we showed on Figure 2 of the management comments document, we do have a pretty good opportunity to continue to lower our cost of interest-bearing deposits with the CD maturities as you noted. And hopefully, we're going to be able to keep those CD rates coming down even lower as they roll over. That seems to be the prevailing trend, and hopefully, that will continue. So that should help us lower our cost of interest-bearing deposits over the next several quarters.

And then in a lot of parts of the market, competition is very intense, in other parts, competition has backed off. So we're getting wider spreads on our new originations in the RESG space than we were getting on those loans six months or nine months ago, which is appropriate because with CECL you have to hold more reserves, so you ought to get paid more for those loans. So we view that as a second leg of our margin thesis. The first leg is keep that cost of interest-bearing deposits coming down over the next several quarters. And then the loans we're closing now and have closed this year in RESG are typically constructions loans that will fund in '21 and '22. So as those loans that we're originating this year with what will hopefully continue to be higher spreads than the loans we originated last year begin to fund in the next couple of years, that ought to give us a second leg to our margin expansion thesis. So we're cautiously optimistic.

We've got two key ingredients to improving our margin in place, and one is better spreads versus LIBOR or prime, or whatever the index is, on newly originated loans, and the other is cost of interest-bearing deposits. And those are two important parts of the puzzle. The mix of the balance sheet, the decision to hold more liquidity, loan yields or investment security yields, those things are other factors in there. But we have got two big pieces lined up in a very constructive way. So we're cautiously optimistic.

Jennifer Demba – *SunTrust Robinson Humphrey*

I have a question about what kind of transactions you're seeing in your pipeline now. And what kind of projects are developers are moving forward with right now in this environment? Can you give us some thoughts on what you're seeing using your clientele as a proxy?

George Gleason

Yes. Brannon Hamblen is President of our Real Estate Specialties Group. So Brannon may be in the best position to answer that. He's in the details of that every minute of every day. So Brannon?

Brannon Hamblen

Sure. Happy to answer that. I would say you probably won't be surprised to learn that a fairly significant number of the deals that we're seeing are multifamily. We're still seeing and looking at and seriously considering all the other property types. But most of what we're moving forward on, the majority of that would be in the multifamily space. So -- and as you look out at the landscape about what's more easily understood in terms of what the future looks like, certainly, that category would fall in line there. But again, we're seeing all types, even folks working on hotel deals and office deals, notwithstanding some of the near-term uncertainty. But as you know, most of what we close on today won't deliver for 24 to 36 months. So we're looking at all the options there as sponsors bring those to market.

Jennifer Demba

I assume you're evaluating the office and hotel deals on a case-by-case basis. You guys have always prided yourself on being very consistent and not coming totally away from different asset classes or geographies or whatever.

Brannon Hamblen

Absolutely. It has always been the case and certainly continues to be absolutely the same way today. We try very hard to go into every deal we do with the best sponsorship out there in the best markets. And some of the things that make the best market today changes tomorrow. So staying on top of that with folks that are developing in multiple markets across the country and learning and exploring what's going on out there is very helpful to our business. Yes, we're every bit as diligent today in that regard as we have been since RESG began over 17 years ago.

Jennifer Demba

And what kind of pricing and loan-to-value and equity can you demand now versus maybe six months ago?

Brannon Hamblen

On the leverage side, we've pushed that and are attempting to move, in some cases, we've been able to -- depending on the property type -- you go from LTC of maybe if you were at 55 before, you're going to 45. And it really depends on the product type in the market and the size and who's chasing the deal as to how far you can get.

But we're trying to win 5% to 10% there on the leverage side, and obviously, that translates into the equity. On the pricing side, as George mentioned, we immediately, as I think we've probably told you guys, following Q1, began to reprice. And we're pricing 75 to 100 bps wide in terms of spread from where we were six, nine, 12 months ago. And as in the last answer, it will be a while before we see that because it does take a while to fund these large loans up with all the equity in front of us. In '21 and '22, we'll definitely start to see the benefit of those wider spreads.

Timur Braziler – *Wells Fargo*
Sticking to the spread question. As some of the competitors step back into the arena and as construction begins to ramp up and normalize, is the expectation that those spreads tighten here in the not-too-distant future? Or is there something else going on that you think wider spreads are going to be here to stay?

George Gleason
Timur, it's been impossible to know how soon competitors will step back in the space and how aggressive those competitors will be. It's hard to know that. Certainly, in an environment where you have more competitors, your spreads will get tighter. In an environment where you have less competitors, your spreads will get wider. Hopefully, the competitors, when they do come back into the space will do the same math that we do, and that is, under CECL, where you've got to put up and allocate reserves for the entire life of a loan, you've got higher reserve costs that have got to be associated with every loan. And prudence would dictate that you get paid a higher spread to cover those reserve costs to generate the same return on equity or return on assets there. So it's hard to know how all those factors play out and the timing of all that, but we're committed to get an appropriate return on every loan we make. And as you guys saw late last year in the first quarter of this year, in our indirect space where competition got really aggressive, we just let our business volume dwindle down because competition was going too far. And we've shown that same discipline in RESG.

So I think one of the key things you've got to understand about our company is we're going to be disciplined on credit, and we're going to be disciplined on pricing, and we're not going to follow competitors and do crazy things because other people are doing crazy things. And that certainly has us in a fantastic position in the current environment. Our discipline on pricing has still got us at a margin that well above the industry, even though it's tighter than it was a couple of years ago, and now we're in a good position to begin to improve that margin. And our discipline on credit has us in an excellent position in what's going to be a very challenging economic environment probably for some time to come. So we feel really good about discipline, and we're certainly not going to give up that discipline in the future.

Timur Braziler

Okay. I appreciate that. Maybe switching over to the color you provide on updated appraisals. That's all very useful. I'm imagining it's quite hard, though, to get into enough granularity and enough visibility in examining current financials and cash flows in this environment. Is that what you were looking at? Are you looking at current financials? Or is there some sort of embedded recovery assumption that you're layering in into these appraisals?

Brannon Hamblen

You have got to look back to the fact that the vast majority of what RESG is originating is new construction. And so there is a forward look in virtually every appraisal that's done on the loans in our portfolio. There are certainly some pre-leasing or early stage leasing involved in if the property -- some of our hotels were operating already and had ramped up, and there's a current state to look at with respect to income. But most of the appraisals will be, from today, the appraiser trying to understand what the impact is in the market around the project to the ramp-up when the project actually opens. And so if they think it's going to take longer and rates are lower and the stabilized NOI is somewhat lower, then you're going to have a lower value. And that can be the case, as we noted, there were some valuations that came down but there are other markets that are extremely strong. And the projection would be that it may not be everything it was, but it's pretty close.

And as we've alluded to a number of times, our underwriting on these deals is very strenuous. We focus very specifically on stress that these deals can endure and still provide debt service coverage, can still demand a refinance debt or property sale values that are multiples of our loan amount. So an appraiser's job is not a certain thing, but they're doing their best they can in this environment. And as we've structured these deals, as noted here, they can stand stress and still be at strong loan-to-value levels and be able to be replaced by takeout debt again at multiples or sale prices at multiples of where we are.

George Gleason

Let me add a little color, and Brannon, weigh in if I don't get this totally correct here -- at the bottom of Page 31 of our management comments documents, we provided the table that showed the 36 loans in the RESG portfolio that had reappraisals. And net-net, there wasn't a lot of change in most of those. And in the aggregate, our loan-to-value went up 8 tenths of 1%. So take probably what the most economically sensitive line item there, hotel loans, we had 13 reappraisals on those. And our loan-to-values on those properties at March 31 were 46.4%, and they went up 2% to 48.4% loan-to-value, on average, which is exceptionally good and favorable and protective of the bank in either scenario. And you might look at it and say, "Well, wow, the hotel industry is significantly impacted and future projections of hotel operations are clearly going to be at a lower projected RevPAR and occupancy and daily rental rate than past projections, how is that possible?" And there are a lot of moving parts in there. The original appraisal may have been two or three years old. So if the original appraisal was 46.4%, and we had appraised it in the fourth quarter of last year before COVID-19, that might have reappraised at 40% because rental rates had gone up and future expectations were better than they were when the loan was closed two or three years ago. But now we're getting a new appraisal based on more adverse assumptions about the future, so the loan-to-value is 48%. In connection with the renewals of a lot of these loans, we've curtailed balances that were in the loan that were not needed for budget purposes, and we've gotten paydowns on a lot of these loans, too. So the 48.4% loan-to-value reflects principal reductions and loan curtailments as well.

And then in a lot of these situations, like on land and other loans where you've had reappraisals, the sponsors created a lot more entitlement rights than were originally projected and appraised in some cases, and that has led to a lower loan-to-value. So the reality is, net-net, when you take into account curtailments and paydowns and value creation where the sponsors have outperformed, an improvement in certain other conditions as well as the adverse impacts of COVID-19 pandemic issues on valuations, we're, net-net, not very far from where we had started when these loans were underwritten, within 1%. So that's a pretty good outcome. Brannon, you agree with that or have any different thoughts on that you want to share?

Brannon Hamblen

No, George, you hit the nail on the head. One might expect more change in some of these numbers, but the fact of the matter is they hadn't fully captured the value that was inherent there from the market build up subsequent to our closing. So we're comparing to a lower number. And while the values are down, they were against a benchmark that was already below where the market was. And as we said before, our underwriting on these things is stressing even the levels that the appraisers are using often. And so we feel very good about these results, and we'll have a number of reappraisals every quarter. 2020 is three years after 2017, which was a significant year in terms of volumes. So we'll continue to gain further insight into how valuations are holding up in the quarters to come.

Michael Rose – *Raymond James & Associates*

George, I just wanted to get some color on why you are deciding to pull back a little bit in marine and RV when the trends in that market are fairly strong. Is it just a competitive dynamic or pricing, et cetera? Because it's been a good source of growth for you guys over the past couple of years.

George Gleason

We pulled back really in Q4 and early Q1 because of the competitive dynamic. We just saw guys, particularly late last year, getting very aggressive on pricing and very aggressive on credit. And we just didn't move in our price and credit standards, and that resulted in us seeing a pullback in volume. And that continued into the first half of Q1. And in Q1, as the pandemic situation was beginning to become more visible, and we were getting more understanding of that, and particularly going into early Q2, when you saw some extreme weekly jobless claim numbers and so forth, we decided to just pull back a little further and see how that portfolio held up and make sure that it was going to hold up like we thought it was. So we raised our pricing, and interestingly, competitors raised their pricing. And we were trying to sort of shut down the volume, honestly. And I think we raised pricing three or four times because when we would move, competitors would move back in to where we were. So it's a market with some good opportunities now, and we're continuing to monitor. Of course, the portfolio has held up very well. I think we're running at a mid-30s basis point annualized loss ratio, about 33 to 35 basis point sort of annualized loss ratio on the portfolio. And our percentage of loans compared to most banks' consumer loan portfolios that we did deferrals on have been pretty low in that portfolio. So we're continuing to monitor that. The portfolio is performing very well. I couldn't be more pleased with the way the portfolio is holding up in this kind of very adverse environment. I think it will continue to hold up very well when we get to a post deferral sort of era, which we're really in now. We have had just less than 10% of our loans that got one 90-day deferral, get a second deferral. So far, we're early in that process, but I think that number is 8% of the loans that had one deferral so far that have matured and gone out of deferral have gotten a second deferral. And I'm not sure that many of the people actually that got deferrals really had to have them. I think it was more, "Wow, this deferral program is available, let's take it." There's uncertainty, and you offer folks a free benefit, you have people who want to take advantage of that. So we like the portfolio. It could become a source of growth for us. When our other parts of the portfolio were not growing a lot in that portfolio, that indirect part of the portfolio was growing a lot. I began to get just a little concerned about the balance of that. I don't want it to be 20% of our loan book. And it was reaching levels that were, from a mix point of view, more than I wanted it to be. So we'll continue to look at opportunities and hopefully make a good decision about when to reengage that market more actively. Our team is intact, and we would like to get those guys working, originating again. So we'll keep you posted on that in future quarterly reports.

Michael Rose

That's great color. And maybe just as a follow-up, George, just thinking about the RESG business and kind of history of it -- in these types of environments, when you have participants pull back, whether it's non-banks or bank competitors, at least coming out of the last cycle, I mean, that was a real opportunity for you to gain market share. I'm not sure what your approval rate is now. I think, historically, it's been somewhere around 5% or 6% of all the deals that you've looked at have met your criteria. Does that number expand here, even though there's less opportunities, but is there a chance to take further market share and actually show better growth than one might expect at this point?

George Gleason

The pie is definitely smaller for deals that make economic sense. You've had a long run of real estate construction in markets all across the country. So there's clearly a need for less of most product types than there was three years ago or five years ago. So the pie has gotten smaller, and COVID-19 certainly has shrunk that pie further. So yes, I don't know what percentage of loans that we're seeing today, we're actually getting pulled-through and closed. I'm confident that our market share vis-à-vis competitors has increased, even though our originations are running at pretty close to the same level they did last year just because the pie is smaller. So I think we are gaining market share in that space. And our sponsors have always appreciated our sophistication and expertise and ability to execute. I think that appreciation is higher now. And they've always appreciated our enduring up cycle and down cycle commitment to the space and the fact that we're always there in the space and active in the space, always there for them if they've got a good project that makes sense. And I think that level of appreciation is probably higher today than it was six months ago. And that is a good thing to help us build market share and customer loyalty and business going forward to have that reputation of being consistent, reliable, always disciplined and always focused on transactions that will endure throughout the cycle, up and down. So yes, I think our ability to continue to grow that business in the future has only been enhanced by what's happened in the last six months.

Catherine Mealor – *Keefe, Bruyette, & Woods, Inc.*

I wanted to see if you could talk about the geographic distribution of some of your new originations right now. I think you've got an interesting perspective for us given that you operate across the country in all different metro markets that I think have all been impacted differently from COVID. So maybe where are you seeing the biggest impact of construction delays and maybe a pullback in new interest? And where you may be seeing a more stable and more promising market opportunities?

George Gleason

Construction delays were pretty widespread across most of the major markets in the country. Most of those markets have kind of reopened, at least from a construction perspective. So I don't think we have a lot of projects, if any projects, right now that are being hampered by shelter-in-place orders and so forth. People seem to be getting their projects either back to normal or near-normal level of development and construction work on those projects. So that's a positive thing, I think, for our customers and a positive thing for us. Our originations continue to be broadly distributed across the country. Tim, I know you've got the top markets where we originated loans this last quarter, I think, don't you?

Tim Hicks

Brannon, you can correct me if I'm wrong, but it looked like Los Angeles was our largest MSA that had originations, followed by Philadelphia, Miami, Austin, San Diego and Atlanta.

Brannon Hamblen

Right.

Tim Hicks

Atlanta was probably Community Bank. But you can provide some additional color on RESG originations.

Brannon Hamblen

I would say that as I look at what we're likely to convert on in the coming quarters, you see a good bit in the Southwest and Southern California, Arizona. So some of the less urban settings, which is probably not entirely surprising. But I would also say that we're continuing to see opportunities in all the top markets that we've historically done business in, probably less so in the New York market. It's for a lot of the reasons that we've discussed and everybody is aware of, more on the cautious side in the more dense urban setting and some of those things are having an influence there. But really, we're seeing good activity in the Southeast as well, good activity up through the middle part of the country. So again, it’s widespread. It does seem to be a little bit more heavily weighted towards the less dense urban settings, but we're still seeing good deals that make great sense with sponsors in Philadelphia and the Washington D.C. area. So all the markets that we've been pushing into in the past and continue to see opportunity in.

Catherine Mealor

And a follow-up on that on just the appraisals that you talked about, were any of those in New York? I would imagine that would be a market where you may have maybe a bigger stress on your LTVs. And so is that reflected in some of these numbers?

George Gleason

Yes. There were a number of those reappraisals, I think, in the New York market.

Catherine Mealor

Okay. Great. And then one more question just on your reserve. I mean you've been really aggressive in building the ACL in the past 2 quarters. You almost -- you went from 60 basis points now almost to two percent. And so I know this is a hard question, but do you feel like you're at a peak provision or add a peak reserve now where the economic outlook is kind of factored into your reserve now, and moving forward, it will be more of a balance between growth and paydowns? Or do you see more economic kind of driven reserve build in the back half of the year?

George Gleason

Well, Catherine, you're asking us to predict impossible to know here. And I appreciate the question. I've asked the same question of Tim and Greg, but the reality is we're working off the Moody's models. And Moody's, like all of us, are trying to model an event for which there is truly no historical precedent. You've never had a pandemic of this scope and scale in modern times where you've had such a global interconnected economy. And you've never had this level of rapid fiscal and monetary response to an event. And you've never had events where you've probably had as much global tension and acrimony and political uncertainty and everything else is you have today.

There's just a lot of moving parts in the current situation. We feel great where we are, great the way our balance sheet is positioned. We're running Moody's models. We said in our management comments that the base case Moody's model, and we used the July, not the June, the early July base case Moody's model as our primary model, and that July model was marginally more adverse than the late June model. So we've used the most conservative base case model that Moody's has out there in the current time frame, the July model. And we then took their S3 model, which is their primary kind of hard downside scenario, and used that as our secondary weighted model and then assigned a very relatively low weight to any upside scenario there. So our use of their models in July and a heavy secondary weighting to a downside scenario. And that weighting to the downside was based on what we saw as the rising number of COVID-19 cases across two thirds of the states or more and concerns that, that might lead to a greater health crisis that might lead to a more adverse economic environment. And then we did overrides or overlays. So we just -- the quant people in our company are trying to get to understand the difference between overrides and overlays. So I suggested to Tim, we just refer to them as adjustments in the management comments document to adjust for things, risks that we thought were not possibly fully incorporated in those models. So there were a number of adjustments for different parts of our purchased and non-purchased portfolios where we thought there could be additional risks.

So we've tried to be appropriate. We've tried to be conservative. And I think we have been very appropriate and very conservative based on the information here now. Now obviously, if the economy gets much more severely impacted than what we envisioned in the first three weeks of July, where we were finalizing these numbers and models and so forth, then there could be more reserve build required. If the economy plays out in line with our model projections, then our reserve build ought to just be for growth. If the economy gets better than what we projected, then we could have zero or even negative provision expense in future quarters. So I've been doing this a long time. This is an unusual environment and truly an unprecedented environment, and it's hard to know -- it's impossible to know actually how it's going to play out over the next several quarters, next couple of years. We feel exceptionally good about how our portfolio is performing in the environment and really solid on what we've done from an ACL perspective, but there are a lot of variables. And there's uncertainty even surrounding models because when you're modeling an environment that's never existed before, you don't have the foundational data to really build your model off of. So you're having to extrapolate into unknown scenarios, and that's very difficult today.

Catherine Mealor
I appreciate it. I know that was a tough question, but I appreciate you taking a crack at it.

George Gleason
What do you mention taking a crack at it? That was the answer, Catherine. Thank you for the good question.

Brock Vandervliet – *UBS Securities*
Brannon, I wonder if you could start with kind of an elevator pitch on interest reserves and what that means for the RESG credits? I know that number has been material in the past. Maybe you could talk about where it is now at June 30 versus year-end and how that sort of is a structural buffer to uncertainty that's part of these loans?

Brannon Hamblen
Sure, Brock. That's a great question and something we do focus heavily on, rely heavily on, and this is a perfect example of why we've taken the conservative approach we have in structuring the loans the way we do and starting off with tremendous amounts of equity that sponsors are heavily incented to protect. And we've been through a three or four-month event that threatens to be longer, none of us knows how much longer, that would definitely be utilizing more of those allocations within our loans for the payment of interest. There are a number of different scenarios that you can find yourself in depending on where in the project you are. For those that are more advanced in terms of completion or being open or near opening, obviously, there's more drain, there's a higher interest cost that has to be covered. But we've talked about, over the past quarter, as we've dealt with our

sponsors in these situations, the quality of our sponsorship has been such with respect to their character and their financial wherewithal that if there was any sort of stress on the interest reserve, they've been good to re-up and refill those buckets. And we've structured some loan modifications that resulted in an extension to give them more time to ramp the property up, and those come with additional deposits to cover the interest costs through those extension terms. And as George alluded to earlier, in many cases, even paydowns on our loan.

And those would be the most stressful situations, but you obviously have a number that -- you'll have some that haven't -- that are still in the equity phase where the interest allocation hasn't even been touched yet, and obviously, no concerns there. And then between those 2 extremes, you'll have some that are perhaps entering the debt funding stage, but lower interest costs and plenty of contingency in that line item to deal with future unexpected delays. All our loans we structure, we require a capital structure that has solid contingencies, not just around hard costs but around operating loss through to ramp up and interest cost to the point of 1.0 debt service coverage. And we expect in our underwriting that you are going to have delays. As we said, construction delays are a common occurrence, and we would never go into the deal without expecting that and being prepared for it. And our great sponsors are the same way about that. They budget in the same way. And we've had them in the past, have a tremendous contingency that they never touch but fund more equity notwithstanding. That's just the way some of our -- the conservatism, not just in the way we underwrite structure, but some of the -- a lot of the sponsors we do business with. So it's an important part of our lending platform.

Brock Vandervliet

I guess just more pointedly, is the percentage of NII from capitalized interest, has that risen? I think it was around 25% in Q1. Has that risen from there? Can you quantify that?

Tim Hicks

Brock, it's a very similar percentage. It's roughly the same 25%, 26% that came in, in the quarter.

Brocker Vandervliet

Okay. I infer that's positive in that it hasn't jumped up a tremendous amount.

George Gleason

Well, I don't think it's positive or negative, either one. The idea that some people have that having interest built into your construction loan capital stack is somehow a weakness in underwriting is a silly, misguided idea. The reality is you're requiring the sponsor to put in all of their equity upfront. So us funding interest as part of the loan is actually a conservative strategy as opposed to not having it in the loan budget and saying, well, the sponsor is going to have to come up with the interest along the way. If the sponsor is going to put $10 million in a project for interest, I would rather them put the $10 million up front on hard cost and us fund the interest than not have the $10 million in the cap stack and trust them to fund it along the way. So our premise is to get all the sponsor's money in before our money goes in. And that means, since interest is funded later in the project that we're going to fund the interest out of the loan as opposed to the sponsor writing the check part.

So if you've got a project that's going to cost $100 million, it's going to cost $100 million. And when you rather the sponsor put in $45 million and then pay $5 million of interest along the way and us fund $50 million while they're still paying interest, or would you rather than put their whole $50 million upfront and us fund the interest out of our reserve. It's much more conservative and much more protective of the bank for us to fund the interest out of our loan and make the sponsor put all that money in upfront. I've had this philosophical discussion with several people who just didn't understand the dynamics of that. And to Brannon's point, we do typically have pretty generous interest reserves in these things because you don't know whether interest rates are going to go up or down over the life of the project and whether or not you're going to have delays that are going to cause more interest to accrue. And that's one of the reasons that, on average, we only fund about 85% of our loan commitments at RESG. We have hard cost contingencies and soft cost contingencies and interest reserve and operating loss reserves on properties like apartments and hotels that are going to have to ramp up the operations. That's all built into the cap stack. And that requires the sponsors to fund that money upfront even though those items are built into our loans. So where we start out with a loan that we think, wow, we're funding 50% of the cost on $100 million project and the sponsor is funding $50 million, if we only fund 85% of our loan, then we're ending up funding 45% or 46% of the project and the sponsor is funding 54%, 55% because we were the last guys to fund in the unused parts of the loan -- unused parts of the cap stack, reduce our loan. And that makes our loans even more conservative than they appear when you underwrite them and close them.

Matt Olney – *Stephens Inc.*

I wanted to circle back on the new RESG appraisal discussion. And I'm curious, were these appraisals ordered under normal policy? Or were these appraisals ordered and evaluated in a post-COVID-19 valuation check just to ensure the LTVs were stable in a new environment? And then part two of the question is, looking at Figure 39, there were a handful of LTVs that did increase by more than 10% or more, so it implies a pretty good drop of value in some cases. And I realize it's just a very small handful of loans. But in that case, what is the solution if the LTVs did increase by that much?

George Gleason

Well, let me tell you first that they were all ordered in the normal course of business. Loans were coming up maturity for renewal and so forth. And yes, there were three loans where the loan-to-value went up by more than 10%. And if you look back at the figure before that, Matt, which is a Figure 38, which is our bubble chart that shows all of our loan to values, you'll notice that it says that other than the one credit, the New Martis credit that's the high loan-to-value, all of our loan-to-value ratios were less than 69%. And if you looked at that lead-in sentence to that table, last quarter, it would have said all of our loan to values were less than 65%. So we did have a couple of loans – three loans where the loan to values went up more than 10%, and that bumped our highest loan-to-value in the portfolio to just under 69% as opposed to just under 65% as a result of that. And I think all three of the loans that had a significant increase in loan-to-value were hotel loans, is that right, Brannon?

Brannon Hamblen

Actually, George two were hotel and 1 was a multifamily loan that we actually -- there was a modification that actually part of the LTV increase was because we increased that loan as part of the sponsors redesign the project and was a very favorable -- that was a situation where it's not a negative LTV increase. It was understood what we were doing there. So it really just two loans that were both hotel loans that had more than a 10% move in the LTV that was related to stress.

Matthew Olney

So in those 2 examples, I guess, on the hotel side, did you ask for more equity? Or did you view the new LTVs as satisfactory?

Brannon Hamblen

So in one case, yes, there was equity contributed. And as George mentioned, these are in the normal course, right? So loan maturities. And any time we extend a loan, we get a new appraisal to understand what the value is at that point. And we typically have loan-to-value thresholds that we're wanting to meet. In the case of one of these new LTVs is at 53%, so the change was significant. But when you start at 43% and move to 53%, that's why we start where we do. And a 53% loan-to-value in COVID is, we believe, a very strong place. So no additional equity was required in that case. But the other situation was -- we listed four, I believe, pandemic '19 deferrals in our comments, and this was one of those. And those were situations that Tim and I have discussed over the past month or so with a number of you, where our sponsors are contributing the same amount or more new equity towards interest or debt service payments into the future than we are deferring. And in this case -- I believe in that particular case, there was a deferral of six months, but the sponsor contributed six months of debt service so that you've got a 12-month extension that's fully covered with respect to our debt service. So that was the situation on that particular hotel.

George Gleason

And not only are the sponsors in those situations, that example that Brannon gave you, contributing six months of that service, but in some cases where we're doing extensions like that, we're requiring them to pre-fund some portion of future operating losses and to carry the property through the pandemic and tax and insurance reserves. So we're being very disciplined in requiring our sponsors to be disciplined in the way they're approaching these.

Matthew Olney

Okay. That's helpful. And I really appreciate you guys disclosing those new appraisals. I think that's helpful from our side.

George Gleason

Well, we think it shows the quality of portfolio. And we're happy to give the information and happy that the information is showing pretty favorable results in a challenging environment.

Matthew Olney

Agreed. And then one more question. George, you previously mentioned that the RV & marine portfolio was getting pretty sizable just in terms of the overall loan portfolio. And that was one of the reasons you wanted to curtail the growth from a concentration concern. How do you think about concentration for RESG? It's now I think 60% of the loan balance and it was 70% a few years ago. What's your comfort level with the concentration of RESG, more of a longer-term analysis?

George Gleason

Well, that's a good question. We've always said that our RESG loans are our best-quality, best-yielding loans in every respect. And that point of view has only grown stronger every year and every quarter that they're our best-quality, best-yielding loans. So we're not concerned about that concentration. I think it's 59% of the outstanding balance of our non-purchased loans today. We're very comfortable with that number there. We were very comfortable with it at 70%, frankly. And we're not telling these guys they cannot do their normal business and so forth. We've got 17-plus years of experience with that RESG portfolio. And we have a high level of confidence in how that portfolio will perform in a variety of environments. And it's not perfect, but the results on it have been exceptionally good in the entire 17 years we've been in that, when our loss ratio is a 13 basis point annualized loss ratio. So it's hard to not like a portfolio that has the yield attributes that, that portfolio has and is going to run, has run historically, and I think probably similarly in the future, running a mid-teens to a low teens sort of net charge-off ratio on an average annual basis. So we like that portfolio. We like the indirect portfolio. It's just newer, and we don't have the two decades almost of experience with it that we have with RESG. So we want to walk that thing up, and I think it is an important part of our future. And I just don't want it to get too big too quick until we have a lot of long-term experience with it. And as I said earlier, it's performing very well so far in this environment. I don't have any reason at this point to think that it won't continue to perform well in this environment, but seeing it do that is going to be the proof in the pudding.

Stephen Scouten – *Piper Sandler*
Just one more question maybe on the reappraisal process, and again, I do think it was extremely helpful. There always seems to be a disconnect around that RESG book. And the truth that LTV's matter more than any sort of guarantees that a real estate developer could give you. So I'm wondering if you guys would consider more proactive reappraisals moving forward as opposed to the ones in the normal course of business? Obviously, I know they're expensive and arduous, but is that a possibility?

George Gleason
Stephen, we'll consider an appraisal wherever we think it's appropriate. And obviously, any loan that's up for maturity or extension or modification of any kind and upsizing of whatever, we're going to always get reappraisals on those. If a loan becomes problematic, we're going to get a reappraisal on it. Given the fairly short duration of the portfolio, most of those loans are three year loans, some are 18 months, some are 42 or 48 months, but most of them are three year initial terms, I think doing it in the ordinary course of business and whenever an issue arises is the appropriate timing of that. It would be a waste of energy and effort to go out and wholesale reappraise the portfolio and it would add a lot of cost. And you wouldn't know any more than we already know. I mean we've got data on all these loans in all these markets, all the time. So we know if there's a material issue developing, and we're going to get an appraisal to tell us to confirm what we know. But it's not necessary to do it more than the way we're doing it now. If there's an issue or an event, we're doing it.

Stephen Scouten
Perfect. And then any update by chance on the Lake Tahoe exposure? I've heard kind of anecdotal information that some of those markets are seeing some improvement and strength. I'm wondering if you're seeing that on your properties as well.

George Gleason
Yes. There's a footnote to the bubble chart, Tim, where is that?

Tim Hicks

Yes, footnote on Figure 38.

George Gleason

Yes. I mean that's about as detailed an update as we can give you. It's what closed in the last quarter what was under contract at June 30 and what's already closed this quarter. And anecdotally, you are correct that the COVID-19 situation seems to be having a beneficial effect on projects like this project that are second home projects or vacation sort of home projects or out in the open spaces sort of projects. And I think if our sponsors had more inventory built, they would be selling more product. The sales velocity seems to be constrained by the fact that they've been judicious in not putting too much inventory on the ground. And suddenly, there was a lot of demand. So I think if they can get more inventory built quickly, they can have better sales. Brannon, is that an accurate...

Brannon Hamblen

It is indeed. We have the happy circumstance of being low on inventory right now. So we'll see if this holds, and newly developed inventory is moving at the same rate. But it's there's definitely been a drift towards the wide open spaces, and we've benefited from that.

Stephen Scouten

Perfect. Yes. Sorry, I missed that footnote. That's good detail. And then maybe last question for me. Just -- you guys have a great track record of being opportunistic in deploying your capital to very accretive opportunities as they arise. Are you seeing anything coming about yet today from any of this tumult we're seeing in the market? And anything you could see burning in the months and quarters to come that you might be able to pursue?

George Gleason

Well, as we talked about in the last call, we had a nice opportunity to add a few hundred million dollars of bonds that we got good pricing on in late March. We also have had the opportunity to improve pricing pretty much across the loan portfolio and to gain market share in the RESG part of the portfolio. So those are the opportunities that I think are worth talking about so far. I believe as this thing grinds on, we'll see some additional opportunities, but I don't know what those are at this point. So we're scanning the horizon all the time looking to make sure we don't miss a good opportunity that really makes sense and would be a good investment.

Brian Martin – *Janney Montgomery Scott LLC*

On the liquidity, George, can you just give any sense on how you think that plays out? I mean how much, I guess, we would expect that to maybe moderate, if at all? Or at least maybe not in the near term, but just over maybe the next 12 months, how you're thinking about that?

George Gleason

Brian, we've built up a lot of liquidity. And Tim made a reference to that, I think, on Page 1 of the management comments document right off the bat in bullet points talking about the build and our investment portfolio and the build in our cash position. That has, as I mentioned earlier, been negative for our margin. But I think this is an environment where you want to hold a lot of liquidity. And we've been building that for several quarters and feel like we're in a good position -- great position from a liquidity perspective. So we'll make adjustments as circumstances suggest we should make adjustments, but we're very comfortable where we are today and expect to be more or less in that same range for the time being, foreseeable future.

Brian Martin

And then just secondly, given your comments, George, about getting the better spreads today and the fact that you've got so much in the loan book after floors. I guess, is it kind of fair to think about it that the loan yields are kind of nearing, at least on the non-purchased piece -- kind of approaching a bottom where we're at today? I mean it's kind of third -- I guess, corresponds to what you said earlier about your outlook for the margin. But just is that fair how we're thinking about that or should we be thinking about that?

George Gleason

Yes. I think that's a reasonable assumption. We're at or near the bottom. Maybe not at the bottom, but if not at the bottom, very nearing.

Tim Hicks

Yes. Brian, this is Tim. The only thing I would add to that is in April that we were -- getting to our floors in April, we weren't all at our floors for the whole month of April. So at May 1 we were at where we are now on floors, but throughout the month of April, there was probably still some loans heading towards their floor.

George Gleason

Yes. So it might be a full quarter effect of being at the floor in Q3, whereas we were above the floors for the first month or so of Q2.

Tim Hicks

Correct. Yes.

Brian Martin

Yes. Okay. And then just lastly, just on the forgiveness of the PPP, just how you guys are thinking about that. I know there's a lot of uncertainty, but just any thoughts as how you guys are thinking about it today?

George Gleason

The guys are looking at options, and we're waiting for the final governmental guidance on how to process all that. So I think we did a good job putting them on the books and qualifying the customers to make sure we had customers that were going -- that we were making the loans to that we're going to be able to provide the documentation and support for the forgiveness program. So we think we'll do well with that once we get started. But I think everyone is ready to get on to that part of the program. And as you know, there's a move afoot, I don't know if it gets passed or not, to kind of have a more expedited forgiveness for loans that are $150,000 or less or maybe even -- we've heard some numbers being thrown around at $250,000 or less, which makes a lot of sense. I mean the government intended the program to benefit small business, and you probably want small business focused on how they're going to get their businesses back up and running and functioning at a high level and not having to do a bunch of paperwork to get their loan forgiven.

George Gleason

All right. Guys, thanks for joining us. We look forward to talking with you in about 90 days. Have a great quarter. That concludes our call.