Bank OZK

Transcript of the Fourth Quarter 2023 Conference Call

January 19, 2023, 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 Jay Staley, Director of Investor Relations & Corporate Development 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;
- Brannon Hamblen, President;
- Tim Hicks, Chief Financial Officer; and
- Cindy Wolfe, Chief Operating Officer.

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

Stephen Scouten – *Piper | Sandler*
So impressive NII growth again this quarter, and I know you guys have talked a lot about this kind of horse race that will be occurring with average earning asset growth versus NIM compression moving forward. I'm kind of wondering, as we look out into 2025, which I know is hard to project, but how you kind of see that potentially playing out based on projected rate cuts and kind of how that dynamic should occur as we look further out? And presumably, I guess, to your guidance, RESG repayments accelerate a little bit?

George Gleason
Stephen, we hadn't anticipated you starting off with a question about 2025. What I would tell you on that, and of course, the answer is tremendously dependent upon Fed action, but our approach in our budget and planning for this year is that we're likely going to have three Fed cuts in 2024. And those are probably going to be July, September and November cuts. So we've taken a little more conservative view in line with the Fed's guidance, ignoring the fact that the market's gotten a little further ahead on that. Assuming that scenario is correct, which is anybody's guess, and assuming that we have another further four Fed cuts in 2025 or five Fed cuts in 2025, you'll begin to have the floors kick in on the loans in 2025 in earnest and we'll be effectively rolling over a large part of our deposit portfolio.

While we think the horse race is fully in play every quarter in 2024, we're generally thinking, if that scenario plays out, we're going to have a more constructive net interest income environment in 2025, even with a lot of RESG payoffs coming in there. So that's our current thinking on it. But 2025 is quite a ways out and a lot of things are going to happen between now and then.

Stephen Scouten
That's right. Yes. And I assume like you said, we'll start seeing that chart come back in your management comments with the floors and kind of how that protects your loan book. So that's obviously very helpful. And then I'm kind of curious around origination trends -- I mean for those of us that aren't in that real estate business on a daily basis and not seeing what you guys see daily, I think a lot of folks on this side would have expected more of a slowdown, but originations have stayed extremely strong. So I don't know if, Brannon, you could talk about some of those dynamics, whether it's competitive, whether there's still an appetite for current projects? Or what's keeping that loan origination demand higher than some of us on this side of the world would have expected?

Brannon Hamblen

It's a great question. Although coming off of a record $13.8 billion sometimes I get it that there should be more, that it should be stronger. But we're so proud of what our team has done in 2023. You saw the number increase at the end of the year, and I would say that moving into Q1 2024 we've got a decent pipeline there.

You're right -- there are a lot of different headwinds for origination, this year, I would say. From an equity confidence point of view, this has been the lowest that we've seen in a long time. But that's juxtaposed against a lot of capital that's out there. We hear about funds that -- fund managers out there are looking to start new funds and are getting pushback from investors because they haven't invested the funds they already have existing. But their reticence in the recent past has definitely shown up in the number of deals that have moved forward or a number of deals that have sort of been on the table and then pulled back. I think the positive trend that you see there for us is simply a result of what we talked about quarter in, quarter out, around being built to be in the market every day, every year, every cycle. And our guys continue to benefit from their well-deserved reputation for execution in that space. And we continue to -- when there aren't nearly as many competitors on the field, you tend to get calls that you might not have received before. And our guys have done a phenomenal job of converting on new relationships, and obviously, loans with existing relationships.

The pie has been smaller, without question. We're just able to take a proportionately larger slice of that pie with our team. And this year will be very interesting in terms of how things play out. But as we'll talk about, and George has already alluded to in terms of our thoughts around rate moves, we would expect, given the amount of capital that's sort of been sitting on the sideline needing to be invested, that with -- if we continue to get some positive signs there, we'll start to see that the number of deals in the market increase. Of course, competition could increase as well. But we, as we stated, believe that we could see being at or above the volume we had in 2023 for the 12 months in 2024.

Stephen Scouten

Yes. And if I could squeeze in one last quick one. Just as you guys think about maybe passing the baton to some of these other loan categories and investments you've made in the bank through the last few years, is there a way to kind of stack-rank where the potential is, whether it's ABL, CBSG, like where you think the most potential is to kind of make that handoff in terms of growth in the longer run?

Brannon Hamblen

Sure. I think you mentioned ABL. Those guys had another good year. We expect that they'll have another good year coming at us. I would tell you that our lending groups, it's no surprise, have been as focused as ever on deposit gathering relationships. And we've, I don't want to say restricted, but that heavy focus has sort of narrowed the focus around what, for example, ABL has been doing. I think those guys have potential to really, just in time might be an overstatement, but to really sort of open to pick it up a bit more as we as we look at what RESG may be facing in terms of paydown in 2025.

So that's a group that comes to mind. But right behind it, as you said, would be our Fund Finance and our Capital Solutions groups continue to make progress. We never know what the future holds, but we feel like we're pretty well positioned as an institution to look at other opportunities in the commercial space. We're thinking about those and watching closely for opportunities we might be able to capitalize on. So that's where our head is at today.

Matt Olney – *Stephens Inc.*

I wanted to ask about the pace of loan growth in 2024. Any insight you can provide about if the pace will be weighted towards the front half or the back half? And then on the topic of loan repayments. I'm curious what you're hearing from the sponsors from some of these RESG loans that have reached stabilization but still remain at the bank. It seems like you'd be getting more requests given the dip we've seen in rates here, but just curious, any comments you have there?

Brannon Hamblen

Yes. So it's largely a timing issue, Matt, and also lender supply out there. There are a lot of institutions that have been less active, but there have also been those that have pushed in, and there are some names, nonbank names, that we're seeing that are active in that space. But I think the proceeds from a refi today are not what they were when a sponsor kicked off its project. So I think a little bit is just managing expectations and trying to find that particular point in time where they feel like they've, whether it's -- they want to burn off some concessions, if it's a multifamily deal perhaps, or get that next turn and link that up to the optimal interest rate. So it's a combination of factors. Given the environment that we've been in, we're pleased with the payoff activity we've had. But we've talked about it a good bit, if -- as the short term rates come down, and I focus on the short term because not all of these are going to go to permanent financing, some will jump from presumably a lower proceed loan with us to a higher proceed loan with trying to minimize the interest rate impact, but certainly getting the higher proceeds, but not necessarily with permanent loans. So the short-term rates are more in play there, and you guys all know what's happening with the curve there. So there may be some delay waiting to get further down the curve and pull the trigger on that.

George Gleason

Yes. And Matt, as we alluded to in our Management Comments, we think that the lower interest rate levels that were much lower a couple of weeks ago and have gotten higher over the last week or two, but still relatively lower, and the expectation, the Fed's not going to increase rates further and the next direction is down in rates. We think that that is going to create a higher level of payoffs in 2024, either to bridge financing, as Brannon alluded to, -- from our construction loan to a bridge loan, or from our loan to permanent financing, which is happening on a lot of apartment deals. There's still a very active refinance market on apartments out there.

The first part of your question is, can we give you some guidance on growth quarter-to-quarter? I think the best presumption we could probably give you at this point is that that's probably going to be fairly linear over the course of the year. It will vary from quarter-to-quarter, but we can't predict that. We would have expected a higher level of originations in the quarter just ended. But several pretty significant opportunities got delayed or otherwise terminated, I guess, because of the fact that sponsors were having trouble putting equity together on it, which is an item Brannon alluded to. The equity guys had a very challenging year, and getting new equity for new projects is more challenging than it was a couple of years ago. And interesting things that are on the drawing board that get late in the process that, for one reason or another, don't get closed or get delayed and it takes another few months to get everything together.

Deals are moving fairly slowly. So we have a projection for every quarter this year. And if we were confident that those quarter-to-quarter closing numbers were going to be close to accurate, I'd share those. But those things are moving around from one or two quarters plus or minus. But some things are getting done sooner than expected. We had a couple of those in the last quarter and a number of things from the last quarter got delayed for a while or perhaps indefinitely. It's hard to predict quarter-to-quarter. I think your best assumption would be to assume a fairly even distribution.

Matt Olney

I appreciated the commentary. And then just as a follow-up, I think in the management commentary, you mentioned the RESG loan concentration, 65% of non-purchased loans, it sounds like that will likely increase in 2024 before contracting in 2025 and 2026. I had thought that the previous commentary assumed that the RESG could peak in 2023 and would work lower in 2024. I could be mistaken on that. But any color on kind of why that inflection is now being pushed out to 2025.

George Gleason

I don't know that we specifically gave that comment in 2023, but I could certainly understand why you would infer that. And the reason that the RESG percentage, which got down to about 62%, I think, is back up to 65%, it's simply because of the slower rate of refinancings and payoffs. And that's a coiled spring that's going to spring, probably in 2025. You're correct that we would expect when that spring uncoils, that that will lead to an elevated level of RESG payoffs at some point. And our best guess is that is a meaningful number in 2025. So we're cognizant of that.

The second thing I would tell you is we enjoyed mid-to-high 20s percent loan growth last year. And as was alluded to in Brannon's comments, we have constrained the growth potential of our equipment finance, capital solutions and ABL groups, and fund finance groups, frankly, by limiting them to relationships that also included substantial deposits. So those guys would have grown a lot more, could have grown a lot more, in 2023, had we not constrained their growth.

So, we knew we were going to have a higher level of RESG driven growth in 2023 because payoffs were slowing as the year unfolded. You could see that. So we limited the ability of the other business units to grow. And that's why we're pretty confident that, as we do begin to see that RESG payoff wave materializing, we would hope those other business units would still have the opportunities to grow that they have. I think they will. Time will prove that out. But that's why we think we're going to have a very smooth handoff of growth in 2025 from RESG that's going to have a lot of pay-downs, and the balances there probably more or less stagnate per year, to our ABL, structured finance, fund finance, capital solutions and equipment finance groups, that will exercise the ability that they've already demonstrated they have to achieve a higher growth rate.

Ben Gerlinger – *Citi*

I think last week or two weeks ago, I went to my local OZK branch here in Georgia and spent some time annoying the bankers and tellers. It seems like you guys are emphasizing a CD rate that's a bit shorter than previous, the people that I spoke with at the one specific branch was kind of focusing on the 8-month CD, which kind of coincides with your expectations for a July cut. I was just curious on your deposit gathering efforts in general. How do you guys feel about gathering deposits even in a kind of difficult rate environment? I get that you probably want to be a bit more nimble, but if you have growth, you kind of need to pay up. So I'm just curious on how you feel about the loan-to-deposit ratio, or any other deposit gathering effort or levers you could pull in over the next seven, eight-ish months before we get to the first rate cut?

George Gleason

Yes. You're correct in your observations that we have -- starting in the last week or two of November and incrementally shifting, we've kind of twisted our focus on maturities to get a little shorter maturity distribution in that deposit book, hoping that we can get that book lined up more tightly with the Fed's rate cutting scenarios. So you're correct in that eight months. And seven months is the focus there on wholesale deposits - we're moving those in even shorter.

We are continuing to pay up, as you noted, because we are growing so much. We grew deposits last year over $5.5 billion, almost $6 billion. And to do that in an environment where the Fed is taking liquidity out of the system and most banks are experiencing shrinking balance sheets was a heck of an accomplishment for our deposit guys. And they are fully ready to do that again this year if we need to do that. We feel really, really confident in our ability to do it.

The biggest focus is achieving the growth we need to achieve, while shifting the mix of the deposit book to align more closely with the expectation that rates are going to head down at some point in the year, and also minimize our cost of deposits. So we're making adjustments weekly, sometimes daily in that regard. And I think our deposit team is doing a great job.

But I appreciate the fact that you're paying attention to what's going on at the local level in the branches, because our 228 or 229, 230 branches, however many it is, are where all those good stuff on the deposit side is occurring.

Ben Gerlinger

Yes. I guess I have to actually open a checking account, otherwise they are going to get suspicious on my constant visiting.

I was just curious if we could just kind of switch gears here. On Figure 14 in the prepared remarks, you had the appraisals obtained, and it seems like there's obviously some oscillation. With every appraisal the valuation is going to be a little bit different. But there were three that kind of stuck out a little bit -- two office and a multifamily. And the worst office change seemed to be a little less than a 50% haircut in the overall valuation.

I think everyone knows at this point office, as stated, is probably a little higher, but it's such an illiquid market in general. There's just not a lot of transactions. Were these valuations kind of what you were expecting? Or is there anything idiosyncratic in that nature? I don't really have an issue with your credit overall, but with those marks down, I'm just kind of curious what your thoughts are on just those couple of loans?

Brannon Hamblen

Yes, I think the short answer is we're generally seeing what we would expect. In terms of idiosyncratic moves, I think there are certain markets that are probably hit harder with respect to the cap rate moves -- but you hit the nail on the head. There is just a real dearth of transactions out there upon which these valuations can draw for cap rate data.

And the fact of the matter is appraisers are human and you have got to make an estimate, and sometimes that estimate can, in hindsight, be a bit severe. But we're extremely pleased with what we feel like, over the course of these quarters that we've given you guys this data, the majority of these loans are falling in that sort of up, down 10% range. Which, given our really low basis, is not at all a bad place to be. And we've had a lot of those that are down. And where the ups are, generally speaking, aligns with what we would think. But we're pleased that those have been of limited nature.

And if you look back historically at what our portfolio LTV is, and we've been reappraising projects through a pretty long cycle of uncertain economic conditions and lack of activity, lack of transactions, you're seeing a solid, it's incremental, but a solid positive trend in our portfolio LTV. And a lot of that's driven by the fact that our guys do such a great job of originating loans at low LTV, loan LTC, putting these sponsors in a position with a lot of skin in the game and a reason to put more in to protect it, but it’s another reason that our LTVs don't move more than they do.

We'll continue to reappraise projects through the year. And we'll see changes. But generally speaking, I think it'd be accurate to say we're not really surprised by most of the results given especially the lack of data in office, in particular, to support any other cap rate than what appraisers are using.

George Gleason

Ben, I would point out also that all of those loans that you mentioned on the reappraised list there are pass rated credits. That pass rating takes into account the higher loan-to-value on the ones where the LTV went up, but they are still pass rated credits. So we don't consider those are problems.

Brannon made an excellent point. If you look back over the last 8 quarters from a portfolio perspective, our loan-to-cost on the entire portfolio and our loan-to-value on the portfolio is kind of 42%, 43% loan-to-value range. That has not moved more than one or two points in the aggregate over that whole period of time. And that's because while we're having some loans like these three you mentioned where the appraised loan-to-value has gone up in a meaningful way, we're also having a number where we've got accretive paydowns. We're also having a lot of new originations where we're originating at high 30s or very low 40s loan-to-value. So the aggregate condition of the portfolio is continuing to perform very well on that LTV metric.

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

Just a follow-up on the credit conversation. You mentioned in your Management Comments that you still have a goal to grow EPS in 2024, which is pretty big coming off of a year where you grew 30-some percent and had a record year. And so as I think about '24, I think we all know the NIM and growth headwinds that we're going to potentially see if we have rate cuts, but I think a big question is, where is the provision? And so just curious how you're thinking about how the provision should trend versus this past year's level to reach an EPS growth goal in this year?

George Gleason

Yes, you're spot-on correct there with the guidance that we've given on tax rates and noninterest expense and the net interest margin and the net interest income number being a horse race every quarter. We think it's a reasonable scenario that, for the year, we will put up improved EPS versus last year. I don't know that we have an improving EPS trend every quarter next year like we did this year -- maybe some quarters are up where EPS is a record -- and some quarters are a little off the record pace. But we expect a good EPS story and, for the year, expect to beat our 2023 net income and EPS numbers.

So our assumption on provision expense in our budget and our guidance on that is predicated upon the Fed achieving a relatively stable landing to the economy. I don't know if that's a soft landing or just not a real hard landing. We have assumed in our ACL calculations, consistently for a number of quarters now, 5, 6, 7 quarters, we've been heavily weighted to the downside scenarios. So, as you know, last year, we grew our ACL over $100 million last year. Part of that was due to our significant growth. Part of it was due to the fact that we were leaning heavily on the Moody's downside models, the S4 and the S6 models. We continue to lean that way. So, we think our ACL is appropriate and pretty well positioned for a range of scenarios.

Unless we have a landing of the economy that's consistent with the S4, the S6 scenarios, if the economy lands in a more benign fashion than that, then we're going to probably look back and I think we can look back and assume that 2023 was kind of a high point in provisioning.

So we're not there yet with that conclusion, but I think you could draw a scenario pretty clearly that would suggest we could have some downside in what we provision each month or each quarter. And the flip side of that, of course, is also true. If the geopolitical, global issues, Fed, congressional issues, government shutdowns, whatever, were to somehow all coalesce into a hard landing for the economy, we could have higher provision expense. But those scenarios seem to be getting mitigated and the chance for the Fed to actually engineer a pretty decent landing for the economy is -- seems to be growing a little bit. So that could hopefully lead to lower provision expense next year.

Catherine Mealor
And it feels like a nice offset if you see -- if you do see lower margins and more paydowns in the loan book, an offset to that headwind is going to be this provision if we are in that soft landing scenario.

George Gleason
We still do expect good loan growth, I would remind you of that, yes.

Catherine Mealor
Yes. And then just another follow-up on credit. Can you give us or kind of talk us through how the Chicago land loan could play out from here. It feels like we went from special mention to substandard accrual this quarter. So we're still performing. But I noticed that your cash reserve did decline. So correct me if I'm wrong, it feels like maybe it's just performing because of the interest reserve, but kind of curious how that's playing out right now. And kind of how much time or how many quarters we have until that potentially that runs out?

And this may flip to nonperforming if you're not able to resolve the credit before that time period. Just kind of walk us through how that credit could -- kind of the path forward for that credit over the next couple of quarters.

George Gleason

That's a great question. And obviously, the fact that we went from a special mention to a substandard classification on that credit in the quarter just ended reflects the fact that we were concerned about the sponsor's pace in their recapitalization efforts here. They've been working hard on this.

This is an excellent sponsor with whom we have done a number of pieces of business. They've got a very successful track record. They're still working very hard on this and still positively disposed and engaged on it. So, we've got that going for us -- that we've got a good sponsor who's working hard and still out there diligently pursuing that. The fact that they've not gotten that recap done yet caused us to do the downgrade. And with that downgrade also, that changed the risk rating on loan, and the risk rating drives our provision for the loan. So, our ACL on this loan is now, as we disclosed in the management comments, $32.8 million. We've pretty much provisioned this thing for an adverse outcome.

You're correct. They are using their cash reserve, which is their money, to pay interest on the loan, and they've got enough cash reserve there to go several more months. I don't know the exact timing of that. But when they get to the end of that cash reserve, they'll have to make a decision if they want to and can support it with further interest payments to buy more time to work out their recapitalization and develop their ultimate plan for this property or if they've run out of gas. So we'll just have to see.

But the downgrade reflected, and the increase in the ACL for the loan reflected, what we thought was an appropriate adjustment for the risk in it at this time. We're monitoring it closely, and of course, we'll do anything that we can do and are doing everything we can do to assist the sponsor in their efforts, but we're the lender and they're the equity. So, the ball is really in their court on this.

Manan Gosalia – *Morgan Stanley*

I wanted to ask on the loan floors you spoke about earlier. Can you talk about where those floors are on average for the portfolio on the books right now? How long will the benefit of that last given the shorter duration of some of your loans? And what if the capital markets open up? And if you can comment on any recent trends there. Have there been any changes in the floors you've been able to negotiate more recently given the outlook for rate cuts?

George Gleason

In kind of the run-up to mid-last year and, I guess, even third quarter, fourth quarter of last year, a lot of the loans that we were originating in RESG had floors at the start rate of the loan. So the expectation -- when the expectation is that the Fed is going to be continuing to raise rates as it was throughout 2022, it's pretty easy to get loans at the floors at the start rate of the loan.

As 2023 progressed and customers began to look forward to when the Fed was going to reverse course, more pressure came in to negotiate that floor rate to something below the start rate of the loan. And those floors have moved. I would tell you today we're still getting floors in some loans at the start rate of the loan, and some loans, the floor is, in the RESG portfolio, 100 or even slightly more points below the, basis points, below the start rate. So they are meaningful floors. And they vary from loan to loan, and that depends on other features, just all the myriad of details in how you negotiate one and structure one of these credits. So they are important for us. I can't give you the breakdown. We'll probably start next quarter or the quarter after giving you a table in our Management Comments. I think Stephen asked for that in our Management Comments that shows where the floors are on various loans.

We're obviously getting old loans paid off at $1 billion a quarter, more or less. And those old loans have floors that are usually far below current rates because they were set in an environment before the Fed started raising rates and the floor may have been a SOFR floor of 25 basis points, which would have been a 4-something floor at the time. So those floors are getting reset about $1 billion a quarter. We're also having loans that don't have as of right extensions - rights that we're doing extensions on.

On a business as usual sort of basis, we're attempting to reset the floors higher on those loans with a fair degree of success. But obviously, that's a negotiating point with every customer. And we're rolling off those loans with lower floors and putting on new loans with higher floors. So this story gets better every time, which is why we have said a higher for longer scenario is better for our net interest margin because, every month, we've reset the floors on the portfolio, on average, higher. So if the Fed doesn't cut rates until July, post March, that's really good for us because we've got another 4 months of floors reset. If they waited until September, that's even better because we get another 6 months of floors reset. Those floors will hold on those loans for the duration of the loans, and they're 3-year loans and typically they'll hold for any extension duration. And we typically have minimum interest protection on these loans, so somebody is not going to refinance a construction loan typically mid-construction because we've got an 8% floor in it and suddenly they can get 6% money. The minimum interest and other features, and the complexity and cost of moving that loan, will tend to keep them there. So those floors will hold and they're going to be an important part of hopefully us expanding NIM in 2025.

Manan Gosalia

So it sounds like the current interest rates matter more than the forward look. So I guess the floors are not going down just because the rate outlook has gone down over the last couple of months?

George Gleason

The fact that the rate outlook is – that the forward curve is down, the rate outlook is down, is causing sponsors to, in some cases, negotiate harder and push more on our negotiation on the floor. But we know that's a very important part of our business, so we're pushing hard back to retain as much of that floor as possible. And if we can't get a floor that we think gives us an appropriate risk-adjusted return in a dynamic rate environment, we're just not going there.

So we're negotiating very hard on those floors, and it's a very important part of our business model, and our origination team understands that and is very dialed in on it. We've really pressed that point with them. So they're doing a really good job of managing those negotiations to an acceptable or better outcome for us.

Manan Gosalia

And then on capital, I know you have a high 10.8% CET1 ratio. You're also looking forward at what loans you put on the balance sheet and what the loan growth eventually is. But as we think through 2024, how should we think about buybacks? Is the flex only about what the balance sheet growth is? Or given some of the uncertainties you mentioned in the environment, do you want to keep an extra capital buffer until the environment changes?

Tim Hicks

As you said, we've got really strong capital levels now. I think you've seen our risk-based capital levels really stabilize at current levels. The last three quarters I think we've been within 10 basis points of where we are this quarter, even with the substantial growth we had during those quarters. We feel like we'll have good growth this year, good earnings retention as well. So feel like we'll have risk-based capital ratios for this year staying relatively, give or take, where we are now or slightly above.

And so moving from there on share repurchases, we're going to focus on where we are from our current capital levels, see where the growth is for this year and in a few years. But know that that's always an option, a lever that we can pull if need be. If our growth moderates in a certain year, we can certainly pull that lever and get a reauthorization to repurchase if our share price is depressed. We can also look at it for that purpose as well. But right now, our focus is growing the bank and finding ways to do that.

Brandon King – *Truist*

So just a follow-up on the Chicago land credit. Being that such a strong sponsor is having some issues there with capitalization, does that give you more concern broadly when you think about your customer base and sponsor being able to support their projects when they run into issues?

George Gleason

Brandon, that's a good question. And I think the answer that I would give you is, if I was answering it yes or no, is no, that doesn't give me a lot of pause. Sponsors come in 2 different flavors, or really more. But you can kind of divide sponsors into a couple of groups. One is sponsors that invest their own money, but also are dependent upon equity capital, preferred equity, partners in their transactions, either as preferred or co-joining them as common equity. And then sponsors who have a huge balance sheet themselves and their equity comes internally from their own balance sheet.

The sponsor, in this case, while they have a tremendous track record, has done a lot of transactions and a lot of big transactions, deploys mostly equity of third parties. So, when they're recapping a deal, they're out explaining their vision and their plan for the deal to a variety of potential equity partners to entice those equity partners into the deal. And as Brannon mentioned, it's a challenging environment for equity in these transactions because it's a high-rate environment, a high-cost environment, the risk that the economy is going to slow. So it's a challenging thing to raise equity. And these guys are good at it. They've done it. They're accustomed to doing it. They've got a good story for the project that makes sense. They have just got to match all that up with an equity investor who likes that story. And they're working on that.

So it doesn't give me any pause about our portfolio. I think it's unique thing to this asset that they're working on this. There are other projects out there that we see every quarter that are making a lot of sense that are new projects that the very skilled, very experienced, knowledgeable sponsors are having trouble putting their equity together on.

Listen, it is a tough environment for equity. Costs of delivering a project have gone up due to inflation, interest rates, costs to carry that project during construction have gone up. You've had all the COVID delays and the impacts. You've had shifts in the demand side because of the concerns about the economy. It is a tough environment for our sponsors. And we see that thing and hear that pain from our sponsors on a regular basis.

The reason that our portfolio metrics are so good and that our challenges on asset quality have been relatively benign and limited to a handful of transactions is because of the fact that we've got great sponsors. We focus on great projects that are new construction. So they're state-of-the-art projects that have a quality advantage versus older product in the market that's not as well designed or well-located or well built. And the fact that we structure these transactions very carefully, and more than ever, the fact that we're in these transactions at around 52%, 53% of cost and 42% to 43% of appraised value, that extreme low leverage of our portfolio makes sure that people who are inferior to us in the capital stack have a tremendous amount of money at risk in front of us to protect our position and to give them the incentive to protect their position. So the way we built this portfolio is really probably about the best constructed you could get for this kind of environment where it's very, very challenging on the equity guys.

Brandon King
My next question would be in regards to competitive dynamics in regards to lending. How has that trended lately? Are you still finding yourself maybe as the only lender competing for certain projects? Or are you seeing maybe more appetite from other lenders in the market?

George Gleason
Well, there's competition out there, but the competition in the space is significantly lower than it was two years ago or three years ago, for sure. The number of people out there to provide financing in commercial real estate is -- all the visitors, the people who are in it when it's easy and fashionable and run from it when it's more challenging and requires more sophistication and expertise -- all those guys were gone. So the people that are out there lending today pretty much understand commercial real estate and are committed to it as an asset class. And I would tell you, I think we're the leader among that group of folks, and that's why we're generating good volumes even in an environment where the pie is massively smaller than it was as Brannon alluded to in his earlier remarks.

So we're going to do things that make sense. We're not going to let a competitive offer from someone else drive us to do something that doesn't make sense. That's always our mantra. That's why we've been successful. And in my 45 years as CEO, we've never lost money in a single year, because we just don't do things that don't make sense to us when we do them. We're pretty disciplined. So there is competition out there, though. I wouldn't say it's changed much in the last 90 or 180 days.

Brian Martin – *Janney Montgomery Scott*
Just one question, George, on -- just on hiring. I know you talked about some opportunities as you kind of look into '24 here. And just wondering if you can give any commentary on just where you see the opportunities potentially as far as hiring goes, and if that kind of involves new business segments as you kind of talk about this handoff to, with RESG are there things you're looking to do here or seeing opportunities to add new business lines or just add to existing business line? Just kind of curious where that hiring position looks today.

George Gleason
Yes. The answer to that is yes, yes and yes, I think. As I alluded to, I think it was a couple of quarters ago on this call, I think talent is a short in supply commodity in our economy and, certainly, in our industry. And we are trying and have been trying for years and really hit the accelerator on this the last year or so, really trying to upgrade the quality of our talent. So when we have a position become vacant, we're trying to fill that position with a person that was better than the person that left. We're trying to continuously upgrade talent. And obviously, as we've alluded to in prior management comment documents, we're adding talent. I mean, obviously, we grew high 20% last year on loans, deposits and everything else. You can't achieve that kind of growth without adding people. We expect to continue to grow. We expect to continue to add talent. And most importantly, we expect to continually upgrade talent as we're adding talent or replacing talent that has left.

So that will keep an upward pressure on our salary expense line. Because of the new applicable AICPA guidance, some of our noninterest expense in '24 and going forward has moved to the tax line on those tax credit investments. So our noninterest expense year-over-year will show a 0% to 3% sort of growth rate, probably 1%, 2%, 3%, low single digits, I think, is what we've guided. But the salary and benefits line of that is going to show some continued good growth because we're adding talent to support our growth and we're constantly trying to improve the quality of our talent. I think the excellent team that we have is one of our best, if not our best, competitive advantage. I mean we've got a great business model that's unique in the industry and it generates higher returns and lower credit losses than the industry averages by far year in, year out. So we're very confident in our business model. But the key to the business model working is our talent. And our people are our competitive advantage.

Brian Martin

And then just -- it sounds like the reserve build is -- you've talked about over the last 12 months or even further going back, the heavy lifting of that is done. Is that kind of how to think about it given your commentary on credit? I know you mentioned in the Management Comments about charge-offs being maybe up a little bit in '24 versus '23. Just trying to understand the aggressive reserve build, if a lot of that is in the rearview mirror based on kind of how you're looking about the world today.

George Gleason

Well, as I said earlier, that is going to depend on the economy. If the Fed and world events and Washington events somehow crash the economy, then we can have more reserve build, the whole industry can have a lot more reserve build, if the economy crashes in an ugly way. But our -- increasingly, I think we're beginning to migrate to the camp that the prospects of some sort of soft or relatively benign landing are getting more likely -- time will tell. We'll know as the year goes on. But if that is the case, given the fairly conservative selection of economic scenarios we've used to build our reserve, and we can shift to a more benign set of assumptions in our reserve build, and that would give us the room for provision expense to come down over the course of next year. Those events have got to play out. And again, I would caution, and Tim would want me to caution you, that if prospects for the economy get worse instead of better, there'll be more reserve builds needed. And obviously, we're going to grow, we've talked about that quite a bit. So we're going to have to increase our dollar volume of ACL for our growth.

Brian Martin

Got you. That's understood. Okay. And then just the last one for me was, on the margin, it sounds as though you've got a little bit more weakness here with the funding costs still catching up the next couple of quarters, and you've got loans maybe under a bit of pressure early on as rates start to cut, and then the floors kicking in and the deposits repricing, I guess. I mean does the general outlook seem as though the margin kind of bottoms or stabilizes midyear or maybe just a little bit lower in the second half and then it's up in '25, is how to kind of think about big picture without giving specifics on the actual level?

George Gleason

Our scenario, Brian, is that we're working for and planning for is that we need to get our floors in our loans set and that we could have enough magnitude of rate cuts in '25 that would really make those floors active and important. And as those floors kick in and we get to lock those rates at a good level, in a falling rate environment, our cost of deposits could drop faster in '25 than our loan rates because of the floors in those loans. That would then give us a favorable NIM experience like we had in '23 -- or in '22, in 2022, when our loan yields adjusted really quickly, and our deposit costs adjusted more slowly. We could have the reverse of that scenario in '25, if we can get these floor rates set effectively and enough of the portfolio and then see the Fed cut rates dramatically. And that's what we've been trying to position ourselves for us to get another nice spread in our NIM and core spread in kind of the second inning or third inning of the Fed cutting rates when they start cutting rates, by getting those floors and then being able to get our deposit costs down even more. A lot of variables in that scenario, but we've been working on that scenario for seven quarters now. From the time the Fed started increasing rates, we started planning for that flip side of that scenario going the other direction.

Michael Rose – *Raymond James*

Just two follow-up ones. Just on the expense outlook. What are the puts and takes of that? It was a little bit lower than I think I was anticipating and obviously good to see. Just wanted to see what investments are made and where you guys are having some offsets to growing costs.

Tim Hicks

Michael, I would point you to Page 33 of Management Comments. We tried to do our best in outlining what the offsets would be there. As George alluded to, just a while ago, we do expect salary expense to continue to increase as we're hiring additional staff to continue to support our growth.

Probably the biggest offset to that is the recategorization of that amortization expense on our low-income housing tax credits and our renewable energy tax credits. We are adopting a new accounting standard effective January 1 of 2024 that really transfers what was $28 million last year into the tax expense line. So that's kind of an offset. And of course, a FDIC special assessment, we are not expecting one of those in '24. And we eliminated the amortization of our intangibles because they became fully amortized in 2023. So those are the offsets to the otherwise increasing growth in other categories, primarily in our salary and benefits.

Michael Rose

Yes. I just meant excluding some of those changes. I appreciate you guys explaining all that. It was even -- excluding that, it was still a little bit better than I think I was expecting even if I normalize for the accounting change, but I appreciate it.

The last question I had was just on the new mortgage initiative. And maybe -- I know it's starting from zero this quarter, but what do you guys expect for that initiative as we think about the next couple of years, and hopefully some lower rates that would help disperse some demand on the mortgage front. So just would love any thoughts there.

George Gleason

Yes, we're going to take -- continue to take a very intentional approach to that. And we do expect to start originating, probably taking applications maybe, in late February or March, and hope to close a handful of loans in March. We will get it going in one market, probably a month or two later get it going in a second market. Of course, we serve a lot of different markets with our branch footprint. So we'll roll it out, and it will continue to roll out and expand throughout 2024 through year-end 2025. I think we pretty much get most of the footprint we're going to cover covered by 2025.

It will be a modest drag on net income and EPS probably in 2024 because we'll be -- we'll get one unit up and running and originating, and a month or two or three later they'll start having some revenue, we will have added another unit. So the expenses will pretty much stay ahead of the revenue during the early part of that build-out phase. We're talking probably an immaterial impact for the year of $0.01 or $0.02 at the most. And then we would hope in 2025 that that begins to turn positive, where we actually have positive net income and maybe it's a neutral EPS and net income impact for the full year of 2025 as we get the full build-out of this thing done.

So where it probably becomes important to income, net income and EPS, is 2026 after we've got it pretty much fully matured and fully rolled out. That's why I got the mix of the last paragraph in the Management Comments. It's not going to be a big deal for a while. But it is important to our customers. And that's the reason we're doing it. We continue to have a lot of customer request and sending that business a different direction is not good for our long-term customer experience. So, this is a customer-driven initiative.

Brody Preston – *UBS*

I just want to ask real quick, George, on CET1, if you're not buying back stock, say you don't buy back stock this year just given the unfunded commitment trends and the fact that growth is still going to be strong but probably slower than it was this past year, do you actually think you could see CET1 reverse course and start to rebuild again just given the profitability levels?

Tim Hicks
Brody, yes, it will depend on growth. Certainly, we feel like we can maintain or slightly improve it from here. And then really growth in 2025 will be dependent on where it goes after this year.

Brody Preston
Got it. And then I wanted to just circle back to the floors. If I kind of take the spread commentary from last quarter, George, and kind of work my way backwards a little bit to maybe a slightly less widespread or something like that, depending on the competitive environment, going back several quarters. I look at your fourth quarter '21 to fourth quarter '22 originations. Those were the biggest kind of origination quarters for you, that 5-quarter time span. The Fed funds rate and LIBOR was decently low for a bit of that. And so I back into floor rates that are anywhere from the low 3s to the mid-5s for most of that, and maybe the fourth quarter is in the 7%-ish kind of range. Is that an accurate description? And if so, would that mean that, if the forward curve comes to pass this year in '24, the floors wouldn't necessarily matter as much for 2024, is that accurate?

George Gleason
Well, I think the floors will matter for 2024 and 2025. But you are correct that you've got to look at the vintage of origination of the loans to determine the floor. And obviously, the floors that we got in 4Q of 2022 were much higher floors than we got in 1Q of 2022 before the Fed started increasing interest rates.

We've never been able to negotiate floor rates that were higher than the contractual start rate of the loan. As I said earlier, in the first part of 2022, and most of 2022, we were getting floors at the start rate on the vast majority of loans. But it was at the start, not a higher rate. So you're correct. And again, honoring the request earlier we will probably put in our next quarterly Management Comments a chart that shows where the -- what the floor rates look like on the portfolio at that point in time. I don't have that information with me today, but we'll work to provide that in the future disclosure.

Brody Preston
Got it. Maybe if I could just extend this into 2025 specifically though, George, if I'm kind of correct in my thought process, s there a point if the forward curve does come to pass where, as the stuff that you originated in 2023 starts to fund up, the loan yield could actually reverse course and start to inflect just by the nature of the 2023 commitments starting to fund up? Because those floor rates are more in the 8% to 9%-ish kind of range.

George Gleason

Again, 2025 is hard to predict and where the Fed is going to be in 2025 and what they're going to do and 2025 is very hard to predict. So I'm going to let you develop and go with your own thesis on that based on the information we provided, because I'm not comfortable trying to give you that number.

Brody Preston

Understood. Do you mind kind of giving me some insight, for the non-RESG loans, the ABL, the RV, all that kind of stuff, what's the origination yields on those loans currently?

George Gleason

Oh, gosh. In the ABL world, it's very dependent. Most of the ABL loans have a spread matrix that is dependent upon the total leverage or availability, utilization of the line. So it's hard to comment on those because they're so deal specific, and there may be four tranches of spread, three or four tranches of spread, in those loans typically, that is dependent upon their total leverage position and utilization of available borrowing numbers. So those are hard to comment on.

The indirect stuff is, again, dependent upon credit score of the borrower and so forth. Those are all fixed rate loans in the indirect lending world. So we're probably around eight plus or minus, I would guess, on that. Actually I'm not -- I'm guessing on that. I don't know, Jay, do you know?

Jay Staley

That feels directionally correct, yes.

George Gleason

Yes. Yes. So -- and those are fixed rate loans. So every month, we're rolling off millions of dollars of lower rate loans and rolling on millions of dollars of newly originated at current market rate loans in that portfolio. So that's helping incrementally improve our margin. And the same phenomenon going on in our securities portfolio, which is pretty much all fixed rate. We expect to roll off about $1 billion of that portfolio in 2024. And either will not replace it, or if we do replace that, we would suspect it's going to be substantially higher yield than what's rolling off. So those fixed rate components of our earning assets, whether it's securities or indirect or other fixed rate loans that are rolling off will help us reprice some elements of the loan book and securities book at a more favorable pricing.

Brody Preston

I have just got one last one on the margin and then a couple more on credit. I guess if I tick and tie all the commentary that you just gave, George, and then the commentary earlier around deposit rates, I understand that you're baking three cuts into your NII outlook, but say we did get six cuts, five or six cuts like the forward curve, how would that change what you think the trajectory of the NII is for 2024?

George Gleason

Well, if we bake in five or six cuts in 2024, that's certainly a more challenging scenario for us, because we don't have our floors in our loans set us broadly in the portfolio as we would like to have set for a declining rate environment. So that would be a more challenging NIM scenario for 2024.

Brody Preston

The current OREO loan that you called out in the release is planning on, the plan is to close the sale of that by the 31st of March, and I think you said you don't expect to take a loss. Are you all planning on financing the sale of that property to the eventual buyer?

Brannon Hamblen

Yes, you read our comments correctly. We do not expect for that sale to result in a loss. And in terms of the transaction that's going forward, I think we got -- we told you guys in the past that we are under a confidentiality agreement around the transaction. So we've tried to share with you everything we can without being in breach of that transaction.

So beyond that, I don't know, George, if there's anything else you feel safe to share. But it is under confidentiality agreement. Everything is moving forward in terms of the sponsor's due diligence. They are the normal closing conditions and due diligence that would be attached to a transaction like that. But the sponsor continues to move forward in all of their due diligence there. So as we guided a quarter ago, we still expect the sale to happen inside of March 31 this year.

Brody Preston

And then my last one was just on that Chicago land loan. With the reserve that they have that they're paying interest out of, I think you said, George, maybe it's a handful of months or less that they would have to pay for the interest of that reserve. At the end of that, if there was a moment where they decided maybe this doesn't make sense anymore, would that loan kind of go the same way as this other L.A. land loan one where you guys would take it into OREO and then try to look for a similar kind of sale process?

George Gleason

Again, presuming -- your supposition there is that the sponsor gives up on it and says they're done, then yes, that would -- I would assume would be a fairly similar scenario.

Timur Braziler – ***Wells Fargo Securities***

Of the $20 billion in remaining commitments from the 2022 and 2021 vintages in RESG, what portion of that $20 billion has yet to fund up?

George Gleason

If you'll look at the cadence chart here, Brannon, Tim.

Brannon Hamblen

Page 11 - that graph is focused on what remains. It hasn't been repaid out of those vintages. I don't think we've disclosed the unfunded by year of origination. So I don't believe we have that number.

Timur Braziler

No, all good. But just using the prior comments of kind of 12 to 18 months for these loans to fund up, it sounds like much of the 2022 originations are going to be funding up here in '24. Is that fair assessment?

George Gleason

Yes. Very fair.

Timur Braziler

Okay. And then maybe looking at the deposit side, so a little continued mix shift out of non-interest bearing into time deposits. I'm assuming the funding, the strong fundings you're expected in 2024, are going to be leaning on time deposits again. Just with 52% of the deposit base now being time, are there internal concentration limits for time deposits that you guys are monitoring? And where could we see that concentration maybe trend up to?

George Gleason

We have a variety of concentration limits on deposits, but there's not a limit on time versus non-time. So if that number continues to rise, that's not a problem. Obviously, we're working hard every day to originate as much business as we can in the checking accounts, savings account, money market account areas, obviously, with rates higher and CD rates being high across the much of the industry. And other alternative investment rates being high, a lot of customers have -- they have drained their excess liquidity out of their money market savings and checking accounts and put it to work at higher yields. The entire industry has seen that phenomenon. But we're continuing to add large numbers of new account holders every month, and we'll continue to work hard on that effort. So we feel we feel good about that. But as we continue to have really good growth in the balance sheet, we will be somewhat more dependent upon time deposits as a percent of the total.

Timur Braziler
Understood. And then just two quick ones on credit. The three reappraisals that had the 25-point plus move in LTVs, can you provide the geography for those 3 loans?

Brannon Hamblen
Yes, I actually do. So a couple of those were in the Northwest, in the Seattle CBSA, and another was in the Minneapolis geography.

Timur Braziler
And then I guess just lastly, if we look at the allowance for funded loans versus allowance for unfunded loans, that gap seems to have widened throughout the course of the year with funded allowance up 27 basis points while unfunded up only 5 basis points. I guess can you maybe talk through the dynamic as to why higher allowance on the funded balance isn't translating directly to a higher allowance for the unfunded component?

Tim Hicks
Yes, Timur, it's just really about the mix. Our unfunded balance is a higher mix towards RESG. The funded balance is a higher mix to others. And obviously, it just depends on the models that it's being run through. So I mean, there's a lot of factors that go into it, but certainly the mix of the makeup of those in the unfunded is a component of it. And obviously, everything in the unfunded is pass rated credit as well. So you obviously have some other ratings typically in the funded balance.

George Gleason
All right. Thank you, guys. We appreciate you joining the call today and appreciate all the questions. Have a great quarter, and we'll see you in about 91 days. Thanks so much. Have a great one. That concludes our call.