Bank OZK

Transcript of the Second Quarter 2023 Conference Call

July 21, 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, Norma, to remind our listeners how to cue in for questions.

Stephen Scouten – *Piper | Sandler*

Maybe if we could start actually around loan growth. It's been phenomenal the last few quarters and the commentary seems to be that origination trends are improving. Obviously, repayments are still a little bit more muted. It seems like we could continue to see this path to growth. I'm just curious if you could comment on any thoughts around pushback from folks that might not want to see growth in today's environment and why you still feel good about adding that growth on these loans you booked largely last year?

George Gleason

We are cautiously optimistic about our continued growth prospects, and view that as a very positive opportunity. We're being very conservative on credit quality. We're very focused on that. We've got a long tradition and track record, so we believe in this more challenging environment and the ability to be very conservative in what we're doing that we're putting on really great quality new assets and getting paid well for it.

So we view it as a very opportunistic time for growth. We're achieving better diversification in our portfolio, but the reality is Real Estate Specialties Group is still the largest loan generating unit, growth generating, unit in our company, and Brannon Hamblen is closer to that than anybody in our company. So Brannon, since RESG is the big dog in the pack leading the growth, I'm going to let you take the rest of that question.

Brannon Hamblen

I'll just tack on to what George said about our absolute confidence in the quality of the credits that we're adding today. We're in the market every day through cycles, and really always sort of pushing leverage down and pricing up as the market gives us the opportunity to do that. And certainly, the market that we're in today has done that. If you look at what we've closed more recently, as some of the uncertainty in the market has increased, you absolutely see our new closing loan-to-values and loan-to-cost ratios being lower than our portfolio average, and our pricing spreads were strong quarter-to-quarter.

We feel great about the quality of what's going on, and in terms of the opportunity, there are still a lot of deals that are coming to the market. There are some that have stepped back as we talked about in previous quarters. But our guys just do a phenomenal job, and have over the years, and built such great market penetration on the origination side and such absolutely outstanding servicing on the asset management side that we continue to get a lot of repeat business from really super sponsors with great projects. And as

I said before, there is a lot of capital in these deals with our loan-to-cost on average being lower currently in this market.

So great job by the guys continuing to stay in the market and of course, working with a lot of sponsors that have seen our execution and the word gets around, and we've got new ones available as well. And along with that, there's obviously, as you read the paper, there are a lot of banks that are pulling back and not giving us as much competition in certain cases as we might otherwise have. So there are a number of factors involved, but we have an opportunity to put some really great quality, low leverage, well-priced credits on the book, and we're going to keep doing that.

Stephen Scouten
Yes, that's great color. I appreciate the commentary about improving quality. If I, for one, take growth -- that may be a bit of a given -- and I think you'll have nice growth trends into back half of this year and next year. I appreciate the commentary around the NIM and that, that will face pressure on the funding side. And I know the commentary, I guess, was NII growth was uncertain, maybe. I forget the exact verbiage used. But it feels like that would still need to be pressured higher given the amount of growth that you're seeing? Or am I just maybe underweighting the continued funding pressures and maybe how you need to fund up this ramping growth? How do I think about that?

George Gleason
There's a trade-off coming between growth and margin to determine whether we can continue to put up positive net interest income. We hope we can. We are working to make that happen. But as we've said from, gosh, April of last year, when -- right after the Fed started raising rates, we made the comment that our variable rate loans would move quickly as the Fed raised rates, deposit costs would lag and we've said for a number of quarters now, well over a year, that deposit cost would begin to catch up with the increases in loan yields when the Fed neared or reached the end of their tightening cycle. And we saw that in this last quarter when our NIM gave back some of that 100 basis point plus of NIM expansion that we saw over the prior quarters when the loan yields were reacting faster than deposit costs. So there is a catch-up, and we're having to be pretty aggressive on deposit costs because we have such tremendous growth opportunities.

We want to continue those growth opportunities, but to achieve the kind of deposit growth that we're achieving, we're having to be moderately aggressive on those rates. And we can afford to do that. We probably have the best net interest margin of our entire peer group, by far. So we can afford to do that.

And we're getting really good yields, as Brannon Hamblen mentioned, on the loan side. So we can afford to do that, and we're doing that.

But that will put a little pressure on our NIM, and we've said for a couple of quarters now that the challenge is going to be to keep net interest income growing as we're going to have less NIM, we're going to have more average earning assets because of the growth, and how that plays out is uncertain. If we get really good growth and do good job of mitigating the impact on our NIM we'll have slightly positive net interest income numbers. And if we get a little less growth and do a little less good job on mitigating the NIM pressure, we could be flat to down a little bit on net interest income. So it's a horse race.

Matt Olney – *Stephens Inc.*
I want to ask some questions around credit. It sounds like there were two loans that were downgraded this quarter as a result of some of those new appraisal values that you disclosed. I assume you've approached these borrowers to ask for additional equity since you've gotten those appraisals back. If so, any color on these conversations with the borrowers?

George Gleason
Yes. What I would tell you on that is both borrowers are working very constructively with us. Both were already engaged in processes of bringing new capital to those transactions. So we're monitoring that closely. We are pretty confident in both these borrowers' ability to get something done that will be useful to them and useful to us in that regard. These guys have shown real commitment to these assets. And we hope and expect that will continue.

Brannon, do you have any other color you want to add on those two deals?

Brannon Hamblen
I would echo what you're saying, George. I mean they were pre-engaged in those activities and making real tangible progress. So we've done a lot of business really with the sponsors in both cases on these projects. So we feel good about the direction those are going, and we'd hope to reflect that in the numbers next quarter.

George Gleason
Matt, I would point out, and Brannon can give you the details on this, but the equity on the land deal has posted a substantial reserve account to continue to carry this asset while they're working on the recap.

Brannon Hamblen

Yes. That's on the land deal that's at 95% LTV -- and they have an $11 million cash reserve there that's additional support for that credit. It's not included in the LTV, but additional support for it in cash reserves for carry and so forth. This is a sponsor there that is a very prolific developer with a national footprint and a great reputation for developing successful projects. We financed, as I said, a number of their projects. That’s a good thing to call out there, George.

And in the other case, dollars have been coming in. Historically that sponsor has put in -- that we did an extension, and in this case, I'm talking about the hotel at 101% LTV. During COVID, they put up additional capital and we did an extension then, and they've continued to fund operating shortfalls in debt service, so significant capital already and ongoing capital infusion in that project. So those are not so much hope cards as historic performance that we're -- we have good expectations of the outcomes there.

George Gleason

And I would add on the hotel. This is a really nice smaller asset, and it's performing at or above the comp set in the market. This is just a Midwestern market that has been really slow to come back from the pandemic and the changes in travel patterns and so forth from the pandemic, but it is a really nice asset. So the quality of the asset there as well as the sponsor's proven commitment that gives us a fair degree of confidence and cautious optimism about the path forward.

Matt Olney

Appreciate the detail. And then just digging a little bit more, I guess, on the topic -- you've been disclosing these updated appraisals now with RESG for a while now. And typically the LTVs have more limited movement post appraisal. The two obviously have been outliers, anything else unique about these transactions in these properties that would have driven more significant value deterioration than other ones we've seen in not just this quarter but in past years as well?

George Gleason

What I would comment, and Brannon may want to add something to this, but land appraisals tend to have a lot of variability to the valuation conclusions from appraisers. And I'll give you an example, you might have a land appraisal that has a $300 million terminal value. You get a new appraisal on it, and the terminal value is still $300 million, but land prices are done on a discounted net present value basis. So if the discount rate on that, because the Fed's moved 500 basis points, the discount rate on that goes up another 500 basis points from, say, 12% to 17%. And the holding period gets extended from three years to eight years. You have a massive contraction in value that has nothing to do with the terminal value of the land asset, it is simply the function of the higher discount rate and the elongated holding period.

We've been doing this a long time. We've seen these land values fluctuate up and down because of those conditions. What I would tell you is most of the land we finance is kind of a bridge to a near-term vertical development. We do very few deals that are intended to be long-term land holds when we go into them. So you noticed land going the other direction on that appraisal list as well, where the loan-to-values went down, and I'm not sure the specifics of those.

But in some situations, the holding period of development actually shortens and in the land value the loan-to-value gets better. So don't get too excited about some of these variations in land values just because if you look at the math, you realize they're saying an 8-year holding period, that's probably on the long side, reflecting current economic uncertainties. When you get on the other side of the recession, those values tend to come back really quickly and that's what the equity guys are looking at is what's the reality of that.

The other thing I would tell you is we're keeping the valuations on this portfolio pretty closely considered. While we had, I think, it was 15 or 16 assets were appraised last quarter, we had 22 payoffs and new loans going on. So if you look at kind of the inflows and outflows of the deals, we probably have fresh values either on new loans and old loans paid off, or reappraisals on something approaching 10% of the portfolio every quarter. So these values are staying pretty freshly updated on the portfolio.

Manan Gosalia – *Morgan Stanley*
I just wanted to follow up on that last comment there. If it's about 10% of the portfolio that comes up for reappraisal every quarter, is it fair to say about 40% of the portfolio has been reappraised over the last 12 months?

George Gleason
Well, Manan has either been reappraised or had new appraisals because their new loans originated. So I would say that's a rough estimate. I haven't actually calculated that, but I would say that's a fair approximation. As I mentioned, we had 22 loans pay off in the quarter just ended. And I don't know exactly how many we originated, but it was probably somewhere in the same range of that.

So new loans have new appraisals and the old loans go off and we're reappraising a dozen, 15 to 18 that just come up for extension, renewal or otherwise show some signs of concern. If we think there's a likely movement in the value and performance of that asset it’s getting reappraised.

Brannon Hamblen

Or I might add, George, there's an opportunity – if good things are happening at the project, and there's some reason that we might consider an upsize a loan. Of course, any time we do that, we get a new appraisal as well. So there are positive activity reasons for that to happen.

Manan Gosalia

Yes. So then maybe a big picture question on downgrades in general and not specifically related to those transactions. You clearly get a lot of repeat business, so you have a great relationship with these sponsors. Can you walk us through other deals where you've had success in bringing in equity? And I guess what you had to bring into that deal, right? Is it just a concession on spreads? Is it re-upping the loan? Or is there anything else that goes into that negotiation?

George Gleason

Well, we had several loans in the last quarter that were on that reappraisal list because they were up for renewal, extension, that a sponsor brought substantial equity. Brannon, you might be able to recap those. And I don't think we gave any concessions on any of them, we probably improved our economics and terms on both, but did get pay downs.

Brannon Hamblen

Yes, most of these are going to have -- they're going to have better terms in addition to just in the quarter just ended, I can think of four different situations where we extended the loan and got material paydowns. One for $20 million on a multifamily project in Philadelphia. One for $10 million on a multifamily project in Oakland. We had another project in Oakland that we curtailed the loan didn't need the full loan amount. So it wasn’t a paydown but a curtailment. And then we had another Midwest hotel that we had a $5 million paydown on and there were others in Q1, and right before Q1, and that we had a $4 million paydown on mixed-use projects. So just to name a few.

George Gleason

Yes. As we get appraisals that indicate higher loan-to-values, and under one of the loans that is in that list of reappraisals, we got the appraisal early, the loan is coming up for maturity this quarter. We got the appraisal early. So the higher loan-to-value reflects the new appraisal versus the current balance of the loan. But we would expect a several million dollar paydown on that loan in connection with the extension of the loan. As we're granting the guys extensions and additional time, we're improving the economics on the deal in most cases as well as that. So keeping the risk in check by getting the curtailments and improving the economics of the transaction at the same time.

Manan Gosalia
As I think about the yield on loans, the 8.4%, 8.5% or so that you have right now, if we do get one more rate hike from the Fed, how should we think about those yields? Should that peak somewhere around 8.75%, or based on the fact that you're getting some better economics and certain deals that there is additional repricing that we're not taking into account?

George Gleason
Well, obviously, if the Fed continues to raise rates, that will translate through to loan yields. The vast majority of our loans are variable rate, Tim, you probably have that number exactly. But what is it?

Tim Hicks
Yes, 79% are variable rate.

George Gleason
79% of our loans are variable rate loans and most of those adjust monthly. So a 25 basis point movement in the Fed funds target rate which has a comparable movement in SOFR and Prime, which it probably would, you would get about 20 basis points of that, or 18 or 20 basis points, so that would translate through into improved loan yields from the impact of that Fed rate increase.

Manan Gosalia
Right. But is there anything beyond that as well that you could get from some of these renegotiations or some of the lagging repricing of the remaining 20% that are not variable rate?

George Gleason
Yes, in some cases, clearly, we are getting better economics in all those transactions. But that's a small number of loans that are -- that are being dealt with there. So is that a basis point or two -- it's not going to move the needle over time. That's just some of that pluses and minuses that it goes into the normal wash of those loan yields.

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

I just had a couple of follow-up questions on the credit discussion. Maybe question one is just what markets? I know you said that the hotel loan was in the Midwest market. And can you tell us the market that the land loan is in? And then my second question on those projects did we see any increase in the specific reserve related to these two downgrades?

George Gleason

The land loan is in Chicago. Obviously, we hold higher levels of reserves for loans that are special mention than pass, and higher levels of reserves are substandard as opposed to special mention. So yes, the reserves went up on those loans in connection with the change in risk rating.

Catherine Mealor

I appreciate your commentary, George, about just the pace at which you get new appraisals -- it feels like you're mostly getting new appraisal either at maturity or an extension or if you see degradation in the project for some reason. Help us think through that and particularly in the land portfolio, how much of that book do you feel like has an updated appraisal? Is there a risk within just that book that we could see as we move through this process just additional appraisals that are going to kind of increase the LTV significantly in just that land book?

George Gleason

Your first premise is correct. Your understanding is correct. We typically get appraisals, obviously, on new loans and then at maturities, extensions or if an issue arises that makes us think we need to get a new appraisal to kind of recalibrate our valuation on a loan. So that keeps our appraisal services guys and our outside appraisers pretty busy doing all of that workload. As I mentioned, Catherine, I think it's really important to know that if you look at the figure in the Management Comments that shows distribution of loans by asset type, the land loans are kind of down there on the far right. It's one of our smaller land-type distributions. And as I mentioned earlier, most of those land loans are done as really a bridge to vertical construction. So we're doing, a lot of times, a 12-month land loan with a couple of 6-month extensions to give the sponsors, who are acquiring a piece of land, time to complete their plans, specs and cost out to get ready to close into vertical development loans. So those tend to be pretty short term, short duration assets that really put us on the inside track to do the vertical construction on those loans.

And as I mentioned, there are very few land hold loans. Now the asset that we dealt with a quarter or two ago, the land deal out in California, that was a land track that was scheduled for vertical development.

And that ended up being a landhold instead because their cost just blew out. That's a fairly unusual situation, but that will occur now and again.

And other than those sort of situations, and maybe a couple of landhold loans, I think that portfolio is well margined and will perform very well. There may be an occasional bump here and there, and we've seen that. But I'm not worried about that having a material impact on asset quality.

Brannon Hamblen

George, I might just add to that Catherine, just circle back to your question. I mean, because of what George said, you're going to have a more current -- currently appraised portfolio in land. I don't know the numbers, but I'm going to say the majority of that portfolio has valuations that are a year or less old because of the short terms that George alluded to. So just to kind of circle all the way back to your question on timing of appraisals, it stays pretty tight on land. And in that figure that George pointed out, it's our lowest loan-to-value property type.

Catherine Mealor

And on that Chicago project, what was the emphasis to needing a new appraisal for that loan?

Brannon Hamblen

I'm sorry. I didn't understand the question, Catherine.

Catherine Mealor

So why did you need to get a new appraisal on that one? Was it degradation? What did they come to maturity?

Brannon Hamblen

It was in connection with an extension loan maturity.

Catherine Mealor

One other question just on the growth outlook. I just wanted to make sure that I'm thinking about this right. I think you mentioned in the Management Comments that you think origination volumes are going to be closer to 2011 levels, which was about $8 billion. And if I do the math, that's putting the origination volumes well over $2 billion for the next couple of quarters. Am I thinking about that right?

George Gleason

2021, not 2011.

Catherine Mealor

Excuse me, 2021.

George Gleason

I knew what you meant, you knew what you meant, but I didn't want others to be scrambling back to the historical archive.

Catherine Mealor

We've been doing this a long time.

George Gleason

We had previously said we expected the number to be in the range of 2020 to 2021, which is kind of, in round numbers, would run in the $6.5 billion to $8 billion range. The thrust of that comment is we now think we're coming in at the high end and a little over probably at the high end of that range by the end of the year based on the pipelines we're seeing. So we didn't want to surprise anybody with that. We wanted to raise the possibility that we now may be at or somewhat above that $7.94 billion level of 2021.

Catherine Mealor

So a pretty big acceleration in the back half of the year? Got it. But it also felt like you were saying repayments should also increase some in the back half of the year as well.

George Gleason

Repayments, I don't know. That's going pretty slow. So we had indicated, I think that around the 2021 2022 level and we cited you to a 5-year average. It's slightly below the low side of that. So I think we're expecting more prepayments to slide into next year and because of the fact that a lot of sponsors for the last several quarters have really been slow playing they're bringing forward projects for development which in a lot of cases that they've been working on for quite a while. I think as folks are thinking the Fed is getting near the end of the tightening cycle, they're getting a little more clarity at the sponsorship level on how a lot of these markets are playing out. Our sense is that a lot of sponsors on certain transactions in certain markets are saying, okay, we've got enough clarity about how the economy and the market is playing out and where the terminal interest rates are likely to be to decide the economics of this deal still makes sense, and we're ready to move forward.

There was a lot of uncertainty about how far the Fed was going and how much impact it was going to have on the economy and different product types and so forth. And I think there's a little more certainty for some sponsors on some projects, and that's not broad-based, all sponsors all projects. But some sponsors on some projects in certain markets seem to be getting a little more clarity. And at the same time, as Brannon mentioned earlier, competition has reduced, particularly in the bank space.

So we're getting probably a little bit bigger piece of the pie, and the pie may be a little bigger now than we thought it would be 90 days ago, just because folks are getting a little more confidence about where everything sort of settles out at the end.

Timur Braziler – *Wells Fargo Securities*
Maybe starting on the funding side, just looking at the deposit base, do you think the rates where you have them right now are sufficient in providing funding and kind of getting all the deposits that you need? Or is there still some needed acceleration in kind of fine-tuning your offerings in order to get an adequate amount of funding going forward?

George Gleason
We've been at the same rate level the last few weeks and volume, inflow volumes seem to be holding up really well at those levels. So tomorrow, there may be a tweak here and there or the Fed action potentially next week could cause folks to move a little bit. But where we are today, we feel good about.

Timur Braziler
As you look at funding the near-term loan growth, deposit growth was actually quite strong this quarter. Cash balances increased. You have some bonds that are coming due over the next 12 months. How should we think about funding loan growth here over the next kind of two to three quarters? Is there going to be as much an impetus in growing deposits? Or are there some other levers you can pull in funding from this near-term loan growth?

George Gleason
Absolutely. We are continuing a very strong focus on deposit growth. And I'd tell you, Cindy, Ottie Kerley, Drew Harper and Dan Rolett, and just our 1,800 people in our 240 retail banking offices in 5

states did an incredibly good job of growing deposits. We had a big deposit growth quarter. We expect that to continue.

If loans grow $1.5 billion or $1 billion in the quarter, we're going to expect deposits to grow a little more than loan growth. So we would expect that to stay the same. And hopefully, we'll be able to maintain roughly the same mix of deposits.

We've been able to do this with mostly organically, locally generated deposits, growing our customer base significantly. And we've not really increased in percentage terms as a percentage of deposits in any material respect our reliance on brokered deposits over the last several quarters or anything. We stayed in that mid-high 9% of deposits there, and we hope to continue that. We've got, clearly, flexibility to increase that if we needed to, but we like growing the organic local deposits through our branches, and we're having really good success with that.

Timur Braziler

And then if we can take out the crystal ball and kind of fast forward into the back end of 2024 just given the funding schedule for RESG and that pace that's at -- let's say, the Fed starts cutting rates in the back end of 2024. Are deposit costs going to fall commensurately with the Fed cuts? Or is there going to be a lag on the way down as there remains some funding constraints from the increased production activity?

George Gleason

Well, clearly, as deposit costs lagged on the way up, there will be a deposit cost lag on the way down. And that's just going to be reflective of the fact that most of the CD deposits we have had 4 to 13-month terms, that's sort of the range of where the vast majority of them are. So those deposit costs will tend to lag a bit on the way down.

It was fun with them lagging when it was going up, it will be less fun within lagging when rates are kind of down. The trick to that is to do a good job getting floors set in our loans that will mitigate, somewhat, a ramp down in our loan rates as the Fed starts cutting. Now that's a negotiating challenge in every loan and it's becoming more difficult to negotiate it. Sponsors think more about a future where rates are lower rather than higher. So that's a big part of the strategy. And we've had good success mitigating the impact of declining rates, slowing that decline of rates on the loan yields down so that it gives us a little room to maintain and protect our margin.

Timur Braziler

And then just lastly for me, maybe circling back to credit. Can you provide the allowance that you currently have on the loan book? And then I'm wondering, we saw the California land deal last quarter where the sponsor kind of balked at developing in this environment. If that type of activity starts to accelerate given the expectation for recession at some point in the future, does that inherently increase the allowance that's allocated to the loan book or to the land book?

George Gleason

Well, Tim, I'm going to let you start off and then I'll add a little color at the end, maybe so.

Tim Hicks

Timur, was your question, what is the allocation of ACL to the land book or the loan book?

Timur Braziler

The land book.

Tim Hicks

Yes. I don't have that number right here. This probably is a good opportunity to talk about our overall ACL. We added a new chart in Management Comments talking about the build that we've had in our ACL over the last 4 quarters, growing the dollar amount by $127 million when our cumulative net charge-offs were only $23 million over that same period. And also the percentage has gone up during that time period as well.

That reflects, obviously, our loan growth during that time period, substantial loan growth during that time period. And obviously, our cautious outlook on the economy during that time period and the uncertainties that are still present. So overall, from an ACL perspective, we feel like we're in a good position there. I don't have the specific allocation to that land book in front of me.

George Gleason

And Timur, I think you asked the question, if we have a recession, will that result in further increases, will we need to build our allowance more for that? And that remains to be seen, obviously. What's the severity and the duration of the recession and how does it impact different parts of our portfolio. But we think we've been pretty cautious in our approach on this. And as we've noted in our Management Comments every quarter for the last five or six, our scenario selection has been weighted predominantly to the downside scenarios, either the Moody's S4 scenario, which is their -- I can't remember exactly what they call it. What is it Tim adverse.

Tim Hicks
Yes, the Alternative Adverse Scenario.

George Gleason
The Alternative Adverse Scenario. That's sort of their downside recession scenario. And then their S6 Scenario that's their Stagflation Scenario. So that's been the majority of our weighting. And I think that's why you've seen us have significant provisions over and above what we would have for growth every quarter, even as our charge-offs have been pretty benign there.

We've been modeling for the recession, which has proved to be very elusive and that's no surprise to anybody. Everybody on all the business talk shows, will say the recession is always going to happen in a couple of quarters and in a couple of quarters and a couple of quarters, and we've been talking about this for a year and a half now, and it hasn't materialized. And it may not materialize or may materialize. That's above my pay grade. But we think we're well positioned from an ACL point of view for pretty cautiously selected series of outcomes.

Michael Rose – *Raymond James*
I thought I'd start off with a non-credit or margin question. In the Management Comments, you guys talked about additional people that you're going to add to benefit the growth in coming quarters. Can you just give us a sense for kind of what areas you're looking to add in and I understand the guidance for this year, but would that hiring extend into next year to support what looks to be pretty strong growth?

George Gleason
Thank you, Michael. I appreciate the focus there. And one of the long history and traditions of our company is to be well capitalized, have ample liquidity, have a great management team and be able to capitalize on opportunities in times of economic challenges or turmoil.

You've followed us for a number of years, and a number of the folks on the call have seen us really be very opportunistic and capitalize on opportunities presented. Every time of economic turbulence kind of results in different opportunities to capitalize on.

And certainly, our opportunities that Brannon has mentioned already on the loan side to capture market share and lower leverage and increase margins on loans is an opportunity that's being very good to us in the current economic times. The fact that a lot of our competitors are shrinking and laying off some really good people. I think it's going to give us the opportunity to make some nice additions of talent across different business lines in our company, to grow and expand those, acquire people who have a different set of customer relations than we currently have, which in the long run will hopefully allow us to expand our customer base in a material way. So without getting specific, I would tell you, right now, we're looking at of people that we would really like to add that are across three or four different lines of business.

And we hope to bring some of those guys on board. They're men and women. They would be very nice augmentations to the robust pool of talent we already have. And I think talent is going to be one of the most important factors for companies going forward, and we're doing more work to recruit and retain, improve the quality of recruits and retain our existing high-quality talent than probably ever before.

And I'm spending a lot of time on this. Cindy Wolfe and others are spending a lot of time on it. But the U.S. workforce is aging. The mindsets regarding hours of work and the trade-off between hours of work and leisure hours and family hours and recreational hours has been probably forever changed by the pandemic. Mindsets that 4 years ago, we would have been ascribed to a younger generation of workers that have been adopted by the more senior members of the workforce.

And our educational system in the U.S. is not what it once was. So we're not turning out as many high-quality workers as a percent of the population as we were before. All of those factors suggest that there is going to be a very challenging environment to recruit and retain talent in the long run, and we are we are keenly focused on that. So if we can pick up 10, 20, 30, 50 people over the next year that are not happy or no longer with a competitor and they are high-quality people that really have a long-term value in place in our company. I think that's a huge opportunity. So we're keenly focused on capitalizing on that.

Michael Rose

Maybe just going back to some comments on the management document. You talk about slower loan repayments in the current environment. So it sounds like -- and I think what we've read about, right, is that the permanent market for these loans is pretty much closed.

You guys have a lot of unfunded commitments that will fund up and result in the strong growth as you've talked about. Do you see this as an issue? On the one hand, obviously, it's good that those loans stick around, you get a little bit more kind of NII, but it would put some pressure on capital levels. Just help us think about how these dynamics would play out over the year or...

George Gleason

Yes. Well, I would say that anyone that tells you that the permanent loan markets are closed is exaggerating or hyperbolic in that statement. As I mentioned, we had 22 loans pay off and go permanent last quarter. So the markets are not closed and our repayments in Q2, I think we're a little above our repayments in Q1 where they came about $100 million or so higher.

So the markets are not closed. And those markets, just like our sponsors who are getting a little more settled now knowing thinking that they've got a clearer view of where all the Fed rate hikes are going to end, and the impact of the economy, that looks like it's a little clearer than it was six months or three months or nine months ago.

I think the same is true in the secondary market. Now the reality is a lot of our sponsors look at the secondary market and they think, wow, that's not the rate I want to refinance into. So I'm going to see if I can stick with OZK another 12 months or six months and improve the performance of my project another degree and maybe rates will come down, and I can get a better exit scenario.

So we don't really view this as a problem. We're happy to have these assets on the books longer term at our leverage. Bear in mind the permanent loans that take us out are usually a substantially larger loan sometimes 150%, 200%, 225% of our loan amount. So we're quite happy to keep these assets on our books at our rates at our leverage for a while longer into the future. So we view this as an opportunity, not a downside.

Brian Martin – *Janney Montgomery Scott*

On the reserve build, maybe for Tim, given kind of where you've come from, maybe an 85 basis point level to 95 over the last 4 quarters, I guess, are you feeling you're at a point now where you don't need to continue to build that reserve given your outlook? Or should we expect that there's more of that to come, just given your cost and the outlook for loan growth?

Tim Hicks

There's just too many factors to really predict that at this point. Clearly, it's going to be dependent on the growth that we have during the quarter, and you've heard our comments on that. And then also at each quarter end, we've got to look at the macro environment at that time and determine the appropriate provision and ACL given those -- given the current environment.

So naturally, if the environment and the uncertainties are improving, then you would expect a lower level of provision. But if there's still the same amount of uncertainties, or worse than the current amount, then you would expect the provision to go higher or at similar levels to what we've got now. So there are just too many factors to predict what that provision will be in future quarters at this point.

Brian Martin

On the expense outlook, I think George talked about the hiring potentially what could happen. The expense rate this year is a pretty lofty level given that's higher as far as the people you've added. Does the expense growth rate, should that come down next year relative to this year even with the additional hiring or how should we think about the rate of expense growth as you get into '24, given what you just mentioned as far as opportunities to add some talent?

Tim Hicks

Yes. Certainly, you saw our comments on the mid- to high teens for this year, 2023 versus 2022 full year. This year, we obviously have the new FDIC assessment that came into effect January 1. We're likely to have a special assessment this year. So our guidance there does not contemplate any sort of special assessments. But in addition, this year, we've had elevated levels of advertising and marketing expenses. We would expect those to continue throughout this year and likely throughout next year as well. The level of headcount depends on the opportunities. Obviously, we were at really diminished levels starting into last year. We've had great success in hiring great talent.

I think our headcount is up 10% year-over-year. We've had, obviously, really strong levels of compensation increases, to George's point, to retain our top talent. So I could see the level of increase – the percentage of increase decreasing next year compared to our 2023 level. It's too early to tell or give any sort of thoughts there, but we wouldn't expect the mid- to high teens percentage to be a run rate for an extended period of time unless we find compelling opportunities to add additional headcount.

George Gleason

I would add to what Tim said and agree with all that, Brian, but I would add the comment. Our growth rate next year is going to be a significant factor in that. Obviously, if we grow our balance sheet 15% or 20%, then we're going to have to add headcount commensurate with that. And I'm not saying we'll grow at 15% or 20%. But if it grows 10%, you're going to have one level of headcount. If it grows 15% or 20%, you're going to have another level of headcount additions. And we are likely to start scattering some new branches into our network of branches.

We're at 240 retail banking offices today. And you've been a longtime follower of our company, and we've talked for years about the tremendous capacity we have in those branches for growth. And you guys have seen that play out right before your eyes over recent quarters. But we're also looking forward three, four, five years down the road at what our franchise and balance sheet looks like, Brian, and the size of that balance sheet and the funding needs of that balance sheet. And we're going to need to add some more branch infrastructure starting really now, starting later this year and into next year, to provide the additional customer connectivity that we're going to need to be able to support our growth three to five years out.

So you will see a handful of branches. I don't know whether that's five or eight or 10 added in next year. But that will add a little bit to our operating cost. But again, that's going to be offset by growth and that's going to be a critical part of our long-term strategic plan to make sure that we've got the branch infrastructure and the customer connectivity and convenience factors to continue to support our balance sheet growth many years in the future.

Brian Martin

Would you have the spot rate was on the cost of deposits and the margin to the end of the quarter?

Cindy Wolfe

So June cost of interest-bearing deposits was 3.11% compared to the quarter at 2.92%.

Brian Martin

And then on the margin?

George Gleason

We don't give that number. And we've got that number internally, but that margin tends to bounce around month-to-month within the quarters. We don't typically disclose those margin numbers. But Cindy gave you a good cost of interest-bearing deposit number for June.

Brian Martin

And then just maybe just margins from a high level view. Just trying -- I appreciate the comments about the NII and just kind of the focus on that being worth it? Just trying to understand maybe where the margin, given the lag you talked about tours on the deposit side, when that might trough if the Fed does pause here after the next meeting. The lag, is it a couple of quarter lag, so we should be thinking about the margin percentage troughing, all else equal in the near term in the fourth or first quarter. Is that fair?

George Gleason

There are a lot of variables in that. One is that I think given the fact that a lot of our deposits run out as far as 13 months, you're probably looking at several quarters of there on the deposit side before if Fed stops and then starts cutting, it takes several quarters to work through those deposits.

The other thing is how long are we at current rates before the Fed starts cutting. If the Fed raises one more time or two more times and then stays there throughout much of next year, we're going to have a really effective time at getting a lot of floor rates reset to the top -- near the top of the market levels, which will give us a lot of protection to our margin as rates fall even as deposit rates lag coming down. On the other hand, if the Fed goes to a peak terminal number and then a month or two later starts cutting rates, that's going to be harder to get our floor reset. So we would be very pleased to see the Fed take a pause and maybe extend the pace of this last cut or two out over a slower period of time because that's very beneficial in helping us get old loans with really low floor rates to roll-off the books and new loans with floor rates at or near current origination rates on the books. So that's really helpful. Our best scenario is Fed rates once or twice more and then stays there for a year, which is probably really good to help Fed accomplish their executing getting inflation under control and stop inflationary pressures, and that's a perfect scenario for us from a margin point of view.

Brian Martin

Would it -- is that trough in early late fourth quarter, early first quarter kind of realistic given those dynamics that the Fed doesn't start cutting in the second half or late next year?

George Gleason

Well, let me just leave you with the concept and let you figure out where the trough is. We've got a -- we run -- gosh, between two and three dozen interest rate models in various scenarios every month. And where the trough is in rates just depends on which set of model assumptions you've got. So -- let me give you -- I'll kind of give you those color comment points and let you run your own models and see where you think the trough should be because I could give you an answer in any quarter and it would match one of our models or more.

Brody Preston – *UBS*

I just wanted to maybe focus on capital for a minute. So you obviously bought back a decent amount of stock this quarter, but the difference between, I think, $33 and $43 is quite a bit on the stock price. And you CET1 ratio is now I think it's 10.8% and it was 11.1% last quarter. I guess, is it kind of safe to assume if we hung out at these levels on buyback that we shouldn't be baking in much more buyback into our estimates, just given the growth outlook remains pretty solid. And so you're going to want to preserve that capital for balance sheet growth?

Tim Hicks

Yes, we gave you not only the average price that we paid in the quarter just ended, but we also gave you the average price for the six months. Obviously, there were compelling value opportunities there at those prices. We still have some authorization remaining. So at these levels, though, I think we're going to focus on organic growth and preserving our capital for that. But if we do see additional compelling values in our stock price, we won't hesitate to repurchase more shares at those values.

Brody Preston

And then I did want to ask just -- and this is a little bit tangential to what you had talked about with discount rates, George, but I guess just given that the discount rates have moved up, and these appraisals have been changing as a result, Is there any relationship between the discount rates and the reserves just given the change, the LTV, like if discount rates were to fall next year, do the values get better on these projects and therefore, the LTVs fall and therefore, maybe you don't need to carry as much reserves against them? Or does that not play a role?

George Gleason

There's a degree of correlation between where interest rates are and where discount rates are, but it's not a perfect correlation. So what I would tell you is if your thesis is correct -- if that correlation maintains at a very positive level and interest rates fall and hence, discount rates fall, then that should translate through into better price values and lower loan-to-values. But that -- again, that's not a perfect correlation.

And the second question you asked, does that have an impact on reserves? Yes, the loan-to-value is one of many factors that compute into our risk rating models for loans. So higher loan-to-values result in a higher risk rating, lower loan-to-values, all other things being equal, result in a lower risk rating per loan. And those risk ratings are correlated to an expected loss and a probability of default calculation on every loan. And obviously, that has an effect on both of those factors.

Brody Preston

I want to just circle back to the credit discussion. And I feel like I get an education from you guys every time I get on these calls and we talk about RESG credits. But George, you said something as it relates to the values on these land loans and just given -- just given how sensitive they are to discount rates and duration within that kind of NPV analysis on the value. So I guess, are you saying that with the land loan that went from a 40% LTV to a 95% LTV, that one in Chicago, was there no change in the actual like end value of the project, it was just the NPV inputs changed in the present value of the project. Am I understanding that correct?

George Gleason

Broadly, I was using my example as a hypothetical. I'm not sure in that particular loan, Brannon Hamblen may know that if the terminal value changed or not. But I do know the -- not surprisingly, and that's probably going to be true of any land loan that has a longer-term hold sort of land loan, where development is not imminent in the next 12 to 18 months. Your holding price probably is going to extend and your discount rates going up. Now Brannon, I don't know -- Brannon may not even know if the terminal value on that.

Brannon Hamblen

I don't, George. I don't have it off the top of my mind, but your point that longer periods and higher rates tend to have more impact than changes that terminal value ultimately in the valuation on our LTV.

Brody Preston

Okay. And so I guess would that be the explanation between -- I was particularly interested in the land on that table just because -- if you look at the top of that table and the bottom of that table, you got about two land loans about the same size except the one went from 40% to 95% and the other one actually went down from 46% to 25% or whatever. And so just a bit of a stark contrast. And to me, just from a layman's point of view, I said, well, maybe like the first one got delayed or the project's been shelved, but the bottom one is going forward is really strong. What drives that kind of dichotomy between those two loans?

Brannon Hamblen

Well, yes, Brody, it's a great question. These tracts of land are located in various markets across the country, and there are very different dynamics that are in play in different markets. So in this case, if I'm not mistaken, you're probably looking at the bottom of the chart, I believe that's a tract in Southern Florida. So that makes our expectations are a little bit different there than they are perhaps in Chicago. And certainly in other markets like San Francisco. So look, it's hard to look at a chart like this and draw correlations. There are so many different factors at play in every single tract land that you're valuing.

George Gleason

Just to take what Brannon said and apply it to your concept. If Brannon is right, that lower piece of land, if it is, in fact, in Florida, the pace and magnitude of development in Florida is speeding up, in most cases, not slowing down. So it would -- to your point, a piece of land or so that's kind of developing three years now is going vertical in 18 months, that's going to improve the holding period discount on that tract of land.

Brody Preston

No, that's helpful and makes sense. If I could stay just on the land topic -- because when I look at the LTV changes and the other properties, right? I mean, like some up, some down, they look fine. And like if I'm a developer, right, it's much easier for me to say to you guys, okay, like, yes, like I'll definitely bring more equity to the table when I've already got shovels in the ground and we've got five floors of a seven or ten floor build that kind of built -- but like the land loans seem like they might just, I guess, naturally be more at risk of LTV changes just because no development has actually happened yet. Is that a fair way to think about it?

George Gleason

Yes. Exactly. As we said, they're the most variable pieces of our portfolio when it comes to variations and appraised value.

Brody Preston

So when you do these reappraisals on the land and just whether or not the value is going up or down, I guess -- do you guys have a sense for what the relative success rate is that you've had over time in terms of -- you're working with strong sponsors, they've probably got multiple projects with you. Maybe one of them is land at this point, maybe one of them is an office building at another point. Do you have a sense for kind of the success rate of kind of getting sponsors to commit more equity to a project regardless of what phase it's in, just given the strength of the sponsor? So like they got a land loan with you. They're still willing to commit to more equity to do because they're a strong partner of yours? Or do they look at it differently, like from an economic perspective, maybe we need to commit less to this land project because we don't know how this is going to work out over the next few years. Like I'm just trying to understand the psychology of these developers.

George Gleason

Well, first, I would tell you, as Brannon mentioned, we had four or five loans or more last quarter that we had reappraisals on where the sponsors either contributed additional equity or curtailed loan amounts that kept the appraisals in line or closer to our original appraised values on that. So we have a good track record of sponsors supporting their loans. And the reason for that is one, we choose our sponsors well or we try to choose them well and have capable sponsors. And two, we get so much equity in these. The weighted average RESG portfolio, I think at June 30 was 53% of our cost and 43% of appraisal. So at 53% loan-to-cost you've got a lot of equity in there that they've got to protect and defend. So we have a fair amount of leverage to encourage the sponsors to continue to support their assets.

The other comment I would make on that is I think our weighted average RESG portfolio at March 31 was 43% and was 43% at June 30. So the percentage of the portfolio change -- it was unchanged on a loan-to-value basis. So we had some appraisals that were higher and some lower. We had loans pay off -- 22 of them. We had a bunch of new loans originated and the net effect of all that on a weighted average basis was an unchanged loan-to-value ratio. And I think that it speaks to the high quality of the portfolio and the high quality, low leverage of the new business we originated.

Brody Preston

We were combing through proxies earlier this week, and one of the things I thought was interesting is that OZK is one of just two companies that I cover that includes a hard target NCO rate within their performance-based comp every year. Interestingly, the other company also does differentiated forms of lending.

So I guess, to me, it says that you're telling your shareholders, "Hey, we do differentiated lending. We're really good at it. But we're aligning ourselves with you in terms of trusting us on credit to actually get paid the way that we want to get paid." Is that kind of what you're trying to do? And then two, why do you view that as important as you do? And then three, why do you think other banks don't necessarily target NCO rates within their comp when they're being trusted by their investors to underwrite loans as well?

George Gleason
Well, we would never be presumptuous enough to try to explain why other banks do or don't do it. But I'm going to let Tim answer your other two questions.

Tim Hicks
Yes -- so in our annual short-term incentive plan that all of our senior executives are part of, three of the components are financial related. We've got EPS, efficiency ratio and NIM. The other two, as you pointed out, one is net charge-offs. The other is non-performing assets. We've had a long-standing track record of having those as components of our short-term incentive and our long-term incentive is a relative comparison to ROA, ROE and total shareholder return.

We certainly feel like our incentive plans, both short- and long-term, are consistent and aligned with our shareholders. But asset quality, we've had a long track record of beating the industry averages on asset quality, and we incentivize our team to maintain those industry-leading levels. And that's been that way for a very long time.

George Gleason
One piece of color to that. I talk with lenders and lending team recruits almost every day and probably have done so every day for 40 years. The guys have heard it, asset quality is of paramount primary importance -- so goal #1. Profitability and margins are goal #2, and growth is purely a tertiary concern. So we live that as part of our culture, asset quality, number one, profit margin, number two, and growth is a tertiary concern. So you saw a couple of years ago, our balance sheet grew very little year-to-year because competitors were out there being very aggressive on structure and leverage and very aggressive on pricing and growth was not a primary concern.

So if we don't grow for a year or two and just stack up capital, that's okay. We're doing the right thing for the long run. We're sticking to the fundamentals. Now when you've got a situation where valuations on assets are a bit beat up and competition is out of the market, we can get lower leverage on the asset values that are already kind of adjusted to a more severe market and get paid better for doing that. We get much, much better risk-adjusted returns. So we may grow a lot in an environment where we're getting high-quality assets at good margin at values that are already stress tested compared to going out and trying to get a bunch of growth when everybody is growing and everybody is aggressive to grow.

We tend to be a little countercyclical. And I think it's why we've been continuously profitable for 45 years. I mean, we pay attention to the fundamentals.

Brody Preston

Got it. And if I could maybe just sneak one last one in. I know we're running long. I did want to just ask just given the focus on asset quality, given that you're paid on charge-offs. When I think about the differentiated nature of what you do, like I guess, maybe could you give us some insight, I think you told me at some point before, but just what's different about the way that your work out loans? Like when you identify an RESG loan that you think maybe needs a little bit of help. I guess, early identification is obviously pretty paramount, right, and strength to sponsor really matters. But is there something else that you're doing within the workout process that uniquely kind of positions you to take less losses on what some might perceive to be a riskier kind of asset?

George Gleason

Well, I would tell you that a great part of our success is the structure, the documentation, the underwriting and the asset management that goes into those. So the structures you set up on the front end, your documentation and the effectiveness and effects of those structures is critically important. So if you can identify where future weak points in a transaction may be long before those weak points, long before you've even closed the transaction, and structure around those weak points, that's critically important.

And then getting all that documented and in your documents and closed and then the asset management team that Brannon and Clifton Hill and Juan Gonzalez and the other guys at RESG has built, is just exceptional in their knowledge and monitoring of credits. There, we've got basically about 14 loans assigned to every asset manager. Most of these asset managers are MBAs with a real estate-focused MBA program. It's a highly talented, educated team, and they've got really good tools and really good team leaders and really good group leaders over those teams, and they are monitoring these assets on a daily basis.

They see every in and out, every lease, every sales contract, every third-party report. They're monitoring these things at a level that lets us know the issues are developing sometimes before the sponsors really have focused on issues and being able to get ahead of things and fix them before they get big is very important in preserving and maintaining the asset quality of that portfolio. And we just have an incredible team and it goes all the way from the originators and the underwriters and the managers over originations all the way through the credit closing process and then all the way through the asset management process to pay off. We've had in 20 years, we've had losses on, I think, six or seven RESG loans and we'll have a few losses here and there on that portfolio. But the job that our team does there is just very helpful critically important in maintaining the quality of that portfolio.

George Gleason

Thank you guys for joining our call today. We're very proud of our quarterly results. We feel really good about it and I'm very excited about talking to you again in 90 days. So thank you. Have a great day. That concludes our call.