Bank OZK

Transcript of the Second Quarter 2022 Conference Call

July 22, 2022, 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, Jonathan, to remind our listeners how to cue in for questions.

Timur Braziler - ***Wells Fargo Securities***

Looking at the pace of origination activity in RESG, that was quite impressive. Was that consistent throughout the quarter? Was that front loaded? And then, I'm just trying to gauge what the broader kind of uncertainty has done for demand within that product more recently?

Brannon Hamblen

We did have very good originations in Q2. And as to front-loaded, back-loaded, middle-loaded, it was really consistent through the quarter. We are very pleased that growth is still very diverse in terms of its location. We continue to achieve a strong diversity across the country and strong diversity with respect to product type as well. So there's consistency in that story. And the pipeline, as we look forward, remain strong. We acknowledge some of the macroeconomic factors and events that are being watched and reported -- geopolitical events, et cetera, et cetera. But here in our business, the pipeline continues to be very strong with the type of product that we continue to see great sponsors, great projects, across a number of markets.

Timur Braziler

And then the commentary for the expectation of continued record repayments in 2022, but for positive loan growth. Is that pertaining specifically to RESG that you think that funding can outpace or pay downs for the remainder of the year? Or is that for the portfolio as a whole?

George Gleason

I think we expect, as we've said, a record year of paydowns in RESG, and we'll have substantial paydowns in Q3 and Q4. RESG going to be net-net over the next couple of quarters of push to probably, I think we are leaning towards slightly positive growth in the RESG portfolio over the next couple of quarters in regard to funded balances. We've got pretty good momentum, as you guys saw, in the other lines of business. Our asset-based lending group has gotten good traction. Our indirect lending group has had positive growth several quarters in a row and in our community banking group. And our corporate and business specialties group only had negative growth, very slightly negative in funded balances, has actually been increasing their unfunded book. So that unit is growing even though it's not translating through into funded balances. So the guidance we gave is that total loans we expect to grow over the remaining second half of the year. I think RESG may be a small contributor to that on a net funding basis, but a likely positive contributor. If paydowns accelerate, a chunky loan or two gets in there and pays down, that could not materialize on the RESG side, but we expect positive growth in the aggregate over the second half of the year.

Michael Rose - *Raymond James & Associates*

Just following up on the loan growth. Yes, you guys did have really nice growth in some of the other businesses. But how should we think about both what the market will give you and then your desire to continue to grow those businesses should the economic backdrop deteriorate. And if we do move closer to a recession, I would think that some of those businesses you would want to slow down potentially the growth. And just wanted to get some just broader contextual thoughts on how we should think about the non-RESG businesses.

George Gleason

You know we have a long-term commitment to conservative underwriting. And while we don't really change our underwriting standards from quarter-to-quarter and year-to-year and up cycles and down cycles, macroeconomic conditions do affect the ability of borrowers to qualify for our underwriting standards. So an adverse environment will lead to a slowdown. Brannon has already mentioned that our RESG pipeline is good and really strong at this point going forward. Obviously, the more severe the macroeconomic downturn and the higher interest rates go, that will longer-term, in future quarters, weigh against that forward top line. But even with that, even in the most severe times we've been through in the 19 years that RESG has been a business unit, we've found opportunities that makes sense every quarter throughout that. And quality sponsors with quality projects that make economic sense.

So I think yes, that could shade to a lower level of pipeline strength if the economy got in a very adversely affected condition. But the portfolio is strong now. As far as other lines of business, that varies a lot from line of business to line of business. Our asset-based lending group is dealing with really high-quality customers who have strong earnings and EBITDA, but need the additional capital that monetization of their inventory and receivables allows them. So there'll be people that will do less well and won't qualify in the future, but there will still be business opportunities, I would think, given the skill and experience of that group.

The indirect lending group may be the most impacted because if we do get in a situation where the Fed destroys enough demand in the economy that it really is affecting the job markets significantly -- that is a consumer line of business. And Obviously, RV is a big part of our business, and higher gas prices do have some effect on consumers desire to buy RVs. So I could see a combination of higher gas prices and weakening job market conditions and weakening financial market conditions that would affect consumer balance sheets, the valuation of consumer balance sheet weighing against that. So it wouldn't surprise me if our positive growth number in the indirect portfolio got compressed as the economy gets worse.

But generally, we feel pretty good about the prospects for continued growth. And the bottom line of that is with $17.3 billion in unfunded loans, we've got significant growth potential for 2023 and 2024 in the can already booked and moving towards funding as the equity and other capital structure components of those loans are funded in front of us. So we feel very positive about our ability to book funded growth in 2023 and 2024 under a wide range of macroeconomic scenarios.

Michael Rose
That's great color, George. And maybe just a follow-up on RESG itself. The growth in unfunded commitments this quarter was really strong. And I know historically during times of concern or stress competitors in that space that you compete against have historically pulled back, and you've been able to get better spreads, better risk-adjusted returns. I understand the credit box stays very, very tight. But are you starting to see that dynamic unfold and in that environment even if the pie of available potential loan opportunities continues to shrink, should we expect to see a similar dynamic where you would get an increasing share of that pie just because the competitors pull back?

Brannon Hamblen
Michael, you've I think hit the nail on the head there. We are starting to see some of that. And there are different institutions that pull back for different reasons. I think a lot of institutions have had pretty good loan volume and some may be reaching sort of the top of their allocation. I think in the bank world, maybe in the debt fund world, it's more around leverage lenders reaching allocations. But for different reasons and different places, we are seeing some pullback, and our guys do a phenomenal job of knowing where the market is. And we're always pushing the lower limits on leverage and upper limits on spread. And here in the last couple of months, we are making good progress in that area and seeing situations where we might have bid for a particular project and lost it to another party at higher leverage and lower pricing, and some of those deals are not closing -- and good deals, absolutely make sense to do -- but we're getting revisited. And of course, we do our best to capitalize on those opportunities to get the most attractive leverage and spread that we can. I don't want to overstate massive, massive pull back, but we are seeing evidence of that in the market. And to George's point, structure every deal in the portfolio to make sure we're in a position to know that our credit is good and that we can stay in the market and find those great sponsors with great deals that we can continue to make good loans to.

Michael Rose

Just on the buyback. You got about $178 million left. Is there the desire to continue to use that as kind of a go-forward tool beyond the current authorization. Meaning should we think about buyback as just one of the proverbial arrows in the quiver for OZK moving forward, whereas historically we did not. I know it was a big step for you guys to initially authorize it after seemingly years of contemplation, but is this something that we should consider as part of the toolbox moving forward?

Tim Hicks

I think we will have conversations with our Board regarding that as we approach or get into the fourth quarter. As you know, a lot goes into that consideration: current macro environment; growth potential organically; or through M&A. So a lot of factors go into that. As you pointed out, we've made good use of our authorization so far. And we've got strong earnings, strong capital. So we've got a lot of opportunities to use our earnings and capital going forward, and we'll just have to have that conversation at the right time with our Board.

Matt Olney - *Stephens Inc.*

I want to ask more about funding the back half of the year, and to the extent that the bank achieves loan growth, how are you thinking about the funding aspect of it? And where do you expect this to come from? It seems like the reliance on wholesale borrowings is pretty low. Is that something you would consider the back half of the year? Or you think you can fund this growth with core deposits?

Cindy Wolfe

Well, first of all, we always have large unfunded RESG loans. And of course, they overlap with our RESG payoffs, so you have to look at both. The question isn't so much how we're going to fund it because we'll fund it using the same channels we've used in the past, but rather how well are we going to be able to optimize the funding for timing, pricing, duration and mix. We have the benefit of a really seasoned deposits team at this point: Ottie Kerley, Chief Deposit Officer; Carmen McClennon, Chief Retail Banking Officer; Drew Harper, Managing Director of Wholesale Deposits. All of us have been working together for years now to position ourselves to meet really the demand of any economic rate cycle. We've been working on our fundamentals, our core deposit growth, of course, you can see our growth in non-CD deposits this quarter. And I want to point out, we hit an all-time high in our number of personal checking accounts. We have had more savings account growth than we've ever had in our history. And so we expect the positive momentum with growing core to continue. We have reduced our concentrations, and as we've talked about in the past, we've improved our composition. And RESG is very diligent about projecting fundings and payoffs. But we've improved on our agility and our ability to be precise and react to that as part of that team. All that said, we do plan to increase CD volume as we need to. And we've added, for example, some brokered deposits towards the beginning of the quarter that just happened to be very good pricing, and locked in some decent pricing there. I expect that we'll need to supplement our deposit growth with CDs and other deposit sources over time as needed as we have in the past.

Matt Olney

Switching gears over to the operating expense side. I think the commentary last night said that it has been a little bit slower to fill some of the open positions in 2Q - but I would love to hear about kind of the outlook for expenses in the back half of the year?

George Gleason

Yes. I'm pleased to report, we really have had a good momentum in the last five or six weeks and adding staff, and have probably added net 100-plus positions over that last 6-week period of time. So we're finally getting this logjam of unfilled positions flowing at a really nice rate. But Tim, I'll let you address the overhead parts of that.

Tim Hicks

Yes, you're right, George. We pretty much kept a fairly stable headcount number throughout Q2. And we're already, with the progress that George is mentioning, we're already seeing an increase in the number of teammates that we have on staff and are looking to continue to fill those positions really to support our future growth, which we certainly view as a positive. But we'd certainly expect total noninterest expense to increase probably several million dollars each quarter for the next few quarters as we fill those positions as we give raises to our teammates and continue to grow our bank.

Brian Martin - *Janney Montgomery Scott*

I'd love to hear some thoughts on just kind of the margin outlook. I see that obviously, a number of loans have moved through their floors, will continue to move through their floors if we get the rate hikes that we're expecting. But also know that some of the pricing on the new production is a little bit less than it was on the old stuff. So just kind of the really nice expansion this quarter -- just kind of looking at the follow-through in the next couple of quarters – how do I think about that or some commentary there would be helpful.

George Gleason

Yes. A lot of moving parts there. And Brian, you mentioned that you remembered from our last several press releases that we commented that the new loans we were originating, particularly in RESG, we're on a little tighter spreads than loans we might have originated a year or two years ago. And Brannon alluded to that in the comment that he made earlier. And you saw that I think that comment probably disappeared from this edition of our Management Comments document. And that comment disappeared because as Brannon indicated earlier, competitors have dropped out of the space. Those competitors who are unlike us, not here all the time in the space, some of them have dropped out. We're getting better margins on deals we're quoting today than deals we quoted a quarter or two quarters ago. So that comment disappeared purposely from the Management Comments document, and that's helpful.

As you saw in the quarter just ended our non-purchased loan yields were up 18 basis points. Obviously, three Fed rate increases so far skewed late toward the quarter with that 75 basis point increase coming later in the quarter. We're getting the impact of that. Our loans are getting off their floors. And most of them, it seems like will be off their floors this month after the next Fed meeting next week. So the loan yields are going up. And as we said in our management comments, we expect those will continue to go up. Most of our variable rate loans are tied to SOFR and LIBOR. So those are sort of forward-looking indexes we use 30-day LIBOR and 1-month LIBOR and 1-month term SOFR for those. So those rate increases tend to get ratably priced in on a daily basis on a ratable basis, starting about 30 days in advance of the expected increase. So that translates into our loan yields going up a little bit on the fast side.

Most of our interest-bearing deposits are CDs so they tend to lag going up, hence you had an 18 basis point increase in deposits or in non-purchased loan yields and a six basis point increase in deposits. We would expect, and Cindy referenced that lag in her comments, we would expect to most likely continue to see loan yields outrun deposit costs early in the cycle and then late in the cycle when the loan pricing changes are pretty much all priced and the Fed's about to stop or has stopped deposit cost as CDs roll over, we'll tend to catch up. So probably late in the cycle, we may have a quarter or 2 where deposit costs go up more than loan yields. And if that coincides we're at a point where we're really growing deposits more aggressively to fund a lot of this growth that's already loaded into our balance sheet, we could certainly see a quarter or 2 where deposit costs accelerate faster than loan growth.

But obviously, we've got a great net interest margin, a great core spread. And we expect that to continue. And we've got a short-duration securities portfolio and kept that really short over the last couple of years. And we're getting good cash flows, as we alluded to in the Management Comments document from that securities portfolio, and that's given us an opportunity to either use that cash flow to fund loans or reinvest that in securities. Last quarter, we found some pretty decent reinvestment opportunities we like. We're finding some this quarter being very particular and very careful and trying to get real value when we purchase securities. The guys are doing a really good job of that and being patient. And that has some favorable implications for that yield on that securities portfolio as well. We are cautiously optimistic about our ability to really keep a great NIM throughout the throughout the tightening cycle.

Brian Martin

Have you changed your outlook on just kind of through-the- cycle deposit beta or just how you're thinking that will play out as it picks up over time?

George Gleason

I think we'll do a lot better than we did in the last cycle for all the reasons that Cindy enumerated. Our deposit team and our retail banking team have been doing a great job growing core deposits. And they continue to grow core deposits nicely. This last quarter, they've got good momentum, I think, on that going forward we feel we do. They're doing the right fundamental things day in and day out to grow core deposits. Now we let some expensive CDs go this quarter because we didn't need the deposits. We can get those back or replace them with other CDs when we need them later. I think they've done a really good job of positioning us. Will our deposit costs go up? Absolutely. And I think Cindy mentioned they probably go up more in Q3 than they did in Q2, the quarter just ended. They certainly will go up more. But we think the deposit betas are going to be very tolerable, and our deposit guys are doing a really good job in managing that process.

Brian Martin

As far as M&A goes, given kind of the market conditions -- there might be opportunities going forward -- is that something that's still being considered. I know you had some good activity or conversations in the past. But just wondering if that's changed with the market dynamics here.

Tim Hicks

Yes. I would say that the conversations are few and far between right now, just given the macro environment and the rate cycle. And certainly, when you start to think about mark-to-markets on loan books in this type of cycle and investment portfolios, you can get some pretty meaningful purchase accounting-type marks that will impact pricing from a buyer perspective that may not be fully reflected in seller expectations. So I think there's just too much uncertainty in the macro environment right now for very much M&A to happen for the foreseeable future.

Catherine Mealor - *Keefe, Bruyette, & Woods, Inc*

I wanted to follow back on the margin and just on loan yields. Is there any level of elevated loan fees this quarter? What did that look like relative to last quarter just given the level of payoffs we saw?

George Gleason

It's hard to say what's normal. But we consider this certainly to be a normal quarter. Now we had a comment in our Management Comments document that was noting that our net interest income this quarter was almost exactly in line with our fourth quarter of last year when we did have significant fees on prepayments and short-term extensions and renewals. I think I probably should not have put that comment in there in retrospect because I think it might have been confusing to some people. But this most recent quarter was what we would consider a very typical quarter. Thank you for the question, Catherine, and letting me clear up that misunderstanding.

Catherine Mealor

On just the deposit rates, you would certainly expect deposit costs to come up this quarter. Is there any indication of maybe what June deposit costs look like? Just to kind of give us a sense as to where those move through the quarter? And then on that comment around CDs, it's interesting that you've continued to see CDs decline. Is it fair to say that we could see kind of some of the higher cost CDs decline again maybe next quarter? And then really the CD growth is kind of more of a 2023 event? Or how do you kind of think about the timing of when we'll see the CD portfolio bottom?

George Gleason

Catherine, I don't know and I don't think Cindy and her team know that yet. They're going to monitor week-to-week, day-to-day, probably hour-to-hour sometimes, as expectations regarding fundings and repayments get updated continuously in our world. I think that's one factor, just the changes in expectations literally day-to-day on what our repayments and fundings are going to look like on a weekly and daily basis and monthly basis over the remaining part of the year. And then the other thing, Cindy mentioned, we did add some brokered deposits in Q2. And that really wasn't because we needed those deposits, but our wholesale funding guys were monitoring the market, and they got an opportunity to add several hundred million dollars that have some term to them and that had relatively favorable rates, and they looked at it and thought it was an opportunistic time to take advantage, capitalize on an opportunity there in the market. If we find similar opportunities where we feel like those deposits are bargains and we're going to need them in Q1 or Q2 or Q3 of next year, and we want to go ahead and lock up some funding for that, they may do that. Otherwise, it will just be a day-to-day pricing decision based on the day-to-day adjustments and our expectation for funding needs going forward.

We could have kept the time deposits that we let roll off in Q2, had we been willing to pay a little bit higher rate for them, but we didn't need them. And it's a present value analysis. If you buy them today at one rate or you buy them 6 months later when you need them at 100 basis points higher rate, what's the net present value and the best long-term life of cycle outcome for the bank. So they're doing very careful decisions on that. And I think they did a great job managing our deposit costs and keeping us with plenty of deposits. And I think they'll continue to do that going forward.

Catherine Mealor

On the originations, it looked like when I looked at one of your charts that kind of showed the number of loans, it was interesting because it looked like a lot of the new originations this quarter were kind of more on the smaller end of the range. Would you say that's more of what's available? Or is there any kind of intentional shift there?

George Gleason

No kind of intentional shift, and I think you'll see quarters where the average loan size originated is down. I think you'll see quarters where the average loan size originated is really high. I think it's just the randomness of it. And Brannon, you may want to comment on what you guys are seeing size-wise and you may also want to comment on the fact that we are doing more business in secondary markets now, and those tend to be smaller deal size, and that's just to diversify the portfolio geographically. Brannon, add any comments you want on that.

Brannon Hamblen

No, you're exactly right, George. And I think one thing I would say is, I'm just incredibly proud of the team, both in terms of the where, the what and the how many. I mean it wasn't just a record in terms of dollars originated, but it was a record in terms of number of loans originated. So that does, obviously, a higher number weighs that average down. We had $82 million average loan size closed in the quarter, which was probably a little wider than Q1. I think we're doing a great job at both ends of the spectrum, Catherine. We're seeing opportunities that we have and increasing volume with larger loans, new sponsors, great projects. But to George's point, our guys just keep hammering away at some of these tertiary markets, and we continue to grab a new one here and there, it seems like every quarter or so. And so it's all of the above. It's not a particular focus other than just on quality. And the guys are doing a great job of digging up quality across the size spectrum.

Catherine Mealor

Great. And then maybe my last question is just on the reserve. It's interesting that you've got more weighting towards the adverse scenario, which makes sense so you can be conservative there. But is it fair to say that as we move through all the baseline changes on a daily basis, and as we move through the next couple of months as the baseline changes and as the baseline perhaps kind of moves a little bit closer to the adverse or worsens a little bit, does that mean there's less risk for you to have a larger CECL reserve build because you've already got so much weighted towards an adverse scenario that likely won't change? Or if we do kind of start to see more recessionary signs, is it actually still going to see a reserve building for you?

George Gleason

Yes. For the last couple of quarters, up until this most recent quarter end, we had the heaviest weight on the stagflation scenario and secondary weights on what was then known as the protracted slump and the least rate on the baseline scenario because the baseline scenario when you dug into all the assumptions, and it looked like a pretty much an upside scenario to us. And as we looked at the political, geopolitical, fiscal policy, monetary policy, macroeconomic environment and all its forms, we thought that was too positive scenario. The stagflation scenario has become a more benign scenario. The baseline has gotten a little more realistic, but still looks like an upside scenario. So we shifted our weighting to the protracted slump. We're conservative people. So we tend to look at the adverse range of outcomes and think about running our business constantly in terms of what could happen and prepare for that. So I think we've tended to be on the more conservative side in our scenario selection. Obviously, if we get in a situation where the baseline assumes an economic downturn, then the baseline probably becomes more heavily weighted. But right now, the baseline scenario in Moody's seems to be pretty positive and not saying they're wrong, but it's just not consistent with our conservative view of the world. Tim, you might want to comment on that, too.

Tim Hicks

George, you summarized it very well. And Catherine, I think you put a note out earlier this month on the July baseline for Moody's has already gotten a little bit more negative than the June version, and we were utilizing the June version for all these scenarios. It's a matter of us really digging into the details of each scenario, evaluating those at quarter-end and selecting the weightings that we think is appropriate given our view of what the macroeconomic trends are showing us at the time.

Catherine Mealor

It feels like a lot of your reserve build actually more coming from your unfunded commitments versus what's on balance sheet. The CECL model, how does that shift when you're moving from unfunded to kind of funded? Is that just you move from one bucket to the next? Or is there more provision when you're actually moving from unfunded to funded that could drive provisions higher as we kind of work through that unfunded commitment bucket?

Tim Hicks

No. I mean a lot of dynamics underlying that question, Catherine. On the funded balance, if you just looked at the funded balance and looked at our asset quality, on balance sheet asset quality, over the last several quarters it's improved tremendously. Our nonperforming loans, nonperforming assets are down. Our substandards are down. Our special mentions are down quarter-over-quarter. Our past due ratio is really favorably low. And then if you look at the bubble chart, you would have seen some of the higher LTV loans in the bubble chart paid off this quarter. So the funded balance and some of the older vintage loans at RESG have paid off over previous quarters. So the funded balance asset quality is continuing to improve. So that's part of that dynamic. And then...

George Gleason

Improving from an already really good level.

Tim Hicks

And then it's just how the models are working through the scenario selections and the mix of loans that we have and the unfunded balance changes that a little bit, and that's grown a little bit, a few basis points quarter-over-quarter.

Timur Braziler - *Wells Fargo Securities*

Just a couple of points of clarification. In the release, you had mentioned that $20 million of additional buyback was completed during the first 20 days of July, but the third quarter repurchases wouldn't exceed $100 million. I'm just wondering why kind of the pause off of the current run rate. Is that just keeping dry powder for opportunities later on? Or is there visibility for other uses of that capital? Just any color around that statement would be appreciated.

George Gleason

Well, our authorization goes through the first part of Q4. So the expectation that we would limit Q3 buybacks to probably not more than $100 million is just to keep some powder dry for Q4.

Timur Braziler

And then just lastly, on the commentary around job openings and accelerating, getting through some of the logjam as you put it, what's the remaining level of vacancies? And is the expectation that you keep on hiring through the rest of the year? Or are these 100-plus positions that you added over the last couple of months, is that primarily filled up the open positions you're looking to fill?

George Gleason

We have probably got 225 to 250 other open positions now. We normally will have 3% or 4% of our staff positions open because we're looking for candidates with specific deals. So I would say we're 125 to 150 positions remaining to be filled that would need to be filled to get as to what we would consider a normal level of open positions. So fairly significant hiring still to go. And as Tim mentioned in his remarks, a lot of those newly created position, some are refill existing positions, but there are quite a few newly created positions in there. And those positions are there because we expect to continue to grow and actually see an acceleration in our balance sheet growth in '23 and '24. We're glad to have our business in a position where we feel confident enough about growth over the next couple of years to still be adding new positions to manage that growth.

George Gleason

Thank you, guys, for being on the call today. We appreciate it. Have a good 91 or 92 days whenever our next quarter's results are. Have a good quarter. Have a good day.