Bank OZK

Transcript of the First Quarter 2020 Conference Call

April 24, 2020, 10:00 am

Note: Administrative communications of the operator and other greetings and social exchanges of no substantial import have been omitted from this transcript.

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

Joining me on the call to take your questions are:

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

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

Timur Braziler – *Wells Fargo*

Maybe we can start on your commentary that you used certain qualitative overlays to increase allowance in excess of the Moody's methodology. Just wondering if you can expand on what some of those overlays might be and which portfolios they were applied to.

Greg McKinney

As we looked at our model results, and we were using the Moody's forecasts that were published on March 27, and while our focus was around the base case forecast, we did look at the alternative scenarios, both more and less severe. And as we began to evaluate at least certain portions of results coming out of the various models that feed into our CECL engine, we certainly felt like that the magnitude and velocity of deterioration in the economy we saw in the last 30-or-so days of the quarter really did not get fully reflected into some of those model results. So what we did was we looked at certain portfolios, and we looked at a number of portfolios across the bank, but we looked at those really in a more severe stress scenario. So we would have taken them and estimated what might the results look like in a more severe downturn relative to the baseline forecast -- that was the base forecast for us -- and what might those results look like. That gave us some kind of boundaries of where we thought some of the outer reaches of projected losses through the models would suggest over the life of the portfolios. And then we used that to then inform various overlays and qualitative adjustments to our model output. So we ended up with several different qualitative overlays over various aspects of the portfolio and various product lines within the portfolio.

George, I don't know if you want to comment on any specific lines of business or aspects of the portfolio, but we did feel like that we needed to adjust, where appropriate, some of the model output to really fully reflect the velocity of change we saw in economic circumstances over the last 30 days of the quarter.

George Gleason
I think you did a good job describing it, Greg. I would comment that two of the overlays that we used increased the allowance allocations generated by two of the models. And then the other -- I think there were four overlays. It may have been five, but I think it was four that were related to specific subsets of different portfolios within different models. So we tried to get it right and be appropriately conservative. Obviously, it's a very dynamic economic situation we're in, unprecedented in many respects. So the model -- the guys building the models, I'm sure, at Moody's are striving to keep up and fine-tune those models to be appropriately sensitive and not excessively sensitive to all the economic dynamics. So we took a good look at it and, I think, made a good set of decisions on how to overlay those models.

Timur Braziler
And then looking at the deferral activity as of March 31, seems relatively in check. I'm just wondering how that's trended post quarter-end. And if you can give deferrals by category within the hotel, the office and the Indirect RV & Marine portfolio, please.

Tim Hicks
The numbers that we gave in the management comments were actually as of the end of the day, April 22. So those are the fairly current numbers. So 1,675 loans had deferrals totaling $356 million, so roughly 2% of our total loan portfolio. A good number of those are from our indirect lending portfolio and obviously, it's a consumer portfolio. I don't have the specific numbers around those right now. But as far as the count goes, the large majority of the count is coming from the indirect portfolio.

Timur Braziler

Realizing that the LTVs across all your different portfolios are quite low and realizing that it's a fluid situation, but I'm just wondering, is there any way to estimate what the LTVs could look like in the office and hotel books, specifically. And then just going forward with the CECL implementation, how punitive will it be for future provision if there is a near-term spike in LTV? Or is there enough flexibility in the model that you can look out longer term?

Brannon Hamblen

We included in our comments good detail on where our LTVs are across our different portfolios and geographies, and those have maintained the same levels that you've seen recently. As it relates to what those look like in the future, I would just say it's really too soon to know. I mean, obviously, with some of the stress that we'll see, there'll be influence on revenues. There'll be an influence on cap rates, and those all affect values. But the degree to which those are affected, honestly, it really is just too soon to know. Obviously, as well, as you noted, the models do look to LTV as a significant influencer of the results there. I think all I would say there is with our very conservative LTVs, we would expect to show in those models as well as one could. Again, it's just too soon to know how fast and how far and then what the recovery looks like.

George Gleason

I completely agree, Timur. And I would point out that our RESG hotel portfolio is 52% of cost and 40% of most recent appraisal. As Brannon said, that 40% will undoubtedly come up given the stress that sector is facing as those properties get reappraised. But when you're at 40% loan-to-value starting out, you've got a lot of room for degradation and still be in good shape. Our office portfolio, which I think was the other one you mentioned, at March 31, we were 39% -- I'm sorry, 49% of cost and 38% of the appraised value on the office portfolio. So I would just echo Brannon's comments, the significantly low leverage points that we're starting out within the portfolio gives us a lot of room, and that's why we've been conservative and worked really hard to keep those leverage points down as for just this sort of economic scenario that we find ourselves in today, it gives us a lot of comfort.

Ken Zerbe – *Morgan Stanley*

When we think about all the moving parts in the RESG portfolio, like specifically loan growth and loan spreads, is the next year or so going to be a net positive or a net negative for Ozarks and RESG versus the trajectory you may have been on prior to the whole pandemic?

George Gleason

I think it's going to be a net positive. We've seen a slowdown in refinancing activity. Of course, it's unfortunate that part of that slowdown is attributable to work being stopped on projects temporarily while a lot of cities are in shelter-in-place mode. That's hard on our project sponsors, but it does have a counterintuitive benefit for us in that the loans stay on our books longer. So the slower rate of paydowns is actually beneficial to us from a margin and yield perspective. Clearly, there'll be some competitors that have already, and will probably longer-term, pull back from the space. That lets us have a little more bargaining power in structuring transactions and pricing transactions. So I think those are positives that outweigh the negatives. Clearly, credit costs are going to be higher, not that we feel like there's significant credit exposure in our RESG portfolio. We feel very good about that. But I would say, on balance, we view it as a net positive for that portfolio. Brannon, you're in the hot seat at RESG as the President there every day. Do you agree with that?

Brannon Hamblen

Absolutely, Ken. And I would say that as it relates to the balances and the growth -- as George said, as it relates to yield, I mean, you're already seeing a pullback in the realm of the competition, and we're already pressing in and trying to gain advantage there by not just holding but improving our LTV/LTC entry points and moving our spread in a positive direction. So again, a lot of things changing rapidly. But as we look forward, I agree with George, I see this as a positive.

Ken Zerbe

Got it. And then in terms of your deposit costs, is there anything structurally different about your portfolio versus someone else's portfolio that might keep your interest-bearing deposit costs much higher than peers over the next, I don't know, say, few quarters or a year or so? Or is it possible to bring that down much more towards sort of the industry average?

George Gleason

Well, Ken, we certainly expect our deposit cost to continue to come down. And I think Tim commented on that in his part of the management comments document that we expect it to come down pretty much throughout the remainder of the year, and we're working hard to do that. Our real estate heavy portfolio is a little different than a bank that is a C&I driven bank. If you're a C&I driven bank, your borrowers are going to have about as many deposits with you as they do lines of credit and loan balances in many cases. If you're a real estate driven bank, as we are, your depositors are different for the most part than your customers because $100 million real estate project doesn't have $100 million of deposits. A $100 million line of credit customer may have $100 million of deposits. So it's a very different dynamic. So our deposit book is very much driven by our branch network, which is very retail and dependent upon online competition and local competition. And for some customers, online competition is relevant and for others it's just local competitors. So we're driven by that. But we do see our cost of deposits coming down steadily if rates stay where they are over the course of the year. And we've given guidance in the management comments about our CD book and how that is priced and how that matures out over the next several quarters. So you can look at that and get some indication.

Arren Cyganovich – *Citibank*
I was hoping you could give us a little bit more feel for how your interaction works with the developers on the construction side when they're obviously going to be struggling as they can't work on their projects and how much kind of cash flow and support that you have from them during an extended period of stoppage and what kind of actions you're doing to help kind of work with them to make sure that the projects get finished.

George Gleason
Well, of course, everyone likes to avoid supply chain disruption and project stoppage because it does create some inefficiencies and runs up cost in the process. The structures that we have in place with our sponsors include on any project we've got a construction completion guarantee, and that completion guarantee basically says, in simple terms, that they're going to complete the project on time, on budget. And if they're not on budget -- if there are gaps in the cap stack, the development cost overruns or project delays that increase carry and interest costs -- that they're on the hook for those. So the vast majority of our sponsors will have the financial wherewithal, we would anticipate, to meet those obligations to rebalance. So if there's a couple of million dollars more interest carry or taxes or insurance that accrued while the project has stopped for 60 or 90 days and before it gets restarted, and there's additional cost incurred in restarting, that is contractually an obligation of the sponsor. And we would expect the sponsors in the vast majority of cases to manage that without any assistance from us. There are also contingency funds built into these project budgets that, in many cases, will cover some portion or all of that. So when you start a large complex construction project, you assume some things are going to go differently than planned and you build some contingencies in the budget to allow for that. There will be some requests that we will get from sponsors where they will ask us, and we will feel capable of doing so to accommodate their request to help them with some cost and carry for a period of time when their operations are shut down or their construction is shut down. We'll do that in a very judicious manner. We're not going to do a modification that we think in any way jeopardizes our loan, and we're going to expect sponsors to come to the table and participate in those requests as well so that we're just not providing the carry for the delay period or something. So it's a very intense subject of negotiation and discussion, but our sponsors understand their obligations and honor them, and we don't really see that as probably, in many cases, if any, resulting in a problem for us.

Arren Cyganovich

That's very helpful. I like the disclosure you've put in the management comments. I thought that was really helpful on page 28 about the hotel portfolio. It looks like the bulk of these are LTVs below 60%. It looks like all but one. Maybe you could talk a little bit about the support you're seeing from your hotel sponsors and the -- I guess, like the real risk here is that, in case the CRE value falls below and then just give the keys back to you, that would be, I suppose, the biggest risk that you're -- at such low valuations there, it seems like a pretty low probability event. But maybe you could just talk a little bit about the hotel portfolio.

George Gleason

Well, we share your point of view that, that's a low probability in most cases because of the significant sponsor's equity contribution and the significant appraised value beforehand. We also acknowledge that, that sector is, along with everything in the travel and leisure sector, is pretty hard hit right now. And most of these properties, if you're completing a property today, you're probably not starting operations. You're probably just mothballing that project for a month or two or three until economic conditions become better to restart it. And a lot of sponsors who started operations with a project and were a few months into it were still incurring operating cost in excess of revenue and just elected to shut down, and will restart those projects in a few months when conditions normalize. So there are issues there that will push those loan-to-values up because you'll have a period of restarting operations. But again, we think all that is pretty manageable with our very low leverage on those portfolios, the quality of the projects and the quality of the sponsors. But a lot of these guys will be starting over their ramp-up and business build up to a point that they can stabilize the property at kind of a full stabilization rate of revenue and get an optimal permanent exit.

Brannon Hamblen

I would just echo and emphasize our entire portfolio was really built for times like these, and we've kept our leverage low -- 40% on our hospitality portfolio and -- we've got across the board really strong sponsorship, and that influenced behavior with the amount of equity that we've got in these deals and supported that with solid structuring. George mentioned completion guarantees earlier and those sorts of things. There will be some challenges here. Roughly half the portfolio, though, is still under construction, and one could argue that having not already spent those ramp-up dollars in the past, they've still got those in the budget and prepared very well there. And so one could argue that those that haven't opened yet are at somewhat of an advantage from that point of view. But in any event, I would echo what George said -- we're in a good spot right now. We're hopeful about what it looks like going forward. There'll be some re-ramp time involved, but we're very well positioned and very close contact with all these sponsors to understand the issues as we go forward.

George Gleason

Yes. And I would add one final comment. Most of our hotel credits are to people that are established veteran hotel operators. And that is -- that's not all of our customers, but it's the vast majority. And I think those guys are going to handle this current situation in a business-as-usual sort of crisis management situation. But a lot of those guys have operated hotels through 9/11. They've operated hotels through hurricanes. They've operated hotels through floods. They've operated hotels through recessions, including the Great Recession. The hotel business is a business that is subject to quite a bit of volatility and the veteran operators are going to realize that they need to continue to support their project and stick with it and that the value is not gone even though their hotel might be shut down right now, and they'll get that built back in a few quarters when they get to resume operations and begin to ramp up occupancy and RevPAR again. So I think the fact that we're dealing with that quality of sponsorship on the vast majority of these projects is a big plus.

Jennifer Demba – *SunTrust Robinson Humphrey*

I'm just wondering what you're seeing in terms of deferral requests or other trends in the RV & Marine portfolio today.

George Gleason

We've talked a lot about that portfolio being a high-quality portfolio. And we have had a number of requests there, but it's in the single-digit percentages of the portfolio. Tim, do you have that number?

Tim Hicks

Yes, I do. From a dollar perspective, about 3.7% of the indirect portfolio currently has a deferral as of today.

George Gleason

We share a lot of data with peer banks and so forth. And we've been asked by a lot of people -- or it's been commented to us that our deferral rates seem to be lower than what other banks are experiencing. And we are certainly honoring deferral requests per the federal banking guidelines for customers that their business is shut down or they've lost employment or otherwise are adversely impacted by the COVID-19 pandemic. But we feel like our portfolio relative to other similar marine RV portfolios, the RESG portfolio, whatever portfolio you're talking about, we feel like we have maintained a conservative level of underwriting that has us with borrowers in most cases who are capable of withstanding these sort of turbulent times and don't need deferral assistance to do so. So I think that's why our loan deferral rates are better. I think we've just got a relatively good portfolio as is consistent with our historically better-than-average credit performance compared to the industry.

Matt Olney – *Stephens Inc.*

On the deposit cost, the commentary mentioned there were two public fund entities that were replaced at the end of the quarter for much cheaper deposits. I'm curious what kind of rates were those entities receiving. And when were they replaced? Just trying to get a better idea of the savings between those entities and the FHLB that was added.

George Gleason

They were replaced -- gosh, Tim, do you remember? Was that late February or early March or somewhere in there?

Tim Hicks

Right at the end of February.

George Gleason

And those deposits were expensive deposits. And really, the replacement was not so much related to cost as it was to concentration. If you look at our 10 largest depositors now in the bank, I think that number is probably in aggregate less than 10% of our total deposits. If you go back a year, 18 months ago, the largest deposit customers, 10 largest deposit customers were high-teens percentage. So we basically cut our concentration among our 10 largest deposit customers in about half and gotten that down to a really core group of customers. So this has been one of the goals that we've had internally is to really reduce concentrations of deposits and diversify our deposit funding sources much more broadly, which we've done to add some duration to those deposits just to take out periods of volatility. And in deposits, if you've got big, chunky deposits and somebody decides to move or you don't want to pay the rate somebody insists on getting paid, then that leads to a noticeable shift in your deposit balances. So we really wanted to get that book much more diversified and add some duration to just add a lot of stability to it at the same time that we've been increasing our cash positions and investment security positions and liquidity position. So we're much more liquid and much more diversified on the deposit side than we were two years ago or a year ago, and we view that as positive. We spent a little money to do it. That's slowed our rate of decrease in deposit costs in some cases, but we've gone in several instances for qualitative factors over margin improvement in the short run, and I think that will serve us well in the long run.

Matt Olney

And then on the investment security side, it sounds like you were opportunistic towards the end of the quarter. Can you tell us more about what you were buying, the average yield? And were you buying these at a discount?

George Gleason

We found a situation that was very short-lived, and short-lived because the Federal Reserve did a great job of repairing the plumbing of the financial markets really quickly with a lot of liquidity and asset purchase programs. But there was a situation that developed for a lot of tax-exempt mutual funds, money market funds, debt funds, suddenly were having calls and had to liquidate their assets. So they were liquidating because they needed money and the market was disrupted. They were liquidating, in a lot of cases, their best quality shortest-duration securities that they could liquidate. And we really bought two categories of assets, and these opportunities are long gone. As I said, the Fed fixed the market so quickly that we really only had about less than 10 days to actually look at opportunities and harvest them.

So what we bought was really two things. There's a variable rate demand note market. That's the sort of modern-day replacement for what a decade ago was auction rate securities, and it's a much more protected market than the auction rate securities. But because these money funds were liquidating assets, they were pulling out of that. So you had a situation where really quickly bonds that should have been trading at 20, 30, 40 basis points in yield went to 5%, 6%, 7%, 8% yield, but it's for a week at a time. So we made several hundred million of purchases in that market. Those things have worked their way back down to pretty much market appropriate rates now. So that was a short-lived phenomenon.

The other area that we had a chance to pick up, and we picked up about $400 million or so of really short AA and AAA munis that are super high quality, and majority of those have already been pre-refunded. So they're pre-re and treasuries, with the trustee waiting for the date that they can be called. So these are bonds from a few months to probably the longest or a couple of years. But most of them are within 18 months and in or a year and in. And so you basically got U.S. treasury securities backing these AA, AAA rated munis. And these are bonds that would normally trade around a 1% level or slightly above or slightly below. And that market's back. You could buy those bonds at 2.0%, 2.5%, 3.0%, 3.5%, I think we even bought some in the 4s yields there. So they're short-term bonds and highly liquid, super high quality, pledgeable at the Federal Reserve, pledgeable to the Federal Home Loan Bank, pledgeable to a lot of state public funds entities. So using $700 million or $800 million of our cash to buy these didn't impair our liquidity at all because they're highly liquid and pledgeable at all sorts of different places for advances. So it was a pretty easy decision to make to do that, and that will help our margin a little bit because we took that out of money that after the Fed cuts was sitting in our Fed account at 10 basis points earnings yield and put that in something yielding quite a bit more even if just for a short period of time. So kudos to the Fed on doing an absolutely marvelous job of fixing the plumbing of the financial market. So that was less than a 10-day opportunity. And darn them for doing it at the same time. We would have enjoyed continuing to harvest those opportunities had the markets stayed disrupted a little longer.

Matt Olney

And just to clarify, George, when you say these were short-term opportunities, are these securities substantially still on the balance sheet at the bank? Or have most of it have now moved on?

George Gleason

Yes. But the variable rate demand notes have largely returned to a normalized yield level. Just really as of this week, they've kind of been drifting back down to what would have been an appropriate yield level. So we'll have to make a decision if we want to stay in those longer-term. They're a 1-week commitment at a time, and that's about half of what we bought. The other half is stuff that we'll roll off over the next two years and most of it in the next one year. We've talked a bit about our desire to maintain more liquidity and higher quality liquidity. And certainly, we've built that up over the last year, including the last quarter. So we could have gone in, the markets were disrupted farther out in duration and on bonds that were not pre-refunded but still high-quality bonds, we could have gone out farther in duration and a little further down the quality scale and probably really captured some very profitable opportunities there, but we tempered our capitalizing on this opportunity by our desire to really keep a lot of liquidity on balance sheet in really short high-quality liquidity that we could liquefy several different directions if we needed to. All that's just an appropriate response to the turbulent economic conditions caused by the COVID-19 pandemic.

Michael Rose – *Raymond James & Associates*

I just wanted to touch on the commentary in the prepared remarks around the dividend. I don't know if this was touched on already, but it said you may not look to increase. You guys have been, obviously, good stewards of capital over time, keeping high levels for these periods of stress. Can you just talk about thoughts on the dividend, potentially a buyback sometime down the road and how you would expect to deploy some of that capital on the other side of this?

Tim Hicks

Obviously, we've got very strong capital levels. Our capital, if you look at Tier 1 Leverage, our capital is, if not the highest, among the highest as of 3/31, it was the highest as of 12/31, of the largest 100 banks in the U.S. Obviously, we've got strong core earnings as well. We've increased our dividend every quarter for the last 39 quarters, increased our dividend every year since going public. Really, what we said in the comments, Michael, was that we may continue to increase it. But if we do, we would expect the Board to slow the rate of increase from our track record for the last several quarters, which has been a $0.01 increase every quarter. The Board will just have to evaluate situations at the time and make a decision of whether they want to increase it and by what amount. But our core earnings and capital levels will certainly support our current dividend level and certainly some level of increase from there.

Michael Rose

One follow-up question. This is always one of my favorite charts. On 21, you have the table, the RESG losses over time. On the one hand, the loss experience has been really good, and we obviously know that. I appreciate all the data you guys have provided over the years on loan-to-cost and loan-to-value, but I guess the pushback would be you guys are doing much larger loans than you did back when RESG was getting going and during the great financial crisis. George, can you just kind of help us, again, and I know you've done this in the past, but help us feel comfortable with the quality of your sponsors and how that translates to maybe some perceived risk around size of exposure by credit?

George Gleason

The sponsor who is going to do $1 billion project or a $600 million or $700 million project or a $2 billion project, that's going to result in a loan of a couple of hundred million, $300 million, $400 million, $500 million, $600 million, those sort of projects are done by sponsors who have substantial experience and capabilities that have been demonstrated on smaller projects. A real estate developer doesn't come in and typically start out with $1 billion project. You sort of have to grow your way into that capability. So the projects that we do that are much larger projects are typically done by your most sophisticated, most capable proven sponsors. They tend to be the best quality assets. And because fewer banks or other lenders are capable of doing those projects with excellence, it tends to narrow down the competitive field to do that. And our expertise in commercial real estate lending, the, I think, distinctive capabilities that we have in that regard are worth enough for our sponsors to call on us to do those sorts of projects. So we feel we get the best sponsorship, the best assets and the best deal structures. And that's pretty evident in our -- if you look at another table in the slide deck where our loan-to-value is shown by project type, the bigger the projects, typically, we tend to get a little bit lower loan-to-value on those projects. For example, our largest project is, in the book, is 43% of the cost and 39% of appraised value. So we think those are our best assets, best structured, best leverage in many cases in the portfolio.

As far as that being a large concentration for us, what I would tell you is, today, the largest single loan we've got is about 80% of our legal loan limit, more or less. That's not an exact number, but a close approximation, and then you get down to 70% sort of for the next one. If you go back to 2008, 2009, 2010 time period, we had a number of loans that were at or within a couple of percentage points being at our full legal loan limit. So our concentrations, while they seem like big numbers now because our capital is multiple times what it was, many multiples of what it was a decade ago or 20 years ago, we've always done large loans relative to our capital account, and we're actually more diversified, less concentrated now than we've probably been at any point in my 41-year history of being Chairman and CEO of the company. So we feel very good about those loans. And we think the quality of those credits, the quality, the sponsorship, the quality of the assets, the structure and leverage on the transactions will prove over time what good projects and good investments they are for. So we feel very good about it.

Brannon, do you want to add anything to that since they're all your loans?

Brannon Hamblen
You hit the nail on the head, I think, to the quality of the sponsorships and the structures and that low leverage brings in more often in these big deals a second really material capital source in the mezz loans that are behind us and, I don't know, call it, 1/3 of our loans. So that would be the only thing I'd add is that you kind of get a 2-for-1 in those situations of really strong, very well-capitalized groups that add a lot of credit quality, in our opinion, to those large loans.

Michael Rose
As we think about RESG and the other side of the pandemic at some point, RESG has historically been a very high-growth business for you, do you think it's structurally changed where we're not going to need as much space going forward and we're not going to have to build as much stuff ex population growth? Have the dynamics of the business changed enough where this becomes a very mature business? Or is there still enough on the other side of this? Do you think that this will be an elevated growth driver for you guys?

George Gleason
That's a really good question, Michael, and I'll give you my answer and let Brannon weigh in with his perspective on that. But clearly, you have periods in the CRE cycles or environment where you have more need for product and then you have periods where you have less need for product. And I think it's very likely that in the aftermath of the pandemic here that we'll have a period where there will be less need for all types of product. And then economic conditions will evolve and you'll suddenly have situations where you need more apartments, you need more hotels, you need more office. And it may be different needs than existed before, but you will have a need. And also against that backdrop, people are going to continue to develop properties because properties age and become less desirable and less obsolete, and people can build a new product that has modern, fresh amenities and features to it that makes it more desirable than the old stale product that is out there. And that's one of the keys of our RESG business is, a lot of times, you're financing an office building or a hotel or apartments, and there are already office building, hotels and apartments in that market. But some of those have become less desirable

because they're dated and they're stale, and the features, the amenities, the look and condition of those properties are no longer desirable. If we were a permanent lender, you have to worry about the fact that your assets are constantly becoming obsolete because the world is constantly changing. If you're a construction and development lender, we just got to make sure that our sponsors are building product that's going to meet the evolving expectations, needs and wants of users of that product going forward. So our product is always the newest, freshest, and best in the market. If our sponsors are building the right product, it's our job to make sure we don't finance them if they're not building product but has a high market acceptance.

Your permanent lenders, on the other hand, are the guys that have the challenge. They say, "Wow, this was a great product a decade ago or two decades ago, but it's become obsolete." And we -- in one of our recent experiences that's been well publicized, a shopping center in South Carolina, you saw that. That was a situation where we had a permanent loan, and that property just became functionally obsolete because of changes in the retail space. The 90-something percent, high 90-something percent, of RESG's portfolio is construction and development loans, and those are all fresh, state-of-the-art properties. So I think we're extremely well positioned for an environment where, for a few years, you may have a need for less new product. I think the other dynamic that's going to play into that is I think a lot of folks that have gotten into the CRE space and financing are going to decide, wow, this is not as easy as RESG, Bank OZK, made it look. Maybe we shouldn't be doing this. And I think you'll have some folks back out of the space permanently, which will let us get a bigger share of the pie with less competition.

Brock Vandervliet – *UBS Securities*
I think you guys are to be congratulated in your deferment policies. I think too many of the banks have just kind of air-dropped these things, and it's good to see a lender who's more judicious. On the RESG issue, I feel like -- I get the stoppage, the construction stoppage. I think here in New York state, they've stopped all construction. It doesn't seem like it's a big deal at all. It seems like the ultimate pain point, though, is takeout financing, where, to your point, George, longer-term, some of these things may not be viable, but I would worry about projects that are coming in the near term. Do those pencil anymore for the takeout financing if they've got a big slug of retail or even office? It seems like so much of the world may be somewhat changed. Can you talk about the risk to the takeout in the near term? Or maybe this is a question for Brannon.

Brannon Hamblen
Good question and somewhat tied to the previous question and the answer, which I felt like George did a good job of hitting on that. I think as prognosticators, sometimes, we look out at change and view it too positively or too negatively. And with or without COVID, you've got the risk of changing tastes and preferences and the aging of

product, et cetera, et cetera. But with the rate of innovation, the markets are increasingly efficient at seeing, adapting to required change and the finance markets follow. And I think, obviously, as it relates to retail, we have, over time, drastically reduced the amount of exposure that we have in that property type. I think we're down to 0.6% in our retail portfolio, and there's obviously some in our mixed-use portfolio but much smaller, more amenity type situations. And in the office market, as long as I've been in this business, 30 years now, people have been having different opinions about what the right configuration is and how much should we have, should we have open space. And those opinions are always changing and people are trying something new and it results in a new direction. But the fact of the matter is I think that people are going to need office space. There is a time required for conversion to the latest and greatest need. And look, in the past few weeks, the CMBS world has obviously had its struggles, but it's showing signs of life and folks trying to, the issuers trying to do deals. So there's no question that, ultimately, that permanent finance will be our takeout, but this is really reminiscent of the Great Recession and where we were, and as George noted it was a different portfolio, there were smaller projects but a lot is similar and as much as our leverage was all right then, and it's phenomenal now and our ability to wait until those markets recover, which we believe they ultimately will, we actually view as potentially positive with respect to balances on book longer. And all the things that we've noted numerous times before with respect to who we're doing this business with and their inclination to protect their significant equity position and plus the fact that they're just good people that do the right thing.

Brock Vandervliet

Have you disclosed a calendar of completions like what we should be kind of having our eyes on here?

Brannon Hamblen

I don't believe we've disclosed anything with respect to that, Brock.

George Gleason

We have a lot of completions. You can look at the cadence slide that we've got in our, that shows originations and payoffs. And most of the 2017 originations, a large percent of those are either recently completed or will complete this year. So you can look at that and infer a pretty good estimate of completion, but that's not the real question. The question is the quality of those assets and the viability of those assets. I mentioned earlier in response to an earlier question, you may have been in queue and not heard it, but I was asked the question, on balance, do we think this environment is good for RESG or bad for RESG. And I said, on balance, it's good because we like keeping loans on the books longer.

We would, you've heard us complain over the last several years about the fact that the velocity of payoffs got faster and faster and faster, and that was cutting into our returns on individual loans. So if the secondary market is disrupted for a few months or a few quarters or a year or two, and those loans stay on the books longer term, we're fine with that because we've got very low leverage on those loans and we've got very good rates on them. We've got the construction loan rates. So if you can have construction loan, our construction loan leverage, roughly 50% of cost or 51%, whatever it is, or low 40s of appraised value on an asset and keep it on the books for an extra six months or a year or 18 months, I doubt we'll get to keep it in at 18 months, but six months or a year extra and earn our construction rates of interest on that, that's really good because the permanent lender that will take them out will charge a much lower rate and will give them 1.5 times to 2.5 times as much leverage as we have on the asset. So if we've got a $100 million loan, the permanent loan is going to be $150 million, $200 million, $225 million, $250 million and at a lower rate than our loans. So if that market is disrupted and it lets us earn our interest for another six to 12 months, that's a positive for us at our leverage.

Stephen Scouten – *Piper Sandler*

I know you talked about some of your peers maybe thinking your percentage of deferrals were less than theirs. And I'm just wondering how much of the deferral process was you all doing outbound calling versus customer requests that were inbound. It seems like some of the higher numbers we're seeing from banks are due to a lot of outbound calls attempting to put loans in deferral, if that makes any sense.

George Gleason

We've not engaged in outbound calling. We've been responding to customer inquiries. And as I said earlier, if a customer's lost their job or their business has been shut down or they've otherwise legitimately been affected by the COVID-19 situation, we're very receptive to, within the guidelines established by the federal bank regulators, being accommodative to help those guys with the payments over the next few months. On the other hand, you don't want to do that unless there's a legitimate need to do that because the reality is if your interest rates, say, is 5% or 6% on the loan you're deferring 6-month payments, well, that's 2.5% or 3.0% increase in your loan amount. That's a modest increase in your credit exposure profile, but it is an increase in your credit exposure nonetheless. So you don't want to do it unless it's a legitimate case to do it because, otherwise, it just slightly degrades your credit quality profile.

Stephen Scouten

Yes. Makes sense. I'm curious, you guys have, obviously, over time, done such a great job of taking advantage of disruptions in the market, and obviously, you talked about the muni investments that were, unfortunately, or fortunately, I guess, to the market short-lived. But I'm wondering what else you guys are seeing in terms of opportunistic ways to deploy the capital that you all have probably rightly been holding for just such of these opportunities.

George Gleason

Well, I do think a lot of business opportunities in the RESG world are coming back our way. We are in a situation where in most product types we're able to get better pricing. Now that better pricing is simply a reflection of the fact that we're having to put up more credit reserves using CECL, and applying CECL in a very difficult economic environment that has resulted from the COVID-19 pandemic, you're going to put up higher reserves for them. We saw that materially in the quarter just ended. So you've got to get your loan pricing up to reflect the fact that you're having to post higher reserves on all of these credits. So we've done that. The market conditions have allowed us the opportunity to do that. Hopefully, some of these reserves that we're posting in this environment will ultimately in future years prove to not be needed, and we can recapture some of those. But right now, you're having to post the reserves for them. So you've got to get the pricing for that. So I think we're already seeing some element of pricing come back our way, some element of business volume come back our way in some areas. The counter to that is, in other areas, we're seeing folks that have continued to amp up their aggression on price and quality to the point that we're out of the market, such as our RV & Marine business, where the competition has just gone to a point that we can't, we're pricing deals there but we're not in the market, and we can't get our risk-adjusted returns based on where our competitors are playing. So we're sidelined in that market for all practical purposes, for what I suspect is going to be several quarters.

Stephen Scouten

I'm curious if you could give some detail -- I know you said pricing is improving a little bit. Like you said, some of that is due to credit buildup that has to occur. But kind of where you're able to put LIBOR floors on new production today versus maybe where that is on the unfunded book even just to give us a feel for if those funded loans will fund at a similar rate to what's on balance sheet now? And then any color you can give to that RESG pipeline into 2Q? You intimated that it was still pretty strong but may weaken in the back half of the year. So just wondering if you could frame that up at all.

George Gleason

Let me take you to Figure 14 of the management comments document depicting where our floors are on all of our loans and how they respond in an up and down environment. So 53% of our funded balance are at their floors. 65% of the total commitments are at their floors as of March 31. Now a couple of things that I'll give you a little color on that will help with that is a lot of our RESG loans, I think Tim or Brannon would probably tell you about 65%, more or less, and I'll say 2/3 roughly of our RESG loans are monthly adjustable as opposed to daily adjustable. So those loans weren't at their floor on March 31 but probably hit their floor on April 1 when the monthly adjustment occurred. So that is a little explanation that probably needs to go with that. But you can see in a down 25-bp environment, 59% and 70%, respectively, would be at their floors. And again, part of that is due to not just the timing of those adjustments on the RESG loans being predominantly on the 1st of the month. But the other factor is as LIBOR kind of flared out in March, which was helpful to us and will be helpful to us throughout the month of April. And you've had LIBOR coming down recently pretty nicely every day, unfortunately. And that will cause us to trip more of those floors just as LIBOR adjusted without any further movement in other market rates. But you can see where the floors are as rates rise. I think that table is very helpful if you study it just a little bit.

Stephen Scouten

And as it pertains to framing up to the 2Q pipeline maybe various versus other quarters?

George Gleason

Well, the pipeline is very good going into Q2. And as we say in any quarter, you’ve got to get it closed and booked. But we're feeling pretty good about that pipeline going into Q2. It's hard to know what the second half of the year looks like. We do expect some of the prepayments that we would have expected in the first half of the year to occur in Q3 and Q4 because I think some of the permanent lenders who pulled back away from some deals in Q1 just kind of in shock and awe at what was going on will get their bearings in the market. These are big companies and big investors in the CRE space on a fairly continuous basis. I think they just pulled back to temporarily to get their bearing. So we expect we'll have more significant payments late in the year, particularly probably in Q4 now. So the timing of that sort of moved in our favor, but I think we still get a lot of prepayments in the back half of the year.

And then originations, it's hard to know. You've seen, on the one hand, sponsors pull back from projects because of uncertainty or they're concerned that they can't make their equity returns that they want in the new economic conditions. And at the same time, you've seen a lot of competitors pull back. So we've had calls from people that we lost business to other competitors based on significant rate differential, they're calling and saying our lender dropped us in the grease a week before closing or at the closing table, and we've still got our equity intact. We want to go forward with this project. We believe in it. We know we turned you guys down on your quote, but we'd like to come back and revisit that issue. So you're seeing some projects get put on the shelf. You're seeing some projects come back our way from competitors, and that's why we pulled our loan guidance for the rest of the year as we're just not sure how all that plays out with everything else that's going on in the economy, but we're hopeful. It's too soon to really call how that plays out in Q3 and Q4.

Evan Lisle – *Janney Montgomery Scott LLC*

Focusing on PPP loans, I know you gave a little color on the number of funded loans and the balance. I was just curious looking forward, in what quarters do you expect to realize those numbers.

George Gleason

I don't know that we know that. This whole PPP program has come about really quickly. And when they launched it with quite a bit of unanswered questions and it took a few days and over the weekend to really get enough of those questions answered for most of us banks to feel comfortable going forward with the program. The second phase of that has probably started today. I don't know it may have started already. Whenever the President signs the bill and the SBA opens up their E-Tran pipeline again, we've got another almost 2,000 loans that are fully documented and papered and ready to submit. And our labs team has built a submission piece of software that will allow us to load those loans in about 2 to 3 minutes each as opposed to what normally would be a 60- to 90-minute process for loading those loans onto the SBA system. So we realize it's going to be a race for our customers to get the final dollars in that. So we're working really hard to make sure that we execute really well, but it's important for our customers, it's important for our communities. So we really want to do a good job for them in that. When these actually get forgiven and paid off, that's anybody's guess. It's going to be a huge process, and we think a lot of those may get paid off in pretty short order, but we've never done this before. So we'll see how it works out.

Evan Lisle

Shifting to the margin -- I was just curious about how much of that emergency cut in 1Q was reflected in the reported margin given that LIBOR didn't turn in line with Fed funds throughout much of this quarter. I guess when would you expect the full cut to be reflected.

George Gleason

I think much of it, most of it was reflected in our last month of the quarter's numbers. I think it will pretty much all get reflected in to Q2. And I want Tim to comment on this. He may have a little bit different perspective and color. With that said, though, it's going to take us really through the end of the year and probably through the first quarter of next year to get substantially all of the deposit cost cuts in there. The Fed's really fast action -- they cut 225 basis points in 3 quarters and 150 bps of it in short order here in March -- we could not adjust deposit cost nearly as fast as loan yields went down. So I think you'll see it pretty much all get baked into loan yields in Q2 if it was not already baked into Q1. But it will take us through the end of the year to get substantially all of it through the end of the first quarter of next year on the deposit side.

Tim Hicks

I agree with that, George, and Evan, I'll point you to Figure 40 on Page 32, we mentioned earlier in the call, that will give you some breakout of our CD book by quarter and by rate. And so obviously, we've got a good opportunity to reprice that book down significantly, and that will help drive some of those deposit cost decreases in Q2, Q3, Q4 and into Q1 of next year.

Evan Lisle

Earlier in the call, you touched briefly on the Indirect RV & Marine book. Given that is in a shrink mode, are there any sub-segments that you're more concerned on from a credit standpoint? Any color would be helpful there.

George Gleason

No. The past dues in that portfolio and all are continuing to behave very well. Obviously, it is a consumer portfolio. And when you have had close to 30 million initial jobless claims in the last 6 weeks, and you've got thousands and thousands and thousands, tens of thousands, probably hundreds of thousands of businesses that shut down across the country, that will have some impact on a consumer portfolio. But our decision to let that market just move away from us on pricing and credit is not a result of any conditions in the existing portfolio. It's just a mathematical fact that with some of our competitors being very aggressive on price, others being very aggressive on credit, we just didn't feel like we could be competitive at risk-adjusted returns that had us in the game. So we're pricing the products the way we think it needs to be priced, but that's got us out of the market. So hopefully, the market will come back our way. We feel super confident in our team's ability to execute our business strategy if competitive conditions will allow us to do so. So we're hopeful the market will come back our way over the next few quarters there.

Evan Lisle

Circling back to my first question on the PPP loans, just a housekeeping item. What's a good average rate to use for fees on that?

George Gleason

Probably in the 3s.

George Gleason

All right. Thank you, guys, all for joining the call today. We appreciate the great questions and your continued interest in Bank OZK. We look forward to talking with you in about 90 days. Stay safe, stay well. Have a good rest of the day. Thank you. That concludes our call.