Bank OZK

Transcript of the Second Quarter 2024 Conference Call

July 18, 2024, 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, Carmen, to remind our listeners how to cue in for questions.

Matt Olney – *Stephens Inc.*

I want to start off on that San Diego life science project and the additional capital that you disclosed in the management commentary. Any color on why the amount of the $87 million that was included? Presumably the new capital partners have some type of intrinsic value they're assuming on the project? Any color on how we arrived at $87 million?

George Gleason

Matt, our loans all include reserve replenishment requirements that are subject to a calculation in our reasonable judgment. And that was simply a mathematical calculation based on our judgment per the loan documents. It was a regularly scheduled reserve replenishment that was required to come from additional equity, and there was no magic to it. It was just a mathematical calculation.

Matt Olney

Following up there, the $87 million, did it come in the form of additional collateral? Or did the new mezzanine partner take out the original equity sponsor? Just any more details behind the transaction that took place.

George Gleason

The original equity sponsor is fully engaged in the transaction and pursuing it. The mezzanine partner is fully engaged in the transaction and pursuing it. It came in the form of cash by wire transfer as almost all capital contributions do, into an account in the bank, where it's held as a reserve for future interest and expenses on the deal. It was a very standard deal. There was no drama or nothing unique about it. It was a standard replenishment of reserves.

If the analyst who wrote the research on the report on this project had bothered to ask us any questions about it regarding what's your capital structure like, who's in it, are they going to continue to support it and so forth, we could have explained it. We have two very strong parties in this transaction. We've done a lot of business with the mezzanine lender in this who is the stronger of the two partners by far. Their capability to support the project financially, as well as executed if they had to, is clear cut.

The sponsor is fully engaged in this. They're proceeding with the transaction. The mezzanine partner is there if needed. This thing should have never gotten the attention it deserved. It’s a great asset, five great

buildings and probably one of the best locations on the West Coast with a very strong, very capable sponsor and capital partner group supporting it.

If it takes two years to lease or three years to lease or five years to lease those guys will get to the finish line on it. I'm confident. That's certainly our view of it. If we had been asked questions about it, I think we could have avoided all the drama and unnecessary publicity about this project because it's an excellent asset. As we said in our Management Comments, we've given full disclosure on it there, we consider it a high-quality asset and we don't expect to discuss it again.

Matt Olney
Appreciate that and appreciate all the good disclosures on that project.

One of the questions that I'm getting from investors is, they are just trying to understand the circumstances that would result in a construction loan to be graded below pass rated. Not necessarily for any specific project, just more broadly, if the construction loan is still under its interest reserve period, but the lease-ups are behind plan, or something is behind plan for the project. Help us just appreciate the circumstances that would drive that construction loan to be below pass rated.

George Gleason
It's going to depend on a totality of circumstances. Number one, we're always looking at the strength and quality of sponsorship and capital partners and their investment and their commitment to continue to support a project that may be maturing a little more slowly than was originally expected. Sponsorship, quality of sponsorship, capabilities of sponsorship are certainly #1.

Number 2 is the long-term expected prognosis and outcome on that project. It's not particularly alarming to us that a project delivers without leasing. The question that really drives our evaluation of a project is #1, do the sponsors have the will and the capability to support a project until you have a successful outcome. Number 2 is the project of the quality in nature that you're going to have a successful outcome, whether it's this year or next year, or three or four years down the road.

If you've got sponsors who have the motivation and the capacity to carry it, and the project is going to ultimately have a successful outcome, then you certainly have a positive view of the project. The San Diego project certainly fits those criteria.

The motivation that drives our customers to support their project is largely dependent upon the tremendous investments they have in the projects. Our average loan-to-cost on our portfolio is 51%. Our average loan-to-value is 42%, even with all the reappraisals in this cycle. That's still where we are on a weighted average loan-to-cost and loan-to-value basis. When you've got 50% of the cost of a project invested as equity, preferred equity or mezzanine, your subordinated members of the capital structure have, by the very nature of the cap stack, have an inherent motivation to defend that investment.

For example, our loan on the San Diego project is $0.5 billion. The capital partners in that, the equity and mezzanine, have over $1 billion committed to that project. They are not going to walk away from a billion investment lightly. The second part of the test is, is the project capable of having a successful execution?

There's a lot of noise in the CRE world today about projects that are just totally dead. Those are projects that are principally older projects that are in bad locations, have 50 or 60 or 30 or 40-year-old designs that are not built to current standards. The combination of our low leverage and the fact that we've got ground-up new construction that is built to modern standards, modern needs, modern expectations from tenant and buyers says that our sponsors have i.) a huge incentive because of their big investment,
and ii.), a motivation to continue to support it because our projects will ultimately lease or sell and be successful.

The other thing I would tell you about that is we talk a lot, and we've said this since the Fed started raising rates, that we expected the vast majority of our sponsors would continue to support their projects until economic conditions normalized or property performance reached a stabilized state. That's certainly true.

While we have a handful of substandard loans and a handful of special mention loans in the RESG portfolio, all of those loans are current and the sponsors remain engaged in working towards solutions on those projects. The only two instances we've had where sponsors have given up on a project are the two pieces of OREO we have. Every one of our substandard credits is current and performing in the sense that it's not past due.

We put one of them on nonaccrual because we wrote it down. What caused us to do that is some noise from the sponsors about their commitment on that small project to continue to support it. We consider that the most challenged project we've got. Even with that, the sponsors have made their monthly interest payment out of their pocket this month, and they continue to work, to try to craft a path forward that will

salvage some of their investment and keep our loan current. We wrote it down, we classified it, because we take a pretty conservative proactive view on these things, but it's still a current loan.

Catherine Mealor – *Keefe, Bruyette, & Woods, Inc.*
Let's start on paydowns, which were accelerated this quarter. I know that you mentioned there were two larger loans that paid down. But just any thoughts on what you think that will look like for the back half of the year? Are there any larger credits that you foresee coming in? Or was this kind of large level anomaly? Will you kind of get back to more like the $800 million to $1 billion kind of pace that we've seen recently in the back half of the year?

George Gleason
Catherine, we were happy this quarter to have included in all of our prior quarterly discussions about paydowns the comment that paydowns may vary significantly from quarter-to-quarter and may have a significant impact in one quarter or another. True to that form, you've seen a wide dispersion in paydowns in the first two quarters of this year -- $790 million in Q1 and $1.840 billion in Q2.

We have telegraphed for some time that we expected a higher level of RESG repayments in the future, and that future showed its first signs of manifesting in the quarter just ended. I think when we really see a greater acceleration of pay downs quarter-to-quarter will be when the Fed starts reducing rates and probably a couple of cuts into that initiative, you'll really begin to see some projects move.
My best guess, and I'm going to lean heavily on our long-standing comment that repayments can vary significantly from quarter-to- quarter, but my best guess is that Q1 and Q2 of this year sort of frame a range within which our Q3 and Q4 repayments will fall. I'd be very surprised if we had over $1.84 billion in repayments in Q3 or Q4 because I don't think the Fed is going to move rates until September or December. I think, really getting more big quarters of paydowns is probably going to be dependent on getting some rate movement. I think Q1 was low, Q2 was high, Q3 and Q4 probably fall somewhere in the middle of those is our current best guess.

Catherine Mealor
That makes sense. As we think about paydowns accelerating next year and trying to refill that bucket, I know there's a lot of momentum in your CIB business, and that's now $2 billion or about 7% of loans. Can you just talk a little bit about your outlook for that business?

What size loans are you typically doing, or you expect to do? And maybe how fast would you expect this business to grow over the next couple of years to refill potentially a decline in RESG balances?

George Gleason

Yes. I'm going to ask Brannon Hamblen, who's on the line with us to comment on CIB and the importance of that handoff for continued growth in our balance sheet in the future years.

Brannon Hamblen

Great question about a topic that you have heard us talk more about and will see us talk more about in the future. As George indicated, there's a great sort of transition in front of us as RESG repayments start to come in. This is something we've been working on for a while. The latest hires and the expansion of the team that we've made are really just the latest evolution of a strategy that we've been working on for quite some time.

The CIB team, as we've said, is made up of several different sort of sub business lines, and three of those were in place, ABLG and equipment finance the most recent additions the last couple of years, and those teams have really started to hit their stride. We've also added some new team members. We've had some phenomenal opportunities to have some folks join our team that are really incredibly talented, incredibly connected, who have had great performance already in their respective careers and they've got a credit mindset that's really well suited to our priorities, which, as you know, are always quality and in yield ahead of growth. But they have, as you can see, demonstrated the ability to achieve all three.

As it relates to sort of the size of credits, it's a lot like RESG in that we have a pretty good spread in terms of the size of the credits. The loans aren't as big as some of the RESG loans, but it's not uncommon to sort of live in that, call it, $30 million to $100 million to $150 million range. We'll have some that will be bigger. But they're solid credits, highly monitored credits, that we expect to have very good credit quality on. And as we said, you noted it’s 7% of the funded portfolio, that's $2.1 billion. They actually originated over $500 million in the quarter just ended. As we see the repayments likely accelerate, as George said, in the near future, we believe we've orchestrated what should be a pretty smooth hand off, sort of passing of the loan growth baton, if you will, from RESG to CIB in a very beneficial manner. I think we've got a great shot at timing that in an almost optimal manner. We're extremely excited about the opportunity there to grow, grow and diversify our book.

Manan Gosalia – ***Morgan Stanley***

You noted that sponsors have a lot of motivation to support the properties given how much they've invested at the bottom of the cap stack. I'm assuming that if the property is taking time to lease, it also stays on your books for longer. My question is, what does the borrower do in the meantime? Is it an interest-only loan until it repays? Do they bring in more reserves? Can you explain what risk mitigants you bake in when loans are extended and they essentially stay on the books for longer?

George Gleason

What I would tell you is our portfolio management to date through this cycle has not resulted in any concessions by us on any of those loans that would constitute one of those loans having been a TDR, troubled debt restructuring, if we were in the old accounting world where there were TDRs.

We're sensitive to make sure that we're not becoming equity like in our handling of the transaction if it takes time to work these things out. We continue to maintain market rates on those current rates on those. In many cases we're improving the terms. The sponsors typically have to pay standard or upsized fees to extend those loans and we require replenishment of reserves as we deem appropriate. And in many cases, are getting principal pay downs on those loans.

Equity is equity, equity has equity responsibilities. We're the senior secured loan. We don't have equity responsibilities. The equity has to do the equity lifting on these things. But as I said, where needed, our sponsors have done that with the exception of the two sponsorship groups that we have those OREO properties in there.

Yes, loans may stay on the books longer, but those loans are structured in a way that we feel good about them staying on the books longer. We're making substantial profits on those. As long as the sponsors are doing the right thing on those credits, we're happy to have those loans on the book.

I'll give you a good example. Our longest-standing classified asset in the RESG portfolio is the project out, the development out near Lake Tahoe that we had some nice progress on that in the last quarter with a sponsor selling the club amenities. That development project had reached the point of maturation that it was time and the opportunity was there to sell those club amenities that resulted in an $11.1 million paydown in our loan.

I believe, and I haven't looked at this in probably since the beginning of the year, but I believe that over the life of that loan, our sponsors have paid us $30-something million in interest and fees on that loan, which is roughly about the same as our $32.3 million funded balance. While we would prefer to not have a classified loan on the books long term, if the sponsor is doing the right thing, and working the project and paying the interest and paying the fees and performing on the loan, we're going to do the right thing and work with the sponsor.

Again, we would prefer to not have a classified asset on the books for a long time. But our principles of do the right thing always mean that we got to do the right thing for our sponsor. The sponsor has got a project that's got challenges, they're rising up and doing the equity responsibilities to meet those challenges. Then we've got to be fair and reasonable and work with the sponsor on our originally agreed terms to get that project to a successful conclusion. We're going to do the senior lender thing. They have got to do the equity responsibilities, but we have got to be fair and reasonable with them. And that's profitable for us to do it even if we would prefer to not have the classified asset.

Manan Gosalia

That's great color. Maybe as a follow-up on NII. I noticed the proportion of NII coming from interest reserves has been ticking up slightly. Can you talk a little bit more about that dynamic? Is that indicative of more stress in general in the CRE market? Or is it just a function of loans just staying on the books for a longer time while rates are higher? Can you just walk us through how that works?

George Gleason

It is not a function of any stress at all whatsoever. Money coming from interest reserves, sounds like, oh my gosh, you're burning down your reserve. But here's the deal. When you put together a loan, you have a capital stack on that loan and the sources and uses of funds on that loan from Day 1. So, interest over the period of construction, the life of the construction of the loan is built into that.

You've got your land cost, you've got your hard construction costs, you've got your closing cost and fees, your tenant improvement and leasing commissions, your interest reserve, your tax reserve, all the costs that go into the cap stack. We want the sponsors to put all of their equity in before we put in. If we say to the sponsor, okay, you're going to fund 50% of the cost of this $200 million project, we want all your $100 million to come in first. Well, there's no interest at the beginning. So, all the sponsor's money is going to come into the land and the architect fees and the closing cost and the title policy in the beginning

initial construction. Then we start funding the last $100 million of the loan. Well, that's going to complete construction. But that's when all of your interest is going to occur.

All of the interest on these loans is typically in our budget, not because we're subsidizing the project by carrying the interest, but we made the sponsor put in all of their equity upfront. Now we could be really stupid and not structure the loan in an intelligent manner and say, okay, sponsor, you put in $85 million of your $100 million upfront and then when it comes time to pay the interest write checks for the other $15 million, that's the interest. But then what if the sponsor doesn't write the checks or what if he doesn't have the $15 million? So, we get all the sponsor money upfront because that's the smart safe way to do it. That means all the interest reserve is in our loan.

As all those loans, that big record volume of originations we had in 2022, fund up more interest is being funded from interest reserves than before. It doesn't mean anything about weakness in those credits. It just means that we're smart in the way we structure these loans. We make sure we've got the equity, or the equity in first, so that there's no doubt about the equity coming in later. And that means the interest reserve is built on our loan. It is not in any way a sign of weakness.

Our loan is also structured so that if we get to the end of construction and the project is not leasing or selling or refinancing as quickly, then the sponsor has an obligation to replenish those interest reserves. And that's happening with virtually every loan extension modification and renewal. Those sponsors having to put more equity into the project to replenish those reserves, to carry it longer because we've got built into our budget enough interest typically to carry it through construction and what was expected to be stabilization of the project. If it takes longer to get to stabilization, then the sponsor has to write additional checks to carry it, and that's an equity responsibility, not a lender responsibility.

Michael Rose – ***Raymond James***
To go back to the life science credit, not to beat a dead horse here, but I think one of the things that I heard from investors is kind of the spec nature of that project in particular. And I just wanted to get a sense if you have some sort of proportion of loans, or percentage of loans, that the projects are somewhat spec in nature because I think, relative to your history, somewhat contrary to what you typically do, where there's a lot of analytical work done, you're pretty sure of the lease-ups, even in the condo stuff, during some more difficult challenges? Good projects in good markets. Is that a concern that we should be worried about? It's certainly a question I'm getting. We'd just love some general commentary there.

George Gleason

No, I don't think it's a concern you should be worried about at all, and it's not any sort of change in our business strategy. Large parts of what we have done over the 23-year history of RESG are unleased properties. The very first loan that we made was on a totally unleased property. It's inherent in our business model and it's reflected in the 8-basis point annualized net charge-off ratio of that portfolio over the 23-year history. Now we love leasing, and we love it when transactions come to us and have pre-leasing. But the vast majority of the transactions we've always done have not had significant pre-leasing in them.

Now back when we did retail, and if you go back to 2010 or so, 2011, retail was probably 20% or 30% of our portfolio there. Pre-leasing was inherent in all of those deals because you don't build a shopping center spec -- you've got leases lined up. Condos in Miami, you almost always have a high level of presales, in most cases, when you close the loan you have enough presales to repay your loan with 30% to 50% deposits down. Condos in New York, since your offering circular has to be approved and go through a process with the state government there, that process typically doesn't happen until you're midway through construction or further. You typically have 0 pre-sales on a New York condo project. If you do get to a point of having presales, you typically got 10% or 20% deposits instead of the 30% to 50% deposits in Miami.

These things vary all over the country by product type and geography. We know what the market is. We know how business is done in all those markets across the country. Our loans sponsorship structure, capitalization, leverage points are all designed to be appropriate mitigants to those risks. There's no degradation or shift in the way we're underwriting or thinking about things. This is what we've always done, and we feel very good about that.

Michael Rose

Certainly, appreciate the focus on CIB and then kind of in the other areas of the portfolio. Is the ramp up there and maybe what we're kind of expecting for pay downs, is this all to help drive the CRE concentration ratio below 300% over time? I know there's been a big regulatory focus there. We've actually seen some capital raises to address those issues, some sales, some acquisitions as well as some sales of banks as well. But how should we think about that for you guys? I know you guys have always kind of operated above the 300% / 100% guidelines, and kind of is the goal over time to migrate below those thresholds?

George Gleason

The goal is to diversify our balance sheet. Michael, I so appreciate that question. Thank you for asking it. We have built a level of expertise and understanding of commercial real estate in our Real Estate Specialties Group that is exceptional, in my view, and highly differentiated from the way most folks understand and think about commercial real estate. We have established ourselves as the leader in that field among banks and really among all the lenders, including the debt funds, I think we enjoy a great deal of respect for what we do and a clear understanding within the real estate community that we're different than other people. And we're very conservative, but we deliver a level of execution and expertise that is worth paying for even with our conservative view on projects.

We have built a very high-performing business with Real Estate Specialties Group, and we want to continue to let that group grow and seize every opportunity that meets our conservative high-quality underwriting standards. We also realize that our performance metrics -- look at our ROAA, look at our efficiency, look at our return on equity, look at all of our numbers. We ought to be trading at a 2 or 3 multiple premium to peers because our financial performance, consistently over the time we've been public, consistently has been at the top of the industry. We're not getting that premium.

We know we're not getting that premium because there are a whole bunch of folks that don't understand the unique expertise and capabilities and conservative approach we take to commercial real estate. Yes, commercial real estate is a complicated business, and it can be risky if you don't do it in an extremely disciplined manner, and we are extremely disciplined. We don't want to lose that extraordinary business we've built, but we also realized if we let RESG grow to its full potential, and we grow other high-quality businesses around it, so it goes from being what at the peak was 70% of the funded balance of our loans to over the next several years to 50% of the funded balance of our loans because Indirect Marine & RV and CIB and Community Banking lines of business, Consumer lines business and our Community Banking world all grow that, that's going to let us achieve the multiple -- the 2 or 3 premium multiple that we ought to have based on our company's performance as opposed to suffering a 2 or 3 multiple discount because we're the poster child for CRE, even though we do it differently, than everybody else.

The answer to your question is, yes, we want to diversify. We're not specifically focused on getting below the 300% and 100% thresholds. That will probably be a natural byproduct though of diversification. It's not the goal. It's just a byproduct of diversifying our balance sheet so that we can get the multiple that our shareholders deserve for the high-quality performance we put up.

Stephen Scouten – *Piper | Sandler*

I know there's been a couple of questions around CIB already, and Brannon, I appreciate your color to Catherine's question, but specifically, it seemed the commentary around the expense commentary of aggressive hiring within that segment, can you give me a view for what that looks like in terms of how many people you might have there now? And how large you want to build that team? As we saw this quarter, have we started to reach that handoff point where CIB, Indirect RV & Marine are going to continue to exceed RESG contributions here near term?

George Gleason

Yes. I would tell you, on the Indirect RV & Marine, we've targeted that to be between 10% and 15% of our portfolio. We were bouncing along for a long while about 11% of total portfolio, I think it bounced up to like 12% in the quarter just ended. That's going to stay in that 10% to 15% range. It may get to 13%, who knows. We're not adding a lot of people there. We are adding a few, but they're just marginal incremental staff additions.

We had, as Brannon mentioned, a nucleus of folks in Fund Finance and Asset-Based Lending and Equipment Finance that was, I don't know, 8 or 10 people who were doing those lines of business for us before. I would guess our head count in the last 6 months, Brannon is approaching 30 or so people in those?

Brannon Hamblen

George, yes. I think it's probably a little north of there. They've been, as you know, really finding great opportunities to bring on, across not just your sort of origination side, but they have, as I said, a very like mindset around credit. They really take a strategic and calculated approach to how they're focused on what they're lending on, who they're lending to, how that can be built into cross-sell opportunities across the organization, how they can manage the loans, which are all senior in nature, that are all stressed for downside when they're originated, but how they can manage those with a great sort of portfolio management group as well.

You brought up RESG. There is really a lot of similarities in the way that infrastructure is being built and how it's being built for defensive structuring and underwriting on the front side, but also, it's a very significantly monitored portfolio. It's not a covenant-light kind of platform, but really digging in deep to the front and middle all the way to the end of the loan life cycle.

Yes, they've been hiring and have made some great hires on the origination side, but also some strong hires on the portfolio management side. As you know, from the way we've run RESG and really the organization since George bought it, has been quality, quality, quality and make sure that portfolio is populated with the right kind of credits and managed the right way throughout and is sustainable and scalable -- and these guys are well along the path to doing that.

Stephen Scouten

Just to clarify, has that kind of significant expansion you guys mentioned in the Management Comments kind of already occurred? Or it's kind of ongoing, like it's expanded a lot already, but it will continue to expand from a head count perspective?

George Gleason

We've gone from the original nucleus of folks -- we had probably around eight or ten people in that area, eight or ten high-quality people. I would tell you that we're building in and around, under and over that group because it is a great group that we had. But there were, I don't know, eight or ten people, maybe 12 at max. We're, as Brandon said, probably north of 30 people now. And that group will continue to grow. We'll end up with 40 and then 50 and then 60 and then more people there probably by this time next year, I would guess we will have continued to grow that and be in the 50 to 60 person range there.

These are highly skilled people that are not cheap. That's why Tim, as we're having success hiring people, and more frankly, we're having more success hiring more highly skilled quality people than we thought possible, and that's why Tim is having to catch his expense guidance up a couple of percent growth rate because we're finding more high-quality people than we thought we could.

You guys have heard me speak at length about people are critical to our business and high-quality, talented, smart, experienced people are essential to our business. We're in an unusual window here with a lot of banks having pulled back to add a lot of talent. It's time to harvest that talent, get those guys on the team and mature those businesses further while we can add the excellent talent.

Stephen Scouten

On the capital side, I mean, I know some of these larger repayments obviously open up some capital -- and you announced the share repurchase. I would presume that slates to be more opportunistic? Then can you talk about how that would maybe stand against potential M&A as another ability to deploy capital

and also diversify the balance sheet? It feels like we might be on the precipice of a big pickup in M&A. So just kind of wondering how you guys are thinking about that given your strong track record there?

George Gleason

First, if any FDIC transactions occur, we would love to have an opportunity on those. You probably noted the one sizable deal that's occurred this year, we were in the bidder group on that. We'll continue to look very favorably on opportunities to acquire failed bank transactions if there are any. That is always a preferred way. We've got a great track record and history doing that. That would be the preferred way.

Tim, do you want to comment a little more on stock repurchases, capital and regular way M&A?

Tim Hicks

Yes. Certainly, a lot of positive things on capital this quarter. We haven't really talked about, so far on this call, how good a quarter it was as far as earnings. The seventh consecutive record earnings really is an amazing track record and you saw during this quarter with the additional repayments and saw our unfunded balance go down, just really the power of that earnings on capital.

When we have less growth than we've had in recent quarters, you saw our risk-based capital ratios expand nearly 30 basis points. That does open up opportunities. We felt like having a share repurchase authorization in place was prudent to be able to utilize that when there's lower growth at times.

M&A, to your point, is another way to use capital. We've been active at times, and we certainly continue to look at M&A in a very disciplined manner. Certainly, a lot of banks out there that have mark-to-market adjustments that would need to be considered if you're looking at M&A. As George alluded to, we've already been active in looking at FDIC deals this year and certainly would be active and if any other showed up as well.

As you said, we try to be very prudent in how we manage our capital. It was nice to see the earnings power that we had and our growth in growth in risk-based capital ratios and our TCE was up, TCE ratio was up during the quarter, our tangible book value over 12 months has been up $5.18. Another good track record there. A lot of positive things happening in this quarter.

Timur Braziler – ***Wells Fargo***

I wanted to ask my first question, maybe a little bit more of a nuanced question, as to the interplay of internal risk ratings when leasing trends don't match kind of expectations that were set at the underwriting. Is there anything happening beneath the scenes when leasing kind of doesn't match underwriting expectations?

George Gleason

The answer is yes, reappraisals or internal evaluations of loans reflect changes in leasing expectations and if the expectation is that leasing is not going to just take longer but occur at lower rates or with higher TI costs that is built into the NOI of those projects. So those factors do find their way into risk ratings.

Over the eight quarters now that the Fed has first raised rates and then for the last two or three quarters, kept them at very high levels, we've seen a migration of risk ratings within our portfolio. We have 72 risk ratings in the portfolio and a lot of those are pass ratings. A lot of them are low pass ratings and then you get to the more rarified special mention and substandard ratings.

There's been a migration from one pass category to another pass category or a pass category to a low pass category that you've not seen. That's just a reflection of higher for longer, creates challenges for our sponsors and the projects. You have seen the evidence of those risk ratings. While we don't disclose those 72 risk ratings. You've seen the evidence of that migration in the fact that over the last eight quarters, our reserve for credit losses has almost doubled from $300 million to $574 million. That's a $274 million increase in our ACL after the modest charge-offs we've experienced, granted a chunk of that was for portfolio growth, but you can see the qualitative migration and in fact that, that reserve percentage has gone from 0.83% of total loans and commitments to 1.19% of total loans and commitments over that period of time. That 36-basis point increase in the ACL percentage as a percent of total loans funded and unfunded reflects the migration that has occurred in those risk ratings of that portfolio.

Again, we feel very good about the portfolio. As we said in January, we expect charge-offs this year to be higher than last year but still well below industry average. That continues to be our expectation. That's not an indication of any sort of serious weakness in the portfolio. It's just a reflection of the fact that these high interest rates cause stress and some of that stress is going to translate through into losses now for the first six months of the year. Our six-month charge-off ratio is just minutely up over last year's net charge-off ratio. But that could drift higher in the second half of the year. But again, that's why we built $274

million in additional ACL over the last eight+ quarters is the expectation there would be some credit deterioration.

Timur Braziler

As a follow-up, looking at the life science sector, specifically, I think some of the cyclical pressures there and some of the recent projects that have come online and have been kind of widely noted. What are your expectations for broader life sciences? Do you need reversal of some of these cyclical trends in order to lease up some of these projects? What's the availability to convert some of the existing office space to suit other industries outside of life sciences?

George Gleason

One of our clients, when I was on the West Coast a couple of months ago, who does Life Science, showed me a very interesting graph which was not our materials. We've not reproduced it and shared it, but it showed the venture capital and IPO money going into the life science industry over like the last two or three years. There was a steady flow of funds into the space when interest rates begin to rise and venture capital funding slowed. Then, in the wake of Silicon Valley Bank, there was a significant slowdown in venture capital funding in the IPO market when there were thoughts 15, 16 months ago that there was going to be a banking crisis that was going to have some sort of systemic impact. IPO markets sort of dried up as well. You had a significant period of time there where there was very, very little new money flowing in the life science space from venture capital and IPOs.

Starting late last year, September, October, that began to click up a little bit. This chart I was looking at, and again, this was a couple of months ago, but it was a steady monthly progression of increase in money flowing into the life science space to people who do that business, who operate those businesses from venture capital and IPOs. You've also seen there have been several announced acquisitions of smaller life science companies by bigger life science companies. Those are the things that drive the demand for life science space.

When I was on the West Coast, San Francisco and Seattle a couple of months ago, the clients there who do life science were very encouraged by the uptick in tenant inquiries in recent months caused by the fact that funding is returning to that space after a hiatus of funding for that space last year.

We've seen a little bit of that translate into leases. We've heard quite a bit of chatter from different life science sponsors suggesting that they're seeing a meaningful uptick in interest in space. I think it's way premature to talk about repurposing life science space for conventional office or other purposes. The space is able to be repurposed for conventional office easily. One of the clients that we met with when I was in San Francisco had a national credit tenant quality tenant looking at an entire building that they had built for life science. It was not a life science tenant, but tenant liked the building, liked the location that fit the needs for their people. They were in contention along with several other buildings as a solution for the space needs for that tenant. That was not a life science tenant even though the building was built to high purpose-built life science standards.

It is convertible, but I think you're going to see a significant improvement in leasing over the next 12 months or so in the life science space because capital is returning to that space. Certainly, the aging of not only our U.S. but the world population, the increased focus on health care at the government level, there are just a lot of factors that are favorable long-term factors for the life science industry. I think you're going to see improved leasing conditions there.

Samuel Varga – ***UBS***
I wanted to just switch back to payoffs just for a second. I'm hoping to sort of dive a little bit into your view of the industry. When I'm thinking about the permanent market I am assuming these projects as they pay off, are there certain types of buildings or industries that are sort of more ready from a permanent market perspective? Or there's no real trend that you can see yet at this point?

Brannon Hamblen
Yes, we've been tracking our repayments to try to understand, Samuel, exactly that the answer to that question. We're starting to actually see some movement there in terms of how much is being refinanced, how much is actually being paid off from sale, and what what's going on there.

In the first quarter, all of our repayments were coming from refinance opportunities. In the second quarter, we actually had a pretty good number, I think, of the 17 payoffs that we had, we actually had a couple of that sold, of course, our condo projects sell out. Then we actually had, I don't know if it's permanent financing, I'm guessing it's temporary, but some folks just pay us off without debt. We did have 11, I think, of those were refi by third party. In most cases, it's going to be more of a bridge solution. The interest rate levels are still at a place where, as we said before, our sponsors are carefully monitoring

what's going on there. Everyone realizes we've been strung along over the last eight, nine months around visions of rate reductions that would spur that refinance market. At the end of the day, we're still seeing good refinance activity in our projects. I think most of it, though, is going to be more at the bridge level, still floating rate. Still short term where they can move on to a more desirable, and for them, profitable long-term financing. There is long-term financing going on out there, but I don't think a lot of it is hitting our portfolio.

George Gleason
Brannon, I would add to that. Where we are seeing a lot of really permanent long-term financing is in the multifamily space because your Fannie and Freddie financing is a very stable, very cost-effective source of financing. That's where we're seeing a lot of people really salt some assets away permanently. I think you would agree with that, Brannon.

Brannon Hamblen
The multifamily is definitely the place that, that happens.

George Gleason
Yes. But there is a lot of bridge financing coming in to sponsors.

Samuel Varga
Then just my follow-up is around loan yields. I'm trying to get a better sense of the residential originations that are currently funding up so far. Are those due to spreads roughly approximate the book average spread over SOFR? Or is there a difference there?

As an addition to that, too, on the indirect side, as you add sort of an extra percentage points, let's say, of the loan book into that portfolio, what are the book yields on those? And are those floating rate as well?

Brannon Hamblen
I'll take the RESG George, and you can dive into indirect. A lot of the spread data is going to be determined by what types of projects you're doing, and how you're working hard market in market out. The guys are doing a phenomenal job really at the same time originating at lower leverage still getting strong spreads.

Of course, our condo loans, which George discussed earlier, we view as some of our safest lending opportunities given the strong presales, especially in the Southeast in Miami, more particularly where Greg has continued to see a lot of opportunity, you tend to get strong spreads on that product type. Depending on how the book is weighted in terms of different product types, it will move.

I believe, generally, I've done a real thorough comparison on that, but I think the spreads today are comparing favorably to what we've got on the book.

Samuel Varga

I was just wondering if you can give some color on the indirect book yield and where those originations are coming in. Are those also floating rates? Or are there some fixed components out there?

George Gleason

The indirect stuff is always all fixed, the RESG stuff is always all variable. I can't give you any color on the indirect really I don't think has moved very much in the last 90 days from where we were, and we continue to continue to see a fairly even steady flow of business there.

Brian Martin – *Janney Montgomery Scott*

Most of mine have been answered, but just a follow-up to that last one, which I was going to ask. It sounds like the yields as you kind of have this transition or handoff, the yields on the RESG portfolio versus the yield on the CIB portfolio are similar? Is that fair how to think about that as you transition from one to the other depending on how things play out there? Are they generally consistent? Or is there some significant differences there?

George Gleason

We are going to have a lower nominal yield on the CIB portfolio. The mitigating factor there is we get meaningful deposits with some of those CIB opportunities and treasury management opportunities as well as some other business opportunities. If you look at it on a pure yield basis, you would say, well, you're giving up a lot to and you're going to dilute your yields. If you look at it on a return on equity basis and you factor in all of the cost and benefits, including deposits, treasury management and so forth, I think we end up fairly close to the same place. But just from a pure nominal yield, yes, there's going to be some long-term dilution to our headline margin number from that.

Brian Martin

That makes sense. You get the diversification with it as well. The other one was just on the margin this quarter held up a little bit better than it seemed like we were looking for. If we do see a potential rate cut here in the back half, if you could just kind of remind us your kind of near-term outlook or as you get into the next two to four quarters on NIM, that would be great.

George Gleason

What I would tell you, and I think we alluded to this in the Management Comments, our higher level of repayments in Q2 contributed to a little bit higher level of kind of minimum interest, accelerated deferred amortization or deferred origination fees and so forth. Q1 was probably on the low side of average, and these are such variable things that it's hard to say what average is. We felt like Q1 was probably low $2 million or $3 million. Q2 may have been high, a couple of million dollars. There's a little noise, a basis point or two sort of noise, in those numbers, but not anything too big.

The RESG portfolio is variable rate. We've talked a lot about the floors in Figure 29 of the Management Comment document. We give you the evolution of those floor rates over the last six months, which we've made some significant progress there. When the Fed does start lowering rates, since all of RESG's portfolio is variable, those will start heading down within a month after the Fed cuts rates. Most of them are tied to 1-month term SOFR. They'll anticipate that reduction and most of them adjust on the 1st or 11th of the month. It'll be a few days depending on when the Fed cuts rates lag between a Fed impact and so forth.

What we've been trying to do to mitigate that is, one, get those floor rates up, as I mentioned. Two, we've been trying to shorten the duration of our deposit book. Cindy and Ottie Kerley, our Chief Deposit Officer, have done a really good job of that. The Fed started cutting a year ago or a month after they've peaked rates, we would have seen a pretty good reversal in loan yields and a long duration adjustment over three or four quarters in our deposit book. We've got most of that deposit book adjustment gone from near term to one quarter and significantly more in the second quarter. We're getting that lined up pretty well in anticipation of a Fed reduction. We'll give up some margin in the short run for a quarter or two, but we've mitigated that impact quite a bit over the last few quarters.

Matt Olney – *Stephens Inc.*

The two large RESG repayments in the 2Q that were disclosed, I think you said one was in New York, one was in Chicago, I know that some of the larger projects at RESG had been published by local real estate publications and some investors like to track these larger projects. Curious if you care to disclose which two projects these are that were repaid in the second quarter?

George Gleason

Yes, I think they've been pretty prominently disclosed and market out there. While I am always reticent about talking about specific projects, the big New York project was the Extell high-rise condo project on the Upper West Side there around 66th Street in New York. Gary Barnett and Extell is a group we've done a lot of business with, and they have just done a brilliant execution on that project.

To give you an idea, that was an $840 million total commitment. We were funded up to $511 million, expecting to fund up close to the max $840 million, but then they were expected to TCO the bottom half of that building and start closing on condo sales and we would have had substantial paydowns on that project in Q3, probably in Q4 this year that would have materially reduced our loan just from kind of sales on the bottom half of the project. They found a refinance opportunity that met some of their needs better than staying in our loans. They refinanced that away from us with our appreciation for having gotten to do the construction financing and appreciation for that long-term relationship.

The project in Chicago was JDL's One Chicago project, which was a beautifully elegant project, expertly done, with great execution. We had funded up to our maximum $475 million on that, and that had begun to pay down from closing of condo sales. We were down to $376 million in that -- I think was fully or nearly fully funded at the max and then started paying down from condo sales. Another just excellent project with excellent execution from our customer side.

Operator

I will pass it back to George Gleason for final comments.

George Gleason

Thank you. There being no more questions. We thank you so much for your participation in call. We look forward to talking with you in another 90 days and reporting another good quarter's results. Thank you so much. Have a great day.