Bank OZK

Transcript of the Third Quarter 2023 Conference Call

October 20, 2023, 10:00 am

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

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

Joining me on the call to take your questions are:

- George Gleason, Chairman and CEO;
- Brannon Hamblen, President;
- Tim Hicks, Chief Financial Officer; and
- Cindy Wolfe, Chief Operating Officer.

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

Stephen Scouten – *Piper | Sandler*

Great quarter here. I'm curious, it looks like in the management comments that you're guiding to a pretty strong origination growth in the fourth quarter. And I'm wondering if you could give some comments there. I would assume that's occurring as some of your competitors maybe pulled back from the space. And obviously, that's been a time when you guys have done really well. I'm just curious if that's what's happening today and where you're seeing the pickup in originations category-wise?

Brannon Hamblen

That is, in part, some of the explanation. It's been an interesting year as we've seen generally a slowdown in the number of projects that we've seen, and that differs from region to region. As we've said a number of times through the year, the Southeast region has remained strong, certainly relative to other regions, and even certain periods of time in the Southeast. So we continue to see very good activity in that region and over into Texas and the Southwest. But yes, despite the slowdown in the number of deals that are out there, there's also been a pullback from some of our competitors out there. And we have, as time has gone on, continued to press down on leverage try to expand on spread and all the time stay very true to our disciplined approach to origination. But in many cases, with fewer competitors out there we were able to still close a number of deals, great deals, with improved leverage and pricing metrics.

In terms of the what the continued theme would be, it would be multifamily and industrial. We're closing other types of loans. I think I've mentioned a couple of times over the last few quarters that our Atlanta office that covers the Miami market is seeing a lot of opportunity in condos in the Miami markets. We'll see some opportunity there. But multifamily and industrial has been, for the most part, the big movers. We've had some good mixed use in there as well. But those are where we're seeing a lot of opportunities.

Stephen Scouten

You spoke to spread there. What are you, and I know every credit is obviously different, but what are you seeing on new loan spreads kind of relative to the incremental funding cost? And I guess you would feel, based on that growth, that you're getting paid well and compensated well on this new loan production?

Brannon Hamblen

Absolutely. We've talked about how our spreads differ pretty materially depending on the product type. But I would say that we're ranging from sort of mid-ish 3% range to up into the 4% range depending on the product type and where it is.

Stephen Scouten

Obviously, the RESG loans are staying on the books for longer. I'd assume this has been driving some of the, what I see as conservatism around the loan loss reserve. But how do you guys kind of speak to that pushback maybe from some market participants and say like, are these loans staying around longer a bad thing, not a good thing even though you're earning more money?

Brannon Hamblen

Well, and George can weigh on this one as well, I think I would first point out that we've had more payoffs than we have had originations this year. So as you can see from the numbers we reported, it's not a significant increase, but they have been up every quarter-over-quarter and evidence of other capital being out there in the market. They're paying off with refis. They're paying off with sellouts or sales of income properties from developer to a new owner. And we even had one situations where the borrower has come into a lot of cash and just paid us off in that method. But as you noted, we don't mind having the earning balances on our book and are getting paid well for those loans. With rates doing what they've done, we've known we were going to have a slower repayment volume. But it has been, repayment volume continues to be, there's still people in the market with capital, so we're not surprised, and I would say on the whole pleased to see the payoffs continue to come in, in the numbers that they do.

George Gleason

Stephen, let me clarify just for our listeners who don't price loans all the time. Brannon said that our spreads typically in the RESG portfolio, I think he said we're ranging in the in kind of the mid-300s up into the 400s. And that references to a spread over SOFR, 30-day terms SOFR is what we are using as the predominant index, so that's a spread over SOFR. And I wanted to clarify that. We just talk about it as spread all the time, but there are a lot of different indexes and we're referencing spread over 30-day terms SOFR. And a point that Brannon made is that our leverage points are coming down. Probably over the last two years, our loan-to-value, loan-to- cost ratios quarter-to-quarter-to-quarter have had a generally down trend not every quarter, but we're probably down five, to somewhere between five and 10 percentage points on leverage now versus what was originated two years ago. So that's very favorable for credit quality. And I would just echo what Brannon said, we're thrilled to death to have loans stay on the books longer, and a lot of times sponsors are quick to exit our loan to go to a cheaper permanent loan solution. Sponsors are being very reticent about trying to figure out where their best exit is refinance-wise. So that's keeping the loans on our books and our higher yield construction loans longer. Our leverage points are low. So we're very happy to have those loans on the books for an extended period of time.

Manan Gosalia – *Morgan Stanley*

So maybe just as a follow-up to that question. As we think about growth in funded balances over the next few quarters, I think this quarter, you had about a $1.4 billion increase. Is that a good run rate to consider as we go through 2024?

George Gleason

I don't know that we're willing to lock in on that guidance, Manan. We expect good growth over the next year, but we're not giving specific guidance on that for the year yet or for the quarter. We will, probably in our January call, gave some specific growth guidance on total loan expected growth in 2024. We expect it to be a nice growth year, but I'm not ready to lock in on a number yet.

Manan Gosalia

And then just on credit, it feels like a good quarter on credit. As we compare the properties that were reappraised this quarter versus last quarter, you had much less LTV migration into some of the high LTVs. Was there something fundamentally different about the properties reappraised this quarter versus last?

George Gleason

No. It's just the normal cycle of what was due for maturity extension, renewal, reappraisal and there was nothing unique about that. Brannon and his teams at RESG continue to do an excellent job of getting pay downs on a lot of these loans where we would have had an upward migration in the loan-to-value based on a reappraisal as part of an extension process. We continue to get quite a few paydowns from sponsors on those that bring the loan to values back out of closer to the loan-to-value at the time of underwriting. That just reflects the strength of the sponsors and the quality of the assets.

Manan Gosalia

And anything different you're seeing on the credit side? Some of your peers have been increasing their NPLs on commercial real estate and also their criticized assets. I know your business is different, but I was just wondering if you're seeing anything different in the areas where you're operating?

George Gleason

No, I'm not, and I'll let Brannon address that. But the reality is that the quality of our sponsorship, the quality of our new construction projects, combined with the low leverage loan-to-value, loan-to-cost metrics on these projects has contributed to the excellent performance of our portfolio so far during this cycle. We continue to think that those are fundamental ingredients, great sponsorship, great state-of-the-art new assets, low loan-to-value, low loan-to-cost, that will continue to help our portfolio perform very well on a relative basis to the industry going forward.

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

I have a three-part question following up on Stephen's question. Just on loans staying on longer within the RESG. I guess, can you, A.) put a number around just how much longer these loans are sticking on balance sheet versus a "normal time;" B.) is there a contractual limit for how long these loans could stay in construction status; and then C.) how much of a cliff or a headwind to growth should we expect as the refi market reengages and paydowns normalize, whether that's in '25 or '26, whatever that might be?

George Gleason

The length of duration that a loan will stay in construction status because they're waiting for a better exit or trying to time the markets for an exit. It's hard to predict, and it varies quite a lot from loan to loan. Brannon shared some statistics with me earlier, which, I can't recall them, on exactly where loans have paid off recently and how many of them have refied, How many of them is sold, and so forth so sold the properties and so forth. So I'll let him share that, and that may answer that part of your question and give you a little color on it. Won't answer it, but it will kind of explain that situation.

And you're accurate in that payoffs that extend today, the things that would have in a normal cycle don't get paid off this quarter because the sponsor is going to wait to what they hope will be a better exit execution to a permanent loan a quarter or a year from now or 18 months from now, when a market sentiment develops that's broad-based, that is time to exit, yes, we will have a lot of payoffs at that point in time. And our RESG teams, our asset-based lending teams, our equipment and structured finance teams, our commercial banking teams are all keenly aware that we've got to build our business and diversify our business and be in a position to originate volumes that will replace those assets when we get that wave of payoffs. So we're building our infrastructure, and that goes back to one of the comments I made in our last conference call that we're working really hard to add quality team members from banks that are cutting back on origination staff and other sorts of staff. We're building the quality of our team, and we've got some really good things that we're very positive about in the works on that, that I think will help us continue to grow our balance sheet and grow our loan balances even when we get some pretty chunky waves of payoffs in the future. So we're looking one year, two years, three years into the future on what those volumes are in planning accordingly. We always do look into the future and plan and that's why our portfolio and our performance metrics right now are doing so well. Two years ago, we were --

and three years ago and four years ago, we were planning for an environment where rates escalated and economic conditions change. We were doing that with our variable rate loans with our floors on our loans with our low loan-to-value type structuring on credit. And all that is paying off now. And as we're going through this part of the cycle, we're looking forward in a one, two, three, four years to future iterations and changes in the balance sheet and preparing now to continue to have a nice steady trajectory in those periods of time.

Brannon Hamblen

Filling those stats for you, George. I sort of alluded to it earlier before. But we've had year-to-date 53 loan repayments, if I got my count right, of that 53, we've had, I believe, 32 that were paid off with a third-party refinance. We had one that we actually had a land loan out on and the borrower is ready to move forward with the vertical construction loan. So we essentially paid off our land loan and moved into a new construction loan there. And then we had 15 that sold that were either condo sellout, so they sell out as the condos contracts are closed over time, but we had a number of those that completed their loan repayment and then a few industrial properties that sold a complete building sale. And then, as I said, we have had just a pure cash repayment by a sponsor that had a lot of cash on hand. And then we had four projects that the sponsor decided not to move forward on the vertical construction and so paid off the moderate balance that would have been outstanding, nominal balance, that would have been outstanding at closing. I would just say in terms of how long they're staying on, look, it's, you look back over time, there have been times where our average age has been longer than it is today, and there have been times, and it's been a bit shorter. But it all makes complete sense in terms of the environment that we're in. And as George alluded to, when you're locking one down for a while, you sure want to try to get it lower than the rates are today. And so it's playing out really as we expected it to and we're very happy, as we said, to be making the return while they're on our balance sheet.

Timur Braziler

And then just one follow-up on the credit side. You mentioned just now land loans and conversations around going vertical. Maybe just provide some commentary as to what you're seeing in the land portfolio? And some of the updated conversations you're having with sponsors about their decision to go vertical?

Brannon Hamblen

There's a mix there. We gave you some pretty good color, I think, on the land portfolio and the appraisal stats that we included in our comments in terms of we had, I think, four different land appraisals that were completed that showed stable to declining LTVs at the end of the day. And as we've noted in the past, a significant portion of our land portfolio is, as you said, initial shorter-term land loans with the thought that the sponsor once they have plans drawn up and costs sort of circled would move forward. And we are, as I said, seeing some of those move forward. But I also mentioned we had 4 that did not move forward. We're still in a period where, just like with refinances, moving forward with a construction loan in today's rate environment, and some of the economic uncertainty certainly makes one think two, three and four times before moving forward. And we're seeing some of those decisions say, what? We're going to wait. It's -- the deal has just not got enough room in it for us to want to move forward. And at the same time, we're seeing a number that are going to move forward. And that's, whether that's land loan situations that we have that move vertical or outside our portfolio. I think there's some, you can deduct some information from our thoughts about originations in Q4. So again, it depends on the market. It depends, it all comes down to the return that one can make versus the cost that it takes to develop and there's more room in certain markets and product types than there are another. So it's a mixed bag there.

Catherine Mealor – *Keefe, Bruyette, & Woods, Inc.*
I just wanted to switch over to the funding side of the conversation and just ask about how you're thinking about funding growth? As we look through '24, it's really nice CD growth. Of course, that's coming in at a higher cost. How do you think about kind of the, if let's say, Fed fund stay stable from where we are today. Where do you think ultimately the blended kind of cost of funding peaks for you as you continue to reprice a 5%, 5.5% pace as you grow CDs?

George Gleason
Well, Catherine, what I would tell you is our guys are doing a great job on the deposit front, and we're growing deposits nicely as almost all banks are experiencing, or the vast majority, these higher rates available on CDs or other alternative investments for customers are sucking money out of noninterest-bearing and lower interest-bearing time and savings or non-time and savings and money market accounts. So that trend is an industry trend. We're experiencing that. We are, as you mentioned, having great success growing CD deposits, we expect that that will continue, and that will put some upward pressure on our deposit cost as we've talked about since the April call last year. As the Fed has raised rates, deposit costs will go up. And because CDs have staggered maturities, the impacts of last quarter's Fed increases or, if there is Fed increases this quarter, those are we felt three or four quarters down the road, when CDs issued in that time frame will roll over and get repriced in connection with that last quarter increase or whatever. So there's an upward trajectory there. We know it. That's why we've said that we will give back some of this very nice expansion that has occurred over four or five of the last six quarters.

Our net interest margin and core spreads expanded broadly as loans repriced faster than deposits. Last quarter we gave some of that back, as we said would happen. We expect that would continue to happen. So I don't know exactly what the Fed's going to do. I don't think the Fed's knows exactly what they're going to do. And it's hard to know exactly where that goes. But the trend is up for deposit pricing because we're rolling over CDs now that were priced two, three, four quarters ago, and their market rates are higher now than they were then. So I think our guys are doing a great job of funding our balance sheet, and doing it in what is a very cost-effective way, particularly considering how much we are growing our balance sheet. So we feel super good about that. And Cindy, Ottie, Drew Harper, the other guys on the deposit team, the guys in the retail branches. They're 1,200, 1,500 people in those retail branches. they are doing wonderful work for us and we're very pleased with it.

Catherine Mealor
And you've been one of the few banks that's been able to grow NII since your NIM has really held in better and then also you've grown so much. But I assume that -- we've talked about this in the past calls -- that would inflect potentially this year just as the NIM falls just from deposit cost catching up a little bit on the industry, but the inflection should be in the next few quarters. But could you argue that with the higher, the better, origination volume you're seeing and the better growth that we could still see another few quarters of actual dollar NII growth?

George Gleason
It remains to be seen. We said in the last quarter's conference call, I think Tim talked about this, and I did, that it was it was going to be a quarter in the third quarter where we were going to give back some of our net interest margin, and we were going to have to offset that with growth in average earning assets. And that it was a horse race. And I think as the way I characterized it as to whether or not we would be able to achieve positive growth in net interest income. I think we were up about $10 million in net interest income this quarter over the second quarter of this year. So the growth horse outran the net interest margin shrinking horse. And we put up record net interest income.

It's going to be a toss-up, probably quarter-to-quarter-to-quarter, in the coming quarters to see which horse wins that race. And if we can continue to improve it. If it goes up a little bit or it goes down a little bit or it stays the same. I don't know, I can't handicap that right now. It's not clear, but we're working really hard do the best we can do to maintain as much margin as possible, book as much growth as we can, book that meets our quality standards and pricing standards and keep the -- hopefully keep the same horse running in future quarters, but I can't predict that outcome right now.

Catherine Mealor

If you don't mind just one clarifying question on the credit comment earlier. On criticized and watch list loans, you did not see any change to that this quarter. Is that correct?

George Gleason

Tim, do you have that?

Tim Hicks

I don't have those specific numbers, Catherine, but no significant increase that we haven't already talked about. Obviously, in our management comments, we talked about the one loan at RESG, the hotel loan that did have a small charge-off of $3.7 million. That loan did go from performing to nonperforming, but that was already a substandard loan. It was just substandard accrual going to substandard nonaccrual. So no other significant movement into risk rating classifications.

Matt Olney – *Stephens Inc.*

I want to ask more about loan floors within the RESG portfolio. I think on the past calls, you talked about the mix of RESG loans is an important dynamic because the new originations have more significant level of loan floors than the older vintages. Any updated thoughts or color you can provide with respect to RESG and loan floors?

George Gleason

Well, every quarter when we have older loans pay off, and we've talked about that volume, those floors typically are much lower than the floors on newly originated loans. So our favored, desired scenario is that the Fed is at or within one quarter of the end of their tightening cycle and that they stay at these rates for two years or longer. Because if the Fed does that, then we get a chance to recycle the vast majority of RESG loans from lower floors to higher floors which will be very helpful to us in a down rate environment. So every time we hear the market beginning to embrace the concept, the Fed's mantra of higher for longer is likely to be reality, it brings a smile to my face because that's our best scenario for profitability.

Matt Olney

Okay. I appreciate the commentary. And I guess, switching over to the capital. I guess with the growth this year, you've been able to deploy some of the excess capital. I think you estimated that CET1 ratio is around 10.7%. Would love to get some updated thoughts around capital thresholds and what's the lower band you'd be comfortable operating in, in the current environment. And I guess, specifically, would you be comfortable allowing that CET1 ratio to drop below 10%?

Tim Hicks

Yes. I mean as you noticed during the quarter, we had significant loan growth and an ROA in excess of 2% and that allowed us to capitalize the vast majority of that growth. We did have a small decline in CET1 ratio, but still feel like we have very strong levels of capital. We've seen a significant increase in unfunded balances over the past year, significant increases in funded balances that has used some of our capital through organic loan growth. But I don't see the pace of decline being the same pace that we've had over the past year. And I would anticipate that our growth in earnings would help capitalize whatever growth we have on the balance sheet. So you've not seen us go below 10% in CET1. And so if we have a quarter or two of further declines and work our way back up over time, that would be generally my thought at this point.

Matt Olney

And then, Tim, I guess, the second part of that would be around the stock buyback. Obviously, no activity in the third quarter, but I think we're now with these valuations where you were more active in the first part of the year. So any updated thoughts around the buyback from here?

Tim Hicks

Yes. I mean you saw in our comments, we are focused on loan growth, and we'll continue to be focused on our organic growth. We continue to deliver, for the last 4 quarters, we've had a return on tangible common equity of over 17%. Our tangible book value per share has increased year-over-year at 14.5%. So if you go back to 2021, 2022, 2023, I think we've done a really good job of managing our capital. In 2021 we took advantage of the low rates and issued a lot of really low rate capital at that point. Over the coming years when we had slower growth, we used that capital to buy back our stock. I think we ended up buying back nearly 13% of our shares outstanding when we started the program. And then now this year, we've had a lot of great organic loan growth, and so we pulled back on the share repurchases. So I think we've managed the capital levels, the share repurchase, just how we wanted to, and we've got good prospects for meaningful growth going forward and want to be focused on that as opposed to focus on share repurchases. However, we do expect sometime in 2024 still have another authorization when values of our stock are very compelling, we would continue to be active at the right price.

Brian Martin – *Janney Montgomery Scott*

Back to the margin - I think you guys -- George, you talked about the dollars of NII and kind of the outlook there. Just as far as the commentary in the past about once the Fed does stop, that the margin in past cycles has kind of taken a quarter or two to kind of reach that inflection point of that trough. Is that still how you're kind of thinking things play out here based on kind of the pricing you're seeing on the new originations? That maybe the margin bottoms here over the next couple of quarters and then stabilizes thereafter. Is that still the right way to think about it?

George Gleason

Brian, what I would tell you in that regard, if we get just to a flat Fed environment, say, in '24 and there's no Fed moves either way, our CD issuance is laddered throughout every quarter. When we issue new CDs, it's a very laddered book, but there's a small chunk in the 7-month time frame and a really big chunk in the 13 month time frame. So the 13-month CDs will basically mean that when the Fed is done, and market rates have stabilized, you'll still see that final tail of our deposit book repricing 13 months after the last Fed move. So it's really probably a four quarter phenomenon, to get to. If the Fed is stopped, it's probably 4 quarters of rising deposit cost to get to a point where deposit costs stabilized and full effects are in there.

Brian Martin

That makes sense. And then as far as where we exited on the cost of interest-bearing deposits for the month of September, would you have that or?

George Gleason

I don't have it, but I have someone here that probably has it. Cindy, do you have that?

Cindy Wolfe

Yes, I do. So September was 3.67% compared to 3.48% for the quarter.

Brian Martin

3.67% versus 3.48%. Okay. Perfect. And then maybe just one or two others. Just on the expenses in the quarter. I think you saw a decline and talked about kind of the guide for the full year, but just thinking about -- you've a decline in the quarter and just how you're thinking about the investments you're making and kind of outlining in the management comments. I mean the rate of expense growth as we look into next year, is it -- should we expect to see some moderation in that expense growth given the investments you've made this year, albeit that you still expect kind of continued growth going forward in the investments?

Tim Hicks

Yes, Brian, yes, if you look through the expense lines, you would see some pretty significant increases in salary and benefits. You'd see significant increases in the FDIC insurance given the rate increase on January 1 that impacted the entire industry. And then, of course, our growth in deposits, and then our advertising has certainly been elevated. So those have generated a bigger growth rate this year over year compared to what I would expect next year, for thinking year-over-year. However, on expenses, what we focus on is how do we grow our bank, how do we invest in growing our bank, invest in our people, so we are super focused on expenses. But we're more focused on ways to grow our bank. And we try to do that in the most efficient way possible. But we've got good prospects for growth. George has talked about good prospects for adding new teams throughout the coming quarters. So that's really our focus. And, on the rate of increase year-over-year, I don't expect '24 to be at the same rate of increase that we had in '23.

George Gleason

And I would comment that the fact that third quarter noninterest expense was a few hundred thousand dollars below second quarter. That's a countertrend anomaly I would expect, and Tim, you can comment on this. I would expect noninterest expense to generally go up every quarter going forward.

Tim Hicks

Yes. I would agree with that being an anomaly. We're growing.

Brian Martin

Okay. Now if I saw that. And then how about just on the RESG front, kind of you talked about the payoffs still being somewhat muted here. I mean, is it likely that we see, I guess, some pickup next year? I mean talking about how long the loans are on the books and the payoff cycle? And should we expect the, some of the payoffs that don't occur this year to spill into next year? Is that the right way to be thinking about this?

George Gleason

Certainly, it's correct to think that some of the payoffs that might, in a more typical interest rate dynamic would have paid off this year will pay off next year or the year after. I would expect somewhat of an increase in the payoff volume next year. That's going to depend on market conditions, interest rate conditions and so forth. But I would expect to see somewhat of an improving trend. And we'll try to -- an improving trend, I guess, is I probably shouldn't use improving because if you want payoffs, it's an improvement. If you're enjoying the tremendous earnings we're generating off of them, it's not an improvement. Every time we have a payoff in this environment, we have very mixed emotions, but it's nice to see that guys are still able to migrate to the secondary market or sell out projects when they want to migrate to the secondary market or sell them out, we also hate losing that spread income. So there's pluses and minuses both ways.

Brian Martin

Got you. And then maybe just the last one on RESG. With the fundings, fundings have steadily picked up each quarter this year given, I guess, the strong originations in '22, I guess, is that I guess is the current year-to-date type of level at kind of a sustainable level given that record originations in '22 and what's going to continue to fund up here. And I think as we look into '24, maybe not at the pace we're at in the third quarter, but kind of on a year-to-date blended basis?

George Gleason

Yes. Obviously, the record origination volume that was exceptional performance by our RESG team in 2022 is leading to significant fundings in 2023, and that fund up of that big chunk of the portfolio will continue in 2024. And I would cite you to the cadence kind of the payoff funding cadence chart that we've included in our Management Comments for years, now that gives you a visual picture of what's funded out of that '22 book and that gives you an indication of what is still to fund out of that '22 book. And as we've said a lot of times, these loans tend to fund in the one, mostly in the one to two years after originations and pay off in three and four years after originations.

Brody Preston – *UBS*

I wanted to start maybe just a question for Cindy, just on the just on the deposit costs. Have you guys had to increase your new offering rates at all during the quarter? And if so, could you kind of give us an indication as to how much?

Cindy Wolfe

Sure. We increased slightly during the quarter from our 13-month went from 5.50% to 5.60% and that was as a result of a little bit of movement in the competitive space.

George Gleason

And Brody, that is APY that you report to the customers, so the actual rate is probably more like went from like 530-something to 540, something, high 530s to 540s is on the actual rate.

Brody Preston

I just wanted to better understand the loan yields, the beta slowed quite a bit on a quarterly basis this quarter. I wanted to ask what drove that? Was it kind of new production coming in at lower yields? Or do -- does any of the RESG loans have rate caps?

Tim Hicks

No rate caps that -- some of the RESG loans have rate caps as a part of their structure where a third party is the counterparty, we are not the counterparty. So we benefit in all of the rate increases. So nothing, nothing capped on our yields there. Brody, I'd have to go back and look at what SOFR did in Q2 compared to what SOFR did in Q3, if that had any impact. But generally speaking, it was a little bit lower increase quarter-over-quarter than we've seen in other quarters, but there's nothing capped from an RESG perspective, certainly had payout volume has been at the subdued level that we've talked about, sometimes that generates minimum interest. There are other fees that are associated with that. That was probably at the lower end of a normal range but still within a normal range that may have contributed to it a little bit.

George Gleason

I think the biggest factor is just the slowing rate of Federal Reserve rate increases. Our loan yields are variable rate, and they mostly adjust either daily or monthly. So as the Fed has slowed the rate of increases, the rate of increase in our loan yields as has moved proportionally.

Brody Preston

I wanted to move back to RESG. I really appreciate you guys giving us the stats on the refis, on the pay downs and all that stuff. I want to ask, Brannon, do you just take a look back as to how that compared to kind of year-to-date trends from prior periods? How that mix kind of looked between like straight payoffs versus third-party exits or anything like that?

Brannon Hamblen

Brody, I would be guessing if I told you that. The guess would be probably more refis, but I don't know what the pure mix was. We started paying a little bit more attention to that recently. I think we got a question last quarter, and we're all incredibly curious here. So we did have those stats ready for you, but I'd be stepping out there too far to tell you how much I think that's different. But I felt like roughly over 50% of the payoffs coming from refi was a pretty positive result in today's world.

Brody Preston

Could I ask you to speak maybe to the land loan in OREO? I'm sorry, if somebody asked this already, I didn't, I thought I didn't hear anybody ask you about it, the one that's, the big one that's in there, and I think you've got it under a sale kind of process. I know you've got to be sensitive to kind of that process at this point from a confidentiality perspective, but you noted it was subject to standard due diligence. I was wondering if you had a sense for how far into the due diligence process you actually are at this point?

George Gleason

Yes. Let me address that. We've got, at September 30, we had a total of six pieces of foreclosed real estate. They're in five different states, and we were very pleased to have gotten three of those, and it just so happened it was the three largest of those six under contracts. So 99% of our OREO balances are under contract for sale. As you mentioned, Brody, all of those are subject to standard due diligence and closing conditions and requirements as is always the case. Each of those three contracts would clear our book value. Each of them is scheduled to close sometime before March 31 of 2024. And we'll see what happens. Sometimes contracts close, sometimes they don't close. But typically, people don't go to the time trouble and legal expense to put them under contract unless they intend to close them. So we're very pleased about that. In fact, that all of them clear our book balance and the vast majority of our OREO is a good thing. These contracts all have various provisions about confidentiality in them as a customer in these contracts. So we're going to limit our commentary on it to that general comment at this time.

Brody Preston

Got it. I appreciate that detail. And then I did want to also ask just getting the quarterly appraisal data is very helpful. And I just kind of tried to quickly aggregate it last night. And I guess when I looked at it, it's about 50 projects that you reappraised year-to-date. At least that you've disclosed and that's like $4.7 billion. So either way you cut it, that's about like 14% to 15% of your commitments either from a number or a dollar perspective? Is that kind of normally, what we should expect it to be on a pace to reappraise 20% per year?

George Gleason

Yes. I mean it's going to depend on what loans are maturing and coming up for extension either as-of-right extension because our as-of-right extension provisions usually have a loan-to-value requirement in them. And or what are coming up for extension that don't have an as-of-right when we're going to get an appraisal. Or what's a loan that is getting some attention on our part that we feel like we need to get reappraised. So there are a variety of reasons you get an extension, get an appraisal, but that's nothing unusual. Let me say it that way. There's nothing unusual about volume. It's just the normal way we would do that. Now if you factor in the originations over the last 12 quarters, that's another 25% of the portfolio. So what that tells you is something 40% to 50% of the portfolio has a fresh appraisal within the last 12 months on which is probably pretty typical.

Brody Preston

I appreciate that. Suffice to say, though, based on the stats we can see, George, it's about 15% has been reappraised so far. On our end and the average change in the loan-to-value is a little less than 3%?

George Gleason

Yes. And again, I would point out that, that average change of 3% is after substantial paydown. We get an appraisal if the loan-to-value is materially different than what it was at origination or doesn't meet the as of right extension requirements. Our sponsors in many cases, are coming to the table with paydowns on those loans. To reduce them back in line with our extension criteria requirements. So the 3% is a really good number, but it's a result of appraisals plus pay downs and that are reducing those balances to back to a lower loan-to-value.

Brody Preston

Got it. And then last one for me is just there's been, obviously, everybody knows there's been a big shift in the interest rate environment. I wanted to ask you kind of just given that 2021 was a big origination year and rates were still at 0%. How did -- what would you assume kind of cap rates? Like anything you can of give us on how cap rates were when you of underwrote these projects? What the assumed exit cap rate was how you kind of stress that in your underwriting? And I guess, how that compares to the current environment today? I think, would be helpful.

George Gleason

Yes. We stress debt service coverage in 100 basis point increments, up 500 basis points using our loan and the projected performance of the project and projected of the performance of the project, we used the sponsors projections and run that right beside ours. So we're looking at it under what the sponsor's expectations are versus our underwriting expectations up 100, 200, 300, 400, 500 basis points. We look at exit refinance market conditions, what the current secondary market, permanent market refinance part of those up 100, 200, 300 and 500 basis points and then we look at cap rates, and take current cap rates for that property type and stress those up 100, 200, 300 or 500 basis points. So we underwrite for a lot of interest rate stress, and that certainly is what we have seen with the Fed moving the Fed funds target rate 525 basis points from the 0 lower bound.

So our methodologies there have been very sound and very helpful and very appropriate for the environment in which we find ourselves. So that's, I think, that focus on how you can stress these loans and the solution is, if you really like a project and it doesn't stress well enough, you just got to get the leverage down to where it does stress. And that's one of the reasons we have so much equity in our projects and our leverage is so low as we are stressing these projects for a significant market risk, including interest rate risk, and that's played out.

Now on cap rates, the interesting thing is cap rates have come up, but cap rates on property types such as apartments and industrial and life sciences have not moved nearly in tandem with Fed move. So the magnitude of changes in cap rates over this period where the Fed has moved 500 basis points 525 basis points has been less than 525 basis points. It's interesting to us if we see further movement in those cap rates going forward, and they ultimately catch up with the Fed, and I think that's really going to be a product of are we permanently in a 5.25% to 5.50% Fed funds target rate environment is in is the tenure going to permanently readjust to high 4s, low 5s sort of situation, and we've had a fundamental shift. And if we're in that environment two, three, four years from now, we see cap rates fully catch up with that. But right now, the cap rates seem to reflect the sentiment that at some point, rates are going to come lower to some degree from where they are now. So that's providing some degree of support to property valuations.

Brody Preston
George, what did you just say about the cap rates? You said you stress them up 300, 400 basis points. Does that mean that even in that scenario, when you underwrite that loan when you stress the cap rates to that degree, does the loan still perform and pay off when you kind of get to that left tail type event?

George Gleason
Yes. On the cap rate stress, is -- best I can remember, I don't think we have closed a loan that wouldn't tolerate 500 basis points cap rate stress and still cover our loan. There may have been a handful of

exceptions to that in the 300-and-something number loans in the RESG portfolio. But the vast majority of them can tolerate that kind of stress on the cap rates.

Brody Preston

Got it. I appreciate that. I lied. I'll sneak in one more. Do you have to know what the reserve on the office portfolio is at this point?

George Gleason

No. Nobody here knows that broken out specifically.

All right. Thank you, guys. We appreciate you joining the call. Thanks for the good questions. We look forward to talking with you in about 90 days. Have a great rest of the quarter. Thank you.