Texas Capital Bancshares, Inc.

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Texas Capital Bancshares, Inc.

Q4 2019 Earnings Conference Call

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CORPORATE PARTICIPANTS

Keith Cargill - *President, Chief Executive Officer*

Julie Anderson - *Chief Financial Officer*

Shannon Wherry - *Director of Communications*

PRESENTATION

Operator
Welcome to the Texas Capital Bancshares' Fourth Quarter 2019 Earnings Conference Call. All participants will be in listen-only mode during the presentation. Please note this event is being recorded. If you do need assistance, please signal a conference specialist by pressing the "*" key followed by "0."

I would now like to turn the call over to Shannon Wherry, Director of Communications. Please go ahead.

Shannon Wherry
Thank you for joining us for TCBI's fourth quarter 2019 earnings conference call. I'm Shannon Wherry, Director of Communications. Before we begin, please be aware this call will include forward-looking statements that are based on our current expectations of future results or events.

Forward-looking statements are subject to both known and unknown risks and uncertainties that could cause actual results to differ materially from these statements. These risks and uncertainties include those relating to the pending merger between TCBI and Independent Bank Group. Our forward-looking statements are as of the date of this call, and we do not assume any obligation to update or revise them.

Statements made on this call should be considered together with the cautionary statements and other information contained in today's earning release, our most recent annual report on Form 10-K and subsequent filings with the SEC. We will refer to slides during today's presentation, which can be found along with the press release in the investor relations section of our website at texascapitalbank.com.

Our speakers for the call today are Keith Cargill, President and CEO, and Julie Anderson, CFO. At the conclusion of our prepared remarks, our operator will facilitate a Q&A session.

And now, I will turn the call over to Keith, who will begin on slide four of the webcast.

Keith Cargill
Thank you, Shannon and thank you all for joining us. Today, I will first discuss the highlights of our fourth quarter and full year 2019, and then Julie Anderson will cover her financial review of the quarter, year and guidance for 2020. Finally, I will offer closing comments on 2019 and plans for 2020 including our announced merger with Independent Financial. We will then open up the call for Q&A.

As Shannon mentioned, let's begin on slide four. As we've discussed, we are always looking for ways to further refine our organization, processes, and products at Texas Capital Bank. We believe that developing more comprehensive and strategic client relationships leads to improved efficiency, revenue growth and continued strong client introductions to new prospects.

To that end, I want to start the call off by discussing our latest initiative to enhance our deposit pipeline and position Texas Capital Bank for the future. Next week, we will be officially launching our newest deposit vertical, Bask Bank, a digital bank that rewards savers with travel rewards. This deposit vertical functions both as a business and as a capability for Texas Capital Bank.

As a business, Bask Bank will allow customers to earn airline miles from their savings accounts through our long-time partnership with American Airlines. As a capability, the build out of Bask Bank and the digital platform has taught us new skills in digital marketing, digital acquisition, and online customer experience, that we will be able to leverage across our businesses as we continue to position the bank to capitalize on the trend toward a digital banking future.

Matt Quale leads this new vertical as President of Bask Bank. With his successful track record in financial services and extensive experience in strategy, brand management and marketing, we are confident Matt is the right individual to lead this exciting new initiative.

Now, let me move on to slide four of the presentation, to provide an overview of the results we announced this afternoon. Our fourth quarter results were ahead of consensus if adjusted for the $12 million of expense related to Bask Bank and our two new C&I verticals; technology banking and education, nonprofit and healthcare banking.

In light of our push to reduce both leverage loans and energy loans throughout 2019, average LHI excluding mortgage finance declined 1% linked quarter. More than offsetting this 1% decline mortgage finance loans increased 7% linked quarter. Further, average total deposits grew 6% on a linked quarter basis.

As Julie will cover in more detail, net revenue declined 2% linked quarter largely due to the continued impact of rate decreases and the runoff in leverage loans and energy loans at higher rates than the rates and growth in mortgage finance outstandings. All-in net income came in at $73.9 million for the fourth quarter including a loan loss provision of $17 million in Q4 versus $35 million in loan loss provision in Q4 2018. Julie?

Julie Anderson
Thanks, Keith. My comments will cover slide six through 13. Net interest income continued to be strong in the fourth quarter, a quarter that can be much lower due to the normal seasonality of the mortgage finance business. As a result of the continued strength of mortgage finance, net interest income was only slightly lower on a linked quarter basis and higher than second quarter. After three rate cuts in 2019, we've been able to outpace the decline in rates with increases in volume. Our net interest income growth compares very favorably to our peer group.

Mortgage finance has acted as an effective hedge in this lower rate environment, as well as, offsetting some of the negative impacts from our deliberate reduction in higher risk asset classes, specifically leverage and energy. We're willing to leverage this capability to drive strong risk appropriate returns while we continue repositioning the balance sheet for more sustainable long-term earnings generation.

Despite the fact that our NIM decreased on a linked quarter basis, it's important to understand that much of it is related to the earning asset shift, specifically an increased level of liquidity as we continue to see growth in average deposits. We continue to believe NIM is not the best metric to assess relative profitability or future revenue generation in this low rate environment and net revenue, and more specifically, net interest income is more relevant.

Traditional LHI yields were down and the impact is more significant than the decline in LIBOR for the quarter which is reflective of the catch-up from prime rate decreases in September and October. Loan fees were basically flat in the fourth quarter as compared to the third quarter.

Mortgage warehouse yields were down on a linked quarter basis and volume incentives continue to be part of the lower yield. Our MCA yields continued to be pressured, which was expected, as compared to actual mortgage rates. Additionally, the timing of sales of higher rate loans and the rebuild of balances at lower rates can adversely affect the average yields.

We continue to have growth in average deposits with growth in interest bearing and slightly more in non-interest bearing. Overall deposit cost decreased by 22 basis points from 121 basis points in the third quarter to 99 basis points in the fourth quarter. The decrease resulted from continued growth in DDAs, as well as meaningful decreases in interest-bearing deposit costs. Interest-bearing deposit costs were down 31 basis points from the third quarter and we expect to see further decline in this with the full quarter of the October revenue.

We continue to have a solid deposit top line. As Keith mentioned, the launch of what we believe will be the most impactful deposit vertical, Bask Bank, occurred late in the fourth quarter with the national launch slated for next week. Coupled with continued strong deposit growth in our core businesses, these new verticals will begin to lessen the sensitivity of our funding stack to changes in market rate.

We experienced a decrease in average traditional LHI during the quarter as we continued to actively manage reductions in our leverage and energy portfolios. Traditional LHI average balances were down 1% from the third quarter and basically flat from this time last year.

The level of overall payoff continues to be high primarily in CRE, where we are continuing to replace runoff with fundings on existing commitments and some new originations. In contrast, the C&I leverage runoff is not being backfilled. Payoffs in C&I leverage for the year were in line with what we planned and we expect another 10% to 20% reduction in 2020 as we focus on rightsizing our risk profile in this space.

With energy, the overall level is coming down, but we are certainly still in the business and are selectively adding relationships if they fit within our defined risk asset class. Again, we have a strong average total mortgage finance balances for the quarter, driven by continued lower mortgage rates. Average balances were up from this time last year about 61%.

We continue to experience good growth in linked quarter average total deposits with the mix of interest bearing as well as noninterest bearing. We normally see some seasonality in deposits in

later fourth quarter and into first quarter. But so far that has been more muted, primarily as a result of our mortgage clients continuing to have strong originations which dropped escrow balances.

We continue to see improvements in deposit mix with some contribution from verticals, as well as, from existing clients, including mortgage finance escrow accounts. We expect that to continue with significantly more meaningful improvement evident in 2020 as verticals, particularly Bask Bank, and our commercial escrow business get more traction.

As we discussed, the goal is to deliver a more granular less rate sensitive funding stack that will serve us well through all rate cycles and while we're optimistic about what we'll accomplish in 2020, we're building this for the long term. Actual interest equivalent cost of Bask Bank compared favorably to other sources with a lower through cycle beta and significantly more granularity than our index deposits. Certainly there are other marketing and promotional expenses that I'll discuss later.

Our focus on deepening existing relationships through our treasury management offerings will continue to provide meaningful deposit improvements in 2020. Interest-bearing deposit costs were down 31 basis points linked quarter. Only part of this improvement translated to overall deposit cost at 40%, our deposit portfolios and DDA, the 22 basis points linked quarter improvement in total deposit cost and 22 basis points improvement in total funding cost. As we've mentioned index deposits have assumed 100% beta while all other interest bearing is assumed to be closer to 60%.

While it appears that rates will be stable for the near term, our playbook for stepping rates down remains in place and we're constantly evaluating ways to optimize. But the most effective tool we have is to continue to deepen existing relationships with treasury services that drive overall deposit costs down. And we believe post merger the existence of more Texas Capital Bank bridges will be extremely beneficial.

As for broker deposits, we increase the overall level slightly to $2.3 billion. With favorable pricing, the selective use of brokered CDs has been an option to supplement the funding stack as we replace some higher-cost deposits and gain traction in new verticals.

Turning to non-interest expense, we continue to see positive trends in core operating expense category, specifically focusing on changes in salaries and employee benefits expense which represents over 50% of total NIE. 2019 salary and employee benefit expense is 8% higher than 2018, while that is slightly higher than the mid single-digit expense we originally projected; it included some investments in Bask staffing and the mark-to-market on deferred compensation of $3.6 million that's directly tied to stock market performance.

We continue to be deliberate in adding revenue, generating hires and attracting exceptional talent. Our story continues to be extremely compelling and we have only seen that interest pick up post-merger announcement.

We experienced some reversal of the MSR impairment in the fourth quarter, approximately $2.6 million, offsetting a portion of the over $8 million of impairment incurred through the third quarter.

As we noted last quarter, classifications of several of the MCA items, as well as, some marketing fees related to deposits have been punitive to our efficiency ratio. So you'll see this quarter, we started reporting efficiency ratio on an adjusted basis which we believe is more representative of what is actually happening.

Efficiency ratio for the fourth quarter was elevated with a few discrete items which include $1.3 million of merger related expenses. Additionally, we incurred $6 million in other professional expenses that represent an upfront investment related to new C&I verticals. There will be another $2.5 million in the first quarter but nothing recurrent subsequent to that in 2020.

The investment has provided for refinement of our go-to-market strategy and includes targeting industries that meet our desired return profile, which generally means industries with higher levels of self-funding. It also included improvements of capabilities required to launch and deliver these verticals. We've already launched two and both will be breakeven during 2020 and we have others that will be evaluated for future rollout that even if we don't launch any others, our $8.5 million investment would be recaptured over a two-year period. We also believe that other lines of business will benefit from some of the enhanced capabilities of this investment.

Lastly, 2019 includes a little over $9 million of expense related to Bask Bank, with almost $6 million of that in the fourth quarter. As we noted last quarter, we believe in more representative measure to focus on evaluating our non-accretive expense trend n noninterest expense to average to average earning assets, which has improved from 2.15% in 2018 to 1.96% in 2019. And that includes the outside investments that I mentioned.

Moving to asset quality, we continue to be vigilant in managing credit and are pleased that our full year provision of $75 million is less than we originally planned for the year and represent some improvement from the 2018 level. Additionally, we experienced an improvement in charge-offs from 37 basis points in 2018 to 31 basis points in 2019. While still higher than we desire, our proactive approach in dealing with a handful of leveraged and energy deals will position us favorably as we know that certain of these loans won't perform well during the next credit cycle.

Nonaccruals increase from third quarter and the increase is made up entirely of negative migration of previously identified loans again in energy and leveraged. Net charge-offs this quarter are primarily related to energy and leveraged. We experienced a slight increase in total criticized levels in the fourth quarter with some of the expected resolution slipping to Q1. The net increase was really related to one energy credit that was downgraded to special mention.

Liquidity and access to capital are key themes for this legacy energy and leveraged credit and we are vigilant in addressing strategy to resolve it as quickly as possible while minimizing degradation in value.

Total criticized as a percentage of total LHI still remains low at 2.4% from Q3 level of 2.2%, but still down from the second quarter level of 2.6%, which we believe was the peak. Earlier in the year, we expected a larger portion of provision in the first half of the year and our actions translated into achieving that. We will continue to see resolutions to existing credit and there could be migration within the criticized book, but we believe they are enough offsets in those forecasted recovery of the provision for us to provide for lower provision expense guidance in 2020, which I'll discuss shortly.

We continue to be focused on brisk management of the problem credit, primarily in leveraged and energy to minimize downside impact and are actively monitoring all portfolios in light of macroeconomic factors. That work accomplished during the year to proactively de-risk our portfolio will serve as well for the future.

Now we look at some of the quarterly and annual highlights. We continue to have strength in year-over-year net revenue by the punishing rate environment. Obviously, the strong volumes in mortgage finance contributed in a meaningful way to the increase, while we proactively reduced leverage and energy exposure in traditional LHI. 2019 non-interest income had $15 million related to legal settlement which will not be recurring in 2020. We continued to improve run rate on core operating expense items. Year-over-year 12% increase in total NIE compared to 2018, that includes almost $6 million in mortgage servicing impairments related to rate, $1.3 million in merger related expenses and $15 million related to Bask and the new C&F initiatives I mentioned earlier.

ROE and ROA levels are lower in 2019 and reflective of the lower rate environment. ROA levels will continue to be negatively impacted by the higher mortgage finance and liquidity balance. Lower loan loss provision in 2019 helped offset some of the negative impact from the lower rates.

Last, I'll turn it to 2020 outlook. Our outlook for average traditional LHI growth is mid single-digit percent growth. This is reflective of continued reduction in energy and leveraged, but includes growth in core C&I including new verticals, as well as the growth from adding some one to four family loans to the LHI portfolio. Both are expected to be more heavily weighted to the second half of 2020.

Our outlook for average mortgage finance is a reduction of high-teens percent. It's important to remember that we have about $700 million in sub participation, so we will shift more growth to NCA in 2020, which is a higher yielding asset. The outlook for NCA is low $3 billion per average outstanding. NCA will continue to benefit from additional volumes with lower rates and will have an increased percentage of the total mortgage finance, which will be positive for net-interest income. We're focused on repositioning toward higher yielding lower risk-weighted asset classes over the next few quarters, which also involves moving some of the NCA purchased [ph] loans to our LHI portfolio as noted earlier.

Our outlook for average total deposit is flat, as we focus on repositioning our funding mix, including approximately $1 billion in deposits from Bask expected by year end 2020. While Bask has been part of our go forward strategy, we believe it's even more important with the pending merger. The

combined company will continue to be growth-oriented and having more granular sources of funding will be critical.

Our outlook from NIM is 3.05% to 3.15%, that's reflective of the lower rate environment and of course this could be impacted if mortgage finance levels differ from our guidance. Our outlook for net revenue is low single-digit percent decrease, which is reflective of a full year of lower rates from three rate cuts, as well as continued slower growth in core LHI and an overall lower level of mortgage finance.

Our outlook for provision expense is low to high $60 million, which is an improvement from 2019 level of $75 million, but also assumes continued resolution of existing problem loans primarily in leveraged and energy.

Our guidance for non-interest expense is mid single-digit percent growth and is reflective of our investment in Bask Bank, which is approximately $44 million for the year with over 50% of this cost being variable. We expect that the expenses could be more front loaded in the first half of the year, as we push forward to gain market share.

It's very important to understand how this money for Bask is being invested and then it's not an endless pool of dollars, but rather very targeted spending to learn what works. In this space, what works is known fairly quickly and spend can be adjusted accordingly. As we gain scale, the overall impact of these variable costs will diminish and that's why it's essential that we get out of the gate strong this month. We have built a digital platform that can be leveraged over time with different value propositions, as well as different targeted customer bases, including some [indiscernible].

Our guidance for efficiency ratio is the high 50% as we focus on some critical investments which will position us favorably as it relates to a more predictable granular funding mix, which will serve us long term. Keith?

Keith Cargill
Thank you, Julie. To wrap our review of 2019, I'd like to highlight a few key points. First, we are optimistic that the launch of our two new C&I lines of business, technology banking and education non-profit and healthcare will help us backfill the deliberate loan run-off in leveraged lending and energy banking and produce meaningful new deposits as well.

Sourcing single-family mortgages from our MCA business will add additional high credit quality loan growth in traditional LHI. The combination of launching our digital bank, Bask Bank, and the growth in our new escrow deposit business will further support the repositioning of our deposit base with granular diversified funding at lower cost.

Loan loss provision was lower in 2019 than 2018 and we forecast provision to be lower yet again in 2020. Problem loan resolution is a key focus for our bankers and credit team and I am confident in our ability to execute.

Finally, let me close by sharing our excitement regarding our merger of equals with Independent Financial, which we announced on December 9th. As I've said before, this is a truly compelling transaction. Together we will become the premier super regional Texas-based bank with a meaningful presence in Colorado and the scale and resources to serve clients coast to coast. In addition to strengthening our position with business and Wealth Management clients, we believe this merger will allow us to regain a strong and growing market position with the small business entrepreneurs who were the foundation of our client base during the first decade of Texas Capital Bank.

Through our investment in talent, technology and new deposit verticals over the past seven years, we have tripled our balance sheet from $10 billion to $33 billion in assets and have gained market share in the corporate C&I, mortgage finance, builder finance, premium finance and commercial real estate segments. However during that time, we operated under a branch-light model with only 12 branches state-wide. As a result, our commercial C&I business, focused on small businesses, did not grow.

Providing extraordinary service and products to small businesses is at the heart of who we are and we recognize that our smaller revenue C&I clients require more convenience than our current branch footprint offers. So, by expanding our branch network from 12 to approximately 70 locations and using the Texas Capital Bank branding for those in Texas, we expect to reinvigorate our market penetration in this important segment.

Another benefit to growing the smaller C&I sector is the fact that this client segment produces more deposits than loans, further delivering more granular, cost-effective funding along with our new deposit verticals and Bask Bank.

As a Texas-based bank of nearly $50 billion in assets, we will have the opportunity to become the banker of choice for small and mid-sized businesses, larger companies, special industries, real estate banking, C level executives and our entrepreneurial business owners. Post merger, we will also be better able to utilize our technology and digital franchise capabilities to serve clients across business lines, while gaining scale advantage. For instance, we will leverage Bask Bank to improve our funding mix and appeal to the mass affluent client market over time, further fueling organic growth in our private wealth client business.

Overall, we have complementary lines of business and deep benches of talent. We are confident that together we will deliver greater benefits for our shareholders, our clients, our communities and our colleagues. As we highlighted when we announced this transaction, we have always been focused on delivering the most premier and differentiated service to our clients possible and the new company will take it to the next level. While there is still a lot of work to do, we are excited about the transaction and the benefits it will deliver. We have started integration planning and remain on track to close the transaction in mid-2020, subject to the receipt of customary regulatory approvals and approval by the shareholders of each company.

We view 2020 as a year of great opportunity at Texas Capital Bank. We'll be adding new capabilities and become the $50 billion powerhouse bank in Texas. We know that entrepreneurs,

private and public companies, private wealth clients and special industry businesses want a bank made up of can-do bankers who understand and embrace growth and prosperity for all our constituents. The special connection and premier service our clients expect remains foremost in our daily work. And we are determined to not disappoint, despite the added work we must deliver for a great merger.

Together with Independent Financial, we are thrilled to be embarking on a new chapter as a company and are as focused as ever on driving enhanced value for our clients and shareholders alike.

I want to thank you all again for participating on today's call. I'll now hand the call back to the operator who will open the line for Q&A.

QUESTION AND ANSWER

Operator
At this time, to ask a question you can press "*" then "1" on your touchtone phone. If you are using a speakerphone, please pick up your handset before pressing the keys. To withdraw your question you can press "*" then "2."

Our first question will come from Brady Gailey with KBW.

Brady Gailey
Hey, thanks. Good afternoon, guys.

Keith Cargill
Hi, Brady.

Julie Anderson
Hi, Brady.

Brady Gailey
As we look at the NPA increase, I think they increased a little over $100 million on a linked quarter basis, roughly $60 million from energy, $45 million from levered lending. Any additional color you can give us on why those criticized assets moved over into the NPA bucket?

Keith Cargill
Yes, it was relatively few but large ones, Brady, that were just migrating through the process. And it just so happened that several hit in the same quarter. These were all identified, but again this migration is part of the process. We reserve accordingly and therefore, as you saw, we had within guidance provision and feel comfortable with where we sit on our reserve. But timing wise, we did have some of those actually move to non-accrual, some large ones in the same quarter.

Brady Gailey
Alright. And then as we approach the closing of the merger with IBTX mid this year, is there any sense of urgency to expedite the disposition of these NPAs before the deal closes?

Keith Cargill
We've had a sense of urgency for a year and a half and that continues. And it's extremely important to us to address these very proactively. And I think we are really on top of it and we'll push them up and bring them to resolution as quickly as reasonably good we can. But I can assure you we have the resources of smart teams and good cooperation and collaboration to accomplish this. And so I think we will see good results the next two quarters.

Brady Gailey
Okay. And then finally from me, just with Bask Bank, it's a little unique you're not paying interest, but I guess you're buying the miles, the airline miles to give to these customers. Regardless of how the mechanics work, I am just wondering, what do you expect to be the average cost of deposits with a vertical like that?

Julie Anderson
So, Brady, you know what, there is an entrance [ph] fee, yes, it's mild, but there will be, I would say it's favorable to Fed funds rate. Then there is some additional…some of the promotional and marketing which is going to be higher at the start until we gain some traction. But that will become a smaller…that will become more diminished over time. So, yes, in the first year the all-in cost is a little higher. But I guess we compare that to alternate strategies of acquiring granular deposits like this and feel like this is the most viable message and it gives us a platform to do different things with going forward.

The miles is the first value proposition that we're going out with. But certainly we could do other value props going forward and could even do something in the small business.

Brady Gailey
Okay, got it. Thanks for the color, guys.

Keith Cargill
Welcome.

Operator
Our next question comes from Michael Rose with Raymond James.

Michael Rose
Hey, good afternoon, guys. How are you?

Keith Cargill
Hi, Michael. Good.

Michael Rose
Just wanted to go back to Bask Bank. I'm sorry, I got on a little bit late. But I think you guys mentioned some additional costs that are going to be coming forward from this initiative. Can you just kind of outline what those are? And maybe as it relates to deposit growth over the next, let's call it six months to a year, do you have any initial set of expectations for how much in deposits you can drive through this initiative? Thanks.

Keith Cargill
We are targeting by the end of the year to have somewhere in the neighborhood of $1 billion of deposits that we'll generate with Bask Bank. Some of the cost we mentioned, if you came in late on the call, we had $6 million of costs related to Bask in the fourth quarter. That's why when you look at some other costs we had on getting our new verticals, C&I verticals launched, it was a total of $12 million if you add the 2 together, Bask Bank at $6 million and some of these related professional costs to gear up our new C&I verticals add another $6 million. And then we'll have some of this acquisition cost. There won't be a lot of other professional cost in the first quarter. I think it's less than $3 million that will actually carry on into the first quarter. But it will be more around client acquisition cost that will be driven by social media marketing, things of this sort that we view as much cheaper acquisition cost as Julie alluded to than building a new branch. I mean that's enormous acquisition cost as you ramp that up relative to what we're going to expand to grab these clients online.

Michael Rose
Okay. That's helpful. And then maybe sticking with expenses just related to some of these C&I verticals, where do you stand in the hiring process with folks that are going to help drive the growth there? And where do we stand in relation to the expense build from that initiative and some of the other initiatives? Thanks.

Keith Cargill
Well, we have our lead to run the technology banking team and really, he has his team hired and on board. So we are out of the gate on that one. We also have our lead, line of business manager for our education nonprofit and healthcare banking group. And so he is in the process of building his team. We think each of those will be profitable by the end of the year and we're very encouraged with the feedback we've gotten already, particularly on the technology teams since they've all come together. But I'm very excited about what we're going to be able to do with also our education nonprofit and healthcare business as well. So it will be a slight drag, it won't be a large drag and it will be profitable. And by the end of 2021, we will have recouped all our cost, so a great private equity return, Michael, is what we forecast on these two lines of business.

Michael Rose
Okay, that's helpful. And maybe one final one from me, Keith. Just looking at the S-4 that came out, I believe it was yesterday, it looks like you and David have been talking since July. But it mentioned that you'd also explored and have been looking around for a period beyond that. Did prior negotiations ever get serious? I'm just trying to gauge how long do you guys have been

looking to team up with somebody just given the competitive environment and rate environment? Thanks.

Keith Cargill
Michael, it was my job when I took over as CEO of the Bank six and half years ago to explore possibilities, strategic alternatives for the good of the shareholders. And so I've been involved in an appropriate way getting to know CEOs of all sizes of banks for the last six and half years. And then each year I will have different investment banks as part of my preparation for my strategic board meeting each year. I'll ask different investment banks, a couple at least if not three, to run their scenarios on potential acquisiters, MOE candidates, and then candidates that we might consider acquiring and then identify characteristics that might make the culture or the match strategically, one that we should consider. And so this has been an ongoing process for quite a long time and I have developed some good relationships with a number of CEOs. One of the challenging parts of looking at alternatives is we have one of the most amazing talented pools of bankers in the country and they're primarily sitting in Dallas-Fort Worth, Austin, Houston and San Antonio.

And so doing an MOE with someone located on the West Coast or at a significant distance and other parts of the country gave me pause and sometimes them because this talent is, I think, a team that could run $100 billion-plus company. And so we want to be really thoughtful and any fit, as I alluded to, over the years kind of has to be that really just special, very difficult fit that we were looking for. And so, we found that here with David Brooks and Independent Financial.

We knew over the last year or two that even with the success we've had with our different deposit verticals and mortgage finance and treasury business overall that a footprint of 12 branches, the same footprint we've had for well over 10 years, was not optimum. And so we are not…we weren't looking for a footprint that would take us to a $50 billion bank with 400 branches, but we think this combination where we'll end up with approximately 70 plus or minus in Texas and 30 or so in Colorado is an ideal addition to what we have to offer with our great talented teams.

And so it's been a long process and I didn't know when that might happen. It presented itself a couple of years earlier than I might ideally have thought. But when the opportunity was so compelling, I know this is the right thing for the future of the company and it really sets us up to be that really dominant…potentially that really dominant bank in Texas and I'm excited about our future with the combination.

Michael Rose
Thank you. Thanks for all the color. Appreciate it.

Keith Cargill
Welcome.

Operator
Our next question comes from Ebrahim Poonawala with Bank of America Merrill Lynch.

Ebrahim Poonawala
Good afternoon, guys.

Keith Cargill
Hello, Ebrahim.

Ebrahim Poonawala
Hi, Keith, just wanted to follow-up on that. So you used the word like potentially creating a dominant franchise with the Independent deal. Would love to get your thoughts around why you think the stock has done so poorly since the deal announcement, because just talking to a lot of longtime shareholders when you look at the stock price today at close to tangible book relative to kind of the vision that you've talked about, where do you think there is the disconnect between shareholders and what you view as the new bank that's going to come out of this merger? Would love to get your thoughts around that.

Keith Cargill
Yes, it's been a bit puzzling. We had a nice pop, really nice upside, and in the announcement and all the analysis that was done by the different investment banks, as you saw, I'm sure, on our announcement, the financials look perhaps as compelling as any combination in the last five years of mid-size banks or bigger. And so, I don't know the answer to that. I do know David mentioned that he got some calls because he was moving out of the Russell 2000 to the Russell 1000. So there was some dislocation temporarily going on there. I don't know how long that takes before it resets or rebalances. But I don't know the answer to your question. I believe it's going to be one of the best banks in the country to work for and be part of. And I think our clients are going to have products and service levels that are second to none.

Ebrahim Poonawala
Got it. And just in terms of the deposit initiatives like you…I think you mentioned $1 billion from Bask Bank by the end of the year. Can we talk a little bit also about the escrow team that you hired? I think you mentioned that in the release. Just in terms of the overall magnitude of churn that you expect in deposits as 2020 progresses. And how much lower can we see the cost of those deposits come relative to where we ended in the fourth quarter?

Keith Cargill
Well, we've…do you want to take that Julie?

Julie Anderson
Yes. So escrow, we think that was going to be…the cost of that is going to be, I don't know, 50% of Fed funds and we're starting to get traction in that. The full system capabilities that we need will be online by sometime in the first quarter. And so in our numbers, we're projecting that we'll have about $0.5 billion in deposits from escrow, a little over $1 billion from Bask and $0.5 billion from escrow.

Ebrahim Poonawala
$0.5 billion from escrow?

Julie Anderson
As I've talked on the cost, I think that we're seeing…we're seeing good traction with the treasury, selling more treasury into our existing clients, which is our existing clients, and selling more to them. That's our lowest beta, lowest cost deposits and we're seeing some good traction with that. We also expect to still have good deposit and some continued growth with our mortgage escrow deposits because of what's going on with rates.

Keith Cargill
And, Ebrahim, I think realistically we really believe we could take those same kinds of numbers and do as well or better in 2021. So potentially a couple of billion in Bask and $1 billion in escrow, these are high growth potential areas for us. And as we get past the acquisition cost on Bask, I think it's going to be really favorable on overall cost. And again, it's the beginning too of a build-out of a digital platform and we will be able to add some other capabilities on that platform for other clients as well over time.

Ebrahim Poonawala
And just on that...

Julie Anderson
I think the important thing about both of those verticals is they just have much lower betas than some of the other deposit categories that we've been so highly invested in the past. They're going to look more like our core market treasury costs, much lower betas, but even more granular than some of those.

Ebrahim Poonawala
And I think, Julie, you mentioned that it's going to be a national launch starting next month. I'm just wondering, is it just going to be promoted by TCBI or you are going to have the airline jump in and are we going to see some promotion from that end as well? If you can talk to about what's the strategy in terms of the marketing campaign.

Julie Anderson
There will be some co-marketing and that starts next week, I think. All of the national launch starts next week. There will be some marketing and then some of it is in partnership with the airline.

Ebrahim Poonawala
Got it. Alright. Thanks for taking my questions.

Keith Cargill
You're welcome.

Operator
Our next question comes from Jennifer Demba with SunTrust. Jennifer?

Jennifer Demba
Thank you. Good evening.

Keith Cargill
Hi, Jennifer.

Jennifer Demba
Thank you. Good evening. Hi. Just, Keith, could you just talk about your confidence in the provision guidance for 2020? You've got quite a few new NPAs here and criticized loans continue to be high. So what gives you confidence that this provision estimate is close to correct?

Keith Cargill
Well, I am confident it will come in on the low end of that guidance, but my team is a little wiser and always counsels me. So we ended up with up to the high sixties. It is never a precise process, Jennifer, but I will call out that this is the second year in a row we've been down on provision. Despite aggressively moving a lot of risk off the balance sheet, our leveraged loans declined 30% year-over-year this year. They will be down another 10% this quarter. And so, while that gives us a little challenge on backfill to show significant traditional LHI growth, it's definitely the right move to make, because we're not taking discounts. These are getting paid off, somebody is taking us out of refinancing or they're getting paid off as portfolio companies are sold and so on.

So I think we really have our arms around those that are problems. We're not doing...this is very important. We haven't been booking late vintage deals and those are the ones that…my experience has been, those are the ones that bite you a year and a half, two years later, and it might present issues on less predictability on provision and reserving. So it never is precise, but I am confident that we're ahead of the game. It hadn't been fun, but we're taking our medicine early and I think that's going to be best for the shareholders to have the strong balance sheet we will have when others perhaps are dealing with it after doing some of this late cycle business. And so, we haven't been.

Jennifer Demba
Okay. Julie, could you talk about the CECL adjustment and what we should expect?

Julie Anderson
Yes. I was waiting for that question. So our day one impact is going to be a slight increase of about 5% to 6%. I think that's consistent with the fact that our portfolio is a shorter duration and commercially focused. The go-forward, we feel like the go-forward provision is not going to be...the 60…the guidance that we gave in the low-to-high 60 that includes our estimate of people adoption and any impact that would have. And we really don't think that the go-forward provision varies significantly from the incurred method. I would continue to remind people about the volatility that CECL can have on provisioning because of the economic forecast that you have to

incorporate. So whatever point we start to see, two years out, are the variable change, we will be able to see some uptick in provision. But that's not...that's not unique to Texas Capital everyone will experience.

Jennifer Demba
Okay, one last question. The technology bankers, just curious what their level of experience is, where they came from, et cetera?

Keith Cargill
Very, very deep in experience, I have been interviewing with our credit senior team and Kerry Hall our Regional President here in Austin for over 12 years, to find a technology banking team that we had very, very high confidence in, on the target market, Jennifer, they would they would go after and the risk profile of the kind of clients that they would target, and I'm extremely excited about Doug Mangum who is going to head this up…who is heading this up for us and his team. And Doug spent a period of time with Silicon Valley Bank. After that he was with Wells Fargo for some time and ran this business for them. So we're just very fortunate that Austin attracts a lot of talented people and we set that business up in Austin.

Jennifer Demba
Thank you.

Keith Cargill
You're welcome.

Operator
Our next question comes from Steven Alexopoulos with JP Morgan.

Steven Alexopoulos
Hi, everybody.

Keith Cargill
Hi, Steve.

Julie Anderson
Hi, Steve.

Steven Alexopoulos
I want to start on the net interest margin. So you were 2.95% in the fourth quarter, the guidance is 3.05% to 3.15%. What's the road map to get from where the NIM was in 4Q to this fairly material increase in 2020?

Julie Anderson
So we assume some shift in assets. We assume that warehouse is going to be down some and that we would shift into more to MCA and then we'll start to see some C&I growth. So it's the earning asset shift. Well, also we had some higher levels of liquidity; we still expect to have a

higher level of liquidity. But as we start to replace some of the higher cost deposits with more granular deposits, you could potentially see some of our liquidity...kind of overall liquidity come down a little bit. But really, it's more about the shift in loan mix.

Steven Alexopoulos
Okay. And do you think you can get into this range before the MOE closes?

Keith Cargill
I think it will be back-end loaded, Steve. I think we will begin to show that trajectory. But what do you think, Julie?

Julie Anderson
Yes, I think...I don't know, I think we can probably get there. I think…

Keith Cargill
I think it would be second quarter, not first quarter.

Julie Anderson
Second quarter. Yes.

Keith Cargill
Yes.

Julie Anderson
The other thing, Steve, that the deposit cost that we have pretty meaningful downtick in. There is still...the ending spot rate is lower, like on the interest variance, lower than what we saw in the fourth quarter. So there will be some…

Steven Alexopoulos
Okay, that's helpful. And then on the deposit growth which was really strong in the quarter, your average savings were up almost $800 million. Can you give some color, it doesn't sound like Bask was a contributor in the fourth quarter?

Keith Cargill
No we're just getting some of these verticals we've developed the last few years kicking in, but our core treasury including our specialized treasury group that works with mortgage finance, those were all really hitting on all cylinders. So we are in fact picking up some of those gap relationships where we had just not been as thorough the last three or four years as we grew loans to pick up the treasury business too. And so, that's really helped as we've doubled down on our focus by the relationship managers teaming up with our treasury team, Steve, and it's really producing good results. But a piece of that too is just the seasonality of the mortgage finance escrow business. And we had very strong numbers on both sides of the balance sheet with that group too.

Steven Alexopoulos
Okay. And then final question on credit, when you look at the increase in nonaccruals on the leverage book which segments did you see the increase in nonaccruals?

Julie Anderson
I don't remember...I don't remember…it doesn't mean it is not really relevant. There has not really been a trend, any kind of industry trend in leverage. So...

Keith Cargill
In our case, we just haven't seen that diverge.

Julie Anderson
No.

Steven Alexopoulos
Okay. Alright. Thanks for taking my questions.

Keith Cargill
You're welcome.

Operator
Our next question comes from Brock Vandervliet with UBS.

Brock Vandervliet
Great. Thanks for taking my question. Just a follow-up on that deposit question, the mortgage finance linked deposits, how sticky are those? And just a tremendous increase this quarter, is that seasonal, do some of those flow back out or is that more likely to stick around?

Keith Cargill
It does have some relationship to the volume of the overall industry. So if you are seeing mortgage finance on the asset side really be high, you are going to see some higher escrow deposits also. There is flow in and out, but it rebuilds rapidly when there are those payments on taxes and things of those sort that occur through those accounts, Brock, but there is some relationship too and just the sheer volume of mortgage originations which was quite strong.

Julie Anderson
Hey, Brock. I think I mentioned that in some of my commentary that sometimes you will see a little more downward pressure from seasonality on the deposit side in those escrow deposits in the fourth quarter and starting in the first quarter. But a lot of that's been overcome with just lower rate and that originations. Our clients are still originating there, so they are masking those flows out for taxes, but just new originations of loans and new escrow.

Brock Vandervliet
Okay. And a couple of people have taken shots at this, but as you look at the trend in the increase in non-performers and criticized, what do you see behind the curtain that gives you the confidence

with that provision guide. I honestly thought you are going to have a very large CECL adjustment, you're not. It just seems a pretty bullish guide on provision given where some of the problem asset levels seem to be headed.

Keith Cargill
Well, again, we believe we'd properly reserve Brock, if you had these not on the radar and not being reserved along the way, then certainly that would be a bigger problem. We did have some tick-up in overall criticized classified. But as Julie said that entire change to the positive quarter-over-quarter was one energy deal that moved to special mention. It was a large energy deal, but that was more than the difference between third quarter criticized classified and fourth quarter. So we don't see that as headed to a significant downward trajectory.

Even if we have an energy deal, a large energy deal that back to Jennifer's earlier question and yours…that we don't have on the radar yet, that could change our life. But, again we feel like we've really going to school on leverage for year and a half, deep dives, frequent reviews, much more thorough monitoring by the line and also the credit teams and energy beginning first quarter. So, we are not quite as deep into the energy portfolio as far as the frequency and a year and half of review like we are leveraged. But, that would be the one of the two that I would think we might see something that pop up. But, we just don't have it on the radar at this point, we feel like we got a good handle on anything that's showing weakness. Things could change. But, at this point it would only be a guess that it would be worse, right now this is our best estimate.

Julie Anderson
And for all of those identified problem loans especially in the non-accrual...in the non-accruals they've been marked to their impairment value based on the information that we have. And so in all those cases where it's a problem loan, there is a defined strategy that the team is working on, so certainly all of that information informs the decision about how to estimate guidance.

Keith Cargill
And we have three or four good sized loans this quarter that should pay off that are in that classified category as well. So Julie alluded to that earlier too, Brock. We are going to see some recovery of reserve, if you will, that helps mitigate the net provisioning for 2020 also.

Brock Vandervliet
Okay. I appreciate the color.

Keith Cargill
Welcome.

Operator
Our next question comes from Brad Milsaps with Piper Sandler.

Brad Milsaps
Hi, good evening.

Keith Cargill
Hi, Brad.

Julie Anderson
Hi, Brad.

Brad Milsaps
Keith, I just wanted to maybe touch on loan growth. Your guidance for mid-single digit average LHI growth in 2020 is pretty much equal to what you grew in 2019. However, the average balances have been flattish for most of the year and just up slightly from the fourth quarter '19 to the fourth quarter of '18. I understand you got the...had the pay-offs, but your period end balances are below the average for the quarter. Just what gives you confidence you can kind of reaccelerate things? Is it just the pay-offs and run-offs slowing down or something else that you see out there?

Keith Cargill
Well, you touched on it, but these pay-downs on leveraged and on energy total about $550 million. So going in…and that's been accumulating, of course, throughout the year. So going in with our run rate for this next year, we have to overcome more than $0.5 billion of average outstandings in traditional LHI. But we do have these two new C&I businesses. Now they're not going to be out of the gate booking hundreds of millions the first year, but we're going to see a nice contribution to helping backfill and give us also businesses. We like the risk appetite and also the self-funding components of these two C&I businesses.

We've really been working hard on a new strategy and tactical plan on our prospecting on general C&I. And we're very, very encouraged by the pipeline that our bankers are creating and I don't know if that is going to have a major impact until maybe the middle of the year because it does take time, of course, for some of those to hatch. But we have been working on this for a year now. And I feel very good about the discipline and focus as we've pivoted away from leveraged and focused more on the general C&I and these new C&I businesses we're launching. So I feel like it's very achievable.

Julie Anderson
And then, Brad, the other thing that I mentioned is that we're planning to portfolio some of the MCA 1-to-4 family loans later in the year.

Keith Cargill
And those come on at a little better rate, as Julie mentioned, than warehouse loans and also a better risk weighted capital assessment.

Brad Milsaps
Great, that's helpful and just one more follow-up. When you guys announced the MOE, I think you had an asterisk next to the 2021 numbers that the Street had for you at the time that you might accelerate some expenses. I'm curious if kind of what you talked about today sort of

encompasses that acceleration or there is kind of more to come in that regard as you kind of think about the combined earnings power of the two companies?

Julie Anderson
All we talked about was that in coming up with the cost saves, the cost saves as a percentage of the combined NIE that we have tried to use...that was for 2020, we have tried to use the Street estimates, except on our side, we had some additional costs and really, Brad, those were related to Bask Bank, so we've talked about those today.

Brad Milsaps
Perfect. Probably just wanted a clarity on kind of what it included…

Keith Cargill
We have to go public with that, on Bask Bank today.

Brad Milsaps
Great. Thank you very much.

Keith Cargill
You're welcome.

Operator
Our next question comes from Gary Tenner with DA Davidson.

Gary Tenner
Thanks. Good afternoon.

Keith Cargill
Hi, Gary.

Julie Anderson
Hi, Gary.

Gary Tenner
Hi. I have a couple of questions. First, Julie, I think if I understood your commentary correct around the yet to be launched verticals, you've mentioned there were I think six additional verticals where you've invested around $8.5 million. If I heard that correctly, I don't recall hearing that kind of commentary before and the ramifications if you didn't roll them out. So I'm wondering if there's been any change in the philosophy or view of the viability of those businesses with the pending transaction?

Julie Anderson
Yes. Now the $8.5 million, that was actually related to the C&I vertical, and so we've launched two and the $8.5 million was related to the evaluation of multiple C&I verticals. We've launched two and we will evaluate some others going forward. But what we said is those two...those two

are going to be breakeven this year and within two years they will recoup the $8.5 million that we've invested even if we don't do any additional C&I verticals.

Gary Tenner
I see, okay.

Julie Anderson
So it wasn't related to deposits at all, that was related to the C&I verticals.

Gary Tenner
Right. And then secondly, on your commentary on the efficiency ratio where you talked about the adjusted number excluding the marketing fee component for deposits, could you help me understand the rationale for excluding that expense?

Julie Anderson
Yes. In the [indiscernible] adjusted, we don't really exclude it, we just move it up into net revenues, we move it up as a component of the margin. The way the fee works is it has to be classified as non-interest expense, but really, it's a margin component. And so, all we do in that adjusted efficiency is move it to the place, move it to the top of the income statement.

Gary Tenner
Okay. So you're not totally excluding it from the efficiency calculation. Okay.

Julie Anderson
No, we're just moving, it's just geography is moving. But to illustrate how punitive it can be just on the efficiency ratio, just because of the way it has to be categorized.

Gary Tenner
Okay, all right, very good. Thank you.

Keith Cargill
You're welcome.

Operator
Our next question comes from Brian Foran with Autonomous Research.

Brian Foran
Hi. It sounds like a lot of people are maybe struggling with the same thing on the deposits. The growth was so strong in the back half of the year. The numbers attached to Bask Bank, the commercial escrow and some other initiatives are pretty big. But then you've got the flat average guide and that's down a little bit from period-end. Is it possible, you referenced some deposits that maybe weren't sticky in the fourth quarter or seasonally elevated, is it possible to put kind of a number on how much of the existing fourth quarter deposits you'd expect to go away in the first quarter?

And then when you talk about the pool of high-cost deposits that you want to optimize, whatever the word was, is there a total number that you have earmarked, like you're looking at your deposit base and there is x billion that you'd love to take out over the next two years and swap into these other initiatives?

Julie Anderson
The flat deposits guidance that is about the repositioning...that's about the repositioning and there are some higher cost deposits that we would expect to replace with some of the new verticals. And then same thing, we have some brokered CDs which those have varying maturities over the next year and depending on how the verticals are held, Bask Bank is tracking, we would replace those. So the flat deposit growth is really about optimizing the liabilities on the balance sheet.

Keith Cargill
And that helps our NIM some too. There was an earlier question about our NIM and again, as we reposition the cost of funds and our funding, it will help us on NIM as well.

Brian Foran
Okay. And then I don't know how it works with the merger pending, but it's maybe a little unusual to see these many kind of new initiatives and changes in this pending period. I mean, are all the kind of strategies, the Bask Bank initiatives, the funding, I mean, is it all something that's aligned in part of the new entities combined strategic plan?

Keith Cargill
This is no surprise, as far as the diligence that we each conducted. So certainly, these are not new ideas or something brand new to Independent. I think they see us as offering some real strategic innovative capabilities that for a $50 billion bank or kind of table stakes really important and certainly, we've always thought of ourselves Brian, as a company that played up and would be a $50 billion bank some day. So I think it's good for our organic standalone company and it will be even better for the combined company. And, yes, there is no surprises relative to the expectations by David Brooks and the Independent team.

Brian Foran
Okay, thank you.

Keith Cargill
Welcome.

Operator
Our next question comes from Jon Arfstrom with RBC Capital Markets.

Jon Arfstrom
Hi, good afternoon.

Keith Cargill
Hello Jon.

Julie Anderson
Hi, Jon.

Jon Arfstrom
Hi, just a quick one on Bask. I know you had a prior relationship with American through Bank Direct. But I'm curious if Bask is some kind of an exclusive with American almost like a card loyalty program or something like that or curious how you defend against competition in the product.

Keith Cargill
Agility. There is not an exclusive. That is something that, of course, we would have liked to have had, but had we done that and that excludes us too from pursuing other potential affiliates. So it ended up being, we don't have an exclusive Jon, but we do have a running start. And I think in this business, you always have to be running, expecting the wolves to be right behind you, and therefore, always looking for new ways to innovate and add new capabilities, new affiliates, new product and we're all about that. So that's our situation with American. We're very excited about it and American seems to be as well.

Jon Arfstrom
Okay. And safe to say it's a likely template for other products that you're thinking about?

Keith Cargill
It is. It is and again it's not just a vanilla only forever, but we want to nail this, and so we're not going to get distracted talking about all the other things we'll be able to do with this digital platform. But we have many other ideas relative to serving other clients business as well as consumer.

Jon Arfstrom
Okay. Okay, thanks a lot.

Keith Cargill
You are welcome.

Julie Anderson
Thanks, Jon.

Operator
This concludes our question and answer session. I would like to turn the conference back over to President and CEO, Keith Cargill for any closing remarks.

CONCLUSION

Keith Cargill
I just want to thank everyone for joining our call and we look forward to a great quarter this quarter, and focused every day on taking better care of clients than we ever had before despite the merger work that's ongoing. Have a good evening. Thank you.

Operator
Thank you for your participation in TCBI's Q4 2019 earnings conference call. Please direct requests for follow-up questions to Julie Anderson at julie.anderson@texascapitalbanc.com. You may now disconnect.