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Texas Capital Bancshares, Inc.

Q4 2020 Earnings Conference Call

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CORPORATE PARTICIPANTS

Larry Helm - *Executive Chair, President, Chief Executive Officer*

Julie Anderson - *Chief Financial Officer*

John Turpen - *Chief Risk Officer*

Shannon Wherry - *Director of Communications*

PRESENTATION

Operator
Good day and welcome to the Texas Capital Bancshares Fourth Quarter 2020 Earnings Conference Call. All participants will be in listen-only mode during the presentation. Please note, this event is being recorded. If you 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
Good afternoon. Thank you for joining us for TCBI's fourth quarter 2020 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. 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 earnings 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 Relation's section of our website at texascapitalbank.com.

Our speakers for the call today are Larry Helm, Executive Chair, 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 Larry for opening remarks.

Larry Helm
Thanks, Shannon and welcome, everybody, and thanks to all of you for joining us today. On May 26th, 2020 the Board asked me to step down as Interim CEO as we were terminating a merger and in a leadership transition period. In my first earnings call with you in July, I said we were putting into place a 6-to-18 month plan to restore our earnings to a higher and more sustainable trajectory. I said we would do this through getting our arms around credit, increasing profitability by moving some excess liquidity into a higher-yielding investment portfolio, expense rationalization, investments in C&I bankers and product sets and completing the succession planning process by hiring our next CEO.

Our results for this quarter are in line with our plan. We made significant progress with the credit portfolio, including a provision similar to the third quarter. As JT and Julie will describe in a few minutes, we saw meaningful improvement in non-performing and criticized levels and importantly

the migration to classified has slowed. We had charge-offs resulting from issues previously identified as two-thirds of that was already fully reserved. This included the resolution of three problem energy credits, which were restructured into one smaller past credit and the resolution of two COVID-impacted credits.

During the quarter payoffs of classified loans at par were approximately $100 million. I have been very proud of our team as they had fully embraced this short term strategy, successfully navigating the pandemic by taking good care of our clients and improving our credit performance and our outlook.

I announced the hiring of our new CEO, Rob Holmes in November after a nationwide search. Although he has officially been on garden leave these last 90 days, he has been studying our company, our employees, our markets, our clients, and opportunities to improve our outlook for the long term. Next week, he will begin formal reviews of our lines of business and carefully assess overall strategy. I could not be more pleased with the choice our Board made in hiring Rob. He will hit the ground running on Monday, January 25th.

And with that, I'm going to turn it over to Julie to walk us through the quarterly results.

Julie Anderson
Thanks, Larry. We're pleased to have finished the year strong executing on the midyear plan Larry mentioned. Total revenue for the fourth quarter was $266 million, which is consistent with the third-quarter level.

Part of our plan was to capitalize on market conditions favorable to our mortgage finance business to drive meaningful revenue using our lowest risk loan category while we continue to de-risk in certain categories and while demand for other risk-appropriate growth has been slow. During that time, we've continued recruiting and hiring C&I bankers. Two new bankers have been hired since June 30th and the recruiting of bankers continues.

As expected, the fourth quarter provision was in line with the third quarter level and is primarily reflective of changes to impairment amount and the subsequent charge-off in the resolution of two COVID-impacted credits. Additionally, deferrals totaled $90 million at the end of December, down from $166 million at the end of September.

Since late third quarter, we've taken a more comprehensive restructuring approach in addressing deferral requests that don't simply involve extending payments or suspending payments for a period of time. Generally, these negotiations include providing the borrowers some level of payment relief while requiring continued interest payments and a range of covenant and support requirements from the borrower.

As a reminder, we started with $1.2 billion of deferrals at June 30. So, the current number is representative of the work that's been done as we actively engage with our clients in understanding the COVID impact on their businesses. It's premature to give guidance on provision at this point because certainly there are plenty of unknowns with the continued

pandemic. What we will say is assuming no meaningful deterioration in the economy, we would expect 2021 provision levels to be directionally much lower than full year 2020.

And now I'll move on to a few of the details for the quarter. Average loans held for investment, excluding mortgage finance, was down on a linked quarter basis as we continue to experience accelerated CRE payoffs and utilization rates have remained low. Obviously, loan growth is only one output of new relationships, and we're seeing positive traction in attracting new relationships as evidenced by loan, deposit and treasury pipeline. And the push for expanding existing relationship is showing success.

There was positive movement in core loan yields in the fourth quarter, which included a higher level of fees, part of which was related to PPP. Loan spread improved as well with funding costs continuing to come down. We experienced another quarter of meaningful average deposit growth. We expect continued reduction in funding costs as higher cost CDs run off and as term FHLB borrowings mature, and those balances, going forward, move to lower overlap rates. Again, longer term, the real driver of improved funding cost will be the optimization of the funding stack to lower beta of relationship deposits consistent with our core C&I strategy.

Net interest income was up compared to the last two quarters, with NIM improving in the fourth quarter. As we continue to say, we're always focused on maximizing net interest income despite some fluctuations in NIM. But it is important to note the drop in NIM, net of the liquidity build since the fourth quarter of 2019 has been only 2 basis points. NIM can continue to fluctuate with shift in earning assets.

Since midyear, we've been able to deploy approximately $3 billion in securities at an average yield of 1.4%. We will continue to assess this strategy, but pace of build could slow as we evaluate overall macro environment conditions and our new CEO's broader strategic objectives.

Warehouse yields continued to decline slightly linked quarter but have been extremely resilient throughout 2020. We do expect some continued compression in those yields in 2021. Core LHI yields improved during the quarter and included the higher level of fees, only part of which was PPP.

At the end of the year, over 30% of our core LHI loans had floors in place, which continues to improve, despite the competitive environment. Again, we still believe there's some room for deposit pricing to come down as higher-priced CDs continue to roll off and FHLB term borrowings mature and move to overnight borrowings.

The provision for the quarter was $32 million and approximately two-thirds of that was related to additional impairment on two previously identified COVID-impacted credits that were resolved this quarter. Additionally, there was continued negative migration during the quarter, primarily in CRE and specifically the hotel book, but that was partially offset by meaningful payoffs of problem credits and some upgrades.

Total criticized decreased as a result of the payoffs as well as charge-offs. As we expected, charge-offs were higher in the fourth quarter and will continue to be more elevated as we move through the cycle. Fourth quarter included resolution of three fully reserved energy deals and the two previously identified COVID-impacted deal.

The pace of migrations to criticized slowed during the quarter. And while again, it's too early to declare victory because we have a meaningful number of deals still to be resolved, we feel comfortable that the remaining criticized book is comprised of loans that have secondary sources of repayment, very different in profile than what we experienced with some of the energy and leverage credits we resolved earlier this year.

Noninterest income levels were consistent with expectations as gain on sale was lower with competition and lower volumes. We are, of course, influenced by the market and contraction of the healthy primary secondary spreads enjoyed earlier in the year. But there are certainly a variety of factors that influence the gains we realized. While we expect gain on sale margins to remain strong through the first half of 2021, we do expect some continued compression.

Core noninterest expenses for the quarter included the benefits from the actions taken earlier in the year. The fourth quarter total noninterest expense was slightly higher than expected primarily related to servicing expenses, and more specifically, the continued increase in amortization expense related to early payoffs. We're working on strategic alternatives to lessen that exposure in 2021. Our initial plan for 2021 noninterest expense calls for levels to be flat to down slightly, but we'll be reevaluating that as we work with Rob on strategic priorities.

We do know that investing in C&I bankers will continue. Our recruiting efforts have been very successful in the last six months, and we expect that success to gain even more traction when Rob joins us.

Larry Helm
Thank you, Julie. I appreciate those comments. So, questions, Q&A now? So, why don't we move to Q&A. Operator…

QUESTION AND ANSWER

Operator
Thank you. To ask a question, please 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, please press "*", then "2." And at this time, we'll pause momentarily to assemble the roster.

And our first question today will come from Brett Rabatin with Hovde Group. Please go ahead.

Brett Rabatin
Hi, good afternoon, everyone.

Julie Anderson
Hi, Brett.

Brett Rabatin
I wanted to first just talk about the loan growth outlook. And obviously, you've been working through some credits, and it's good to see the NPA is down and dealing with those energy and leverage credits. Can you talk about maybe the pipeline? Where it is today maybe versus at the end of last year, and at some point, during the summer months, when it was obviously impacted by COVID.

Larry Helm
So, look, we're still in the middle of a pandemic. And so we're not really giving guidance on what loans are going to do over the next 12 months. Our clients have done well through this period of time. We're beginning to see opportunities that we haven't seen in the past. We believe that there will be opportunities for good loan demand. But I think it will be soft, certainly in the first half of the year. And we'll see what the second half looks like as we get further into any economic consequences of this pandemic.

Brett Rabatin
Okay. That's helpful. And then secondly, I think PPP loans were $715 million at the end of 3Q. What were they at the end of 4Q? And then, can you talk maybe about the matriculation of the fees in the first half of this year as those loans are forgiven? And then just maybe any thoughts on the second round of PPP?

Julie Anderson
So, I'll take the fee part and then JT can talk about the balances. The fees, we would expect there's still to be some impact from the fees for the next two quarters at least, as those pay off.

John Turpen
Yes. As far as the PPP loans, we had a peak of $717 million in Q2, and that's down to $617 million now, so about $100 million down. And then the prospects of the second round going forward, at this point, we opened up our application process at the beginning of this week. Based on early returns, we would estimate somewhere between 30% to 50% of the volume that we saw in the first round program.

Brett Rabatin
Okay. And if I could sneak in one last one. I was just curious on the…if you have maybe the loss factor, what you realized on those net charge-offs in the energy and leveraged loans? What kind of loss you took on those?

Julie Anderson
Yes. That's not something that we usually give. I can tell you that the energy deals were energy deals that had been problems for a while. So, that wouldn't really be representative of anything that would be left in the book. And then, the COVID-impacted credits, those were just…those credits were fine prior to the COVID. But yes, we don't really talk about that.

I guess, what I would point you to Brett is that, what's left when you look at the breakdown of what's left in non-performing, I think that the secondary sources of repayments we feel good about. So, I think that's probably what you're…what you're focused on is loss exposure going forward.

Brett Rabatin
Alright. I appreciate all the color. Thanks.

Operator
And our next question will come from Brady Gailey with KBW. Please go ahead.

Brady Gailey
Hi, thanks. Good afternoon.

Julie Anderson
Hi, Brady.

Brady Gailey
I just wanted to ask about the growth in the bond book, I know, you guys signaled that you'd be adding and you did at the back half of last year. What about from here? What about into 2021? Will growth in the bond book continue at this pace or will it slow or will it be flat? How are you thinking about putting in excess liquidity to work in the bond book?

Julie Anderson
Yes. So, I think that…yes, we've been pretty aggressive since the middle of the year at moving that up, because we needed to pick up the yield. I think we'll be cautious with what's going on with rates, we're going to be cautious. And then again, we're going to spend time with Rob and figure out what strategic objectives we're going to be focused on. So, I would say, in a couple of months we will tell you more about what we're planning for the bond portfolio. But I think for now, we would probably expect to pause a little bit on some of that growth.

Brady Gailey
And then, within the fee income there you have the line that's the gain on the sale of loans held for sale from MCA, I mean, that line could just be all over the place and very lumpy?

Julie Anderson
Yes.

Brady Gailey
So, any color on how we should...I mean, I think in for full year 2020 you did about $58 million. How should we think about that going forward?

Julie Anderson
So, I think that…you know, it hit its peak in the second quarter. Like I said in my commentary that's where we are all taking advantage of the premium pricing. It hit the peak in the second quarter, was a little bit less in the third, and then a little bit less in the fourth. So, I think that the fourth quarter is probably a decent run rate. There could be a little bit more compression, but I think the fourth quarter is probably a decent run rate for what you see going forward.

Brady Gailey
Okay, great. Thanks, guys.

Julie Anderson
Thanks.

Operator
And our next question will come from Brad Milsaps with PSC. Please go ahead.

Brad Milsaps
Hi, good evening.

Julie Anderson
Hello, Brad. How are you?

Brad Milsaps
Hi, Julie. How are you doing? Just to kind of follow-up on Brady's question around the bond portfolio. It looks like the yield stayed pretty stable linked quarter at around $144 million. I was thinking you may be buying stuff in the low ones. But just curious how that's changed and kind of what you might...do you expect that to hold fairly stable, assuming you kind of slow down some of the purchases in '21?

Julie Anderson
Yes. I think we will slow down a little bit. I don't think that we're going to...we're cautiously evaluating that now. I don't think you'll see much change in the rate if we do a little bit more. But again, I think we're going to...we're going to pause on that as we kind of evaluate Rob's strategic objectives.

Brad Milsaps
Okay, great. And then just in terms of the warehouse. Just curious what the participation number was this quarter. I know, you're probably not going to give a lot of guidance for '21. But just want to think about what...maybe you could call back in to maybe offset some of the natural maybe slowdown we see this year.

Julie Anderson
So, we have a little over $1 billion. I think it's probably $1.2 billion or $1.3 billion at the end of the year. So, yes, that would all be available to. The commitment level is a little bit higher than that but outstanding at the end of the year was about $1.2 billion. So, that's absolutely available to bring back on at…during the year we choose to do so.

Brad Milsaps
Okay, great. And then just one final housekeeping, I apologize if I missed this in the release. But the tax rate was maybe a little higher in the fourth quarter. Was there something specific going on there or just making more money and that rerated higher? Is there something else going on in the tax rate?

Julie Anderson
Yes. Well, that has to do with losing money for the six…first six months of the year, and the rate on the permanent items. So, yes, that was a little bit higher. I would expect 2021 goes back to a more normalized rate.

Brad Milsaps
Okay. Alright, great. Thank you, guys.

Julie Anderson
Thanks.

Operator
And our next question will come from Jennifer Demba with Truist. Please go ahead.

Jennifer Demba
Thank you. Good afternoon. Just wanting some more color on your expense guidance. I think you said it…you said it would be flattish this year…year-over-year, and…but you do want to continue doing hiring. Can you just talk about what your hiring objectives are and what the puts and takes are on the expenses for this year, Julie? Thanks.

Julie Anderson
Yes. So what I said with our preliminary plan and that's preliminary free raw plan it is flat to down a little bit, but we will certainly be evaluating that as Rob joins us next week. So, the hiring...and that included...the flat-to-down included some expected hiring of bankers. I think that's probably been...what we've had so far was what we planned or maybe a little bit ahead of plan.

So, again, it is premature for us to give any guidance on that. We want...when Rob...after Rob gets here and we start to reevaluate all that we'll try to give you a little more guidance on that. But, I guess, I would tell you in the support areas...what we've said is in the support areas. The support areas are going to be focused on giving the frontline what they need and the targeted...the hires are going to be focused in the frontline primarily as of right now.

Jennifer Demba
Okay. So, you would think that you would hire at least the number of people that you hired in 2020 this year?

Julie Anderson
Well, I mean, what we...what I've said was we hired 10 C&I bankers in the last six months. Again, there is a pipeline for more talent, but I think it's premature for Larry or me to tell you how many bankers we think we'll hire. We'll wait and let Rob talk to you about that.

Jennifer Demba
Okay. Thank you.

Operator
And our next question will come from Bill Dezellem with Tieton Capital Management. Please go ahead.

Bill Dezellem
Thank you. Would you please discuss the $5.7 million of energy loan recovery in the fourth quarter?

Julie Anderson
Yes, Bill. That's just...that was just related to a previous charge-off that we took, where there was some recovery based on...yes, that's all there is to say. It was a deal where there was a previous charge-off and we knew there might be some recoveries and they come through. I don't know. JT anything else to add?

John Turpen
Yes, I wouldn't expect that to be reoccurring, that pretty much wraps that up.

Julie Anderson
And pretty much...and it was related to one deal.

Bill Dezellem
And if we were to want to take it one step further and have the presumption or the hope that higher crude oil and natural gas prices would actually help with future recoveries and/or take some of your current non-performers in the energy arena and move them out of those buckets. So, is that something that you're thinking is possible or most of them too far gone at this point?

Julie Anderson
I think, I would say that...I don't think there's going to be recoveries. I don't think there...I don't think that the current commodity pricing would affect future recovery. Certainly the overall book is more stable with prices at this level.

John Turpen
It certainly factors into our reasonable and supportable forecast and how we think of just economic impact on our reserve needs, but it's not recoveries in the prospective natural gas and oil prices, it doesn't factor into to our calculations at this point. Nice surprises, but not anything that we're counting on or that we have specific line of sight into.

Bill Dezellem
No worries. And then last question. You mentioned the provision going forward will be down and '21 will be down from '20. That's a little bit of an easy hurdle. Let me ask it in a slightly...the question in a slightly different way. How do you view the provision going forward relative to the second half of 2020?

John Turpen
Yes, this is JT here. The way that I would...the way that I would describe it is, the next two quarters are going to be extremely telling. Depending on the asset class the recovery is quicker or elongated. Commercial real estate being the prime example where if you look at peak-to-trough on commercial real estate based on what you read in the macroeconomic forecast, it's really, I mean, we're out there still another two, two and half years before CRE has a final reckoning.

But we're cautiously optimistic, the information that we continue to get on the economy and just how sustainable the vaccination gets rolled out and how quickly that can get administered and how that decreases volatility and the economic forecast will have a huge impact. But we do like the mix of our criticized assets better now than we did given that that pool now is representative of the lower loss given default asset pool. So we'll see how it goes, but what I would suggest is we won't revisit 2020...second half of 2020, feels more directionally correct in the first half.

Bill Dezellem,
Thank you both.

John Turpen
You're welcome.

Operator
And again, if you would like to ask a question, please press "*", then "1."

And our next question will come from Matt Olney with Stephens. Please go ahead.

Matt Olney
Yes. Thanks for taking the question. I want to circle back on the discussion around liquidity and I believe the average overnight liquidity position was down a little bit but still around 30% of earning assets. You've talked about over time kind of moderating this. How much realistic opportunity is there to bring this down in 2021 and 2022?

Julie Anderson
So, we're focused on optimizing the funding stock, and so certainly there is some actions that we will take to reduce exposures to some of the index deposits. And that's going to happen over time, Matt. That doesn't happen quickly. But definitely there are already actions in motion to reduce some of those higher beta deposits over the course of 2021. Now, I mean, obviously the overall liquidity is...that's dependent on how core deposits grow. So, more to come as we see how the year evolves. But certainly we are focused on repositioning the funding mix.

Matt Olney
Okay, got it. Thank you. And then on the loan yield side, the LHI loan yields were...it was impressive in the quarter. I think you said it includes some higher fees even outside of PPP. Can you quantify what the quarter-to-quarter change was in the fourth quarter?

Julie Anderson
Yes, I mean, we don't like to...I don't like to get into specifics about that. So there was, I guess, what I would tell is, there is…I would expect first quarter LHI yield, there could be some compression there. We will still have some impact from fees. And then, just the pipeline for some new deals and related fees is good. So, I do think that first quarter will have some of that. But it would not be surprising if first quarter LHI yield is compressed a little bit from the fourth quarter.

Matt Olney
Got it, okay. And then just lastly, you mentioned the expectations for expenses kind of flattish from here, if not down a little bit. What's the starting base that we need to start from for that assumption?

Julie Anderson
Normalized for this year…the normalized for this year which is...yes in 2019…yes, $600 million, yes, normalized of about $600 million.

Matt Olney
Okay. So $600 million is the starting point for the…

Julie Anderson
Yes.

Matt Olney
For the flat to down commentary. Okay.

Julie Anderson
Yes, because that's pretty much in normalized for 2020.

Matt Olney
Okay, great. Thank you.

Julie Anderson
Sure.

Operator
And this will conclude our question-and-answer session. I'd like to turn the conference back over to President and CEO, Larry Helm, for any closing remarks.

CONCLUSION

Larry Helm
Thank you for joining us today. I really appreciate your patience with us as we go through this transition in leadership. I promise you it will pay off and we will be able to answer a lot more of your questions as we get further into the next administration. So again, thank you very much for your patience with us and your attention to our company. So, I hope you guys have a great and safe weekend. Thanks.

Operator
Thank you for your participation in TCBI's fourth quarter 2020 earnings conference call. Please direct requests for follow-up questions to Julie Anderson at julie.anderson@texascapitalbank.com. You may now disconnect.