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Veritex Bank Third Quarter 2017 Earnings Conference Call
October 24, 2017

C: Susan Caudle; Veritex Holdings, Inc.; IR,
C: Malcolm Holland; Veritex Holdings, Inc.; CEO and Chairman
C: Noreen Skelly; Veritex Holdings, Inc.; CFO
C: Clay Riebe; Veritex Holdings, Inc.; Chief Credit Officer

P: Matt Olney; Stephens, Inc.; Analyst
P: Brett Rabatin; Piper Jaffray; Analyst
P: Brad Milsaps; Sandler O'Neill; Analyst
P: Gary Tenner; D.A. Davidson; Analyst

+++ presentation
Operator^ Good day and welcome to the Veritex Holdings, Inc.'s third quarter 2017 earnings conference call and webcast. All participants will be in a listen-only mode. Please note, this even is being recorded.

I would now like to turn the conference over to Ms. Susan Caudle, Veritex Holdings, Inc.'s Investor Relations Officer and Secretary to the Board.

Susan Caudle^ Thank you, Liz, and good morning, everyone. Welcome to the Veritex Holdings, Inc.'s, third quarter 2017 earnings call. Before we get started, I'd like to remind you that this presentation may include forward-looking statements. Those statements are subject to risks and uncertainties that could cause actual and anticipated results to differ. The company undertakes no obligation to publicly revise any forward-looking statements.

At this time, if you're logged into our webcast, please refer to the slide presentation available online, including our safe harbor statement, beginning on Slide 2. For those joining by phone, please note that the safe harbor statement and presentation are available on our website, veritexbank.com. All comments made during today's call are subject to that safe harbor statement. In addition, some of the financial metrics discussed will be on a non-GAAP basis, which management believes better reflects the underlying core operating performance of the business.

I'm joined today by Veritex Holdings, Inc.'s, Chairman and CEO Malcolm Holland, Chief Financial Officer Noreen Skelly, and Chief Credit Officer Clay Riebe. After the presentation, we'll be happy to address questions that you may have as time permits.

With that, I'll turn it over to Mr. Holland.

Malcolm Holland^ Thank you, Susan, and good morning, everyone. We're excited to host our very first live earnings call for Veritex Holdings. I'll start with a short summary of the quarter, and then Noreen will give you some additional color on our numbers. And then I'll come back and close, and we'll open the line for questions.

The third quarter, it was an extremely transformational quarter for Veritex Bank. We closed and completed our conversion of our largest acquisition to date, the $1.1 billion Sovereign Bank. We also announced the acquisition of the largest remaining community bank in Fort Worth and Tarrant County in the $450 million Liberty Bancshares. We did receive all of our final regulatory approvals late last week. We completed our second follow-on capital raise, and this morning we announced the sale of our two Austin branches to Horizon Bank in Austin. And, finally, for the fourth year in a row, we've been named one of the best banks to work for by the American Banker. So, obviously, you can see it's been a very, very busy quarter from an M&A perspective.

We've also been busy the growth front. Jeff Kesler, our Chief Lending Officer, and his team continue to be active in our markets. We're incredibly fortunate to be in the DFW and Texas markets. I heard a stat this week by the DFW chamber that approximately 400 people are continuing to move into North Texas every single day.

Houston continues to be strong as well. Although parts of Houston have been and will be rebuilding from Hurricane Harvey for several years, the majority of the market is back up and running strong. We did a deep dive of all of our Houston clients and Houston collateral, and as of this date, we have not found any significant concerns amongst our Houston portfolio.

Loan growth for the quarter was excellent. Veritex portfolio, excluding Sovereign, organically grew $53.3 million or 19% annualized. For the first nine months of 2017, the Veritex loan portfolio has grown at an annualized rate of just under 25%. The acquired loan portfolio from Sovereign did shrink $19 million from paydowns and in the normal course of business. Loan pipelines remain strong and robust, and we look for the fourth quarter to produce much of the same results.

Credit quality continues to be very strong, with NPAs to total loans of 0.1% and net chargeoffs for the year-to-date of 0.05%. Deposits remain strong top-of-mind focus, but, candidly, have been a challenge over the last quarter. Historically, the fourth quarter has been a strong deposit quarter for us, and we look for this trend to continue.

I'll now turn it over to Noreen, our Chief Financial Officer, to summarize the third quarter numbers.

Noreen Skelly^ Thanks, Malcolm. Let me start my comments by leading you to Slide 7 of the presentation. As Malcolm mentioned, we had a transformational quarter, and our financial results bear witness to this. We closed the Sovereign transaction on August 1. Thus, the 9/30 results represent one month of legacy Veritex balance income and expense, and two months of the combined company. We had record earnings of $5.14 million, producing $0.25 of diluted earnings per share. Also, recall that we raised 2.285 million shares of Veritex common stock, with net proceeds of $56.7 million to support growth activities in December. Our EPS results reflect the dilution from that capital raise.

Included in this quarter's income was $637,000 of income related to purchase accounting on acquired loans and $1.4 million of noncore merger and acquisition expenses related to the Sovereign transaction. Excluding noncore income and expense, our core net income was $5.7 million and our core diluted EPS was $0.28. The core efficiency ratio improved to 56% as of quarter end.

Ending assets totaled $2.5 billion and included preliminary purchase accounting marks. We anticipate fair value accounting to be finalized in the 12/31 financial results.

Turning to Slide 8. Malcolm hit the headline on loans. Loan balances at 9/30 reached $1.9 billion, growing $785 million from the second quarter. The acquired loan balances as of 9/30 included an estimated accretable purchase discount of $6.4 million. The average yield on loans for the quarter was 5%, which included a 15-basis-point contribution from accretion on purchase discounts.

Turning to Slide 9. Credit quality remains strong for the legacy Veritex portfolio. Nonperforming loans and nonperforming assets are consistent with historical levels. At 9/30, we had $32.2 million of purchase credit impaired loans, and they represent just under 2% of average loans outstanding for the quarter.

Turning to Slide 10. Deposit balances were $1.986 billion, growing $775 million over June 30. The increase is the result of acquired deposits of $809 million. Acquired deposit accounts declined $100 million over the last two months of the quarter. The average rate paid on interest-bearing deposits was 0.86% and the total cost of funds was 0.62%.

Slide 11 provides insight into net interest income and drivers of margin change. The margin and yield on this page is what we're calling core as it excludes the income recognized on acquired loans from net interest income. You will note that over the last two quarters, we have used the excess proceeds from the December capital raise to pay off Sovereign's [SPLF] preferred shares and to fund loan growth.

At this point, let me turn the presentation back to Malcolm.

Malcolm Holland^ Thanks, Noreen. Now that we have the Sovereign system conversion behind us, we're focusing on the close and conversion of Liberty. At this point, we expect to close Liberty in early December and complete the system conversion in early second quarter 2018. Additionally, we anticipate consummating the sale of the two Austin branches later this quarter.

Another piece of exciting news is the addition to our C-suite team and new CIO, Michael Bryan. As our business moves more and more into the technology world, we recognize the importance of such a position. Michael most recently served as the CIO at BNC in North Carolina. He'll start next month and will lead our IT teams, both internal and external, and is an excellent add to our already talented team.

At this time, I'd like to open it up for any questions.

+++ q-and-a
Operator^ (Operator Instructions) Our first question comes from the line of Matt Olney with Stephens.

Matt Olney^ I want to start on the branch sales in Austin and exiting that market. Any more color you can give us as far as the overall impact on loans, deposits, revenue, expenses? Anything that you can point towards in terms of forecasting this out in our models?

Malcolm Holland^ Sure. So the deposit balances are going to range between $80 million and $100 million. Loan balances are around $60 million, but we've basically given the buyer the option to buy or not buy, so we'll know by the time we get to closing what they're going to buy or not buy. I think they're going to buy them, but they're actually going through their diligence process right now.

From a P&L standpoint, Matt, we've looked at that as a breakeven, so it's not going to be a plus or a minus either way. And just the color is that when we looked at our resources and the time and effort that it was going to take to build that market -- and in my opinion, that had to be at least $0.5 billion market for us -- we were going to get a much better return if we spent those dollars and then management time and effort in the Houston market than we would get in Austin, so that was just the top-of-the-head decision.

Matt Olney^ Okay. That's helpful, Malcolm. And then on the margin, any balance sheet restructuring that went on in the quarter? It looks like there was some FHLB that was paid down. What was the amount of that? And when did that happen? And would you expect any more restructuring in the next few months?

Noreen Skelly^ Hi, Matt, it's Noreen. So there was $80 million of federal home loan advances that Sovereign had that were maturing at the beginning of August, and at the same time, we rationalized our securities portfolio and looked at certain securities that didn't really fit our strategy. Most of them were in energy markets around Houston, kind of timely in terms of the hurricane. It was about two weeks before the hurricane, and those were the exact same markets that got hit by the hurricane. So we sold about $100 million of bonds, including municipal bonds, from those markets, and we deleveraged with the maturing of the federal home loan advances. We think that's it. We don't think there's any more restructuring that will come with that.

Matt Olney^ Okay. Thanks, Noreen. And then I guess on operating expenses, still lots of noise, full impact of the Sovereign, partial impact of Liberty, the branch sales. Any guidance or color you can give us, Noreen, as far as expectations for operating expenses over the next few quarters?

Malcolm Holland^ So, Matt, all I'll say is -- and I'll let Noreen give you a little bit more detail. But the cost saves for the Sovereign deal have come quicker than we had anticipated, quicker than we had forecasted. But with the quick conversion and the addition of Liberty and the addition of a CIO and a few other things, you've calculated it properly; it's very, very noisy.

We're actually going through our detailed budget analysis right now for next year. So my sense is we've far outpaced our cost saves on Sovereign, but at the same time, the other expenses, closing both Sovereign and Liberty, have also kind of created some more noise. So from a guidance standpoint, I don't know that we feel totally comfortable with throwing out any numbers right now until we get our arms around this a little bit better.

Noreen Skelly^ I don't think I have much to add. I mean we still have -- in the fourth quarter, expect some one-time expenses, noncore expenses, related to closing Liberty. And, again, rationalizing kind of the expenses and what we need is going to be top of effort for November.

Matt Olney^ Can you speak in more detail to the Liberty transaction in terms of cost save expectations on just that transaction? I think initially we said around 30%. And remind me of the timing of the conversion there and when we'll get a clean run rate from just that transaction.

Malcolm Holland^ Yes, so December 1 close, early August, mid-August conversion -- I mean, April. Sorry, April conversion. Cost saves at 30%. We think we'll get half of them -- probably a little bit more than half in the first 12 months. That one is going to come a little bit slower, obviously, because of what the conversions put back, but we feel real good about the 30% number.

Matt Olney^ Okay. And then last question from me on the fee income side. It looks like SBA and mortgage were a little bit soft this quarter. Anything that you can point towards?

Noreen Skelly^ I think SBA and mortgage gains were flat to the quarter, and we had a one-time securities gain on positioning those securities, the $200,000. The mortgage business -- and Malcolm, you can fill me in here or help me out here on -- the mortgage pipeline does look a little bit soft going into the first quarter.

Malcolm Holland^ Yes, it does, but the SBA piece of it potentially could pick up a little bit, because we added Sovereign, who had a really nice SBA/USDA group. But we're forecasting for it to stay pretty static to where it was this quarter.

Operator^ Our next question comes from Brett Rabatin with Piper Jaffray.

Brett Rabatin^ I wanted to first ask -- I guess, first, congrats on getting Sovereign done and early on Liberty. Can you just maybe give us a little color on the -- you mentioned the deposits that ran off. Any more color around that? And then just any more expected loan atrophy from the Sovereign transaction on the loan side?

Malcolm Holland^ So, on the deposit side, I mean, they've had a couple of clients leave. So when we took over Sovereign, about seven of their lenders did not transfer over to us. Four of them, that I'm aware of, have landed somewhere else. That is certainly part of it. Part of it also is they had a couple of large CD customers that candidly were priced at a fairly high number, and we chose not to renew those at those rates. With the excess liquidity we had coming in from some of the sales of those bonds, we felt like we could fund it that way.

So we don't see any others. I think it'll be a little bit of a challenge with a couple of people on the deposit side. As I said, we have a historical very good fourth quarter, we don't -- we haven't had any other that we've identified that we think are going to leave. In terms of the loan apathy, using your words, I think it was a long closing, and their lenders kind of went silent for a little bit, but I will tell you our pipelines are really, really strong. The lenders that did stay have been very active. I mean we had a loan meeting yesterday and looked at some really, really nice loans.

And so I think they're starting to get some ground especially down in Houston. We've spent some time in Houston. What [Reuben] is doing down there has been very, very good. So I think that's going to start picking up some on their side. Again, the Veritex has remained incredibly strong.

Brett Rabatin^ Okay. I meant atrophy, not apathy, okay.

Malcolm Holland^ Yes. They just told me that. Apathy may be correct in some cases.

Brett Rabatin^ And then any color around -- the margin was better than I expected. Obviously, the discount accretion helped that. Can you give us any thoughts on the margin and then just the scheduled discount accretion as you see it helping the stated margin over the next few quarters?

Noreen Skelly^ Sure. Let me take that one. So just as a note, I mentioned in the presentation that we haven't finalized all the fair value work. So the accretable discount is still a preliminary number. However, we think that the amount that we accreted in the quarter is fairly representative of what we will have for the next couple quarters. We'll add the accretion from the Liberty portfolio beginning December 1. We'll have a partial impact and then full impact in the first quarter.

We think that the loan margins, the core loan margins, look pretty solid. I don't see any real change from historical levels off of that. And as Malcolm mentioned on the deposit or the funding side, that's something that we're watching very closely and managing cost of funds. But also we know there's going to be some time to manage the Sovereign balance sheet into what the Veritex balance sheet looks like. There’s some incentive work that happens in the first quarter that gets people aligned around deposit growth. And so cost of funds, I'm not expecting it to increase, but that's one thing that we're watching very closely. And, also, it's all predicated on not having any rate increases. We're asset-sensitive, so if the fed raises rates, we expect that we will pick up the benefit of that. But right now our assumption is there is no rate increases going into 2018.

Brett Rabatin^ Yes, I was just going to ask that. I know it's probably tough with everything you've added. But December rate hike, any idea of what that might add in terms of the margin?

Noreen Skelly^ There's always a bit of a lag on our margin in terms of the loan. We've worked through our floors on loans, but there is still a bit of a lag, so we won't pick up the entire increase if prime rate goes up, but there will be a couple basis point impact, in my estimation.

Operator^ Our next question comes from Brad Milsaps with Sandler O'Neill.

Brad Milsaps^ I wanted to follow up on Brett's question regarding the loan atrophy that's occurred at Sovereign. I think when you announced the acquisition, they had around $860 million in loans; now, the net number around $730 million. How does that change, if at all, your sort of accretion assumptions? And I know that a big part of it, too, is you wanted to run off a bit of an energy book that they had. I'm just kind of curious where you are with that process and how much of that is related to the decline we've seen in kind of total loans at Sovereign since you announced the acquisition.

Malcolm Holland^ Yes, so there's no doubt that the book of loans that we brought over was about -- was it $80 million play, $90 million last year when we originally looked? So it's come down just through payoffs and the lack of refilling their pipeline.

The energy piece -- Clay, you want to give them the history on the energy and where we started and kind of where we are now?

Clay Riebe^ Sure. Sure, Malcolm. Yes, when we did due diligence, the energy book was at about $92 million, and that over time has decreased by about 52%, as of closing, to be at $44 million, so a 52% drop, which is about 2.3% of our total portfolio.

Malcolm Holland^ And then you also, Brad, have to put it -- we had a pretty good fair value mark on that portfolio as well. So that obviously decreased some of the net a little bit.

Brad Milsaps^ Okay, great. That's helpful. And just maybe kind of a bigger-picture question. Malcolm, you've got a lot of moving parts, not only this quarter, but over the next couple quarters as you integrate things. As you kind of come out the other side, what metrics are you kind of looking at? Prior to these deals, you had eclipsed kind of a 110 ROA, low double-digit ROE. Is that kind of where you see the combined companies? Is that where you aspire to get back to? Do you think you can do better than that? I'm just kind of curious kind of your thoughts of what things look like as you come out the other side of all these transactions that you've made.

Malcolm Holland^ Yes, so I think you're right. We certainly feel very confident that we can get back to the -- we think we should be operating in the 110 to 120 ROA number. In terms of ROE, we keep jacking with our equity to bring in more stock and more dilution here and there. Once we kind of right-size it all, I think we'll be in a pretty good place. As you know, I mean, it's obviously a very scalable business, and when we can get this $3 billion or so in assets and we don't have any acquisitions and we don't have any of these extra expenses, certainly the 110 to 120 is where we expect to be operating.

Operator^ (Operator Instructions) Our next question comes from the line of Gary Tenner with D.A. Davidson.

Gary Tenner^ I have two questions. First, on the energy portfolio, I think it's around $38 million or $39 million at the end of the quarter. Does that make up any disproportionate amount of the PCI loans of $32 million? Or is there not much of a correlation there?

Clay Riebe^ Yes. This is Clay Riebe. It's at $44 million currently net, and it does make up a pretty large percentage of the PCI loans. I would say in excess of 50% are from energy-related credits.

Malcolm Holland^ So our gross number on energy loans is what?

Clay Riebe^ We have 55.

Malcolm Holland^ Fifty-five?

Clay Riebe^ Yes, so there's about an $11 million mark on that portfolio.

Gary Tenner^ Okay. Great. So as you think about trying to exit that portfolio pretty quickly, does that suggest a little more of a front loading of some -- if you're able to exit them at a good price, some more front-loading of the discount accretion benefit?

Malcolm Holland^ We don't really think so. I mean, obviously, we're not going to accrete anything in unless we get more than we've got it written down to. At this point, I think we've done a really good job of writing it down to real asset value. So if we did our job and our assumptions are accurate, there won't be any effect on the income side of it. I hope there is, but I don't think there will be any effect on that energy piece, anyway.

Gary Tenner^ Okay. And then regarding Houston, obviously making that decision to sell the Austin branch is in your commentary about today and previously about being focused on Houston. How does the impact of the hurricane factor into conversations? Does it make things more difficult in terms of executing deals in that market? Or perhaps do you think it might free up some opportunities?

Malcolm Holland^ I actually thought it was going to make it more difficult, but in the conversations that I've had, I think your characterization of freeing it up is probably more accurate. I think it's kind of got a sense of urgency for some of those folks to go -- you know what, let's get something done. And that's just a complete tangible -- intangible of how do I feel comment, but it feels like people want to get something done potentially down there. So I'd look for Houston to be active over the next six to 12 months.

Operator^ I'm showing no further questions in queue at this time. I'd like to turn the call back to management for any closing remarks.

Malcolm Holland^ Liz, thank you. I appreciate everybody's time today. We did our first live call and look forward to doing many more. So thank you, everyone, and if there are any other questions that we can ask or follow up on, don't hesitate to contact us directly. You guys all have a good day.

Operator^ Ladies and gentlemen, thank you for your participation in today's conference. This concludes the program, and you may now disconnect. Everyone, have a great day.