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ANALYST INTERVIEW

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Watching Credit Trends and the Impacts on Texas Banks

B R Y C E W . R O W E — R O B E R T W . B A I R D & C O .



BRYCE W. ROWE, CFA, is Robert W. Baird & Co.'s Senior Analyst covering community banks/business development companies. Prior to joining the company in 2006, Mr. Rowe held Equity Analyst positions at several regional brokerage firms with the most recent being Legg Mason. In 2011, he was selected for The Wall Street Journal's Best on the Street Analyst Survey for commercial banks and savings & loans, ranking number four, and his second recognition by The Wall Street Journal. He received a B.A. in economics from the University of Virginia.

SECTOR — BANKING

(AGV801) **TWST:** What do you see as the main drivers to the year-end rally? What is your broad outlook going forward?

Mr. Rowe: I focus on three banks in Texas: **Allegiance Bancshares** (NASDAQ:ABTX), **Prosperity Bancshares** (NYSE:PB) and then **IBERIABANK Corporation** (NASDAQ:IBKC), which is headquartered in Louisiana, but with plenty of exposure to Texas. Pretty much the entire sector participated in the year-end rally. Our stance is that the potential for lower corporate tax rates was really the primary driver behind the year-end rally. Secondary catalysts include the perception of the interest rate environment, and higher interest rates and the impact on bank balance sheets and income statements. And then another secondary catalyst would be the relaxation of some of the regulatory scrutiny that banks have faced since the credit crisis of 2008, 2009.

TWST: How closely do oil prices correlate to banks' performance?

Mr. Rowe: They've proved to be very correlated. Early last year and as we moved through the year, you saw Texas banks particularly weak through the first quarter. And once oil prices rebounded, the Texas banks rebounded; Texas bank stock prices rebounded fairly dramatically as well.

I think from a fundamental perspective, oil prices are certainly important to those local economies, but most of the lenders that we cover — **Allegiance**, **Prosperity** and **IBERIA** — are senior in the capital structure on direct oil and gas lending. So we didn't expect heavy losses last year. The stock prices definitely whipped around, but credit losses have been minimal so far.

TWST: What do you see ahead for oil prices? Will the

new administration's expected changes impact oil prices?

Mr. Rowe: I think it's hard to say at this point, just like everything else related to the new administration. We still don't know yet what corporate tax rates are going to look like and what the evolving regulatory environment is going to look like. I think all of that, almost all factors are going to play into how these local economies relate to the new administration. So it's hard to make any form of concrete call in terms of oil prices or even just broader impacts from changes the new administrative implements.

TWST: You cover **IBERIA**, **Allegiance** and **Prosperity Bank**. Why did you choose those three?

Mr. Rowe: I've covered **IBERIA** since the early 2000s. The management team at **IBERIA** is one of the better management teams among smaller banks and has a good reputation. It's been a good stock to cover; the management team is typically well-prepared for coming risks, so the company informs well on future trends. The management team was one of the first to call out risks associated with residential construction lending in the last credit cycle. They were also very thoughtful about accepting TARP and redeeming TARP, and have been fairly offensive-minded in when and how to raise capital and take advantage

of growth opportunities, whether they be acquisition or organic. So definitely a dynamic company to cover.

Prosperity is one that we've covered for quite some time and also dates back to legacy Texas bank coverage from a previous firm. It is also a historical relationship. And it's a good fit for our Texas coverage.

Allegiance is a relatively new company. It IPO-ed at the end

Highlights

Bryce Rowe discusses banking in Texas. Mr. Rowe says the entire sector participated in the year-end rally, and the primary driver for that was lower corporate tax rates, with secondary catalysts being around the interest rate environment and regulatory scrutiny. Mr. Rowe is most focused on credit trends at the moment. He is also focused on net interest margin changes and what happens to loan and deposit pricing and competition given the Fed's tightening cycle. He is concerned about the late-stage nature of the credit cycle relative to where valuations are. Companies discussed: Allegiance Bancshares (NASDAQ:ABTX); Prosperity Bancshares (NYSE:PB) and IBERIABANK Corp (NASDAQ:IBKC).

of 2015. Baird led that IPO. And Baird personnel within capital markets have a rich history with the management team there, and so it is clearly a good candidate for us to cover from an equity research perspective, too.

TWST: You mentioned, I believe, that IBERIA is smallish bank. Overall, do you see that small banks are better positioned to capture upcoming tailwinds?

Mr. Rowe: IBERIA isn't necessarily a small bank anymore. They certainly were when we first started covering them. Now they've grown to a balance sheet that is \$20 billion-plus, so you can't call them small. Allegiance is small compared to both Prosperity and IBERIA, with a balance sheet of about \$2.5 billion.

Our particular stance in terms of small versus big banks depends on the particular region or community that is being served; it depends on each particular bank. Smaller banks that have a clear strategy with the right people, the right relationship managers have historically been able to compete effectively against larger banks in their particular markets, and also compete well against smaller banks that may not have a clear competitive advantage. We believe that banking is a commoditized business, and there are too many banks. We need fewer of them, and so those banks and those bank management teams that compete with less scale do it effectively with their people.

TWST: Among those three you focus on, where is your strongest conviction? Which look best positioned for the short, intermediate and longer term?

Mr. Rowe: In terms of those three, we currently have an "outperform" recommendation on Allegiance Bancshares; we actually upgraded the stock later last year, during the rally, and it was primarily a valuation call. If you look at smaller Texas banks, or those that have a predominance of their operations in Texas, they trade on average at about 2.7 times tangible book value, which is going to be rich relative to the rest of the country. Allegiance is smaller and trades at a pretty wide discount to its Texas peers. It trades at less than two times tangible book, but does have relatively comparable or even better core profitability. We're comfortable to continue to recommend Allegiance given that discounted valuation and its high-quality fundamentals and higher-quality balance sheet. Allegiance is focused primarily on smaller businesses in Houston, and they do very, very well in that market.

IBERIA has a wider net being cast. It has really grown from being a Louisiana-based company to now covering the Gulf South region and now into the Southeast part of the U.S. with operations from Texas to Florida, and then up to Tennessee and into the Carolinas. To establish a presence in new markets, IBERIA has traditionally grown its deposit base with acquisition, and then also with acquisitions of commercial lending teams that are well-connected in certain markets. So they do a very effective job. I think that from a stock price perspective, we see that that stock as being more or less fairly valued at these levels, trading at about two times tangible book value.

Prosperity is mainly in Texas, but also with some operations

in Oklahoma. Prosperity carries one of the higher valuations in the space, at about three times tangible book value. And Prosperity has been very acquisitive since the late 1990s, and has made a mark for themselves by being able to acquire with that highly valued currency and then bringing efficiency to those acquired operations to a point where they carry one of the lower efficiency ratios among banks of their size.

So I think all three of those companies are different. Stock prices and companies are different; we're very valuation-focused, and that's why we like Allegiance here. IBERIA and Prosperity are good companies, but their stocks are more fairly valued than

anything else. So all three are good companies, and all three have good management teams. We just think that Allegiance's stock, from a valuation perspective, is attractive at these levels.

TWST: What level of M&A activity have you seen over the recent past? What are your expectations for the year ahead?

Mr. Rowe: Acquisition activity has been spotty, I would say, within the sector. All three of these companies have participated to some degree with acquisitions. Prosperity's last transaction closed January 1, 2016. With nine acquisitions since 2011, Prosperity has grown from sub-\$10 billion in assets to \$20 billion-plus, but hasn't announced an acquisition since August 2015. And so the expectation is that they will be able to do more acquisitions at some point. But they haven't been able to announce any recently.

IBERIA has been acquisitive as well, having been very active during the credit cycle with failed bank acquisitions. And then they have been active since then too with acquisitions in Georgia, Florida, Texas and Louisiana. Allegiance did an acquisition prior to going public that was significant in terms of size. We would like to see more acquisition activity if it makes sense and if it's priced well. We believe that there is a need for fewer banks, and that can certainly be achieved with more acquisitions.

"We believe that banking is a commoditized business, and there are too many banks. We need fewer of them, and so those banks and those bank management teams that compete with less scale do it effectively with their people."

1-Year Daily Chart of Allegiance Bancshares Inc.



Chart provided by www.BigCharts.com

TWST: How important has the trend to digital finance

been to any of these banks?

Mr. Rowe: I wouldn't call it out as being a big driver of strategy one way or other. I think that all three of these companies are relationship-oriented, and more commercially oriented than they are retail-oriented. Although **IBERIA** and **Prosperity** are large enough that they have retail branch networks. From a digital perspective, they are offering everything that you would expect to see from larger banks, but I wouldn't really call it out as a key driver of strategy.

TWST: What are the ways that you like to see banks in the space invest capital in this environment?

Mr. Rowe: What's proven to be the most effective way is through hiring the right people. Most of these companies have devised ways to deliver their services efficiently. A good way to allocate capital now is to attract and hire talent for growth purposes. And then if acquisitions can be priced effectively, then we would certainly like to see more and more acquisition activity if it makes sense strategically and financially.

TWST: What is the risk/reward scenario like for an investor in Allegiance or IBERIA?

Mr. Rowe: Risk could come in the form of corporate tax change not having as optimistic of an impact as expected. Another risk is the interest rate environment not delivering net interest margin expansion, which we believe is currently baked into expectations and estimates. And finally, the late-stage nature of the current credit cycle needs to be contemplated as a risk.

TWST: What do you see would be the impact if changes to the tax structure don't play out as expected?

Mr. Rowe: We expect changes, but the degree of tax rate changes is a wild card. I think if you look at our coverage list, not just these three, but our coverage list of banks, I would tell you that the valuation increase, the stock price increase since the presidential election insinuates to us that earnings should go up between 15% and 20% when a full year of tax changes are reflected on income statements. So if we don't get as significant of corporate tax reform as currently reflected, then you could certainly see estimates come in from where they are now, and that could obviously lead to pressure on stock prices.

TWST: Where is your strongest conviction? It sounds like you are most enthusiastic about Allegiance. What is its ability to deliver shareholder value in terms of dividends and things?

Mr. Rowe: **Allegiance** doesn't pay a dividend. It's more of a growth-oriented story. **Allegiance** is based in and focused on Houston, and relatively new since it started in 2007. However, the management team has a history in the Houston market that dates back to the 1980s. **Allegiance** targets businesses that are relatively small and carries an average loan size less than \$1 million, so it is lending to smaller businesses.

Allegiance has been able to capture better pricing on loans because of their focus on the more underserved markets Houston. And they've also been able to capture market share by hiring strategically

in that Houston market. So we like the growth prospects there. At **Allegiance** we don't think that its growth prospects are necessarily reflected in the stock price. So that's the thesis there on **Allegiance**.

TWST: Are there any below-the-radar trends that you are watching that prospective investors should keep an eye on?

Mr. Rowe: We are most focused on credit trends, given that we've gone quite a while since the last credit cycle. Early indicators would be increases in classified and criticized assets. In addition to the late stage of the credit cycle, we are also concerned or focused on net interest margin changes and what happens to loan and deposit pricing and competition given the Fed's tightening cycle. Those issues are really the big bogies out there — credit trends and margin trends, given that net interest income typically accounts for 70% of revenue for smaller banks.

TWST: So you see that fact that we're in the late stage of credit cycle as being a definite headwind? Something you worry about more so than anything else going forward?

Mr. Rowe: It's something that we worry about it. It's a big question mark more than anything else right now. But if you look at loan loss provisioning and the level of provisioning over the last couple of years, it's very nominal. So any uptick in credit issues and credit weakness would put pressure on earnings, which when you consider where valuations are right now would likely lead to weaker stock prices. So we're more concerned about the late-stage nature of the credit cycle relative to where valuations are more than anything else.

TWST: Any topics we missed? Anything else you'd like to comment on?

Mr. Rowe: I think at this point it will be interesting to watch loan growth trends, especially as lending rates have gone up. It's not just the increase from the Federal Reserve, but we've seen pretty dramatic increases in LIBOR rates and dramatic increases in the five-year and 10-year Treasury since the presidential election. So it will be interesting to see how that plays out in terms of loan pricing.

And those institutions that have better engines for loan growth are potentially going to be better suited to capture that better pricing that may in fact be there. So that's one of the reasons we like **Allegiance**. And **IBERIA** has traditionally has been able to produce some pretty strong loan growth, so they could also benefit as well.

TWST: Thank you. (VSB)

Note: Opinions and recommendations are as of 01/09/17.

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