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ANALYST INTERVIEW

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Looking for Catalysts in the Southwest Banking Segment

BRETT RABATIN — PIPER JAFFRAY & CO.



BRETT RABATIN, CFA, is a Senior Research Analyst at Piper Jaffray & Co. covering Southwest banks. Mr. Rabatin has been on the sell side since 1998, having worked for Sterne Agee, FTN Midwest and JC Bradford. Prior experience also includes an Analyst position with Mercer Capital focusing on transaction advisory and valuation services for financial institutions. Mr. Rabatin was recognized as the number one stock picker in *The Wall Street Journal's* Best on The Street survey for banks and thrifts in 2002, among 97

analysts, and recognized as number two overall, in all sectors, in 2003 in *Forbes* and StarMine. He was also the number one earnings estimator in 2013 and number two in 2004 and 2011 within the bank/thrift sector.

SECTOR — BANKING

(AGV803) TWST: Introduce your coverage and tell us about the regional economies that they operate in.

Mr. Rabatin: I've covered the Texas bank group for many years, and that's currently a group we still cover. I also cover some banks on the West Coast that tend to be more specialized lenders, as well as covering Hawaii and then Puerto Rico. And so from an entire group perspective, it's a bit eclectic, but it kind of makes sense given how we look for names that are either growing or names that are potentially going through a long-term improvement in core operations and profitability.

TWST: Did your overall outlook for the space significantly change after the Trump victory?

Mr. Rabatin: It did change significantly. And I think everyone's aware of the big boxes that people were checking in terms of what his presidency could mean. And now at the level bank stocks have reached, we need to see some of these things people are hopeful for come to fruition.

TWST: So obviously the sector rallied sharply at year end. How sustainable is the uptrend? What is your view for the short and intermediate term?

Mr. Rabatin: In the short term, I think you're talking about two quarters or less, and I think the outlook for the space is to find its footing here unless something changes related to the outlook for tax rate cuts,

because that matters for the stocks at current levels.

I think over the intermediate term, we could see some more upside from the space, but I think there's a fair argument that a lot of the benefit of things happening is already baked into the valuations. And to outperform the group, you have to have specific things happening. You have to have loan growth better than expected; you have to have nicely accretive M&A transpire; or you have to have a much different tenor on where your capital ratios might go to.

TWST: What are your expectations for oil prices going forward? How tightly correlated to the price of oil are the Texas banks' performance?

Mr. Rabatin: I think oil from here — and we have a very good oil research group at Piper that thinks about future oil prices — we're going to be in a \$50 to \$60 range going forward. Obviously, if you were to go back to last year, the Texas banks in particular were significantly correlated to what happened with the price of oil, and I think that's going to be less of a factor in 2017. However, if oil were to drop to \$40, I think you could see some correlation with the Texas bank stock prices. But by and large, I think oil and bank stock prices are not going to have much of a correlation factor this year.

TWST: Tell us about your top picks and walk us through your related investment thesis.

Highlights

Brett Rabatin covers the Texas and West Coast bank group. Mr. Rabatin looks for names that are either growing or going through a long-term improvement in core operations and profitability. He says that over the intermediate term there could be more upside from the space, but there's fair argument that a lot of the benefit of things happening is already baked into the valuations. He says investors should be looking for where there are catalysts for earnings to be better than expected or for valuations to improve.
Companies discussed: SVB Financial Group (NASDAQ:SIVB); Western Alliance Bancorporation (NYSE:WAL); Triumph Bancorp (NASDAQ:TBK); Cullen/Frost Bankers (NYSE:CFR); Texas Capital Bancshares (NASDAQ:TCBI) and Independent Bank Group (NASDAQ:IBTX).

Mr. Rabatin: Sure. On the West Coast our favorite name has been **SVB Financial Group** (NASDAQ:SIVB). We still like it despite the recent move. It's obviously really poised well to benefit from higher rates, but our main thesis is actually more around that we think revenue growth, loan growth, operating leverage, profitability and credit quality are all going to be relative positives this year. And so consensus expectations may be able to move higher from here. And then it's also a name we think the market is going to be comfortable with assigning at least a similar to possibly a higher valuation given their growth profile, the quality of the franchise and the potential for profitability improvement over the next few years.

"If we're not going to get corporate tax rates lower, I think that could be an issue for the bank space valuations, just because that there is a pretty significant expectation built into these names that we're going to see tax rates lower — to benefit bottom-line EPS numbers."

And then the second name that I would mention also on the West Coast is **Western Alliance Bancorp** (NYSE:WAL). It's about a \$5 billion market cap name, and they've done really well over the past few years. It's a highly profitable franchise, and another name that has strong growth prospects. They're in California, Phoenix and Las Vegas. They also operate some businesses that they call central lines of business that are non-commoditized-type lending platforms that can be outside of those geographic areas.

And the management team there does a great job with acquisitions. They've done several over the past few years. We think they're likely to be looking for deals over the next few quarters and that organic growth prospects will be double-digit. Profitability should remain high. The company is also asset-sensitive, and we like the prospects for the company in a strong economy, and believe that the valuation vis-a-vis the peer group is undervalued and could have some upside as well.

TWST: Walk us through your investment thesis for **Triumph Bancorp**. Why do you think it could go still higher?

Mr. Rabatin: We initiated coverage on it in the middle of December, and it's a franchise that I've known for a while, but it's another specialized lender play. This is a little smaller name than the other two; essentially it's a bank that does community bank acquisitions to fund a commercial finance operation.

The margin looks high at first glance, and investors might reason a high margin means they're taking excess risk in their loan portfolio. But I think once investors look through what their commercial finance operation entails and how they do these loans, I think people will get more comfortable with how they're operating. We're pretty bullish on **Triumph** (NASDAQ:TBK) being able to improve their profitability over the next couple years as they grow. And over time, with their specialized lines of business, it should be a faster-growth EPS company than its small-cap bank peers.

TWST: How significantly do your short- to intermediate-term picks differ from your longer-term recommendations?

Mr. Rabatin: I think there are some franchises that I think about more from a longer-term perspective. For example, if you're a three-year to five-year investor, you think about **Cullen/Frost** (NYSE:CFR) and **Texas Capital** (NASDAQ:TCBI) in Texas.

I think those are two great franchises that investors would do well owning for a longer-term time frame. But I also think the names that I mentioned earlier for the short to immediate term should also do well over a longer-term period as well.

TWST: What do you see as the related risk/reward scenario? What could possibly happen to upset the rosy outlook for the space?

Mr. Rabatin: I think there are a couple things that could upset the apple cart pretty dramatically. The biggest thing would be if we get into a scenario where there's not going to be any change to the corporate tax structure. If we're not going to get corporate tax rates lower, I think that

could be an issue for the bank space valuations, just because that there is a pretty significant expectation built into these names that we're going to see tax rates lower — to benefit bottom-line EPS numbers.

The other thing that I think would be meaningful is after the December rate hike, the expectations and outlook are for the Fed to probably continue increasing rates this year a little bit more, maybe another 50 basis points. But if we get into a situation where it becomes clear that additional movement in the short end of the yield curve is not likely, I think that's going to be detrimental, especially to the more commercial-oriented names that have a high proportion of core funding.

And then I think the third key piece would be related to regulations. There is sentiment that things like Durbin won't be repealed, but that the pendulum will be swinging toward easing on regulation. And if that were to change, then I think sentiment on the group might be a little stifled. Expectations on taxes and interest rates are probably more important, but investors are hoping bigger deals can get approved and that management teams will be focused on growth rather than dealing as much with compliance/regulatory items.

1-Year Daily Chart of SVB Financial Group



Chart provided by www.BigCharts.com

TWST: What worries you most as we head into the new year? Are there any names or related business models where you've grown more cautious?

Mr. Rabatin: I think the thing that probably worries me

the most right now is just thinking about mortgage banking, which posted strong results in 2016. I think 4Q probably ends up being OK, but gain-on-sale margins are probably going to be under pressure throughout this year. Fortunately, most of our coverage names tend to be more purchase rather than refi-type oriented, but I think mortgage banking is something to watch.

I think in terms of loan portfolios, hopefully credit quality is going to behave with expectations for a strong economy. But there are pockets of things to worry about; people have been concerned about multifamily lending for some time, and so that can be something to watch from a credit quality perspective. Most of my names tend to be more C&I oriented, but the regulators have been letting the banks know for some time, CRE concentrations are high. And with that being the case, more so I think in the Northeast than parts of the country where I cover banks, I think there may be some concern that growth in 2017 could be more limited than people realize. There has also been some pullback in auto, but I don't cover anyone exposed much to that type of lending.

TWST: I believe you said that accretive M&A would be something that you'd like to see going forward. Tell us a little bit more about that, and if you saw any significant M&A over the past year.

Mr. Rabatin: Yes, in particular, one of my coverage names that we haven't talked about that we like in Texas is **Independent Bank Group** (NASDAQ:IBTX). They were able to buy a private bank called **Carlile**. The deal was interesting because one of the things that investors are concerned about is what the tangible book payback period looks like. In this case, there was no payback period given the valuation of the buyer and the issuance of stock.

I think you're going to see more of that this year, buyers being able to do deals where the tangible book payback periods are very reasonable. We've seen a few transactions recently that were perhaps too expensive. But hopefully there will continue to be deals that benefit both the buyer and the seller. Given the rise of valuations on the Texas banks and the lack of deals over the past few years, I think you're going to see more M&A activity in Texas.

TWST: How has commercial real estate activity trended over the recent past? And how do you see the related banking activity will grow, or slow, going forward?

Mr. Rabatin: A lot of banks have been slowing the growth in the various forms of commercial real estate lending that are tied to occupancy absorption the past quarter or two. We mentioned concentration issues. It may actually get less competitive for banks on a pricing basis in 2017 depending on the level of rates, but I think CRE lending will be less of an overall growth driver for the bank space this year.

TWST: Why the slowdown? Is it related to the segment's cyclical nature?

Mr. Rabatin: It's more related to regulators not wanting concentrations to rise, as well as banks looking at their portfolios and saying real estate, its various forms, has had very good runs, and maybe we should be more cautious now on how much we do in commercial real estate going forward. And particularly if multifamily does show some weakness, banks don't want to be too exposed to that. So I think it's more just caution around concentration and around how good things have been for that asset class over the past few years.

TWST: Could summarize what prospective investors should focus on when evaluating a bank in this space?

Mr. Rabatin: Well, I think if you're looking at bank stocks, it boils down to a few things. One is the geography. Second is what the management's game plan is, and what kind of growth and profitability can that achieve. And what catalysts might fuel growth in earnings, whether it's the bank's ability to grow the loan portfolio without taking too much risk; possibly it is expense leverage, fee income initiatives or deploying capital. Investors should be looking for where there are catalysts for earnings to be better than expected or for the valuation to improve. Buying core funded institutions with good management in attractive areas has never been a bad strategy.

TWST: In terms of the competitive landscape, what are the key differentiators that help a bank to outperform its peers? How important is it for a bank to have cutting-edge technology?

Mr. Rabatin: I think technology is the great leveler of the playing field. Everyone has to spend money on it, and it allows smaller banks to compete with large banks in terms of offering services and products to clientele. And so if you think about market share, at the end of the day, those that are gaining are generally those that are focused on providing more service and providing specific subsets of abilities to provide advice.

For example, if you're a lender that focuses on health care, if you have lenders that have specific expertise, that's going to help you in terms of being able to garner business from other lenders that might be trying to drive the same business. Bankers love to say this is a relationship business, and technology is something you have to use. But at the end of the day, it's about who's out there trying to drive new relationships and bringing in new clients.

TWST: Thank you. (VSB)

Note: Opinions and recommendations are as of 01/13/17.

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