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Bank OZK: A True Compounder

"Identifying businesses with unique business models, skilled management teams, and competitive positioning, which have also demonstrated an ability to grow intrinsic value at attractive rates over the long term, is what truly excites us."

When articulating our intrinsic value-based investment philosophy, we frequently describe it as valuing businesses and identifying those that are worth "a dollar" but are trading for "$0.70-$0.80." We want the current price to be at a discount to our estimate of intrinsic value, providing us the margin of safety that is so frequently referenced in these monthly Industry Perspective pieces.

We certainly wouldn't bemoan buying partial ownership of a business at 70% of our estimate of intrinsic value and then having the market price converge on that estimate, providing a 40% investment return. However, identifying businesses with unique business models, skilled management teams, and competitive positioning, which have also demonstrated an ability to grow intrinsic value at attractive rates over the long term, is what truly excites us.

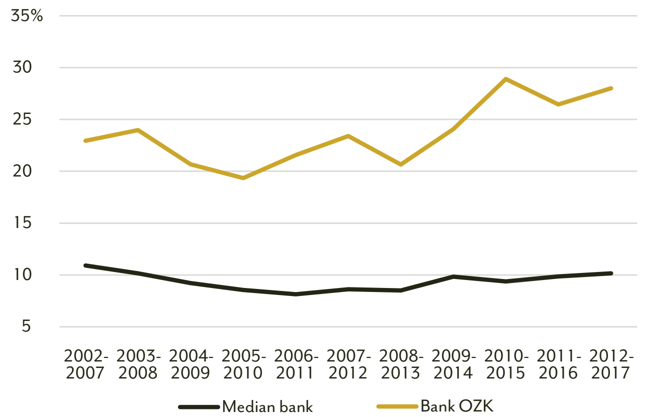
Even if the price to intrinsic value gap never closes but the company continues to grow intrinsic value over time, it can provide the attractive rates of return we so desire as investors and work to deliver for our clients. Identifying these "compounders" and having the opportunity to invest at a meaningful discount to our estimate of intrinsic value is the double bonus. Investors get the chance to benefit from the potential closing of the price to intrinsic value gap as well as the growth in intrinsic value.

Bank OZK, recently renamed from Bank of the Ozarks, has demonstrated an unmatched ability to grow intrinsic value at attractive rates and has done so with remarkable consistency. Using the growth in tangible book value per share plus cumulative dividends paid as a proxy for intrinsic value growth, Bank OZK has grown their intrinsic value at over two times the median rate of banks between $1 billion - $10 billion in market cap over rolling five-year periods. The strength of this track record warrants a finer point.

There are over 100 publicly traded banks in the $1 billion - $10 billion market cap range. Looking at the 11 five-year periods starting with year-end 2002, for which the data is readily available, there are 12 banks that have compounded the above definition of intrinsic value at greater than 10% in all periods. There are only two that have compounded at greater than 15% in all periods, one of which is Bank OZK.

Bank OZK has grown intrinsic value above a 23% compound annual growth rate in the last 15 years. It has also compounded above 20% in 10 out of 11 five-year periods, while 80% of banks in this group don't have a single period over 20%, and Bank OZK's lone "miss" was a return of just over 19%. The chart below illustrates their remarkable track record versus the median bank in the group, confirming the fact that Bank OZK is a true "compounder."

COMPOUND INTRINSIC VALUE GROWTH*



Source: SNL Financial Data.
*Intrinsic value growth is the tangible book value per share growth plus cumulative dividends paid.

Current Chairman & CEO George Gleason has led the bank since 1979 and has built this track record through efficient operations, pristine credit performance, and a highly specialized lending group that supports a higher net interest margin than peers.

This lending group, known as RESG (Real Estate Specialties Group), has fueled much of Bank OZK's lending growth since the group's founding in 2003. It focuses on lending for complex real estate projects, which generate higher loan yields. Bank OZK's meticulous credit underwriting standards have helped avoid the credit pitfalls that have tripped up many banks in this area. In the group's 14-year history, they've only had two loans that resulted in losses to the bank, leading to an impressively low average annual net charge-off rate of 0.05%.

Bank OZK has also been opportunistic in driving growth of the franchise. During the financial crisis when many lenders were hobbled by rapidly deteriorating credit, Bank OZK gained substantial market share through their ability (strong financial position) and willingness to lend. The bank also rapidly grew their deposit base and expanded into new geographic markets through the purchase of failed banks from the FDIC during the crisis. Lastly, RESG gained additional market share as competitors were forced to curtail their lending due to increased regulatory scrutiny toward commercial real estate and construction lending in 2016.

Recent market concerns around slowing growth, rising deposit costs, and the general health of commercial real estate markets have weighed on the shares and provided an opportunity to invest at an attractive discount to our estimate of intrinsic value. While loan growth will be slowing in the near term, it is primarily due to management's credit discipline. They are willing to walk away when deals don't meet their credit standards or return hurdles. While this discipline impacts short-term results, it is the right decision for the long-term health of the franchise and we believe their "slower" growth rate will still be more than double that of peer banks.

Despite industry competition that is putting upward pressure on Bank OZK's deposit costs, management's focus in recent years to increase the percentage of variable rate loans on their books has helped offset this pressure and allowed them to grow their core margin, as the increased yield earned on loans has exceeded the increased cost of deposits. Even if they experience short-term margin pressure, their margin will still likely be in the top decile of peer banks and help support their well-above-peer profitability.

Should investor fears surrounding commercial real estate manifest into reality, we'd expect Bank OZK's credit underwriting discipline to be on display yet again. Since going public in 1997, not only has the bank's net charge-off ratio been below the industry average every year, it has also averaged only one-third of the industry rate over that time period. The bank has also tightened underwriting standards since the crisis. Loan-to-cost ratios, which were 65% in 2009, are now below 50%. Increased equity from project sponsors and subordination to Bank OZK's senior loans should provide more than sufficient coverage in a real estate downturn to help prevent meaningful losses for the bank.

Having followed and admired Bank OZK for the last decade and witnessed the execution of George Gleason and his management team, we are excited to have the opportunity to invest in their high-performing franchise at an attractive discount to our estimate of intrinsic value. We are confident the franchise will be able to grow its intrinsic value at well above peer rates in the years ahead, and the closing of the price-to-intrinsic value gap could provide an added boost to investor returns.

As of July 31, 2018, Diamond Hill owned shares of Bank OZK.