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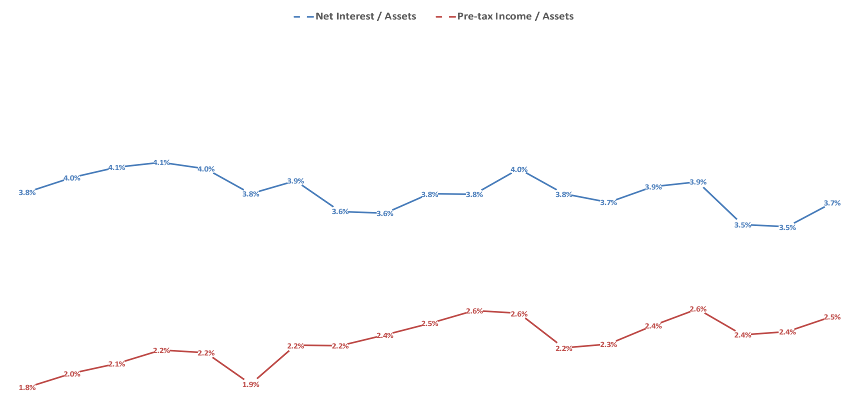
Prosperity Bancshares

NYSE: PB

Prosperity Bancshares (NYSE: PB)

Stock Price: $45.21



	EV/Earning Assets	EV/Deposit	EV/EBT	EV/Owner Earnings
Texas Capital	0.13	0.16	11.39	11.44
Southside Bancshares	0.14	0.18	17.92	10.55
Frost	0.15	0.16	8.50	5.32
International Bancshares	0.16	0.20	7.42	7.60
First Financial	0.33	0.40	14.42	11.09
Minimum	0.13	0.16	7.42	5.32
Maximum	0.33	0.40	17.92	11.44
Median	0.15	0.18	11.39	10.55
Mean	0.18	0.22	11.93	9.20
Standard Deviation	0.08	0.10	4.32	2.65
Variation	46%	46%	36%	29%
Prosperity Bancshares	0.18	0.20	7.40	6.26

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	Minimum	Maximum	Median	Mean	Standard Deviation	Variation
Net Interest Income	9	11	13	19	23	42	54	66	83	112	139	203	221	281	307	325	381	490	661	9	661	112	181	185	102%
Net Non-interest Expense	5	6	7	9	11	22	23	25	29	39	44	74	91	110	113	108	123	152	207	5	207	39	63	59	94%
Pre-tax Income	4	5	7	10	12	21	31	41	54	73	96	129	129	171	195	217	258	338	454	4	454	73	118	127	107%
Short-term Investments	6	4	7	14	10	30	21	25	46	43	33	71	164	77	49	27	69	50	144	4	164	33	47	44	94%
Securities	128	158	178	242	330	666	818	1,108	1,384	1,471	1,612	1,850	2,410	4,053	4,509	4,626	6,365	7,933	8,723	128	8,723	1,471	2,556	2,709	106%
Loans	105	118	143	194	233	420	525	697	872	1,435	2,037	3,093	3,250	3,456	3,395	3,649	4,514	6,203	8,988	105	8,988	1,435	2,280	2,424	106%
Total Earning Assets	238	279	328	450	573	1,116	1,364	1,830	2,302	2,949	3,682	5,014	5,824	7,586	7,952	8,301	10,948	14,186	17,855	238	17,855	2,949	4,883	5,112	105%
Non-interest bearing Deposits	46	57	70	90	113	181	230	355	474	609	783	1,143	1,271	1,489	1,568	1,800	2,443	3,346	4,688	46	4,688	609	1,092	1,264	116%
Interest-bearing Deposits	190	221	253	349	441	880	1,071	1,394	1,716	2,183	2,666	3,584	4,200	5,723	5,965	5,951	7,306	9,419	12,003	190	12,003	2,183	3,448	3,445	100%
Total Deposits	236	278	323	439	553	1,061	1,301	1,749	2,190	2,792	3,449	4,728	5,471	7,212	7,533	7,751	9,749	12,764	16,690	236	16,690	2,792	4,541	4,697	103%
Tangible Equity	14	17	20	28	25	63	76	89	104	160	196	280	350	390	466	564	766	983	1,227	14	1,227	160	306	354	116%
Return on Earning Assets																									
Net Interest Income	3.81%	3.96%	4.06%	4.11%	4.05%	3.79%	3.93%	3.61%	3.60%	3.79%	3.79%	4.04%	3.79%	3.71%	3.87%	3.92%	3.48%	3.45%	3.70%	3.45%	4.11%	3.79%	3.81%	0.19%	0.05
Net Non-interest Expense	1.99%	2.00%	2.00%	1.92%	1.87%	1.94%	1.68%	1.37%	1.24%	1.32%	1.19%	1.47%	1.57%	1.44%	1.42%	1.30%	1.12%	1.07%	1.16%	1.07%	2.00%	1.44%	1.53%	0.33%	0.22
Pre-tax Income	1.82%	1.96%	2.06%	2.20%	2.17%	1.85%	2.25%	2.24%	2.35%	2.47%	2.60%	2.57%	2.22%	2.26%	2.45%	2.62%	2.35%	2.38%	2.54%	1.82%	2.62%	2.26%	2.28%	0.24%	0.10
Leverage																									
Earnings Assets/Tangible Equity	16.59	16.41	16.20	15.90	23.17	17.86	18.02	20.64	22.16	18.41	18.81	17.89	16.65	19.43	17.06	14.71	14.30	14.43	14.55	14.30	23.17	17.06	17.54	2.51	14%
RETURNS																									
Return on Tangible Equity	30%	32%	33%	35%	50%	33%	40%	46%	52%	45%	49%	46%	37%	44%	42%	39%	34%	34%	37%	30%	52%	39%	40%	7%	0.17
GROWTH																									
Net Interest Income		22%	21%	39%	25%	83%	26%	23%	25%	35%	25%	45%	9%	27%	9%	6%	17%	29%	35%	6%	83%	25%	28%	17%	0.61
Net Non-interest Expense		18%	18%	31%	25%	102%	6%	9%	14%	36%	12%	69%	24%	20%	3%	-4%	14%	23%	36%	-4%	102%	19%	25%	25%	0.99
Pre-tax Income		26%	24%	46%	26%	66%	48%	34%	32%	35%	31%	35%	0%	33%	14%	12%	19%	31%	34%	0%	66%	32%	30%	15%	0.48
Federal Funds and Other Deposits		-38%	88%	117%	-30%	199%	-31%	19%	85%	-7%	-24%	120%	129%	-53%	-37%	-45%	156%	-27%	186%	-53%	199%	6%	45%	89%	1.97
Securities		24%	13%	35%	37%	102%	23%	35%	25%	6%	10%	15%	30%	68%	11%	3%	38%	25%	10%	3%	102%	24%	28%	24%	0.85
Loans		12%	22%	35%	20%	80%	25%	33%	25%	65%	42%	52%	5%	6%	-2%	7%	24%	37%	45%	-2%	80%	25%	30%	22%	0.73
Total Earning Assets		17%	18%	37%	27%	95%	22%	34%	26%	28%	25%	36%	16%	30%	5%	4%	32%	30%	26%	4%	95%	27%	28%	19%	0.67
Non-interest bearing Deposits		24%	22%	29%	26%	61%	27%	54%	34%	29%	29%	46%	11%	17%	5%	15%	36%	37%	40%	5%	61%	29%	30%	14%	0.47
Interest-bearing Deposits		16%	15%	38%	26%	100%	22%	30%	23%	27%	22%	34%	17%	36%	4%	0%	23%	29%	27%	0%	100%	25%	27%	21%	0.76
Total Deposits		18%	16%	36%	26%	92%	23%	34%	25%	27%	24%	37%	16%	32%	4%	3%	26%	31%	31%	3%	92%	26%	28%	19%	0.67
Equity		18%	19%	40%	-13%	153%	21%	17%	17%	54%	22%	43%	25%	12%	19%	21%	36%	28%	25%	-13%	153%	22%	31%	33%	1.08

SINGULAR DILIGENCE

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Prosperity Bancshares (NYSE: PB) is a Serial Acquirer of Texan Banks

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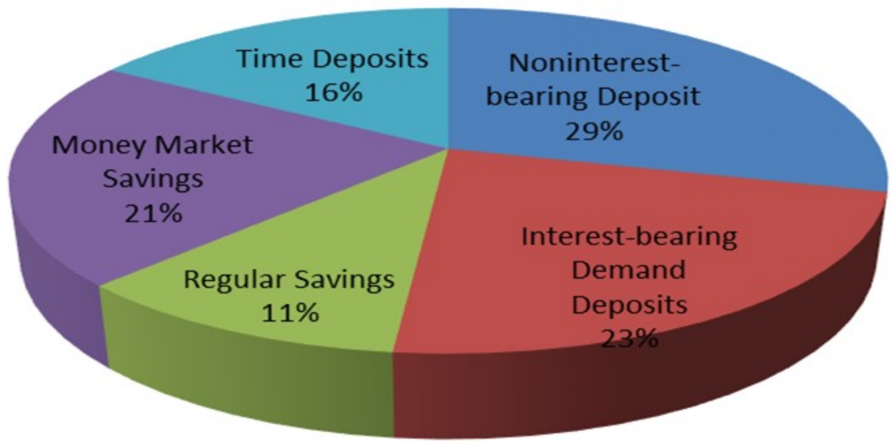
OVERVIEW

Prosperity is the second largest bank headquartered in Texas (behind Frost). Unlike Frost, Prosperity is a serial acquirer. The bank was formed in 1983 to acquire the former Allied Bank in Edna, Texas. During the 1980s, Texas banks began failing in huge numbers. In 1986 alone, a total of 175 Texas banks failed. Prosperity was able to grow by acquiring failed Texas banks. In 1988, Prosperity was a tiny bank with just $40 million in assets. By 1994, it had $224 million in assets. By 1998, it had $436 million in assets. From 1996 through today, Prosperity has grown its deposits by a compound rate of 27% a year. Prosperity went public in 1998. This allowed the bank to use its common stock as currency – instead of cash – to do acquisitions. Some banks have been successful growing through a series of value creating acquisitions. The first key to doing this is paying a low enough price for the bank you are acquiring. It is important that Prosperity pays a low "core deposit premium". Prosperity defines "core deposit premium" as (Price – Tangible Equity) / Core Deposits where "core deposits" are defined as the acquired bank's total deposits less CDs (certificates of deposit) that are more than $100,000 in size. Prosperity's acquisitions have been done at an average premium of 12% over core deposits. Prosperity often uses its own stock to make acquisitions. In almost all cases, Prosperity's stock traded at a higher premium over its core deposits than the premium it was paying for the bank it was acquiring. In other words, Prosperity – as a large, public company – has usually been able to issue stock at a higher price multiple than it has paid for the banks it has acquired. So, there is an immediate value creation in this model to the extent Prosperity is valued in the stock market at a higher price than it pays for the banks it acquires. This is a key part of how publicly traded serial acquirers work. They take advantage of the fact that the stock market allows them to issue new shares in their company at a higher price than they pay to acquire other companies. The same dollar of deposits is valued higher at Prosperity than it was at the bank it acquired.



Nearly two-thirds of Prosperity's deposits come from traditionally low cost funding sources like non-interest bearing deposits (29%), interest checking (23%), and regular savings (11%).

Is this justified? It is possible for banks to have cost synergies. Small banks tend to have higher expenses than medium sized banks. And large banks tend to generate more free income – by cross-selling products to depositors – than medium sized banks. So, there is some advantage in being a bigger bank. But, the economies of scale in banking are often overstated. Plenty of smaller regional banks can earn as good a return on their equity, deposits, etc. as much bigger banks. It is possible that other metrics are more important than mere size. For example, in normal times, Wells Fargo and Frost are probably two of the highest quality banks in the U.S. By this we mean that at a normal level for the Fed Funds Rates, these banks would generate some of the highest earnings for shareholders per dollar of customer deposits. Wells Fargo is much bigger than Frost. It may have some advantages due to this size. But, it may also have some disadvantages due to size. For example, it may be in some less attractive states. The reason Frost and Wells Fargo both have strong earning power is due to their economies of scale at the customer and branch levels. These banks have very high deposits per branch. So, expenses like rent and general branch operating expenses are lower relative to deposits. Frost has a high retention rate while paying a low amount of interest. It has a lot of free deposits from commercial customers on which it pays essentially nothing. The bank is almost entirely funded through sticky customer deposits (not CDs). Wells Fargo cross-sells many products to the same customers. These are important drivers of profitability. And they are more important than the absolute size of the banks.

So, does Prosperity have such a driver of profitability that makes its acquisitions add value? Or, does the bank just count on snowballing acquisitions where it pays less for the banks it acquires than it knows the market will value the newly acquired deposits for when they become a part of Prosperity?

Prosperity's advantage is in how it runs the bank. Prosperity is more efficient than the banks it buys. So, it is not a matter of synergies. It is a matter of one-time cost efficiencies. Prosperity does two things better than other banks. One, it has lower expenses. It simply runs its offices more leanly than other banks. For example, Prosperity usually acquires banks with an efficiency ratio (a measure of expenses relative to revenue) of 60% to 80%. Prosperity then brings that efficiency ratio down to 50%. How does it do this? Prosperity usually targets cost cuts of 25% at the bank it acquires. Sometimes, the actual cost cuts exceed this original target. But, from the time the acquisition is first being considered, Prosperity is already planning to cut costs at the bank and to exit loans. Loan losses are the other thing Prosperity is better at than other banks. Prosperity losses less money on the loans it makes than other banks. Again, this is a management issue. Prosperity makes changes to both expenses and loans at the banks it acquirers. If Prosperity hadn't acquired these banks, their loan losses in the future would almost certainly be more typical – that is, higher – than what loan losses as part of Prosperity turn out to be. Prosperity has a 42% efficiency ratio. Stated another way, its operating expenses are 1.07% of its earning assets. An efficiency ratio of 42% is among the lowest such rate for U.S. banks. Prosperity's net charge-off rate has averaged 0.05% of loans. This is also among the lowest such rate for U.S. banks. So, Prosperity has 3 advantages as an acquirer. First, its stock price is usually higher than the price it pays for the banks it acquires. Second, Prosperity cuts expenses when it acquires the bank. Third, Prosperity reduces loan losses when it acquires the bank. In other words, Prosperity attempts to eliminate all unnecessary expenses and all risky loans from the banks it takes over. Historically, it has been successful doing this. Prosperity also runs the bank in a more interest rate neutral manner than many U.S. banks. For example, since 2007, Prosperity has grown earnings per share by 12% a year. Almost no other banks have been able to do that. The decline in interest rates meant that even banks like Frost that could grow deposits – and therefore, "normal" earnings – by close to 10% a year since the crisis, couldn't possibly grow present day earnings by much at all. Most banks that grew deposits since the crisis, haven't grown earnings nearly as quickly. Their earnings will only recover when interest rates rise. This is what makes Prosperity and Frost most different from each other as stocks. Frost is the biggest Texas based bank. And it's a great investment. Prosperity is the second biggest Texas based bank. And it's a great investment. But, Frost is very interest rate sensitive. Frost's earnings will eventually surge along with the Fed Funds Rate. Prosperity's earnings are already quite good today. It will make little difference to Prosperity what the Fed Funds Rate is in 2020. The stock trades for about 11 times 2014 earnings. We think this is about 10 times normal earnings. Prosperity is not as cheap as Frost. And Prosperity has much less of a capital cushion than Frost. Prosperity is simply more levered than Frost. However, Prosperity also doesn't make energy loans while Frost does. And Prosperity's net charge-offs have historically been even lower than Frost's. So, it makes sense for investors to own both of these two biggest Texas banks.

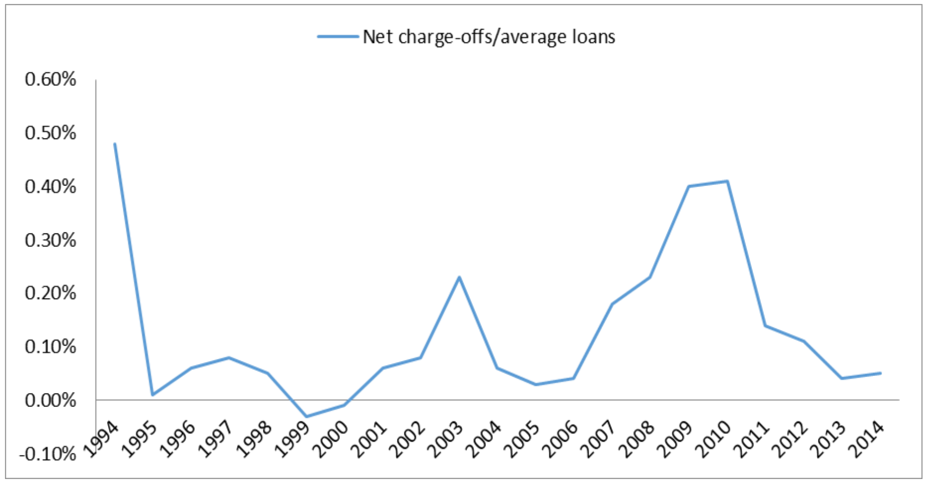
DURABILITY

Prosperity Has Some of the Lowest Loan Losses of Any U.S. Bank

Prosperity's durability depends on its ability to safely and successfully integrate acquisitions. The company has higher leverage – lower tangible common equity to total assets – than banks like Frost. So, Prosperity does not have a large capital cushion to absorb loan losses. It relies instead on not having many losses. Over the last 21 years, Prosperity's loan losses have been some of the lowest in the banking industry. From 1994 through 2014, Prosperity charged off just 0.13% of its total loans in an average year. Loan losses peaked at around 0.50% in 1994 and again at about 0.40% in 2008, 2009, and 2010. Prosperity's loan losses in the crisis years of 2008 through 2010 were similar to Valley National. Valley National – which is a New Jersey based bank – is a good point of comparison for a very conservative lender. A bank with loan loss results similar to Valley's results is a conservative lender. So, Prosperity has historically been a very conservative lender.

There are risks at Prosperity. The bank is overwhelmingly a Texan bank. It has some small business in Oklahoma. But, it's not really meaningful to consider. So, like

Frost, Prosperity can be thought of as a 100% Texan bank that both gathers deposits from Texan households and businesses and lends to households and businesses in Texas. Prosperity's loans are quite different from Frost's loans. About 75% to 80% of Prosperity's loans are usually real estate loans of some kind. Most recently, the company's loan portfolio was 74% real estate, 19% commercial and industrial (this is the category Frost lends heavily in), and then a mix of agricultural, consumer, and other loans. These last three categories are far too small to be meaningful to Prosperity no matter how large the losses within one of the groups gets. The only loan categories that are worth thinking about are commercial and industrial (about 20% of loans) and real estate (right now, 74% of loans – but sometimes up to 80% of loans). Obviously, Prosperity's greatest macroeconomic exposure is to Texas land values. About 32% of Prosperity's total loans are commercial mortgage loans, about 24% are residential mortgages, and then 11% are construction and land loans of some kind. So, you have 32% business real estate, 24% residential real estate, and 11% construction. Together, these three types of real estate loans account for more than two-thirds of Prosperity's entire loan portfolio. All three categories can be affected by land values in Texas. The biggest concern would be a bubble in Texas land values that eventually pops. There is no evidence for this. Texas land remained more affordable than land elsewhere in the country throughout the housing boom despite Texas's exposure to oil. The oil boom of the 2000s in Texas did not cause the kind of land value bubbles that happened in other parts of the country during the 2000s. Texas banks failed in the 1980s oil bust. Quan and I don't think we'll see many Texas bank failures today despite oil going from about $100 to about $30 a barrel as I write this. Although this is similar to what happened in the 1980s oil glut that devastated Texas banks – there are several key differences. One, Texas banks are very safe right now. They have strong capital positions. Most Texas banks have very small amounts of problem loans to loan loss reserves plus tangible equity. Two, Texas's economy is much less dependent on energy than it was 30 years ago. For the entire state, energy is a small part (probably 15% or less) of economic activity. Industries like chemicals, refining, and transportation of oil and natural gas are important to cities like Houston. Some important oil companies have large offices in parts of the state. They are key tenants. And there are some parts of Texas – like Midland / Odessa – that have boomed along with production of oil.



Prosperity has always charged off less than 0.50% of its loans even during crisis years.

In some ways, a bank like Prosperity may be safer when oil is at a more normal price than when oil is incredibly overvalued. This is because the greatest risk to a real estate lender is making loans during an asset bubble. So, the fewer bubble years a lender experiences – the less likely they are to make loans at values that while reasonable compared to the market value of the property turn out to be unreasonable compared to the true intrinsic value of the property.

Prosperity is less interest rate sensitive than many banks. The bank's real estate loans generally start at 80% loan-to-value and move down over the life of the loan. The loan is usually paid off in 10 to 15 years. Prosperity has had very low losses in its residential mortgage loan portfolio. The average life of a loan in the bank's residential mortgage loan portfolio is usually between 5 and 8 years. The fixed rate mortgages are 10 or 15 years. At any time, the average loan in the portfolio might be about half the length of the loans being made. So, the average 10-year fixed rate mortgage in Prosperity's portfolio might be fully paid off in 2021 (5 years from now). The average 15-year fixed rate might be paid off around 2024 (8 years from now). These are not exact figures from the bank. But, they are a good estimate of how the portfolio is likely to look at any time. Prosperity doesn't keep any 30-year mortgages on its books. And jumbo loans are a very small part of Texas mortgages (Texas land values are not high compared to the rest of the country).

Prosperity's commercial real estate loans are much smaller than those big banks make. The average commercial real estate loan in Prosperity's portfolio is about $400,000. Owner occupied commercial real estate is often for professional firms like a doctor's office, a vet, a law practice, etc. or a small manufacturer. Land loans – construction loans – are obviously somewhat speculative. They account for 11% of Prosperity's total loans at the moment. Generally, Prosperity says they make land loans to "well-seasoned" customers they have done business with for two or three decades and that these borrowers tend to have more money on deposit with Prosperity than they are borrowing from the bank.

It's possible that Prosperity faces less competition in its commercial real estate lending than big, national banks do. Competition in lending often results in less favorable terms (looser credit) for the bank doing the lending. Banks can compete with each other by adjusting the rates they charge on loans, the length of the loan, and the credit requirements for the borrower (like loan-to-value ratio, fixed charge coverage, etc.). So, competition between lenders can lead to higher loan losses rather than just lower rates. This is why we are discussing competition on the lending side in the durability section.

Prosperity's commercial real estate loans have gotten bigger over time. But, they are still small. In 2005, the average commercial real estate loans was $400,000. Prosperity said that competition for commercial real estate loans was lower among $100,000 to $400,000 sized loans. They also said that that they missed out – passed on – about 5-6 loans that average about $5 million a piece because the rates on these loans would not have been any better than simply adding bonds to their portfolio. This is evidence of the competition among lenders – for larger loans – causing an inadequate value proposition for the bank. If the bank can simply buy a bond with the same yield as the real estate loan – it should just buy the bond. In 2009, Prosperity's average commercial real estate loan was $406,000. The average construction loan was $238,000. And the average loan of the bank's entire loan portfolio was $101,000. By 2011, average loan of the whole portfolio had risen to $114,000. The bank said it had only two relationships of between $30 million and $40 million. No relationship exceeded $40 million. In 2014, the average loan size had soared to $157,000. The bank still has about 59,000 different loans. Today, Prosperity has a few very big loans. For example, we know the bank made a $30 million loan for residential development in Houston (the bank claims the collateral was worth $100 million – so LTV was maybe 30%), and they even made a $100 million loan. So, some of the bank's lending is not very different from the size of loans done by the biggest banks. In general, Prosperity has tended to make smaller loans and have somewhat lower charge-offs than Frost. Frost and Prosperity are good peers because they are the two biggest banks that only do business in Texas. Prosperity's loans tend to be secured by hard assets. Frost's loans tend to be more commercial and industrial and less real estate. Frost doesn't hold residential mortgages. Prosperity does. But, it doesn't hold 30 year mortgages.

There is strong evidence that Prosperity is a more conservative lender than the banks it acquires. Non-performing assets – this is loans plus foreclosed property – has always been less than 0.5% of total loans from 1994 through today. Prosperity generally reduces the total amount of loans from an acquired bank over 1-2 years from the date of acquisition by 15% to 20%. In some cases, Prosperity acquired a troubled bank and basically kept the deposits but got rid of most of the loans. Prosperity sometimes requires an acquisition target to exit certain loans before the acquisition can go through. Prosperity's exposure to oil and gas is much lower than BOK Financial or Frost. Oil and gas loans are 5.5% of total loans and 2.7% of total earning assets. The investment portfolio is mostly mortgage backed securities (Ginnie Mae, Fannie Mae, Freddie Mac) and has a duration of 3 to 4 years. Like a lot of banks – Prosperity has increased the duration of its securities holdings during the period from 2009-2015 where the Fed Funds Rate was close to zero percent. Higher interest rates can cause paper losses at Prosperity like at Frost. However, Prosperity (like all but the biggest U.S. banks) is exempt from having to include paper losses on securities in determining capital adequacy. Overall, higher interest rates would benefit Prosperity somewhat after about 2 years despite the initial paper losses. Prosperity's liquidity is excellent. The bank's sources of funding are not as good as Frost's – but really, no bank's funding is as good as Frost's. About 21% of Prosperity's liabilities are time deposits and borrowings of some sort. The other 79% of funding can be considered safe and sticky deposits. Prosperity's customer checking and savings accounts as a percent of total funds is – like I said – lower than at Frost but much higher than the banking industry generally. The biggest risk to Prosperity's durability would be somehow making an error in due diligence during an acquisition and ending up with losses on loans it acquired but did not make. I'm not sure how big a risk this really is anymore. Prosperity has a long history of safely acquiring banks – including failed banks – without causing loan losses to even approach the level other banks typically end up with when they don't make any acquisitions. Also, Prosperity is such a big bank now that any acquisitions it makes will tend to be smaller relative to the size of the existing bank than they used to be. Prosperity also has a mix in assets of about half loans and half securities. So, when you look at the size of any acquired loan portfolio as being loans of acquired bank divided by loans plus securities of the post-merger Prosperity Bank overall – the risk seems manageable. It's possible that if management changes in the future, there may be changes in acquisition due diligence. Historically, Prosperity has looked at a lot of loans in the acquisition target's portfolio before closing the deal. And, like I said, Prosperity sometimes requires the target to exit loans before the acquisition closes and Prosperity often reduces total loans of the acquired bank by up to 20% within the first 2 years of the acquisition. So, Prosperity is not afraid of shrinking loans as long as it gets the acquired bank's deposits at a small premium.

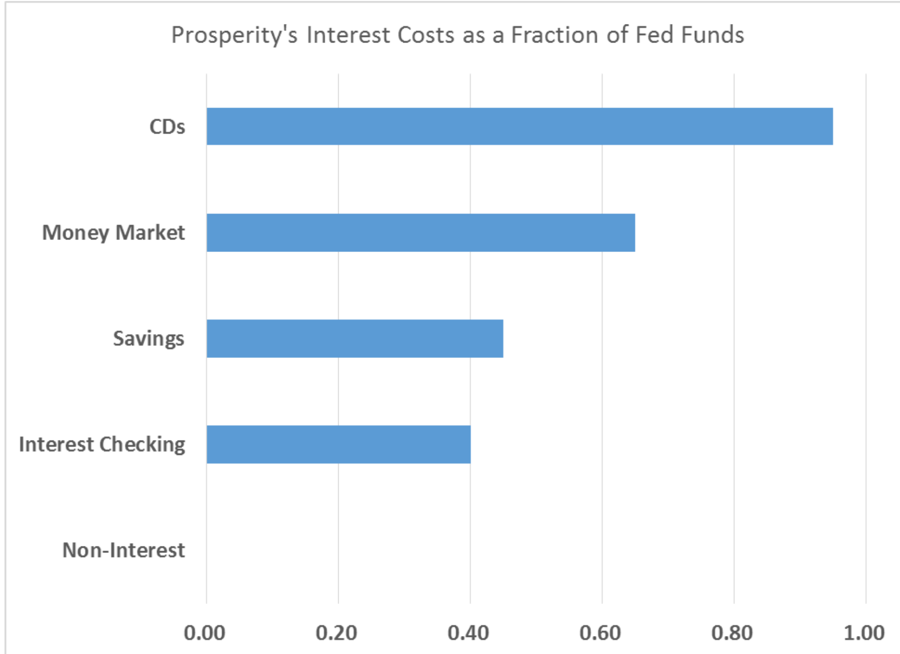
MOAT

About 84% of Prosperity's Deposits Come from Sticky, Low Cost Sources

Like all U.S. banks, Prosperity's moat comes from its sticky deposits. American households and businesses that deposit money with a bank for their checking and savings accounts rarely switch banks. Customer retention is high. Regardless of whether switching costs actually are high – switching is rare. So, the moat for these banks is as high as if there were big switching costs for depositors. Competition is mainly on the lending side. So, a bank like Prosperity can have a moat around its deposits – which determines the company's cost of funds – and yet simultaneously lack a moat around its loans. For this reason, Prosperity may be able to gather capital at a lower cost than other banks. But, it may only be able to earn the kinds of returns on loans and securities than any other bank or investor could earn.

Time deposits account for 16% of Prosperity's total deposits. We should consider these no moat deposits. The other 84% of total deposits are money market savings accounts (21%), regular savings accounts (11%), interest bearing demand deposits (23%), and non-interest bearing demand deposits (29%). The widest moat is around checking accounts that either do or do not bear interest. Savings accounts also have some moat – many customers who have a savings account with a bank also have a checking account with that bank – but when interest rates are higher, it is possible banks might have to match each other's rates on savings accounts. Obviously, Prosperity pays nothing on the 29% of total deposits that are non-interest bearing checking accounts.

Different types of deposits have different levels of interest rate sensitivity. The least sticky deposits will rise the most in interest costs as the Fed raises its rates. Historically,



Prosperity gets most of its deposits from non-interest accounts (29%), interest checking (23%), and money market accounts (21%), and savings accounts.

Prosperity's accounts have paid 0.40 times the Fed Funds Rate on interest bearing checking, 0.45 times the Fed Funds on regular savings, 0.65 times the Fed Funds on money market accounts, and 0.95 times the Fed Funds on CDs. So, deposit sources vary from a perfect moat (0% interest cost) around non-interest bearing demand deposits that make up 29% of Prosperity's total deposits to no moat (95% of Fed Funds interest cost) around the CDs that make up 16% of Prosperity's total deposits.

A bank's franchise is its deposit base. The banks with the widest moats and the highest profitability in normal times are the banks that have the lowest cost of funding. This means they are the banks with the greatest number of customer accounts that pay little or no interest. Prosperity knows this. In 2009, the company's CEO said: "…a lot of the banks that we are seeing are banks that we're not necessarily interested in, simply because when we look at them, they were banks that were started in the last five or ten years and 60% and 70% of their money is CD money…if we ever find a bank that's really a good…bank with a good core relationship that (has) been around for a long time that fits into that category we will certainly consider (acquiring) it."

Five years earlier (in 2004), Prosperity's CEO said: "When we are looking at banks and we are modeling out acquisitions and where we are, you know, we believe we make money off of the deposit base. We believe that's where the value in a franchise is in the deposit base, and so, you know, holding deposits and growing deposits are important to us."

Along the same lines, in 2006, one of Prosperity's Vice Presidents told investors on earnings call: "We tell our team that if somebody is looking for the highest rate in the market, we're probably not the bank for them. If somebody is looking for the absolute lowest loan rate in the market, we're probably not the right bank. We're relationship driven. We want the full benefits of both sides of the customer's relationship."

This is the only way there can be a moat around any of a bank's lending. It can lend to customers it has relationships with. It can get both deposits from a customer and make loans to that customer. A customer who only needs a large commercial mortgage loan is simply going to look for the lowest rate and best terms they can get. But, a customer who needs a mortgage on their commercial real estate probably has a checking account for the general day-to-day operations of their business. They probably have a savings account. The proprietor of the business – the owner/occupant – may also have household needs that include their own mortgage, their own accounts, etc. This is how it might be possible for one bank to have higher yields and lower losses on its loans than other banks. It could have a moat if some customers – especially smaller customers looking for smaller loans – did a variety of business on both the deposits and loans side of the bank without shopping around at competitors.

Prosperity's lending results have been very good. But, as the bank gets bigger it will be harder to differentiate itself on the lending side as easily as on the deposit side. A bank's moat comes from its deposits. The bank with the best overall results in lending is probably Wells Fargo. Wells Fargo cross sells a lot of financial products to each of its customers. It has a high share of the customer's wallet. Wells Fargo customers must do more business with Wells Fargo and less business with other banks than most bank customers. Wells Fargo is an example of how it's possible to earn higher net yields on loans than other banks. In other words, Wells Fargo is proof you can have a moat around lending if it is combined with relationships that include an excellent deposit base. Wells Fargo has a lot of deposits per branch and these are low cost deposits. So, even when there is a moat in lending it seems to grow out of the bank's relationships on the deposit side as well as the lending side.

Prosperity has done a good job with organic growth. The bank prefers buying competitors instead of opening new branches. So, while opening very few branches it managed to grow deposits by between 4% and 6% a year over 20 years. A 4% annual growth rate in deposits per branch is excellent. Prosperity's biggest competitor in Texas – Frost – probably does a better job in deposit growth per branch than Prosperity. Frost has much, much higher deposits per branch than Prosperity. But, that is because Frost has some of the highest deposits per branch – and probably the highest non-interest bearing deposits per branch – of any bank in the U.S. So, Prosperity's results in winning new deposits in Texas organically is very good though perhaps not quite as good as Frost's record.

Prosperity has weaknesses compared to big banks. It doesn't have much of a trust business. It has no merchant card processing. The bank's strengths seem to be at the branch level instead of the corporate level. Prosperity doesn't run call centers. Customers must call their branch directly. Customers work only with bankers at their branch – not anyone at headquarters. Lending is handled at the branch level. Each branch has its own profit and loss statement. And bankers at each branch can make commercial real estate loans, C&I loans, construction loans, and residential mortgage loans for customers of that branch.

Prosperity's weaknesses compared to big, national banks may not matter much. Frost and Prosperity are the two biggest Texas based banks. They have been very successful for decades now. Their earning power relative to deposits, equity, etc. is tremendously high. And yet they generally focus on smaller customers and offer fewer financial products than big, national banks in Texas do. Prosperity earns very little in fee income.

Obviously, Prosperity must compete with other banks when it comes to acquisitions in Texas. So, competing suitors for the same bank can drive up the core deposit premium. When a bank in Texas is looking to sell out, it probably calls Frost and Prosperity (perhaps in that order, perhaps in the opposite order). Frost is the correspondent bank for a big number of banks in Texas. So, it probably knows a lot of Texas banks well. But, Frost isn't a serial acquirer. It prefers organic growth. The cultural fit with Frost may be narrower as well. Prosperity is probably more financially driven as a buyer. This is because Prosperity cuts costs at the banks it takes over.

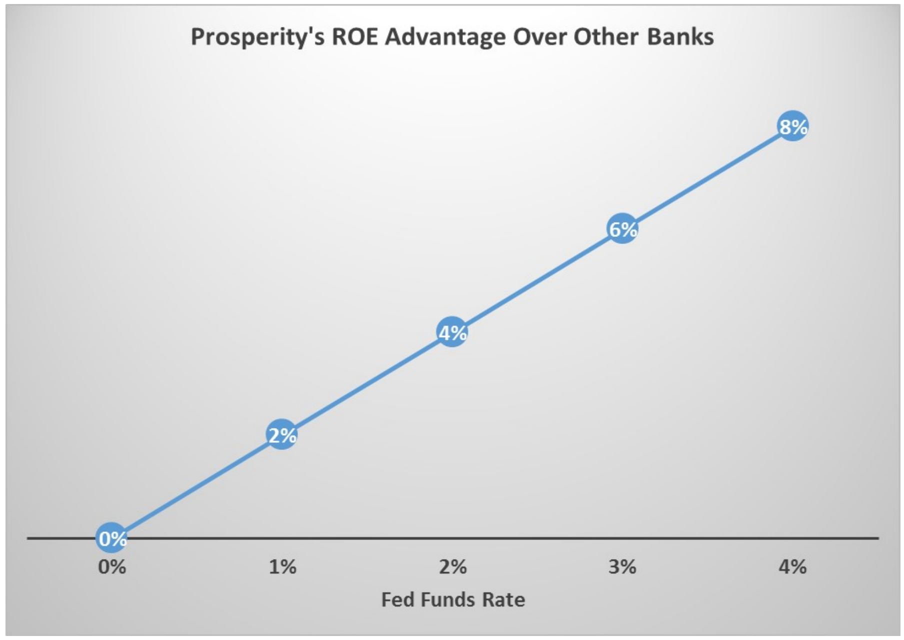
Prosperity can squeeze more out of an acquisition than another buyer could though because it will implement harsher cost cuts. A 2014 anecdote by Prosperity's CEO illustrates this well: "I'll give you just a little story, and I shouldn't, but I will anyway. One of the banks we first bought…that really got us going in the Houston market was the Heritage Group, and their President – I was talking in the lobby one day and (Prosperity's CFO) was on the speaker box on his phone. I heard all this ranting and raving and hollering. I said – what the heck is going on here? And the President was hollering because David (the CFO) had taken away – I don't know if it was his popcorn or what. And then he said – well, what about the hot chocolate or something. And David said – well, is that for the customer or is it for the employees? And then he was ranting and raving again. So that's how all this stuff all works. I did get him to buy some better toilet paper, though…today, it's a real issue because we don't provide tissues and a lot of people want tissues and so it's a big issue because we won't buy Kleenex tissues for anybody." Another employee said: "I do remember the day we found out that we wouldn't get Kleenex. That raised a little bit of concern, and then that we wouldn't have personalized letterhead, and then you realize, well, you can type your name on there, it's not that big a deal."

Even though other banks look at the same acquisition targets as Prosperity, it's possible Prosperity may be able to get better results from what it acquires than another bank would. Historically, it has certainly been more successful in both cutting operating expenses at branches further than other banks and also having lower loan losses. So, given the same amount of deposits and loans, Prosperity can make more money than another acquirer would from acquiring the same bank. However, this is purely a cultural advantage. It's a management based advantage. If you get a different CEO and CFO in there at Prosperity who cares less about taking costs out of the branches and risk out of the loans, then the results will be different. The deposit base is a permanent franchise. The moat around that will be there for Prosperity regardless of who is running the bank. Top management doesn't matter in terms of whether or not you have a moat around deposits – your existing customer relationships are the moat. The only advantage you can have over others when it comes to acquisitions is simply having management that does things other managers wouldn't. Prosperity certainly cuts costs others wouldn't.

QUALITY

Prosperity's ROE Advantage Over Other Banks Rises Along with the Fed Funds Rate

Prosperity is a higher quality business than most U.S. banks. The quality of a bank comes from the cost of its funding sources. Deposits make up 89% of Prosperity's earning assets. Prosperity's sources of funding from highest quality (cheapest) to lowest quality (most expensive) are: Non-interest bearing deposits – plus shareholder's equity (29% of funding), interest-bearing checking accounts (21%), regular savings accounts (10%), money market savings accounts (19%), CDs (15%), and other borrowings (6%). The highest quality funds are the non-interest bearing accounts, the interest bearing checking accounts, and the regular savings accounts. All of these sources of funding tend to cost less than half of the Fed Funds Rate. So, if the Fed Funds Rate is 2% in a certain future



Every 1% increase in the Fed Funds Rate will cause a 2% increase in Prosperity's Return on Equity versus the average U.S. bank from Prosperity's cost of funding advantage alone.

year, you can expect these funds to cost Prosperity less than 1%. If the Fed Funds Rate is 4%, you can expect these funds to cost Prosperity less than 2%. A reasonable range of costs for these funds at some point in the future would be 1% to 2% during a period where the Fed Funds Rate is 2% to 4%. As you can see, this is a much lower cost of funding than other financial institutions can achieve. Money market savings accounts are a more expensive cost of funding. They are equivalent to 19% of Prosperity's total earning assets. Money market savings accounts tend to pay about two-thirds of the Fed Funds Rate. So, if the Fed Funds Rate is 3%, money market savings might pay 2%. If the Fed Funds Rate is 6%, money market savings might pay 4%. Prosperity's overall cost of funding is about half the Fed Funds Rate. This is based on blending the different sources of funds and what they historically pay as a percent of the Fed Funds Rate.

The U.S. banking industry's cost of funding is around 70% of the Fed Funds Rate. So, imagine a future in which the Fed Funds Rate is say 5%. The banking industry as a whole, might be paying 3.5% in interest for its funds. Meanwhile, Prosperity would be paying 2.5% in interest for its funds. This is what makes Prosperity a higher quality business than the average U.S. bank. It has a cost of funding advantage. It is lower cost than the industry. Instead of predicting the Fed Funds Rate long-term, it is easier to figure out the relative cost position of banks. The banking industry as a whole, should have a 30% cost advantage versus the Fed Funds Rate. So, Fed Funds Rate time 0.7 equals the U.S. banking industry's cost of funds. Prosperity should have a 50% cost advantage relative to the Fed Funds Rate. So, Fed Funds Rate times 0.5 equals Prosperity's cost of funds. This means Prosperity has a 20% of Fed Funds advantage over the industry. Put another way, Prosperity's ROE should be 1% higher than the industry for every 50 basis point increase in the Fed Funds Rate. In other words, when the Fed Funds Rate is close to zero – Prosperity has almost no higher return on equity than other banks. When the Fed Funds Rate is 1%, Prosperity's return on equity can be 2% better than other banks. When the Fed Funds Rate is 2%, Prosperity's return on equity can be 4% better than other banks. At a "normal" Fed Funds Rate of 3% or 4%, Prosperity's return on equity would be Industry Average ROE + 6% or Industry Average ROE + 8%. So, if the average bank had a 10% return on equity during a "normal" year, Prosperity could have a 16% to 18% ROE. This illustration considers only the relative interest cost position of Prosperity versus the industry. Prosperity also has an operating (non-interest) cost advantage versus the industry. And, historically, Prosperity's net yield on loans has also been good. Those are separate factors. They may also be somewhat less predictable long-term. The most predictable parts of a bank's relative business quality are its interest and non-interest costs. Prosperity's interest costs are low enough compared to the industry that it should have a 1% higher return on equity for every 0.50% (so, for every two 25 basis point rate hikes) the Fed Funds Rate increases. Prosperity has a better relative cost of funding position today than it did 10 years ago. However, we can use 2005 as an example of how a relative advantage like this works. In 2005, the Fed Funds Rate averaged 3.21%. Banks with more than $10 billion in assets had average interest costs of 2.30% of their total earning assets. Prosperity's cost of funding was 1.74%. So, the average bank's cost of funds was a lot lower than the Fed Funds Rate. And Prosperity's was even lower. Prosperity had a 0.56% cost of funding advantage in 2005. Today, Prosperity's advantage would be a lot bigger. High cost funds (CDs plus other borrowings) were about twice as much (39% of funds) of Prosperity's balance sheet in 2005 as they are today (21%).

The biggest Texas based bank is Frost. Frost has even lower funding costs than Prosperity. However, Frost's net yield on its loans is not good. Prosperity's net yield on its loans is great. From 1996 through 2014, Prosperity's net yield on its loans (that is gross yield minus charge-offs for loan losses) was 1.34% higher than Commerce, 1.20% higher than BOK Financial, and 1.18% higher than Frost. Prosperity's loans have higher gross yields than most Texas banks. However, Prosperity also has lower charge-offs. So, the bank's gross yield advantage over other banks turns into an even bigger net yield advantage.

Banks don't provide enough detail about their loans to know precisely why one bank's loans have higher yields than another bank's loans. The most likely reasons for Prosperity's yield advantage are that Prosperity makes: 1) Small loans 2) Real Estate loans 3) Long-term loans. So, Prosperity's average loan may be smaller, backed by real estate rather than working capital, and longer-term. Regional banks tend to make shorter term loans. However, regional banks tend to own securities that may be longer-term. So, it may matter more to other banks whether they make a loan or buy a bond. Until recently, the difference in duration between Prosperity's loan portfolio and its bond portfolio was probably a lot smaller than the difference for most banks (who buy longer-term bonds than the loans they make). For example, Frost's loans tend to mature within 5 years. Meanwhile, 63% of Prosperity's total loan portfolio won't mature till 2021 or later.

Prosperity makes a lot of amortizing real estate loans. The bank lends 80% of the value of the property. And then over a period of 10 or 15 years, the value of the loan outstanding declines as the borrower makes regular payments to reduce principal. Usually, the value of the property would tend to increase over time. So, there is a tendency for both the loan to fall and the value to rise over the 10 or 15 years the loan is on Prosperity's books. So, in theory, the loan starts at 80% of value and falls from there. This means the average loan on Prosperity's books should be closer to half the time till maturity of the 10-15 year loans Prosperity makes and the loan-to-value should be closer to half the ratio Prosperity makes the loan at. In this way, Prosperity should be able to have a loan portfolio at any one time that has a fairly low loan-to-value ratio and more like a 5-8 year time till maturity. If these loans are also smaller loans than competitors tend to make – it's possible this type of loan has high yields and low charge-offs. Historically, that's been true. This is the kind of loan Prosperity has made. It pays higher yields than other banks get on their loans. And it has much lower charge-offs than other competitors have on their loans.

This also makes Prosperity more interest rate neutral than other banks with good funding sources. Normally, a bank with very low cost funds – like Frost – is extraordinarily interest rate sensitive because the yields it can get on it loans and securities rise along with the Fed Funds Rate but its cost stay anchored much closer to zero, because many of its depositors get little or no interest regardless of the Fed Funds Rate. Because Prosperity makes longer-term loans, it can be less interest rate sensitive than other banks and it can take longer for the impact of a Fed Funds Rate hike to alter the bank's earnings. Frost and Prosperity are good peers in many ways. The biggest way the two banks differ though is that Frost will benefit a lot with every quarter point increase in the Fed Funds Rate. Prosperity won't. Prosperity's earnings are fairly normal now. If you looked at the P/E of Frost and Prosperity – they'd look similar. On a normalized basis, Frost is a lot cheaper than Prosperity. This is because Prosperity's earning power is not very different during periods of low interest rates and high interest rates. Frost's earnings will be a lot higher during a period of high interest rates. As a business, Prosperity is as least as high quality as Frost overall. And Prosperity's advantages come from multiple sources. Prosperity is a great serial acquirer with skilled management, it gets better results on the loan side of the business than other Texas banks, and it has a great deposit franchise with very low interest costs. Frost's advantage over Prosperity is just its low cost deposits. Frost has even lower cost deposits than Prosperity. And Frost has been able to grow those low cost deposits organically faster than Prosperity probably can. Prosperity can earn about a 2.84% return on earning assets pre-tax. Prosperity's leverage tends to be a lot higher than Frost's. Right now, Earning

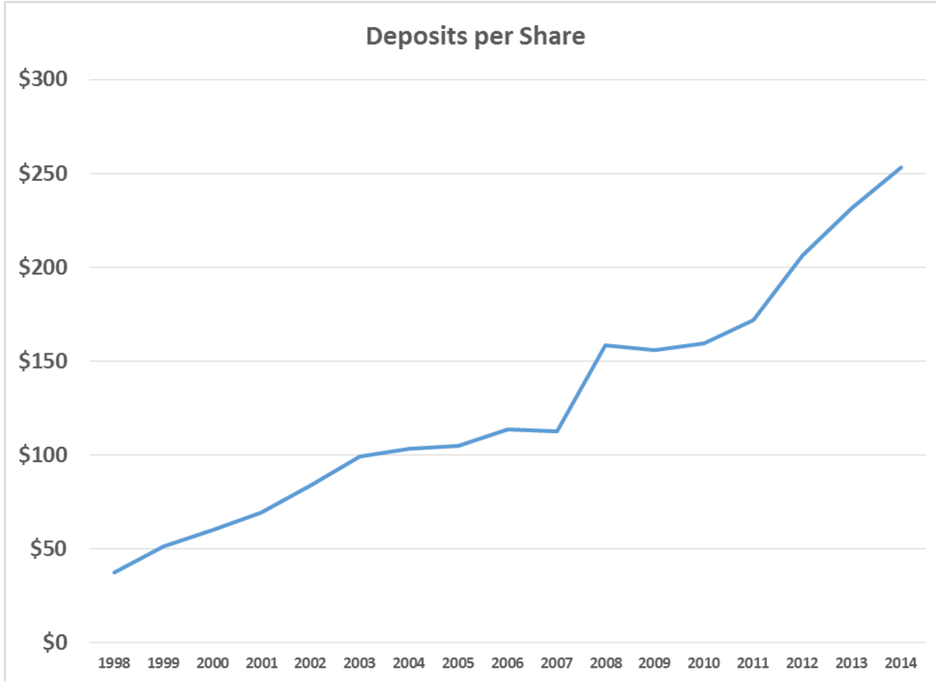
Assets / Tangible equity is 15. Normally, it's in the 15 to 20 range. So, Prosperity can earn a pre-tax return on equity of 30% to 40%. This means the bank can earn a 20% or higher after-tax return on equity. But, it's important to remember Prosperity's higher return on equity versus a bank like Frost comes in part due to higher earning assets compared to tangible equity. In other words, Prosperity is more leveraged than Frost.

CAPITAL ALLOCATION

Prosperity Has Made 13% a Year on Its Acquisitions

Prosperity's capital allocation has been excellent. From 1998 through 2014, the company grew both earnings per share and deposits per share by 13% a year. These are good proxies for intrinsic value. So, for the last 15 to 20 years, Prosperity has been able to grow intrinsic value by far better than 10% a year. That is a better record than most public companies are able to achieve. And Prosperity has done it while paying out some of its earnings in dividends. This means the company has been run in a way that has delivered more like 15% annual returns while the average stock is lucky to make it to even a 10% annual return.

The company's compensation policies are traditional but not extravagant. Share-based compensation has been about a 0.5% drag on results per year. The 3-year average total compensation for Prosperity's CEO is about half what the CEOs of BOK Financial and Frost received. Some of Prosperity's management owns stock in the company. But, over time, Prosperity's insider ownership has declined. After the 1998 IPO, executives and directors owned 20% of the company's shares. Today, executives and directors own just 6% of Prosperity. However, compared to other banks, insider ownership is still good. As Prosperity said in a 2014 investor presentation: "I think the other thing that's really unique for us is that our management team, what I consider our executive committee, the majority of our net worth, I would say 75% plus for most of us, is tied up in Prosperity Bancshares stock."



Prosperity's deposits per share have compounded at 13% a year from $38 per share in 1998 to $253 per share in 2014.

Prosperity's most important capital allocation decision is to acquire other banks. Most of the banks Prosperity has acquired are private community banks. These are not publicly traded banks. So, Prosperity is able to acquire the banks using publicly traded shares in Prosperity. The management that sells to Prosperity can then cash themselves out by selling shares of Prosperity over time. For example, this is what the Chairman of Commercial Bancshares did. Prosperity acquired Commercial in 2001. The former Chairman of Commercial (Ned Holmes), had 2 million shares in Prosperity stock in 2001. He sold 700,000 of those shares between 2001 and 2004. So, within 3 years of the deal, he had sold over a third of his stake. He continued to sell his stock. So, his ownership went from 2 million shares in 2001 to 430,000 shares in 2014. The value of Prosperity stock increased for much of this time. So, he was able to receive a lot of cash for the original 2 million shares he got as part of the merger. Prosperity can compound intrinsic value at a higher rate than the banks that sell to Prosperity. And then there can also be a one-time benefit to the selling shareholders because they are selling out of an untraded stock into a publicly traded stock by doing the merger. Right now, the market does not put a very high value on Prosperity's earnings. But, in normal times, it would be common for a publicly traded growth stock like Prosperity to have a much higher earnings multiple than what anyone but a control buyer would ever pay for a smaller, closely held bank.

At a 2015 investor conference, Prosperity tried to explain why Texas banks sell to them: "…we don't want to brag or anything. But I think if you really want to sell your bank in Texas or Oklahoma, we are going to be the first guys you are going to come to. Maybe Frost, but Frost has said maybe that's not what they want to do. So we are probably the company that you're going to come to." That makes perfect sense. And the benefits described above – that you can receive shares in a publicly traded Texas bank you can sell at any time (or hold on to for as long as you want), that those shares can compound their value even faster than other investments you might make with your own money, and that you can keep a career in banking by going from top management in a small bank to a part of a bigger bank – all make perfect sense. There is one part of the appeal of Prosperity as a buyer that doesn't make sense. Why do the shareholders of a privately owned Texas bank – who are often members of that bank's management team – want to sell out to a serial acquirer known for its aggressive cost cutting. This is the one confusing aspect of the Prosperity picture.

For example, a Senior Vice President of Prosperity said in 2012: "Most of our transactions have been private community banks, not publicly traded banks. And sometimes the emotions behind selling a private bank are different than selling a public bank. In this particular case Mr. Collier has been with the bank since 1959. He's put a lot of blood, sweat, and tears into this organization and he needed to pick a partnership that he thought would be good. And I don't want to put words in his mouth, but I think he picked us because he felt like this would be a good fit for him and his team…" Prosperity is a Texas based bank. And it is decentralized in terms of how each branch is run. Those things can appeal to the sellers of a private community bank in Texas. But, a private community bank is likely to be run with less concern about costs than a publicly traded bank. It might be run more for the benefit of employees. It may not be as careful about keeping operating expenses as low as possible. And Prosperity cares a lot about that. Prosperity is one of the leanest run banks around. So, it is part of the success of Prosperity's acquisition record that it's been able to buy banks with some fat on them in terms of operating expenses and then cut that fat after the acquisition. Prosperity usually targets a 25% cost cut when it acquires a bank. But, the question is why would a bank's management sell to an owner that it knows will aggressively cut costs. Why sell to a bank that is going to take away the snacks and Kleenexes and so on in your offices. Prosperity's business model seems to be a great one for shareholders and a good one for customers. But, is it above average in any way for employees? Do employees like working in a low cost organization? This hasn't been a problem for Prosperity in the past. It's managed to acquire plenty of banks. But, it could be a problem in the future. It's certainly a puzzle.

Since 1996, Prosperity has averaged a 2.4% return on its deposits. Prosperity has paid an average premium over core deposits of 11% when acquiring a bank. By this logic, Prosperity should be able to earn about a 20% pre-tax return (13% after-tax return) on its acquisitions. Obviously, if Prosperity started paying a 25% premium to core deposits, it would only make about half the return on acquisitions it historically has. So, the incremental return on the acquisition would plunge from about 13% to about 7%. Even if Prosperity paid as much as a 25% premium to core deposits, it wouldn't necessarily start destroying much value – as most investors would have a hard time making more than 7% a year on any cash Prosperity paid out to them. It's important for Prosperity to pay a low premium to core deposits if it wants to create value. In many cases, Prosperity has done a merger where its stock traded at a higher premium to core deposits than it paid for the bank it was acquiring. This obviously creates value because the deposits will all belong to Prosperity when the deal is done and the branches will all be run as leanly as Prosperity runs its branches. The highest price Prosperity ever paid for an acquisition was a 24% premium to core deposits for Texas United Bancshares in 2007. However, Prosperity did the deal using 100% stock and 0% cash. Prosperity's own stock traded at a 24% premium to its core deposits. So, the deal was done paying a high price but using a highly priced currency. In most of the stock deals Prosperity has done, its own stock was valued more highly than the premium it paid to acquire the bank.

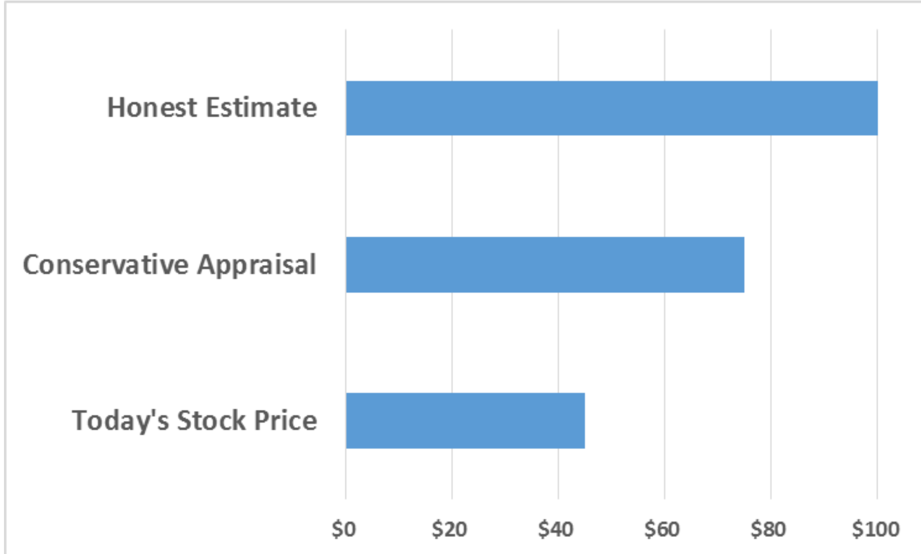
Prosperity always has high leverage. Tangible equity is usually between 4.5% and 7% of total assets. Prosperity acquires banks with lower leverage. This means it doesn't have to add cash after a deal to lower leverage. This is different from Frost. It's entirely possible that after a deal Prosperity's leverage will decrease because the acquired bank was overcapitalized from Prosperity's perspective. With Frost, it uses lower leverage. So, when it acquires another bank, this may actually increase leverage and require Frost to retain more cash for a little while to bring leverage down. Simply put, the price you see us talk about for Prosperity is the all in price. Prosperity doesn't have added costs in terms of adding to capital levels after the merger. But, this means Prosperity is more highly leveraged than a bank like Frost. If Prosperity grows organically at as much a 5% a year, it will only need to retain about 25% of earnings to keep capital levels where it wants. The bank now has a dividend payout near 20% to 25% of earnings as it has for the last decade. However, this can rise a lot in the future. Because Prosperity reduced leverage by 44% from 2004 till today. It is unlikely Prosperity will continue to deleverage. So, Prosperity will either need to use cash to acquire other banks, use cash to buy back stock, or increase its dividend payout faster than it increases earnings per share. Long-term, we think the last option is the most likely. If you own Prosperity stock for the next 10 years, it's likely the company's dividend payout ratio will rise while you own the stock and so dividends per share will increase faster than EPS.

VALUE

Prosperity is Worth At Least $75 a Share

Prosperity trades at about 11 times its 2014 earnings. So, the bank has a P/E of 11 – which is a little lower than Frost's P/E as I write this. However, Prosperity's price to normal earnings is higher than Frost's price to normal earnings, because Frost is more interest rate sensitive than Prosperity. Prosperity's net interest margin is more stable than at many other banks. From 1996 through 2014, Prosperity's net interest margin ranged from a low of 3.53% to a high of 4.18%. The median was 3.96%. And the mean was 3.90%. In 2014, Prosperity's net interest margin was 3.90%. In other words, 2014 was a perfectly normal year for Prosperity's net interest margin. This is not true for many other banks. At many banks – like Frost – the net interest margin in 2014 was much lower than the net interest margin in a normal year.

The best way to value Prosperity is to look at enterprise value to deposits and at enterprise value to normal EBIT. Enterprise value to deposits is 0.20. In other words, Prosperity has 5 times more deposits than the bank's total enterprise value. This is a good, low price for a bank. However, many other banks are priced at say 0.20 to 0.30 times deposits right now. So, it is not an extraordinarily low price on deposits alone. Prosperity's earning power on its deposits is very high though. Remember that Prosperity has lower operating expenses than other banks. It has a higher efficiency ratio. It also has high gross yields on its loans and low net charge offs. So, Prosperity is able to gather each dollar of deposits more cheaply than other banks due to low non-interest (operating) expenses. And then Prosperity is able to make more money per dollar of loans it makes because it receives a high yield for these loans while simultaneously charging off a lower than normal amount of each loan each year for its losses. As a result, Prosperity should be able to generate a 2.84% pre-tax return on earning assets.



Prosperity is trading at a 40% discount to our conservative appraisal of the stock's value and a 55% discount to what Quan and I think the stock is really worth.

The 2.84% return calculation is as follows. Prosperity's net interest margin since 1996 – which has been very stable and therefore does not need to be adjusted – has a median value of 3.96%. Over that time period, Prosperity has charged off 0.05% of loans per year. The bank's net operating cost is 1.07% of deposits in normal times. It was 1.16% in 2014, but Prosperity had made several acquisitions over the past two years. The minimum net operating cost was 1.07% of deposits and it was achieved in 2013. Banks like Prosperity – and in fact, many U.S. banks – tend to reduce net operating expense as a percent of deposits over time. For example, Frost has continuously lowered its non-interest expenses as a percent of total deposits. Prosperity should do the same. So, it is reasonable to use 1.07% as Prosperity's "normal" future net operating expense. So, 3.96% (net interest margin) less 0.05% (loan loss charge offs) less 1.07% (non-interest operating expenses) equals 2.84%. This means Prosperity's 3.96% net interest margin translates into a 2.84% economic margin. This is a pre-tax figure. So is enterprise value. But, we can adjust the pre-tax figure into an after-tax P/E by multiplying earnings at a rate of 0.65 to approximate the 35% federal corporate tax rate in the U.S. So, pre-tax owner earnings would be $18.92 billion in earning assets time 2.84% pre-tax return on earning assets equals $537 million in pre-tax earnings. At a 35% tax rate, $537 million pre-tax becomes $349 million after-tax. Prosperity has 70 million shares outstanding. So, $349 million after-tax divided by 70 million shares equals $4.99 a share in normal earnings per share. Prosperity is a growth stock. It has been able to grow at 10% a year or higher in per share earnings and deposits while paying a dividend. So, perhaps it deserves a higher than average P/E. Let's assume for now it gets a typical P/E of 15. This would be $5 in normal EPS times a 15 P/E multiplier equals a $75 intrinsic value per share. That means at $50 a share, Prosperity stock would be trading for a one-third discount to intrinsic value. The stock would have 33% downside in terms of how wrong the intrinsic value estimate could be before someone buying the stock at $50 a share would lose money permanently on the investment. Or, you can think of Prosperity stock as having 50% upside at a purchase price of $75. In some ways, both of these are inaccurate statements.

Prosperity is a high leveraged financial institution. Its margin of safety is in its loan losses relative to capital ratios. Prosperity is safe because it has very, very low loan losses. If that changes, the margin of safety would not be good.

On the other side of the scales, Prosperity is not a typical stock. It's a growth stock. An average stock – say the typical big U.S. stock for most of the 1900s – might grow its sales, earnings, and dividends per share by 5% or 6% a year while paying out a dividend of 3% a year. This would get you to an annual total return of 8% or 9% a year. At times, stocks may have returned more like 10% a year – but this was usually during periods where things like the price-to-book ratio and price-to-sales ratio expanded and the dividend yield declined. In other words, stocks really only returned 10% a year when they went from being especially cheap to especially expensive. Putting that aside, the return you are left with comes from per share intrinsic value growth and the dividend paid on the stock.

Prosperity has historically done better than the average stock in delivering intrinsic value per share growth. Frost deserves a P/E of 15. If that's true – Prosperity may deserve a P/E even higher than 15. Frost had a long period where it was able to grow deposits organically by 10% a year. Prosperity grew deposits – with acquisitions – by closer to 25% a year. It issued a lot of shares to do this. But, it was still able to grow deposits per share by about 13% a year for a long period of time. If Prosperity paid no dividend and grew deposits by 13% a year, it would still deserve a much higher P/E than the average stock which might grow only 6% a year and pay a dividend yield of 3%. Overall, Frost grew deposits per share by about 9% a year while Prosperity grew deposits per share by about 12% a year over the time period we compared the two banks. Both banks have similar returns on earning assets. Prosperity's at 2.84% is perhaps a tiny bit higher than Frost at 2.81%. But, they're essentially equivalent in our eyes. Frost is cheaper at just 0.16 times deposits. And Frost has higher capital levels. Frost uses less leverage in the sense that earning assets divided by tangible equity is lower. Frost makes riskier loans than Prosperity judging by past results. And Frost makes a lot more energy loans. This is an area investors may be concerned about. Overall, though, I would say that Frost is perhaps both safer and cheaper than Prosperity. It doesn't acquire much. It has very sticky deposits. Prosperity might have better growth prospects. While I prefer Frost over Prosperity, I think the two stocks deserve the same P/E ratio. What should that ratio be? Based on their long-term past results, you could say that banks growing deposits per share at 9% or 12% a year while paying a dividend deserve a P/E of something like 25 to have similar future expected returns as the S&P 500. The banks are bigger now and may not grow as fast. So, it might be too aggressive to assume such high P/E ratios are required to keep these stocks from outperforming the S&P 500 going forward. But, neither Prosperity nor Frost should ever be priced below the S&P 500's P/E multiple. That is normally around 15. So, an intrinsic value estimate of $5 in normal after-tax earnings per share times a 15 P/E equals $75 a share. So, I'd appraise the stock at $75 a share. Historically, Prosperity has traded between 13 and 20 times earnings. This suggests an intrinsic value of $65 to $100 per share. Mathematically, Quan and I think Prosperity may be able to grow deposits per share by 7% to 10% a year while paying out between one-third and half of earnings as dividends. This suggests a 20 times P/E. I think, realistically, Prosperity is probably worth $100 a share. I think, conservatively, I'd like to value it at no less than $75 a share. I'm sure it's worth $75 a share. I think it's really worth $100 a share. It's a bargain if you can buy the stock at $50 or less.

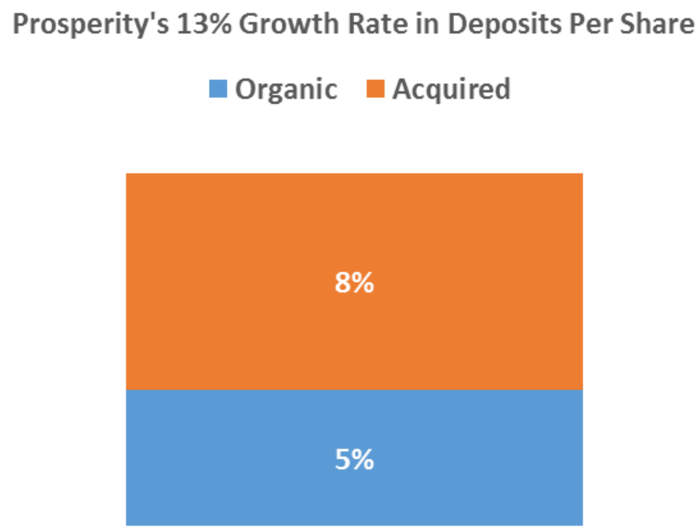
GROWTH

Prosperity is a True Growth Stock

Prosperity is a growth stock. The company has grown deposits per share extremely quickly in the past. Texas is a faster growing state than the U.S. generally. So, unless more banks open more branches in Texas – the number of banks has declined since the financial crisis – deposits at each bank in Texas will increase faster than the nominal GDP of the United States. In the recent past, Texas has grown about 1% faster than the U.S. So, it is reasonable to expect growth of Texas banks to be 1% faster than the nominal GDP growth of the U.S. generally. Over the last 22 years, total bank deposits in the state of Texas compounded at an annual rate of 7.1%. Texas is not growing as fast now as it was then. The price of oil has declined. And this will affect the number of jobs in Texas. It is reasonable to assume deposit growth in Texas will be lower than it was over the last 20 to 25 years but still higher than U.S. nominal GDP growth. A good long-term expectation for growth in total bank deposits in the state of Texas would be 6% a year. Changes in market share between banks will determine which banks grow faster or slower than 6% a year.

Prosperity has grown its deposits much faster than other Texas banks. In 1994, Prosperity had $198 million in deposits. In 2014, it had $16.7 billion in deposits. That is a compound growth rate of 25% a year. This was achieved in large part through acquisitions. And some of these acquisitions include share issuance. So, deposits per share grew much slower than 25% a year. The required capital levels at a bank and Prosperity's return on equity taken together suggest that the bank would need to issue stock to acquire growth at levels beyond about 12% a year. The actual growth rate at which the bank would need to issue shares depends on dividend payouts. Obviously, the greater the share of earnings Prosperity pays out in dividends the less the earnings it can retain.

Prosperity prefers to grow through acquisitions rather than opening new branches. In 2001, Prosperity's CEO said: "Many banks open de novo branches. We've done a couple of de novo locations as well, but we prefer to buy whole banks. It just seems that for us it has worked a lot better to buy banks and try to retain management. That has been a lot faster as an expansion method for us. When you start a de novo location, it's more of a slow process, it usually takes three to five years just to get up to maybe $20 million in deposits and loans. We have found that we would really like all of our locations – and they're not all there (yet) – to grow to somewhere between $40 and $60 million." In 2014, the company said that: "So historically, on an organic basis, we've grown about 8% to 9% organically on loans and 4% to 6% on deposits, and that's over a 20-year… history." That's not a bad growth rate considering Prosperity has rarely opened new branches. A 4% to 6% deposit growth rate for existing branches is in line with what other Texas banks probably achieve. My best guess would be the long-term growth in deposits per branch has been about 4%. If you look at deposit per office growth of all Texas banks, it was 4.3% a year from 1994 through 2015. Other organic growth beyond that usually comes from opening new branches. And Prosperity doesn't do much of that. Quan puts potential organic growth at 5% a year in his estimate. I might argue lower. Texas banks only grew deposits per branch by 4.3% between 1994 and 2015. And Texas may grow slower over the next 22 years than it did over the last 22 years. It's very unlikely to grow meaningfully faster. Prosperity usually acquires other banks. It's possible banks will be more restrained in opening branches. Technology may encourage this. So, all banks may benefit from fewer branch locations. This would be excellent for the economics of banks long-term. I'd go with a 4% organic growth rate assuming Prosperity almost never opens a new branch. Like I said, Quan might go with 5%. So, 4% to 5% is a reasonable range for organic growth at Prosperity.



From 1994 through 2014, Prosperity grew deposits per share by 13% a year through a combination of acquired growth (8% a year) and organic growth (5% a year).

One question here is whether Prosperity and Frost have the same growth prospects. I'm not sure they do. I think it's possible that Prosperity and Frost may have similar loan growth potential at existing branches. But, it seems really likely that Frost's customer base – its existing commercial relationships especially – may allow it to do better with deposit per branch growth. I'm not as confident Prosperity can grow deposits per branch as quickly for as long as Frost can. But, I think Frost is very, very good at growing deposits per branch. So, this is something of an unfair comparison. Frost and Prosperity are peers in the sense of being the two biggest Texas banks. But, comparing the organic deposit per branch growth prospects at Prosperity with Frost may give the impression Prosperity is bad at growing deposits per branch. That's not true. I think Prosperity is pretty typical in terms of organic growth prospects. I just think Frost has an atypically good possible future in terms of deposit per branch growth.

Prosperity is focused on acquisitions. If we assume 5% annual growth from organic sources, Prosperity would need to retain up to 25% of earnings. To grow 10% a year between now and 2026, Prosperity would need to acquire about 5% growth per year (the other 5% would be organic). This means the bank would need to acquire a total of $15 billion worth of deposits over the next 10 years. In other words, Prosperity would need a bank – or a combination of banks – with $1.5 billion worth of assets to acquire each year for the next 10 years. Since 2012, Prosperity acquired over $10 billion in total assets. It's possible that acquiring growth at such a rapid rate might be a problem 10 years down the road. It seems doable for the next 10 years. At its current size, Prosperity should be able to find acquisition targets for years to come that are big enough to move the needle. There are 53 banks in Texas and Oklahoma with assets over $1 billion. Prosperity has only 2% deposit share in Texas. Frost is bigger than Prosperity. But, Frost is less interested in doing acquisitions. If a bank in Texas (or Oklahoma) is selling, it's likely that Frost and Prosperity would be considered as potential buyers. And Prosperity would definitely be the more likely buyer. If you exclude the top 10 banks in Texas (since they wouldn't be good acquisition targets) that still leaves 38% of all deposits.

The number and terms of acquisitions Prosperity makes depends on which Texas banks want to sell, what Prosperity's share price in the stock market looks like, and how high a premium over core deposits other bank deals are being done at. If Prosperity can find enough deals, it can acquire its way to 10% annual growth through a combination of a little more than half acquired growth and a little less than half organic growth. Prosperity's dividend payout ratio has been about 20% to 25% of earnings. It could pay out 35% of earnings and grow 10% a year. If the bank grew slower – say just 7% a year growth in deposits – it could pay out more like 50% of earnings in dividends. The most likely scenario is probably 10% annual growth and a dividend payout that isn't much higher in the future than it is today. In other words, earnings per share and dividends per share will both grow around 10% or so over the next 10 years. A less likely scenario is lower growth – because Prosperity can't find enough acquisitions to do – and a higher dividend payout ratio. To illustrate, my best guess is that if Prosperity only grows earnings per share at 7% a year from 2016 till 2026, it would actually increase dividends per share by 15% a year. This is necessary because at such a slow growth rate, Prosperity would deleverage much more than it probably wants to. At a 10% annual growth rate, Prosperity could keep its earnings per share growth rate and its dividend per share growth rate very similar. However, if Prosperity grows earnings per share slower it's actually likely to grow dividends per share faster. This sounds counterintuitive. But, Prosperity has historically been a fast growing stock. So, it actually pays out only a quarter of earnings in dividends while a bank growing at a more normal – that is, much slower – pace would be paying out half of its earnings in dividends or even more. If Prosperity succeeds in staying a growth stock it should be able to grow earnings per share and dividends per share both by about 10% a year. If Prosperity slows down due to difficulty in finding acquisitions, it will grow dividends per share much faster than earnings per share – because a slower growth bank can have a much higher dividend payout ratio than Prosperity does. Either way, the combination of growth in intrinsic value per share – which is best measured in terms of deposits per share – and the dividend yield on the stock is likely to be no worse than 10% a year.

MISJUDGMENT

Prosperity's Leverage is High – So it Must Stick to Making Safe Loans and Safe Acquisitions

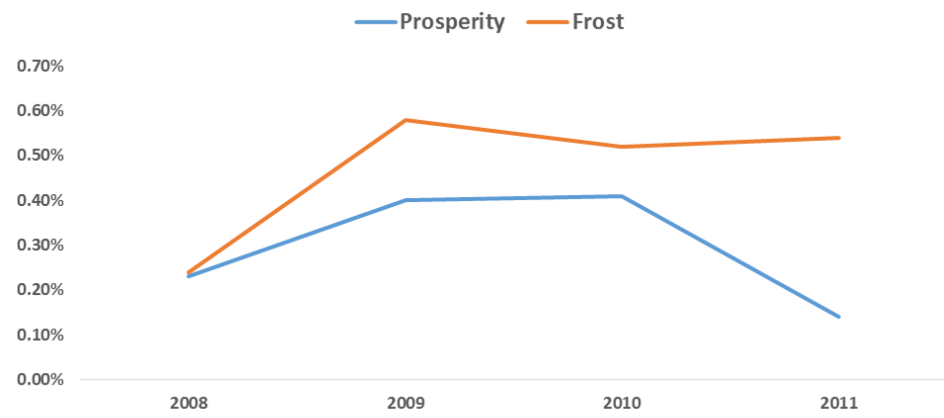
The greatest risk of misjudging Prosperity's future is that a different management team will do a worse job of making acquisitions. Prosperity is a highly leveraged bank. It is also a serial acquirer of other banks. It has only been a safe bank because of the low net charge-offs on its loans and the care given to each acquisition. Prosperity has often reduced loans by 20% within a couple years of taking over a new bank. Prosperity's organic loan growth has been much faster than its organic deposit growth. So, Prosperity tends to buy deposits that were gathered by another smaller bank and then make loans itself with those deposits. The bank doesn't open many new branches. And it doesn't have a diversified portfolio of loans. Instead, Prosperity's loan portfolio is about 75% to 80% Texas real estate. The bank's loan charge-offs have been incredibly low – just 0.13% a year over the past 21 years – in part because Texas did have a good economy and did not have a housing bubble during that time period. Still, Prosperity's charge-offs were even lower than Frost. Frost is the biggest bank based in Texas. It is not a real estate lender. It does much more lending in commercial and industrial generally and energy specifically than Prosperity does. However, Frost is not an aggressive lender. And its charge-offs were manageable through the financial crisis. Frost did not need government assistance (TARP money) during the financial crisis. In 2008, Prosperity charged off 0.23% of its loans versus 0.24% at Frost. In 2009, Prosperity charged off 0.40% of loans versus 0.58% at Frost. In 2010, it was 0.41% versus 0.52%. And in 2011, it was 0.14% at Prosperity versus 0.54% at Frost. So, Prosperity had lower loan losses each year than Frost did. It's a very safe lender.

Prosperity is also an experienced acquirer. The bank was formed in 1983 to acquire another Texas bank. And it has grown through acquisitions ever since. Prosperity sometimes acquires much more in deposits than loans. For example, in 2008, the bank bought a failed bank (Franklin) from the FDIC. Prosperity got about $2 billion in deposits and essentially no loans through that deal. Here is Prosperity's CEO describing another acquisition a couple years later: "Then in 2009 and 2010 First Bank out of Missouri…they were trying to sell off some of their locations in the Houston/Dallas metro market so we bought about $500 million of their deposits and only got about $100 million in loans at that time. We also bought three banks from U.S. Bank who acquired three banks in Texas through a failed transaction related to a Chicago firm. So we got $500 million there. So you can see that we got a lot of deposits and we didn't have a whole lot of loans. But again this is not unusual for us. In the '80s we bought a lot of failed banks and again our loan-to-deposit ratio fell this low and it took us three to four years to build our loan to deposit ratio back up to about 65%. A lot of banks would think 65% is low, but again our bank that is probably a target for us: 65% to 70%."

This last point is worth discussing in a bit more detail. Prosperity – like Frost – will tend to have a relatively low ratio of loans to deposits. This does not mean the other money is idle. It is invested in bonds. In Frost's case, it is invested in municipal bonds. In Prosperity's case, deposits that are not loaned out are invested mostly in mortgage backed securities.

A bubble in Texas real estate could pose a problem for Prosperity. The bank lends at 80% of value and then the loan gets paid down over time while the value of the real estate does not decline – so the loan to value ratio starts at 80% and goes gradually downward. This makes the loan safer over its life as the collateral is higher relative to the loan and the time till maturity of the loan is shorter. But, it's possible that in a real estate bubble you get a higher volume of loans made than normal in those particular peak years that are problematic. And then you've made loans at 80% of the market value at the peak which turns out to be say 160% of the value of the collateral if the collateral declines 50% in value, because there is something like a 50% collapse in land prices. Is this a realistic danger in Texas? Not right now. Texas is a huge state. The economy is diverse. And people can move freely into and out of the state – so it's not susceptible to bubbles like happened in Japan or Hawaii or something like that. Those regions have incredibly high population density. Texas ranks 26th out of 50 states in population density. Obviously, the most dangerous contributing factor to a real estate bubble is high population density. The thing that keeps a real estate bubble from developing is the ability to turn raw land into useable real estate. So, a crowded and restrictively zoned region is more prone to a real estate bubble than a sparsely populated region with very permissive zoning. Overall, Texas seems like one of the least likely places in the country to have a statewide housing bubble because the state is still fairly sparsely populated, it has a diversified economy, and it consists of multiple – and essentially separate – metro areas. The economies of Austin and Houston are not so linked that a real estate boom in one city would necessarily coincide with a boom in the other.

Prosperity's safety will be greatest while it has management that has been with the bank for a long time. The current Chairman and CEO has been running the company since 2001. David Zalman joined Prosperity as a President in 1986. The bank's chief lending officer has been in that position since 2001. The CFO has been at his position since 1998. So, three of the most important positions for managing risk – the Chief Executive Officer, Chief Financial Officer, and Chief Lending Officer – have all been at their current positions for about 15 years each and have been with the company for about 25 years. There is the potential for the exact same management team to run Prosperity for a few more years. The CFO is 59, the CEO is 58, and the Chief Lending Officer is 56. Assuming a typical retirement age of 65 – there's no reason to assume that age, I'm just using it as an illustration – you have the potential for close to 5 to 10 years from these executives. There's no reason to believe Prosperity would need to use outside candidates for top jobs. Prosperity routinely acquires other Texas banks and retains top management. So, there should always be people in the organization who once worked as Chief Executive Officer, Chief Financial Officer, or Chief Lending Officer of a smaller bank at some point in their careers. For example, the current Chief Operating Officer (and Vice Chairman) at Prosperity was the President and CEO of a bank that Prosperity acquired in 2001. The bank's lending is also decentralized. So, large numbers of people in the organization would have experience making a variety of loans – not just one particular type of loan – from a fairly early point in their career. It's hard to know if cultural continuity at Prosperity is going to be as high as someplace like Frost. Prosperity acquires other banks all the time. So, it would need management at the acquired banks to buy into Prosperity's way of doing business for the culture of the bank's top management to stay the same long-term. That shouldn't be a problem. As I mentioned earlier, the CEO, CFO, and Chief Lending Officer have all been in place for about 15 years or so. Whenever a succession takes place and the replacement is an internal candidate, that person will have been working for probably most of their career at Prosperity under the person they are replacing. So, whatever "cost culture" or "lending culture" there is at Prosperity should be easy to preserve for at least one succession. For now, we know that the current management team is proven and reliable and young enough that they could stay with the bank for 5 years or more without being especially old compared to the people who run other banks. So, looking just 5 years into the future, Prosperity's culture seems durable. And its safety both in terms of how it integrates acquisitions and how it makes loans seems assured for the next 5 years.



Throughout the financial crisis, Prosperity had lower losses as a percent of total loans than the biggest Texas bank (Frost).

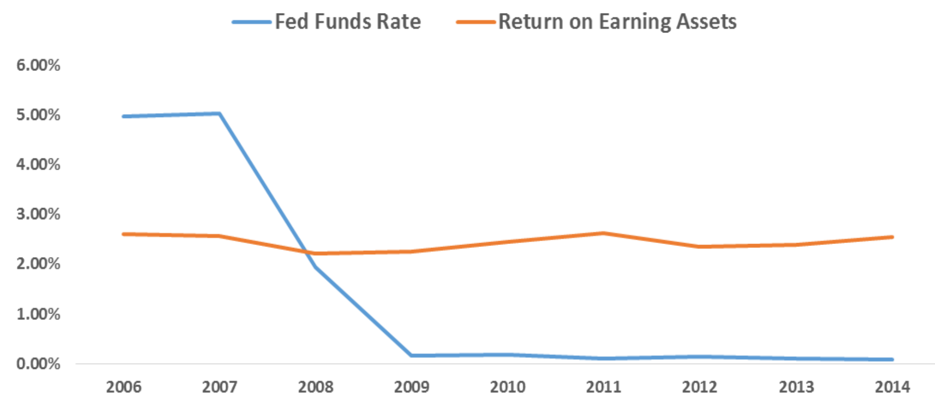
CONCLUSION

Don't Pick Between Prosperity and Frost – Buy them Both

An investor interested in Texas banks should simply buy both Prosperity and Frost. These two biggest Texas based banks are among the best banks in the U.S. They each have their risks. Frost makes energy loans. And Prosperity does not have especially high capital levels. But, these risks should be small because of the conservative attitudes toward lending and acquisitions at each bank. Frost doesn't make big, transformative acquisitions. And Prosperity is a serial acquirer that has never had high loan losses despite acquiring many different Texas banks.

We can certainly compare Prosperity and Frost. But, my advice and Quan's advice would be not to buy Prosperity without also buying Frost and not to buy Frost without also buying Prosperity. Unless you have a very, very concentrated portfolio – there is little reason to focus on buying only one bank and not the other.

Prosperity is less interest rate sensitive than Frost. And Prosperity doesn't make energy loans. So, if your two big concerns are that oil prices will stay low for many, many years to come and the Federal Reserve will keep interest rates at or below zero for many, many years to come – it makes sense to buy Prosperity instead of Frost. I understand some investors may have a feeling about where oil prices or interest rates are headed in the next few years. And they may want to bet on that feeling. But, oil below $30 a barrel is cheap long-term. And a Fed Funds Rate under 1% is low in normal times. So, it doesn't make much sense to bet against either an increase in oil prices or an increase in the Fed Funds Rate. Buying both Prosperity and Frost can diversify whatever risks Frost has in terms of energy loans and low interest rates. But, I can't suggest picking Prosperity over Frost. Because, actually, it's reasonable for rates to rise



Prosperity's return on earning assets stayed flat even while the Fed Funds rate collapsed

over the next 5 years and for Frost to benefit far more from that than Prosperity. As for energy loans, the truth is that while Frost might have to write-off a lot of energy loans if oil stays below $30 for years – those losses would not bring Frost's tangible equity levels lower than Prosperity's. In other words, Frost can charge-off a lot of its energy loan portfolio and still have higher tangible equity to total assets after doing so than Prosperity does now. So, it's not logical to prefer a bank with lower tangible equity levels over a bank with higher tangible equity levels just because the bank with higher tangible equity might charge-off loans that would still leave it more highly capitalized than the bank that doesn't charge-off any loans. So, again, I see no reason to prefer Prosperity over Frost because of energy loans. Low oil prices will cause bad headlines at Frost and not at Prosperity. But, bad headlines don't necessarily make for a bad stock.

What about interest rates? This one is speculative. But, it's also a meaningful difference between Prosperity and Frost. If you really did know what the Fed Funds Rate would be at various points in the future – you could discriminate between Prosperity and Frost on that basis. For example, Quan and I estimate that based on today's interest rates, Prosperity is more than 10% cheaper than Frost. However, based on a 3% Fed Funds rate – which we consider normal – Prosperity would actually be about 20% more expensive than Frost. So, is Prosperity cheaper than Frost or more expensive? In my opinion, Prosperity is more expensive than Frost. I always look at normal earnings. If you're analyzing an oil company while oil is $27 a barrel and you expect oil to be $55 a barrel in 2021, then you would estimate 2021 earnings based on $55 a barrel. And if you're a long-term investor, it doesn't matter what earnings are in 2016 when you buy the stock. It matters what earnings will be in 2021 when you sell the stock. I think the same rule applies to interest rates – except only more so. Central banks have implemented negative interest rates in other parts of the world. It's technically possible the Fed could do that in the U.S. But, is it important to consider? There are real problems with having interest rates very close to zero and even bigger problems when interest rates are below zero. It's not reasonable to believe that a negative 3% Fed Funds Rate in 2021 is as likely as a positive 3% Fed Funds Rate in 2021. And yet we know that Frost will benefit more from higher rates than Prosperity. So, with interest rates as close to zero as they are – we would expect higher rates to be a more likely event in 5 years' time than lower rates. This is speculative. But, it's not speculative in quite the same way as looking at $38 a barrel oil today and wondering whether oil is more likely to be at $76 a barrel in 2021 or $19 a barrel in 2021. Long-term costs would suggest $76 a barrel might be a little more likely than $19 a barrel. But, $19 a barrel is not an unreasonable price for oil in quite the same way that a negative yield on money is an unreasonable price for a loan. Oil at $19 a barrel in 2021 would not be as odd an occurrence as a meaningfully negative Fed Funds rate in 2021. So, Prosperity is cheaper than Frost now because interest rates are abnormally low now. But, Frost is cheaper under any reasonable “normal” interest rate scenario. That’s why I consider Frost the cheaper stock. You shouldn’t price a stock based on what it’s earning in an abnormal present. You should price it against what it will earn in a normal future.

Prosperity might have more upside. Quan believes Prosperity’s organic growth has a 20% or better after-tax return on equity. He also thinks any acquisitions Prosperity does should have a 13% or better after-tax return on equity. The stock has a 2.5% dividend yield. So, the only part of the future return equation that could be sub-standard is the reinvestment of that dividend. Prosperity may be able to earn between 13% and 20% on the earnings it retains. It’s unlikely you can earn that much on the dividends it pays you. But, as long as the dividend payout ratio is low, it’s unlikely your total return will be pulled below 10% a year.

Prosperity has a P/E around 11 today. Historically, it has traded at between 13 and 20 times earnings. So, the stock is cheap relative to its own past. It’s not clear why this is. Prosperity is a Texas bank. Some investors may worry that Texas real estate will perform poorly in an oil bust. They may worry about Prosperity’s real estate loans in areas like Houston where energy companies are large employers and large office tenants. Energy loans are only 5.5% of Prosperity’s loan portfolio. That’s 2.7% of earning assets. Losses on those loans can’t meaningfully increase risk at all for shareholders. To put this in perspective, if every energy loan Prosperity made defaulted and Prosperity recovered zero cents on the dollar in all these defaults – Prosperity could cover all of the losses out of roughly one year’s earnings. Investors may also dislike all regional banks because of interest rate sensitivity. But, Prosperity is fine with low rates. The Fed Funds rate declined from over 5% to less than 0.25% from 2007 to 2014. During that time, Prosperity grew earnings per share by 12% a year. At worst, the risk that investors are worried about for the next 7 years is that the Fed Funds Rate is fairly flat near zero – not that it declines by five full percentage points. So, Prosperity was a growth stock over the last 7 years when rates were falling rapidly. No one expects rapidly falling interest rates. So, the next 7 years should present Prosperity with interest rates that are easier to cope with than the last 7 years. Right now, Prosperity’s net interest margin is in line with the bank’s long-term historical average net interest margin. Honestly, Prosperity’s net interest margin doesn’t vary much with the Fed Funds rate. So, concerns about the Fed not raising rates as fast or at all as expected are an argument against buying Frost right now. They aren’t an argument against buying Prosperity. It’s also worth mentioning that we are really only debating the upside here. Even if interest rates don’t rise, Frost is a cheap stock that will deliver good returns. It just won’t deliver great returns quickly if rates stay near zero. Prosperity’s upside is pretty similar regardless of what happens with interest rates.

So, if you are concerned about energy loans and believe the Fed will not raise rates – you might prefer Prosperity over Frost. Quan and I aren’t that worried about energy loans. And we expect the Fed Funds rate to be a lot higher in 5 years than it is today. So, if you’re a long-term buy and hold investor, we suggest putting equal amounts of your money into the two biggest Texas based banks: Frost and Prosperity.

Prosperity Bancshares (NYSE: PB)

Appraisal: $99.69

Price/Appraisal: 45%

Prosperity Bancshares Owner Earnings	(in millions)
Return on Earning Assets	
Normal Net Interest Margin	3.96%
- Net charge-offs	0.05%
- Operating Costs	1.07%
= Return on Earning Assets	2.84%
Pre-tax Owner Earnings	
Earning Assets	$18,918
* Return on Earning Assets	2.84%
= Pretax Owner Earnings	$537

Business Value

Prosperity's business value is $6,981 million.

- Pre-tax owner earnings are $537 million
- Fair multiple = 13x pre-tax owner earnings
- $537 million * 13 = $6,981 million

Fair Multiple

Prosperity's business is worth 13x pre-tax owner earnings

- Prosperity can grow deposits by 7-10% annually
- Dividend payout rate can be 35-55%

Share Value

Prosperity' stock is worth $99.69 a share

- Business value is $6,981 million
- Equity Value = $99.69/share
    - 70.03 million outstanding shares
    - $6,981 million / 70.03 million = $99.69

Price to Appraisal Value

Prosperity is trading at 48% of its value.

- Business Value = $6,981 million
- Enterprise Value = $3,361 million
- $3,361 million / $6,981 million = 48%

	EV/Earning Assets	EV/Deposit	EV/EBT	EV/Owner Earnings
Texas Capital	0.13	0.16	11.39	11.44
Southside Bancshares	0.14	0.18	17.92	10.55
Frost	0.15	0.16	8.50	5.32
International Bancshares	0.16	0.20	7.42	7.60
First Financial	0.33	0.40	14.42	11.09
Minimum	0.13	0.16	7.42	5.32
Maximum	0.33	0.40	17.92	11.44
Median	0.15	0.18	11.39	10.55
Mean	0.18	0.22	11.93	9.20
Standard Deviation	0.08	0.10	4.32	2.65
Variation	46%	46%	36%	29%
Prosperity Bancshares (Market)	0.18	0.20	7.40	6.26
Prosperity Bancshares (Appraisal)	0.37	0.42	15.39	13.00

ABOUT THE TEAM

Geoff Gannon, Writer

Geoff is a writer, blogger, podcaster, and interviewer. He has written hundreds of articles for Seeking Alpha and GuruFocus. He hosted the Gannon On Investing Podcast, The Investor Questions Podcast, and The Investor Questions Podcast Interview Series. He wrote the Gannon On Investing newsletter in 2006 and two GuruFocus newsletters from 2010-2012. In 2013, he co-founded The Avid Hog (the predecessor to Singular Diligence) with Quan Hoang. Geoff has been blogging at Gannon On Investing since 2005.

Quan Hoang, Analyst

Quan is a stock analyst. Quan won first prize in Vietnam's National Olympiad in Informatics in 2006. He graduated from Manhattanville College in 2012 with a B.A. in finance and a minor in math. In 2013, Quan co-founded The Avid Hog (the predecessor to Singular Diligence) with Geoff Gannon.

Tobias Carlisle, Publisher

Tobias Carlisle is the founder and managing director of Eyquem Investment Management LLC, and serves as portfolio manager of the Eyquem Fund LP and the separately managed accounts.

He is best known as the author of the well regarded website Greenbackd, the book Deep Value: Why Activists Investors and Other Contrarians Battle for Control of Losing Corporations (2014, Wiley Finance), and Quantitative Value: a Practitioner's Guide to Automating Intelligent Investment and Eliminating Behavioral Errors (2012, Wiley Finance). He has extensive experience in investment management, business valuation, public company corporate governance, and corporate law.

Prior to founding Eyquem in 2010, Tobias was an analyst at an activist hedge fund, general counsel of a company listed on the Australian Stock Exchange, and a corporate advisory lawyer. As a lawyer specializing in mergers and acquisitions he has advised on transactions across a variety of industries in the United States, the United Kingdom, China, Australia, Singapore, Bermuda, Papua New Guinea, New Zealand, and Guam. He is a graduate of the University of Queensland in Australia with degrees in Law (2001) and Business Management (1999).

SINGULAR DILIGENCE

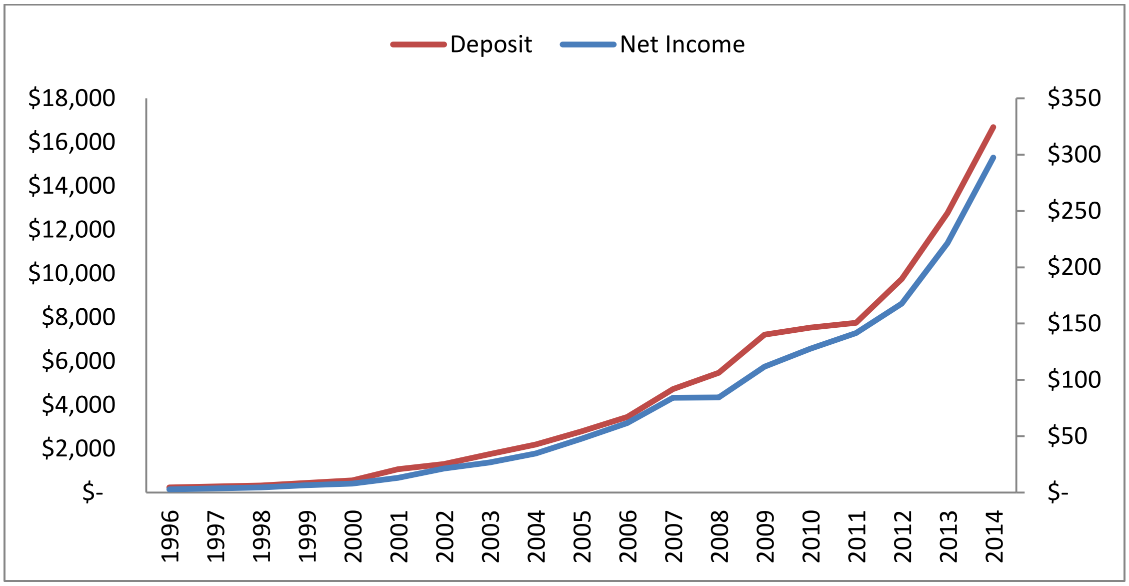
NOTES

Prosperity Bancshares

NYSE: PB

Overview

Prosperity: a Fantastic Growth Story



Prosperity's deposit and net income grew about 27% annually since 1996

- Prosperity was formed in 1983
    - To acquire the former Allied Bank in Edna, Texas
- The banking crisis in Texas started around 1986
    - The number of bank failures increased to 175
        - There was only 3 bank failures in 1983
    - 506 banks failed between 1982 and 1992
- Prosperity has been profitable in every year of its existence
    - As a result of
        - Conservative lending approach
        - Low funding cost
        - Stringent cost control
- Prosperity took opportunity to acquire failed banks[1]
- Grew assets by more than 5 times between 1988 and 1998
    - Total assets were
        - 1988: $40 million
        - 1994: $224 million
        - 1998: $436 million
- Prosperity went public in 1998[2]
    - It's a serial acquirer

        - => Would benefit from access to capital market
- Insider ownership is significant
    - After the IPO, Directors and Executive Officer owned **20.25%** of Prosperity
    - After merging with Commercial Bancshares in 2001
        - Directors and Executive Officer owned **32.06%** of Prosperity
            - Ned S. Holmes owned 12.69%
                - Ned Holmes served as Chairman of Prosperity
                    - From 2001 to 2006
                - He was chairman of Commercial Bancshares
                    - From 1991 to 2001
    - Today, Directors and Executive Officer own **5.96%** of Prosperity
        - Two reasons for the decline
            - Ned Holmes reduced his ownership by about 80% overtime
                - Owned about 2 million shares in 2001
                - Reduced to
                    - 1.3 million shares in 2004
                    - 0.43 million shares today
            - Prosperity issued shares to make acquisitions
                - Reduce ownership of existing shareholders
        - Other executives didn't sell many shares
            - Over **75%** of net worth of most of the management team is tied up in Prosperity's stock[3]
- Prosperity created a lot of value through acquisitions
    - Prosperity significantly cut costs of banks it acquires
        - Prosperity usually targets **25%** cost cut at banks it acquires
            - But did better many times
        - Acquired banks usually have **60-80%** efficiency ratio[4]
            - Prosperity brings down to below **50%**
    - Prosperity exits loans that don't fit Prosperity's strategy
    - Prosperity usually acquires banks at a low Core Deposit Premium
        - Core Deposit Premium = (Price – Tangible Equity)/Core deposits
        - Core deposits = deposits excluding CDs over $100,000
    - Prosperity paid an average of **12%** Core Deposit Premium
        - Core Deposit Premium = (Price – Tangible Equity)/Core Deposit
        - Core Deposit = Deposits – CDs over $100,000
    - Prosperity can make **2.4%** return on deposits
        - => pre-tax return on investment is 20%

- Prosperity issued shares when it trades at a higher multiple than acquired banks
- Prosperity enjoyed astronomical growth
  - Deposit grew **25%** annually over the last 21 years
    - 1994: $198 million
    - 2014: $16,6980 million
  - Growth was very consistent
    - There were only 3 years with growth of less than 14%
    - There were 16 5-year periods
      - Min CAGR of these periods were 16%
    - There were 11 10-year periods
      - Min CAGR of these periods were 22%
  - Deposit per share grew **12.6%** annually over the last 17 years
    - 1998: $38
    - 2014: $253
  - Deposit per share understated shareholder return
    - Dividend payout ratio was about 23% over the last 10 years
      - Yet, Prosperity reduced leverage over the period
        - Tangible Equity/Earning Assets has increased
          - 2004: 4.5%
          - 2014: 6.9%
          - 2015 Q3: 7.8%
  - In the future, Prosperity is likely to have either
    - **7-10%** deposit per share growth
      - And **35-55%** dividend payout
    - Or more than 10% deposit per share growth
      - And about 25-30% dividend payout
- Prosperity is now the second biggest Texas-based bank
  - Second only to Frost
  - Prosperity has
    - $19 billion earning assets
    - $17 billion deposits
    - 244 banking centers
      - 230 in Texas
      - 14 in Oklahoma
- Prosperity remains a community bank[5]
  - Serves individuals and small business

    - Prosperity's community bankers handle all of customer's financial needs
        - If you want to make a $1 million or a $3 million loan, you can talk to a banker
        - If you want to buy a car for your daughter, talk to that officer
        - You won't be sent to a CRE Department
    - There's no 1-800 number
        - You call directly to the branches for customer service
    - Each branch has its own balance sheet and income statement
        - Creating pressure for each branch to perform
- Prosperity can make about **40%** pre-tax Return on Tangible Equity
    - Was about 40% since 1996
        - Min: 30%
        - Max: 52%
        - Median: **39%**
        - Mean: 40%
        - Standard Deviation: 7%
        - Variation: 0.17
    - Prosperity can make about **2.84%** Pre-tax ROEA, thanks to
        - Incredibly stable net interest margin:
            - Was about 3.96% since 1996[6]
                - Min: 3.53%
                - Max: 4.18%
                - Median: **3.96%**
                - Mean: 3.90%
                - Standard Deviation: 0.19%
                - Variation: 0.05
        - Extremely low operating cost
            - About 1.07% of earning assets
            - 41.81% efficiency ratio
                - One of the lowest in the industry
        - Extremely low net charge-offs: 0.05%
- Prosperity is very profitable even in a near-zero rate environment
    - In 2014
        - Net Interest margin was **3.80%**
        - Pre-tax ROEA was **2.54%**
        - Pre-tax Return on Tangible Equity was **37%**
    - Since 2007, diluted EPS grew 12% annually

        - 2007: $1.92 per share
        - 2014: $4.32 per share
- Prosperity is a great investment at current price
    - $60 per share
    - **11.4x** 2014's earnings
    - **9.6x** normal earnings

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[1] "Operating under a community banking philosophy, the **Company seeks to develop broad customer relationships based on service and convenience while maintaining its conservative approach to lending and strong asset quality**. The Company has grown through a combination of internal growth, the acquisition of community banks, branches of banks and the opening of new banking centers. **Utilizing a low cost of funds and employing stringent cost controls, the Company has been profitable in every full year of its existence**, including the period of adverse economic conditions in Texas in the late 1980s. **From 1988 to 1992, as a sound and profitable institution, the Company took advantage of this economic downturn and acquired the deposits and certain assets of failed banks** in West Columbia, El Campo and Cuero, Texas and two failed banks in Houston, which diversified the Company's franchise and increased its core deposits. The Company opened a full-service Banking Center in Victoria, Texas in 1993 and the following year established a Banking Center in Bay City, Texas. The Company expanded its Bay City presence in 1996 with the acquisition of an additional branch location from Norwest Bank Texas, and in 1997, the Company acquired the Angleton, Texas branch of Wells Fargo Bank. In 1998, the Company enhanced its West Columbia Banking Center with the purchase of a commercial bank branch located in West Columbia and acquired Union State Bank in East Bernard, Texas." – Prosperity's 2001 10-K

[2] "Diane Montague, Analyst: Great. Another part of that question is, in terms of your acquisition strategy -- I heard you say, number one, that your focus here is on internal growth, which is very positive. The second part, shortly after that, said that you would like to continue to look for acquisitions. Can you give me some color on where you are in your ability to finance any future acquisitions? And whether you would consider diluting current shareholders if you needed to?

Unidentified Speaker: Two parts to that. I'm going to let David jump in there on the dilution question. But what David said was, we've always had a two-sided coin here, where we have been focused on internal growth. We've never not been focused on internal growth.

Diane Montague, Analyst: Right, right, I did not mean to imply that.

Unidentified Speaker: And we have been opportunistic on the acquisition front. So, you know, while the last two years have been fairly robust in that category -- we did nine (ph) acquisitions -- there are still a lot. There are many, many potential acquisition targets out there for us that we talk to on a regular basis, that we cultivate relationships with. That we're looking -- when you look at the style and the success that we've had, it's the partnership that comes into that. **We are not an acquirer that is going to come in and clean house and ship you and your manual on how to do things. We are looking for partners that want to provide quality service and maintain that customer relationship that is there.**

Diane Montague, Analyst: I understand that and I fully expect you to keep doing that. My question was really on the financial side of things. How close are you to –

Unidentified Speaker: The last few acquisitions that we have done have been more with a stock component.

Diane Montague, Analyst: Yes, I have seen that. That is part of what is fueling my question.

Unidentified Speaker: If I can jump into the deal, I will. I am going to answer the second part of your question first. (indiscernible) that aspect of it. **When we went and did our IPO in 1998, we committed -- and we are still committing to this -- that we're not going to do dilutive transactions.**

Diane Montague, Analyst: That is what I was hoping to hear.

Unidentified Speaker: The shareholders, and even insiders own a pretty good chunk of the stock. **Just to grown to say we're going to beat the other guys, doesn't impress me that much**. So, from that aspect, we are not going to do -- now, I did put **one caveat, I think, when we did the IPO. If we could get into a market that would enhance our stock value for shareholders (multiple speakers) a growing market, and there would be some benefit for shareholders, we would consider something like that**. But the bottom-line is, we are not in favor of dilution. We own too much of the stock -- (multiple speakers).” – Prosperity 2004 Q1 Earnings Transcript

[3] “I think **the other thing that's really unique for us is that our management team, what I consider our executive committee, the majority of our net worth, I would say 75%-plus for most of us, is tied up in Prosperity Bancshares stock. And so I think that we are aligned with the investor**. We are not here just as management people, and trying to make money and the highest salary that we can. Our real reward comes basically when you as shareholders do good, we as shareholders do good at the same time.

I would also say that if you look at our top management team, our executive committee, and **our management committee, which consists of about 30 people, I think that all of them have 20 to 30 years of experience, if not with us, with the banks that have joined us**. So we have a very experienced group of people.” – David Zalman, KBW Community Bank Conference, 29 July 2014

[4] “You can see in the last two years that our efficiency ratio was 50 and 51 percent. And that's against the backdrop of these nine acquisitions. **So what that's telling us is as we bring these new partners on -- and they're typically running 60, 70, 80 percent efficiency ratio -- is that we integrate them into our culture and we bring them down to the 50 percent mark, which is our target, by the way**. We are targeting a 50 percent efficiency ratio.” – David Hollaway, Prosperity’s CFO, Gulf South Bank Conference, 27 April 2004

[5] “I want to kind of give you just a little bit of our culture for those -- most of you know but some don't, that we are now a $20 billion-bank-plus and **we still operate under a community bank philosophy**.

We have what we call real bankers, where when you go into one of our banks, and you're a business person and you want to make $1 million or a $3 million loan, you can talk to that officer. If you want to purchase a home, you can talk to that same officer. And if you maybe want to buy a car for your daughter or son that's going to college, that same officer can take care of all of those needs for you. You won't be sent to a Commercial Real Estate Department; you won't be sent to the Home Mortgage Department. That one banking center President, we have 246 locations, can generally take care of that for you.

So we think that means a lot. At the same time, **we give a lot of authority and a lot of autonomy to our people**, that -- if you come into one of our banks, our banking centers, and you need it, and you had all your financials, which was highly unlikely, and all your tax returns and everything else you need, but if you did, and you had -- and **you needed $3.5 million that day, that senior lender could get the concurrence person to sign off with it, and you can have a $3.5 million in that one day**.” – David Zalman, Prosperity’s CEO, KBW Community Bank Conference, 29 July 2014

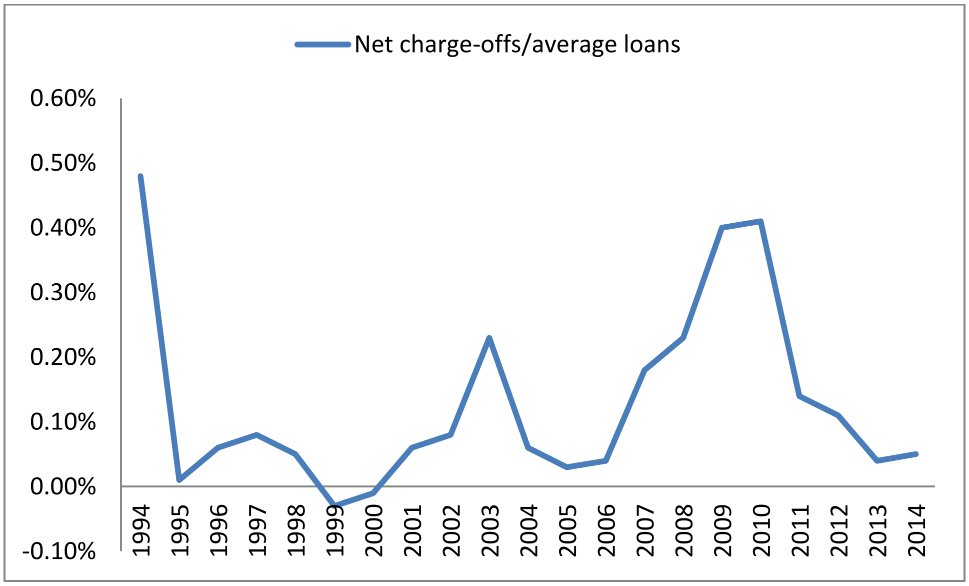
[6] “The net interest margin, again you are seeing a chart that goes really just from the first quarter of 2009 to the second quarter of 2011, and you can see that the net interest margin is probably our 4%.

If you took this chart and went all the way back for 10 and 15 years through interest rates going up and interest rates going down, you would see the same thing. You would see that our net interest margin has always been maintained at around a 4% net interest margin -- some higher, some lower depending on how

you go. So we have been able to navigate through low interest rates and high interest rates at the same time." – David Zalman, Prosperity's CEO, KBW Community Bank Conference, 02 August 2011

Durability

Prosperity Is an Amortizing-type Credit Lender



The average net charge-offs/average loans was about 0.13% over the last 21 years

- **Biggest Negative**:
    - 75-80% of loans are real estate loans
- Loan: **$9.2 billion**
    - Historically, 75-80% of loans are real estate loans
        - Loans by type
            - Commercial & Industrial: **19%**
            - Real Estate: **74%**
                - Construction, land development and other land loans: **11%**
                - 1-4 family residential: **24%**
                - Home equity: **3%**
                - Commercial mortgage: **32%**
                    - Multi-family: 3%
                    - Owner-occupied: 16%
            - Agriculture: **2%**
            - Consumer: **2%**
            - Other: **3%**
    - Prosperity says that C&I has higher delinquency rate than mortgage[1]
        - This is contrary to Frost's focus on C&I loans
        - Possible reasons

    - Texas didn't have a real estate bubble
        - A lot of raw land
        - Great transportation infrastructure
    - Real estate loans are amortizing credits[2]
        - Start at 80% LTV
        - And moves down
    - Prosperity prefers loans that have hard collateral[3]
- Single-family residential loans have been very good historically
    - Virtually zero default
    - Average life of 5 – 8 years
    - Doesn't keep 30-year mortgages
    - Make
        - Some variable rate mortgages
        - Some 10-year fixed and 15
            - 10-year fixed: average life of 4.xx years
    - Jumbo loan is still small in Texas
- Every mortgage loan is to Prosperity's customers[4]
    - If not, PB get them to be customers
        - Turn 80-90% into a customer with
            - Checking accounts
            - Car loans
        - And try to cross-sell
            - Business loans
            - Commercial loans
- 90% of mortgage loan customers have[5]
    - Checking accounts
    - Car loans
    - Business accounts
    - (at the same time)
- There's no large office building or complexes in the loan portfolio[6]
    - The average loan in CRE: $400,000
    - Really focus on more of the owner occupied[7]
        - Doctor's office building
        - The veterinary clinic
        - The small manufacturing plant
        - The new law office
- Make land development loans to well-seasoned customers[8]

            - Had these customers since 1980s
                - Have more money on deposit than what they have in loans from Prosperity
- 2 key features of Prosperity's lending
    - Small
    - Relationship-based
- **PB makes small loans**
    - Average loan size increased overtime
        - But remains small
    - In 2004[9]
        - The average commercial loan was still under $100,000
        - The sweet spot was $500,000 to $3 million
    - In 2005[10]
        - Average loan: under $100,000
        - The average Commercial Real Estate (CRE) loan: $400,000
            - Rate competition is high in the multimillion dollar loans
                - Prosperity missed 5-6 loans
                    - Totaled $30 million
                    - Same rate as it can get in the bond portfolio
            - Competition isn't as strong for $100,000-$400,000 loans
    - In 2009[11]
        - Average CRE loan: $406,000
            - Very small compared to peer's CRE loans
        - Average construction loan: $238,000
        - Average loan of the whole portfolio: $101,500
    - In 2011[12]
        - Average loan today is $114,000
            - 14-15% higher than it was a year ago
            - Still got 30,000+ loans
            - Making more loans of loans in $1 million up
                - But only 2 relationships over $30 million
                    - Below $40 million
        - Prosperity focuses on smaller loans than many regional peers
            - Not playing in the $30-40 million revolving credit C&I loans[13]
            - Peers are focused on $20-40 million credits[14]
    - In 2014

        - Average loan size: **$157,000**
        - Number of loans: 59,000
        - Total loans: $9.2 billion
    - Prosperity maintain closely watch bigger loans[15]
        - Loans between $1 million and $3.5 million
            - Evaluated and acted upon on a daily basis
                - By 2 of the company-wide loan concurrence officers
        - Loans over $3.5 million
            - Evaluated and acted upon by a loan committee
        - Loans between $25 million and $50 million
            - Evaluated and acted upon by a directors' loan committee
                - Consists of 3 directors of the bank
        - Loans above $50 million
            - Evaluated and acted upon by the board of directors
        - Some big loans are very safe
            - One loan in residential development[16]
                - $20-30 million loans
                - In one of the best areas of Houston
                - $100 million in collateral
            - Lend $100 million to a district capital[17]
                - $400 million assets
                    - 1/3 is liability
                - Gets $30-40 million in checking account
- Prosperity focuses on relationship
    - Never keen on bringing in dry relationships[18]
        - Make loans to customers who bank with Prosperity
            - They need loans for their offices
                - Not for speculative deals
        - Did bought banks that did take more risk
            - Prosperity outsourced that type of loans
                - And got them out of Prosperity
    - Still operate under a community bank philosophy[19]
        - Have real bankers
            - If you want to make a $1 million or a $3 million loan, you can talk to a banker
            - If you want to buy a car for your daughter, talk to that officer

            - You won't be sent to a CRE Department
        - Give a lot of authority and autonomy to PB's people
    - Purely focus on a customer-by-customer relationship[20]
        - Don't have a silo approach to lending
            - Don't have a CRE team
            - Don't have a C&I team
            - Don't have a construction team
    - Wants lenders to have relationships with customers[21]
        - Can do anything and everything that customers wants
        - Still not siloed up
            - No CRE department
            - No C&I department
            - No residential mortgage department
            - No construction department
        - Look for lenders who are generalists[22]
            - Fit into Prosperity's model
        - Encourage loan producers to get out of their chairs[23]
            - Meet with existing customers and potential customers
        - Try to know customers[24]
            - Not be just a transaction account
            - Want to know who you are
            - Want to know your kids
            - Want to know everything about you
        - Even know the customers' customers[25]
- Prosperity is careful about assets of acquired banks
    - Usually ask the acquired banks to exit some loans as part of a deal
    - Prosperity usually looks at up to 90% of loan portfolio of an acquired target[26]
        - Always try to outsource or exit some of the loans
            - Even if they're performing
    - Bought $500 million deposits from First Bank[27]
        - But got only $100 million loans
        - Similarly bought failed banks in 1980s
    - Asked American State Bank to sell long-term bonds before acquiring[28]
        - American State Bank sold $500 million
    - Prosperity usually exit some types of loans that the acquired banks make[29]

            - Usually see 15-20% decrease in loans in a 1- or 2-year period after the acquisition
        - Reduced loans at First Victoria and F&M by 15%[30]
            - Prosperity doesn't like some loans
    - Prosperity's net charge-offs is extremely low
        - Averaged only **0.13%** of loans since 1994
        - The worst year was in 1994
            - **0.48%**
        - Was **0.41%** in 2010
    - Non-performing assets/loans plus foreclosed assets has always been lower than **0.5%**
- Few oil & gas loans
    - Total $502 million
        - $218 million in E&P loans
        - $215 million in the service industry
        - $69 million to businesses with 30% of income from the oil industry
    - **5.5%** of total loan portfolio
    - **2.7%** of earning assets
- Securities: **$9.5 billion**
    - Mostly mortgage-backed securities (MBS)
        - **$9 billion**
        - Principally issued by federal agencies
            - Ginnie Mae
            - Fannie Mae
            - Freddie Mac
    - Mostly held-to-maturity securities
        - **$9.4 billion**
        - Doesn't bet
    - Historically Prosperity maintains 3-year duration
        - Recently increased to 3.8 year
            - Possibly due to the prolonged period of low interest rate
            - Prosperity lengthened duration to get some extra yield
    - Higher interest rates may cause some paper losses
        - But will benefit Prosperity
            - It'll take 2 years to see the benefit of higher interest rates
- Liquidity is great
    - Time deposits: **16%** of total deposits

- Time deposits + other short-term borrowings: **21%** of total liabilities
    - **$3.9 billion**
- The loans and securities portfolio throws off about **$3.5 billion** cash a year[31]
    - The loan portfolio has an average life of **4 years**
        - Annual cash flow: **$2 billion**
    - The securities portfolio has **3.8-year** duration
        - Annual cash flow: **$1.5 billion**

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[1] "In nearly all cases, the Company's commercial loans are made in the Company's market areas and are underwritten on the basis of the borrower's ability to service the debt from income. As a general practice, the Company takes as collateral a lien on any available real estate, equipment or other assets owned by the borrower and obtains a personal guaranty of the borrower or principal. Working capital loans are primarily collateralized by short-term assets whereas term loans are primarily collateralized by long-term assets. **In general, commercial loans involve more credit risk than residential mortgage loans and commercial mortgage loans and, therefore, usually yield a higher return.** The increased risk in commercial loans is due to the type of collateral securing these loans as well as the expectation that commercial loans generally will be serviced principally from the operations of the business, and those operations may not be successful.

Historical trends have shown these types of loans to have higher delinquencies than -mortgage loans. As a result of these additional complexities, variables and risks, commercial loans require more thorough underwriting and servicing than other types of loans." – Prosperity Bancshares 2014 10-K

[2] "The pluses in that commercial real estate book for us is -- remember, **our Bank is more of an amortizing type credit originator. So when you look at that commercial real estate book, those are amortizing credits**. They have been on the books for a while. We are getting principal payments or principal reductions on a monthly basis on the majority of that.

The LTV that is in that book, we started at 80 and moved down from there. So I think when you look at the overall commercial real estate book today and the amortizing nature of that book, you've got credits that have been on the books for three to five to 10 years or more. Those loans are paid down significantly.

So the overall LTV in that commercial real estate book is relatively low. I think you can see that when you look at the net charge-off information that we provided this morning, that shows that over the last 15 months we are in a net recovery position in the commercial estate book.

So again we all understand the focus that is on the commercial real estate today. I think what David was saying and what I'm saying is I don't think that is where we are the most concerned today." – Dan Rollins, Senior Vice President, Prosperity Bancshares, 2009 Q3 Earnings Transcript

[3] "Regarding your question on the construction lending, I think it's driven internally by our policy and externally by the economy. **Internally, we still prefer a loan that's got hard collateral to one that doesn't. So a real estate loan in the universe of lending is relatively attractive to us**.

In addition, as previously mentioned, the economy in our marketplace continues to be decent, if not strong. The housing sales are good. Commercial occupancies are decent. So there is demand out there from a construction standpoint, and once again, when you look at the various categories of lending that we can be involved in, there's obviously risk in all of them, but **in our opinion, there's less risk if you have hard collateral as opposed to having soft collateral**. So we try to do construction lending and the economy has facilitated that." – Tim Timanus, Prosperity's Vice Chairman, 2006 Q3 Earnings Transcript

[4] "You know, when we're making 1-to-4 family residential long loans, we're doing it to people in our market. It's not coming from a mortgage company. These are loans that are generated within the banking centers, and I would say that **every 1 of the loans that we make is usually a customer of ours, and if it's not, we get them to be customers**.

I would say -- again, this is an approximate number -- but I would say **80% to 90% of every loan that we make in the 1-to-4, we turn them into a customer with their checking accounts, and then we try to cross-sell car loans**. **We also try to cross-sell their business loans and their commercial loans at the same time. This is really a product that we have used over the last 15 or 20 years to really develop long-term relationships.**

Our experiences or my experience has been that usually when you finance a home for somebody, it's just a lot different. I mean, **there seems to be a lot of loyalty when you finance a home for an individual. And they generally, if you do a good job at it, they generally will bring you their other businesses going forward**." – David Zalman, Prosperity's CEO, 2011 Q2 Earnings Transcript

[5] "One of our other bigger categories would be one-to-four family residential at 25.68%. Again, I would say none of these -- **these loans are not broker loans. We really don't have a mortgage department**. These one-to-fours are loans that are generated within the banking centers and they also are -- **a good 90% of them have checking**

accounts with us, car loans with us, or business accounts with us at the same time." – David Zalman, Prosperity's CEO, KBW Community Bank Conference, 02 August 2011

[6] "Erika Penala, Analyst: And do you expect in your term commercial real estate portfolio in '09 for some asset classes as some of the leases come up, do you expect some of the rents to start coming down, renegotiated lower?

David Zalman, Prosperity's CEO: You know we -- Tim can answer this -- but **our portfolio probably doesn't consist of any major buildings that these $50 million, $100 million, $150 million buildings.** That is not our portfolio. So I don't think that we ever got to that point really. Tim, you may want to add to that.

Tim Timanus, Prosperity's Vice Chairman: That's exactly correct. **We have virtually no large office buildings or complexes in our portfolio**. So from an office perspective, we are not directly impacted by that in an extremely significant way and really the same thing is true on the retail side. **We have very few big box retail sites that we have financed. There are some obviously, but there are not that many**. And we are all cognizant of the difficulty that many of these large retailers are experiencing right now. So we don't see an immediate direct impact from that either. Obviously there's fallout from any negative economic activity that occurs. So indirectly we could be affected by all of this at some point in time, but we don't see it staring us in the face right now.

Dan Rollins, Prosperity's SVP: Remember, Erika, our portfolio is very granular. **The average credit size in that commercial real estate box or the commercial real estate bucket of loans is still in the $400,000 range**. So lots and lots of relatively small credits. Tim is right, we have some bigger credits in there, but we also have some smaller credits in there." – 2008 Q4 Earnings Transcript

[7] "Jon Arfstrom, Analyst: Okay, that's helpful. In terms of the commercial real estate balances, they were stable sequentially and it was stronger than the other categories. I'm just wondering if you could talk a little bit about impressions of the Texas commercial real estate market in terms of what you are affording and what you might be attracted to in that category?

Dan Rollins, Prosperity's SVP: I think we probably can all jump in on that a little bit, Jon, I think. Commercial real estate obviously is where folks are focusing today, and that is what I was trying to say a few minutes ago. **You first have to start with our bread and butter. And obviously $1.3 billion or $1.4 billion or whatever is in that category is the biggest part of our loans.**

But the granularity in there -- with an average size, again, of $385,000 -- says we are making loans today in the $1 million, $2 million, $3 million, $4 million, $5 million range. We are seeing those on a regular basis. They run the gamut from A to Z, 1 to 99.

If you can dream it up, it is probably in there in some of the markets that we are in, **ranging from the doctor's office building, the veterinary clinic, the small manufacturing plant, the new law office.** Just if you can dream up a small project in the $5 million or $10 million down, that is probably things that we are seeing today.

I think we are really focusing on more of the owner occupied, the folks that have the wherewithal to play in the game. We're not focused on a whole lot of investor or speculative properties at all. But our commercial real estate book is very diverse and is again spread across the state from the bigger Houston and Dallas markets to many others." – Prosperity's 2009 Q1 Earnings Transcript

[8] "I would say in the land development area, again, we don't want to be cavalier about this because nobody is that great, but **the kind of loans that we've made in loan development, land development are usually to well-seasoned customers that we've had since the '80s. Some that have more money on deposit than what they have in loans to us.**

And I would say that **we are not afraid of land development. That we know where we're at. In fact we made an offer to a customer recently a week ago, a $30 million loan, that has probably financed one of the hottest subdivisions in the nation right now in Texas, here in Houston and it's secured by possibly $150 million of collateral and there is a lot of loss and at selling**.

So we are not necessarily afraid of that and I don't think that we have a great deal of fear in that area for the loans that we have. Tim, you may want to jump in on that." – David Zalman, Prosperity's CEO, 2009 Q2 Earnings Transcript
[9] "Barry McCarver, Analyst, Stephens, Inc.: Good morning, guys, and great quarter. I think most of my questions were covered. Actually, I just wanted to ask about the average size of the loan in the commercial loan portfolio, and if that is coming up any at all.

Dan Rollins, Senior Vice President, Prosperity Bancshares: The answer to your question is yes, it's moving up, but I don't know that it's moving the needle. **The average commercial loan is still under $100,000.**

Barry McCarver: But what are you making today?

Dan Rollins: Well, the loans we're putting on the books -- the sweet spot in our loans, when a loan gets into the batter's box, **the sweet spot is really $500,000 to $3 million**. And we are seeing a lot of that flow through the process. But as far as moving the needle up, we have so many loans, we have almost 20,000 loan accounts out there today. So it's going to take a while for that number to move on an average size." – Prosperity's 2004 Q3 Earnings Transcript

[10] "Let's talk about some of the loan transactions that we are looking at that we've missed. **We have historically been a under-the-radar-screen lender**. We are looking at smaller credits. When you look at our loan portfolio today, let me give you some numbers we haven't talked about. **We've said from the very beginning of time our average loan was a little less than $100,000 when you lay on the FirstCapital Group our average loan today is $108,000**. So we didn't move the needle very far.

When you drill further into the portfolio, the largest loans we have are in the commercial real estate transaction category. **Average commercial real estate loan today is right at $400,000. The pricing on a $400,000 commercial real estate transaction is not in the same ballpark as a multimillion dollar transaction**. So where we've been not playing the game as well or not playing the rate game as aggressively as some of our peers in the market has been in the multimillion dollar category, and **when you look at the five or six loans that we missed that totaled up to a little less than $30 million the question comes back should we have made those $30 million loans at a lower rate, basically the same rate as we can get in the bond portfolio** or are we better off not making those loans and keeping that money in the bond portfolio and continuing to work with the lenders to find the loans that we can get a better rate on." – Dan Rollins, Senior Vice President, Prosperity Bancshares, 2005 Q1 Earnings Transcript

[11] "Let me give you some specific numbers. This quarter we've been putting out some average numbers for you guys. **Average commercial real estate credit on our books is $406,000 this quarter**; it's actually down a little bit from last quarter. So the average construction loan is down from $300,000-something down to **$238,000 for the average construction loan for us**. And that's the two biggest pieces**. The average loan on the whole portfolio is $101,500.**

So very low average loan size; **even on the commercial real estate size, a $406,000 loan -- that would be considered very, very small for most of the folks in our peer group today.**" – Dan Rollins, Senior Vice President, Prosperity Bancshares, 2009 Q3 Earnings Transcript

[12] "Dan Rollins, Senior Vice President: I think you hit it head on. When you look at what is coming through the pipeline today, we are booking larger loans today on average than we were two years ago. But we still have a lot of little relationships.

But when you look over the total numbers, that average number has moved up pretty good over the last year**. Our average loan today is about $114,000, which is 14% or 15% higher than it was a year ago**. So that is telling you that we are booking larger loans.

We have still got 30,000-plus loans on the books today, so it takes a lot of bigger loans to move that number. But David is right; **we are seeing a whole lot of loans in $1 million up range that we didn't book as many of a year ago.**

David Zalman, CEO: But in having said that, though, I don't want to give a misconception that we have a bunch of $100 million relationships. **I would say that probably -- I don't know that we have any relationships over $30 million.**

Dan Rollins: **Two.**

David Zalman: Two over $30 million? And probably -- they are not over $40 million?

Dan Rollins: That's right.

Tim Timanus: **None over $40 million**." – Prosperity Bancshares, 2011 Q3 Earnings Transcript

[13] "I think that when we talk about competition for us it is again important for us to talk about the customer base that we are after. **We continue to hear stories in the market about the guys that are chasing the $30 million and $40 million revolving credit C&I loans. We are really not playing in that market**.

We continue to hear that there's people chasing that stuff very aggressively on pricing. I don't know that is something we have been chasing or playing in. So I am not sure we are a good gauge of what is really happening on the C&I side." – Dan Rollins, Senior Vice President, Prosperity Bancshares, 2011 Q1 Earnings Transcript
[14] "So, remember, Dave, when you look at our balance sheet, while we are doing larger loans than we've ever done in the history of our bank, **we are still playing in a smaller size, or smaller bite-size, for many of our regional peers**. **And if they are looking at $20 million and $30 million and $40 million credits on a regular basis, the competition is a lot higher than it is in our average ticket size.**" – Dan Rollins, Senior Vice President, Prosperity Bancshares, 2009 Q3 Earnings Transcript

[15] "**Loans to borrowers with aggregate debt relationships over $1.0 million and below $3.5 million are evaluated and acted upon on a daily basis by two of the company-wide loan concurrence officers. Loans to borrowers with aggregate debt relationships above $3.5 million are evaluated and acted upon by an**

officers' loan committee which meets weekly. In addition to the officers' loan committee evaluation, loans to borrowers with aggregate debt relationships **from $25.0 million to $50.0 million are evaluated and acted upon by the directors' loan committee which consists of three directors of the Bank and meets as necessary**. Loans to borrowers with aggregate debt relationships over $50.0 million are evaluated and acted upon by the Bank's Board of Directors either at a regularly scheduled monthly board meeting or by teleconference or written consent." – Prosperity Bancshares 2014 10-K

[16] "We are getting, though, opportunities at some bigger loans. We haven't funded many of them, but we have two larger loans from larger banks that we should be funding this quarter, right now. And again, it's just an opportunity where the times have changed and we've got an opportunity to do them.

In one case, it's probably something, this company had a loan and it's in a residential development. **You would think, well, nobody would want to make a loan on a residential development right now. But this is probably one of the best areas of Houston. And where we might have a $20 million or $30 million loan, we probably have over $100 million in collateral in a really good area** where homes are still selling and doing very good." – David Zalman, Prosperity's 2009 Q3 Earnings Transcript

[17] "The larger credits, I think they are unique and special by itself. **I think the $100 million that we referred to is a hospital district. It has about probably $400 million in assets and about a third of that is in liability.** And, of course, the reason we'll probably keep all of that if we get it is because, you'll probably **average $30 million or $40 million in the checking account.**" – Tim Timanus, Prosperity's Vice Chairman, 2015 Q3 Earnings Transcript

[18] "I would say that going back as far as two years ago where a lot of **people were really taking in any and every commercial real estate they could for getting the points and we really got out of the market**. I mean we really -- of course I would say we really never did participate in that type of market to begin with.

But **we were really never really keen on bringing people in that really weren't core customers of the Bank, meaning dry relationships, people that were just moving loans and going based on price**.

We always look at every type of loan, whether it's a commercial real estate loan or a commercial loan, to be, say, a full relationship where the customer banks with us. They have their checking account with us.

So just sitting in on loan committees and looking at what -- and watching nonperformings, I don't see the amount of risk maybe in our portfolio that maybe some of the other people do in the commercial real estate side. **Because the kind of loans that we make, we make loans to individuals who bank with us; they needed it for their offices, or -- we really didn't do speculative deals and just hoped that they would fill out**.

Having said that, you know **we bought some banks that did take more risk. And the good part about that is we over the last couple of years have been outsourcing those type of loans and really getting them out of the Bank when the market was still good**. So I really don't seen the amount of risk in the commercial real estate area in our Bank that some people might think that there is." – David Zalman, Prosperity's 2009 Q3 Earnings Transcript

[19] "I want to kind of give you just a little bit of our culture for those -- most of you know but some don't, that we are now a $20 billion-bank-plus and **we still operate under a community bank philosophy**.

We have what we call real bankers, where when you go into one of our banks, and you're a business person and you want to make $1 million or a $3 million loan, you can talk to that officer. If you want to purchase a home, you can talk to that same officer. And if you maybe want to buy a car for your daughter or son that's going to college, that same officer can take care of all of those needs for you. You won't be sent to a Commercial Real Estate Department; you won't be sent to the Home Mortgage Department. That one banking center President, we have 246 locations, can generally take care of that for you.

So we think that means a lot. At the same time, **we give a lot of authority and a lot of autonomy to our people**, that -- if you come into one of our banks, our banking centers, and you need it, and you had all your financials, which was highly unlikely, and all your tax returns and everything else you need, but if you did, and you had -- and **you needed $3.5 million that day, that senior lender could get the concurrence person to sign off with it, and you can have a $3.5 million in that one day**." – David Zalman, Prosperity's CEO, KBW Community Bank Conference, 29 July 2014

[20] "Our credit teams -- Randy Hester is the Chief Lending Officer, and Chris Bagley is the Chief Credit Officer -- those guys are **very focused on a relationship customer-by-customer basis. We really don't have a silo approach to lending. We don't have a commercial real estate team. We don't have a C & I team. We don't have a construction team.**

We are purely focused on a customer-by-customer relationship, old-fashioned community banking. I don't think we have a red marker that says we don't like this type of credit or don't like this type of credit. However, I can tell you as we are going through the process, we are certainly looking very closely at credits that are coming in areas that we feel may be stressed, and we want to make sure we have got equity, that we have got good borrowers, that we have got cash flow capacity. That we stress those loans. I don't know that we are red-lining anything." – Dan Rollins, Senior Vice President, Prosperity Bancshares, 2006 Q1 Earnings Transcript

[21] "We are looking for a relationship lender. You heard Tim talk about it on the one-to-four family side. You heard David talk about it when he was talking about rates a little earlier.

We want the lenders that have relationships with their customer, and that lender can do anything and everything that that customer wants. Remember, we are still not siloed up. We don't have a CRE department and a C&I department and a one-to-four family department and a construction department. **We have a lender, and that lender can take care of whatever he needs to help you take care of.**

He may need to get some assistance from other folks in our Company. But that lender is going to be your primary relationship, and he is going to take care of everything you need.

That appeals to a lot of lenders out there today. That is why I think, David, in this quarter I think we added four or five lenders in the quarter spread out across the state. " – Dan Rollins, Senior Vice President, Prosperity Bancshares, 2011 Q3 Earnings Transcript

[22] "I think if you're looking at the staffing levels, we have hired -- I don't know how many lenders this quarter -- five or six probably. And when you look at where we are hiring from, and not just this quarter, but if you go back two or three quarters, we have hired some from Whitney, we have hired some from Compass, we have hired some from Sterling. We have hired some from lots of little community banks. So you wouldn't recognize a lot of them.

We are typically looking for the lender that can fit into our model, which is a generalist that wants to play in the game that we like to play. So as David says, we are not out trying to raid a big team and bring a big group of people over here to change our process. That is not us. We are looking for the one-off guy that can fit in the model." – Dan Rollins, Senior Vice President, Prosperity Bancshares, 2011 Q1 Earnings Transcript

[23] "We have had numerous meetings with all of our loan people throughout the state. **We have emphasized the need for the growth in quality loans, and I underscore quality**. I don't think that our approval process has gotten any weaker. I think we're looking at loans the same way we always have. We typically have a disciplined process in everything that we do, and that's certainly the case when it comes to loan approvals. **We're encouraging our people to get out of their chairs, get out of the marketplace, meet with existing customers and potential customers and bring business in** and I think that renewed focus and that level of encouragement that we give them is showing that it is paying dividends." – David Zalman, Prosperity's CEO, 2010 Q4 Earnings Transcript

[24] "I would say also that, again, we are not a bank that deals directly based on transactions. If -- I would say we're not the **-- we're never charging the highest price on or paying the most on a CD; we're not charging the lowest on a loan. But what we try to do is we try to really know our customer and not be just a transaction account.**

We really want to know who you are. We want to know your kids. We want to know everything about you. Again, we are not going to try to just bid on a big share of national credit just to get your business and operate off a very thin margin. That's just not the way we operate." – David Zalman, Prosperity's CEO, KBW Community Bank Conference, 29 July 2014

[25] "We know the business in the state. Our people have been there a long time. We know probably the business, I would say, better than anybody else that -- over there. **And I think, because we've been there so long, we know the customers. We even know the customers' customers. So we think we do a really good job**." – David Zalman, Prosperity's CEO, KBW Community Bank Conference, 29 July 2014

[26] "Again, we mentioned about we have a lot of acquisitions and one of the things that's unique to Prosperity is as we buy these banks and take them down and, I should point this out, in the M&A we send in our own team to do due diligence on that loan portfolio. **It's our own team that will look at up to 90% of that portfolio and once they view that; as part of the transaction, it's our intent a lot of times to try to outsource or exit some of those loans**. It's performing, but in our eyes could it sustain itself over different economic cycles and we can use a very specific example. **Our last transaction was an entity called F&M Bank out of Tulsa, it's a $2.4 billion ban**k. But when we went into it and we closed this thing about a year ago in 2014, **we knew that it wasn't a $2.4 billion bank after our due diligence.**

This was a bank that was started in the 1940s, but they grew rapidly over the last few years and the way this bank grew in new places and a lot of other stories; they hired a lot of lenders out of another institution, paid them a lot of extra money to bring them over, and they bought discounted loans to bring the loans over with some, then they paid up on deposits. **So this $2.4 billion bank ends up being maybe a $1.8 billion bank and when we bought it, the price that we paid was based on it being a $1.8 billion bank and so what happens is we need to come in and start cleaning up that portfolio**. So when you look at our loan numbers, if you're pulling our press release or our quarter release, **you'll see our loans coming down; but that's being impacted by this acquisition. We're going to need to clean it up and so we say we'd probably outsource roughly $400 million loans**." – David Hollaway, Prosperity's CFO, KBW Community Bank Conference, 28 July 2015

[27] "Our loan growth probably needs a little bit of explanation. Today we have a very low loan-to-deposit ratio, probably a little bit below 50%, but if you go back to 2008 you can see -- in 2007 we were at about 65%. In 2007 or at the end of 2008 we bought the failed Franklin Bank from the FDIC. And again that was about $2 billion in deposits; we really didn't have any loans at the time that came along with it.

Then in 2009 and 2010 First Bank out of Missouri they had -- again, they were trying to sell off some of their locations in the Houston/Dallas metro market so **we bought about $500 million of their deposits and only got about $100 million in loans at that time**. We also bought three banks from US Bank who acquired three banks in Texas through a failed transaction that was related to a Chicago firm. So we got $500 million there.

So you can see that we got a lot of deposits and we didn't have a whole lot of loans. But again this is not unusual for us. In the '80s we bought a lot of failed banks and again our loan-to-deposit ratio fell this low and it took us three to four years to build our loan to deposit ratio back up to about 65%. A lot of banks would think 65% is low, but again our bank that is probably a target for us 65% to 70%." – David Zalman, Prosperity's CEO, KBW Community Bank Conference, 02 August 2011

[28] "We pre-bought a lot, but again a lot of this was in preparation for the merger with American State Bank. So, a lot of it depends -- they have repositioned some of their portfolio, so -- **they had some longer-term bonds that really hadn't -- real final maturities of as much as 10 and 11 years**, **and it really didn't fit necessarily in our portfolio.**

So, we had asked them to sell them before they closed, and they did. So, in essence they bought about -- they sold about $500 million, and they just bought some real short-term treasury bills that actually mature next month. So, right now our balance sheet looks a little beefed up with additional bonds that were bought, but again, once we merge these two banks together, it will stabilize and we'll be back where we are at." – David Zalman, Prosperity's CEO, 2012 Q2 Earnings Transcript

[29] "I would answer that and say that it's not unusual that whenever we merge with another bank, that we do see a reduction in loan dollar amounts. **It's just simply loans that we might have identified that they may not typically fit our model**, or something like that. **It's not unusual to see as much over a year or two-year period, as much as a 15% to 20% decrease in the loans that a bank that joins us may have before they start picking back up.**" – David Hollaway, Prosperity's CFO, 2013 Q2 Earnings Transcript

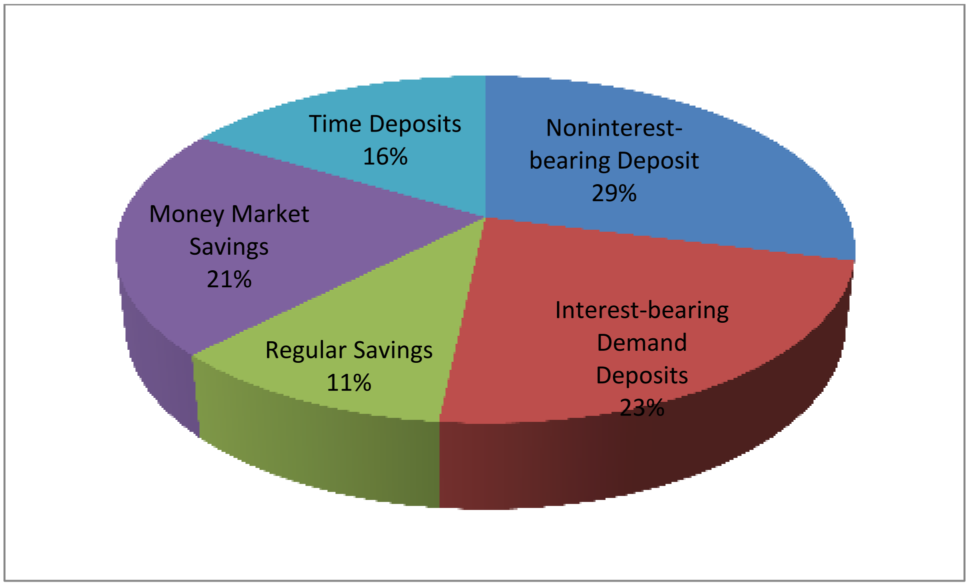
[30] "**When you look at First Victoria and you look at F&M bank as they come on, again, I think in the first year you could have anywhere from 10% to 20%, maybe 15% just because the kind of loans that they may had that we may want or not want**. You may see those gone. So I think in our history that's just it is what it is, I would say." – David Zalman, 2013 Q3 Earnings Transcript

[31] "**I don't know if we would tell you we're as asset sensitive as the guys that you see that loan deposit ratios over 100% or 90%, we're only 50% loan deposit ratio**. But we still would benefit from rates rising and here's why. For a 50% loan deposit ratio, (inaudible) money is tied up in **a security bond portfolio which is basically Freddie Mac and Fannie Mae paper and it's like a temporary repository if you will. I mean the effective duration on that portfolio is about 3.8 years and we get an annualized approximate cash flow coming off of that thing about $1.5 billion.**

And I'd also point out on the loan side, that average life on that loan portfolio is somewhere in the four year range and it's throwing off $2 billion a year in cash flow. So you can imagine if we can see rates start to move up a little bit, it will also be beneficial to us; you just won't see it in the next three and six months. **It will take us up to two years to turn that ship around and realize that reinvestment of all that cash flow as rates are going up**." – David Hollaway, Prosperity's CFO, KBW Community Bank Conference, 28 July 2015

Moat

By Building Total Relationships, Prosperity Has Secured a Sticky Core Deposit Base



Time deposit represents only 16% of total deposits

- **Biggest Negative**:
  - Doesn't have big fee-based businesses
- **Michael Porter Questions**
  - (-) means low
  - (=) means medium
  - (+) means high
  - **For the industry**
    - Is the threat of new entrants high or low?
      - **(-)** The number of banks in Texas declined by 2-3% annually
      - The number of offices
        - Has grew about 3-5% annually
          - Between 1995 and 2008
        - But has declined since 2009
    - Is the bargaining power of buyers high or low?
      - **(+)** Borrowers care about rates and terms
    - Is the threat of substitutes high or low?
      - **(-)** No threat of substitutes
      - Online banking isn't a threat

        - People need physical branches for services
    - Is the bargaining power of suppliers high or low?
        - **(=)** Suppliers of money
            - Low for checking accounts
            - High for CDs
    - Is the rivalry within the industry high or low?
        - **(+)** banks compete aggressively for loans
  - **For the company**
    - Is the threat of new entrant different for this company specifically?
        - **(-)** similar to the industry
    - Is the bargaining power of buyers different for this company specifically?
        - **(-)** Prosperity make small loans
            - Rate competition is weaker
    - Is the threat of substitutes different for this company specifically?
        - **(-)** no threat of substitutes
    - Is the bargaining power of suppliers different for this company specifically?
        - **(-)** Time deposit is just 16% of total deposits
    - Is the rivalry within the industry different for this company specifically?
        - **(-)** Prosperity focuses on less rate-sensitive customers
- **Customer retention: Core deposit customers are sticky**
  - Prosperity focuses on less rate-sensitive customers
  - Rate competition is lower for small loans[1]
    - Prosperity's average loan size is about $157,000
        - Average CRE loans is around $400,000
    - Competition isn't as strong for $100,000-$400,000 loans
    - Prosperity works with owner-operators
        - They won't switch because of 0.1% move in the rate
    - There're more players in the multimillion dollar transaction
        - Not really a relationship
  - Each type of deposits have a different level of rate-sensitivity
    - If base rates go up 1%[2]
        - Rates on CDs may go up 0.8% or 0.9%
        - High-yield money market accounts may go up 0.8%
        - Rates on NOW accounts and the savings accounts may go up 0.2-0.25%

            - 0.3-0.4% for the second 1% increase in interest rates
        - Historically, Prosperity's cost of deposit as a % of Fed funds was
            - Interest-bearing demand deposit: **40%**
            - Savings account: **45%**
            - Money market: **65%**
            - CDs: **95%**
    - Prosperity goes after core-based customers[3]
        - They have more business with Prosperity than just CDs
            - Core deposit customers aren't rate sensitive[4]
        - Prosperity isn't going after interest-rate sensitive customers
            - Value CDs only if the customers have a total relationship[5]
                - Checking accounts
                - Loans
    - Prosperity isn't interested in dry relationship
        - Willing to let competitors to have dry relationship[6]
            - But if the customer is borrowing a half a million or a million dollars
                - And have $200,000 or $300,000 in the bank with it
            - => Prosperity will be very competitive
                - And try to match the loan rates
        - Prosperity is relationship-driven[7]
            - Not for people looking for the highest rates on CDs
            - Not for people looking for the cheapest loans
    - Prosperity looks at core deposit when making acquisitions
        - Looks at what Prosperity can make off of the deposit base[8]
            - The value in a franchise is in the deposit base
                - Holding deposits and growing deposits are important
            - Don't chase high-cost deposits
        - Isn't interested in a lot of banks Prosperity looked at[9]
            - 60-70% of their money is CDs
        - Completed the assumption of $3.6 billion in deposits from Franklin Bank[10]
            - (from FDIC in 2008)
            - $1.6 billion was brokered money
                - Got rid of brokered deposits immediately
            - Planned to let go of $700-800 million of CDs[11]
    - Prosperity improved deposit quality overtime
        - CDs as a % of total deposits has declined

        - 1996: 45%
        - 2014: 16%
    - Noninterest-bearing deposit as a % of total deposits has increased
        - 1996: 19%
        - 2015: 30%
    - Core deposits are **84%** of total deposits
    - Prosperity came out of the rural areas[12]
        - Refocused to a more urban-based
            - Add more commercial deposit relationships
                - Brings a lot of non-interest bearing money
    - Prosperity became more of a commercial-type bank[13]
        - Has more non-interest bearing deposits
        - High-cost deposits will decrease
- **Customer acquisition: potentially good, but Prosperity prefer acquisitions**
  - Prosperity focuses prefer acquisition over opening new branches[14]
    - It takes 3-5 years for a new branch gets $20 million deposits
    - It's faster to grow through acquisition
  - 20-year organic growth in deposits was 4-6%[15]
    - Prosperity opened few branches
    - => 4-6% is a very good organic performance
  - Prosperity's **weakness** in customer acquisition:
    - Small trust business
    - No merchant card processing
    - (Weaker than BOK Financial or Commerce Bancshares in these areas)
  - Prosperity's **strength** in customer acquisition:
    - Customer service
        - 3-point service commitment[16]
            - Greet customers with a smile
            - Address customers by name
            - Try to say yes instead of no
        - There's no call center
            - Customers call directly to branches
                - And works with bankers in the branches
        - Prosperity's lenders have close relationship with customers[17]
            - Can do anything and everything that customers wants
            - Lending isn't siloed up
                - No CRE department

        - No C&I department
        - No residential mortgage department
        - No construction department
      - Prosperity looks for lenders who are generalists[18]
        - Fit into Prosperity's model
      - Encourages loan producers to get out of their chairs[19]
        - Meet with existing customers and potential customers
      - Tries to know customers[20]
        - Not be just a transaction account
        - Want to know who you are
        - Want to know your kids
        - Want to know everything about you
      - Even know the customers' customers[21]
  - Second biggest Texas-based bank in Texas
    - Large banks focus on large customers
    - Prosperity and Frost focuses on smaller customers
    - Prosperity has products the big guys have[22]
      - Treasury management
      - Trust company

- **Margin protection**: **Prosperity is a low cost operator**
  - Customer's willingness to pay is high
    - Prosperity focuses on less rate-sensitive customers
  - Low operating cost is extremely low
    - Net operating cost/earning assets:
      - 2014: 1.07%
      - 2015: 1.16%
      - Has declined overtime
        - 1996-1998: 2.00%
    - This is very impressive because Prosperity has little fee income
      - Just 0.7% of earnings asset
    - Commerce and BOK Financial have similar operating cost
      - But much more fee income
        - Commerce
          - Net operating cost: 1.03% of earning assets
          - Fee income: 2% of earning assets
        - BOK Financial

                - Net operating cost: 0.89% of earning assets
                - Fee income: 2.5% of earning assets
        - Most regional banks have between **1.6%** and **3.3%** in net operating cost
            - (Based on a sample of about 50 publicly trade local banks)
        - Prosperity is excellent at cost control
            - Prosperity's secret sauce: David Hollaway – the CFO[23]
                - He doesn't pay for anything
                - He watches all expenses
            - All banking center has a balance sheet and an income statement
                - Everything is tracked and budgeted[24]
                    - People are rewarded for adhering to budget
                    - Can be penalized for not doing so
            - David Hollaway took the President's popcorn away[25]
                - And chocolate
                - Won't buy Kleenex tissues for anybody
                - No personalized letterhead to employees
                    - They can type their name on there
            - Prosperity usually targets 25% cost cut at banks it acquires
                - But did better many times
        - Prosperity has opportunity to grow fee revenue
            - Cross sell to its existing customers
            - => further reduce net operating cost
            - => expand margin
- Moat evaluation
    - Barrier to entry
        - **Low**
        - It's easy to open a loan office
    - Potential damage
        - **Low**
        - The number of bank in Texas has been declining
            - 1994: 954
            - 2015: 526
        - It's very difficult to grow core deposit
            - It takes 3-5 years for a new branch gets $30 million deposits
        - => Competitors enter Texas through big acquisitions
    - Rivalry among firms
        - Prosperity focuses on less competitive segment

- Core deposit
- Smaller loan
- Relationship-based banking

- **Conclusion**: Prosperity's moat is strong

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[1] "Scott Alaniz, Analyst: I want to follow up that Burt and Joe and Greg talked about pricing on the loan side in particular. And as I look at it and what I want to you to talk about is, how in the world is it going to get any easier? I really don't see it getting any easier out there. And if you were to look out a year, I mean, how -- how challenging of an environment could it be from a loan pricing standpoint?

Dan Rollins, Prosperity's SVP: I think that -- that there's multiple parts. I think you have a lot of moving parts here. Let's talk about some of the loan transactions that we are looking at that we've missed. **We have historically been a under-the-radar-screen lender. We are looking at smaller credits**. When you look at our loan portfolio today, let me give you some numbers we haven't talked about. **We've said from the very beginning of time our average loan was a little less than $100,000 when you lay on the FirstCapital Group our average loan today is $108,000**. So we didn't move the needle very far.

When you drill further into the portfolio, the largest loans we have are in the commercial real estate transaction category. **Average commercial real estate loan today is right at $400,000. The pricing on a $400,000 commercial real estate transaction is not in the same ballpark as a multimillion dollar transaction**. So where we've been not playing the game as well or not playing the rate game as aggressively as some of our peers in the market has been in the multimillion dollar category, and **when you look at the five or six loans that we missed that totaled up to a little less than $30 million the question comes back should we have made those $30 million loans at a lower rate, basically the same rate as we can get in the bond portfolio or are we better off not making those loans and keeping that money in the bond portfolio** and continuing to work with the lenders to find the loans that we can get a better rate on.

Scott Alaniz, Analyst: Got you.

Dan Rollins, Prosperity's SVP: There are loans out there -- we are making loans. I don't remember the number that Tim threw out, but roughly 50 million a month is the average loan production number. **We are making loans at the higher rates. We are just not feeling the need to chase those loan rate loans just like we are not feeling the need to chase the low rate -- or the high rate deposits**.

Scott Alaniz, Analyst: So you **haven't seen the same degree of competition on your bread and butter type, the 100 to $400,000-type loans**.

David Hollaway, Prosperity's CFO: Not as much and you normally would not. **It is the larger more what I will call sophisticated commercial loans where you see the focus of that aggressiveness.**

Dan Rollins, Prosperity's SVP: And again, we are a relationship lender. So **when we are working with the owner-operators, or the small investors that want to build a relationship with a lender that they have confidence in, that they know can take care of what their needs are those transactions aren't going to move over a 10-basis point move in the rate, where your multimillion dollar transaction, you are going to have more players in the game up front and it is really not a relationship**. It is a you buy the business." – Prosperity 2005 Q1 Earnings Transcript

[2] "Basically, on the CD rates that we have -- and again, I'm going from the top of my head, so you know, this may not be exactly accurate. **But on CDs, as interest rates move 100 basis points, we are moving those 80 or 90 basis points**. **Our money market accounts, or what we call our high-yield money market accounts, is the same. We are raising those rates probably 80 basis points for every 100 basis points in increase in the prime rate or Fed funds rate.**

As David mentioned earlier, **with regard to the NOW checking accounts and the savings accounts**, those things are not going to move nearly as fast as -- if there's 100 basis points increase, **it's almost a tiered model, where maybe the first 100 basis points would go up 20 basis points or 25, the second 100 basis points rise might go up 30 or 40**. But it's a tiered model, and I just don't have those in front of me. But I'll be more than happy to share those with you later and get those to you." – David Zalman, Prosperity's CEO, 2004 Q3 Earnings Transcript

[3] "Adam Barkstrom, Analyst: We're going to touch on the deposit market as well, and I guess Brett was right, you guys -- from a lot of our companies, we're are really starting to see -- I guess in other areas -- the DDA [Demand Deposit Account] starting to run-off here -- pretty significantly -- and you guys have benefited from yet another sequential quarter of growth in that bucket. Just curious, overall, with the entrance of -- with Capital One now, and Hibernia buying Coastal -- any pick-up in the competition for pricing of deposits you are seeing, or is it the same environment that you've been seeing for the last year?

David Zalman, Prosperity's CEO: I think that it's been -- David Zalman again -- I think it has always been competitive. It is still a very competitive market. I don't know if you have seen any new players jump into the market. I just think it is highly competitive, and, again, we -- **we are still relying on the customers that we have, which are really core-based customers. We are not going after the interest rate-sensitive customer**. **If we were, I mean, you would have a lot bigger balance sheet, but we just won't be making the money. We are after relationship-banking**.

Dan Rollins, Prosperity's SVP: It's easy to grow deposit, you just pay up on the money.

Tm Timanus, Prosperity's Vice Chairman: This is Tim Timanus. One of the things that I do on a day-to-day basis is work with our banking center managers and presidents on their deposit issues, and that typically translates into trying to deal with the customers that want the higher rates. We really don't see any change in that environment over the last quarter, in '05, for example. It is still very competitive, but **we focus on the core relationships and those customers that have more business with us than just CDs**. We tend to be reasonably successful in keeping those customers, and working with them. So, I don't think there has been any change." – Prosperity's 2006 Q1 Earnings Transcript

[4] "Our deposits is probably one of the strengths of our company, keeping our efficiency ratio where it is at 43%/44% is the first -- **we always talk about keeping our costs down, but the other part of the equation for our bank is deposits. We have a great core deposits base**. Today our cost of deposits are 0.57%.

Again**, if you break this down, you will look that our CDs, our CDs are about $2 billion and only represent about 28% of our deposits. The rest of our bank is predominately a transaction bank**. Today we have almost $1.8 billion in **non-interest-bearing deposits**. We have **interest-bearing DDA** of $1.3 billion that we are paying anywhere between 7 to 10 basis points on.

And again, **our money market and savings** we are probably paying an average of about 35 basis points so you can see **we have a very good core deposit bank. It's there, it's not rate sensitive, and it stays with us**. So if we really wanted to grow the bank and double in size and start paying higher rates on money and CDs you could see our bank could easily double." – David Zalman, Prosperity's CEO, KBW Community Bank Conference, 02 August 2011

[5] "Does it make sense to keep CDs? The answer to that is yes.

We not really trying to go out and purchase CDs in the market. But we are trying to go after a total relationship. If the customer has their checking accounts with us, their loans with us, we want their time deposits too.

But if it is just a customer that is just coming to us for a rate-driven certificate of deposit, we are really not that interested in that kind of relationship." – David Zalman, Prosperity's CEO, 2011 Q3 Earnings Transcript

[6] "David Hollaway, Prosperity's CFO: I would add Barry, that, so many banks, especially banks that occurring to growth mode and maybe some of the smaller banks, especially, they are so focused on the loan side of the balance sheet that they're willing to price underneath the market because they tied up a bunch of these of lenders and the lenders have come over. I think they feel compelled that they have the lenders -- that they have to get up to the 85 or 95% loan to deposit ratio and in so doing, they have pretty much just really cut rates very dramatically. Having said that, that's part of the business. It's been like that forever, and as Tim said, **we look at the good customers of people trying to undercut us and if it's a dry relationship, we generally will let that other company or competitor have it**.

Barry McCarver, Analyst: Dry being no deposits?

David Hollaway, Prosperity's CFO: Right. **If it is a true relationship and the customer is borrowing a half a million or a million dollars and they have $200,000 so or $300,000 in the bank with it, we will be very competitive and try to match it**." – Prosperity's 2004 Q4 Earnings Transcript

[7] "Brett Rabatin, Analyst, FTN Midwest: A couple of questions for you. First off, I heard you mention talking about being more aggressive on deposits. I know like [Citi] is paying 6% in Texas. How much more aggressive are you guys intending to be, and can you give us some deposit goals that you guys have for this year, in terms of thinking about how much more aggressive you might be to grow the deposit base?

David Zalman, Prosperity's CEO: First of all, when we say that we're going to be a little bit more aggressive, comparing it to paying 6% -- we're not even in that league.

Brett Rabatin, Analyst, FTN Midwest: I just throw them out since they're just off the chart.

David Zalman, Prosperity's CEO: When we're talking about being more aggressive, we're talking about maybe raising six-month CDs and one-year CDs maybe by 25 basis points or something like that, to be a little bit more aggressive. Our bank really has never gone for hot money. **Again, we've always tried to create relationship banking. And again, we're looking for a total relationship. We really don't have a lot of customers with the dry relationship that -- what I would call just have a CD with, because that's really not what we're looking for**. But at the same time, we're -- in the past couple of quarters, if somebody wanted us to raise and be more competitive by raising it a quarter to a half, we have not been. And I would say going forward for us to keep our deposits and not let it run off, we'll have to be a little bit more aggressive on the CD rate. And that's really what we're referring to, something like that.

Dan Rollins, Prosperity's SVP: We tell our team that **if somebody is looking for the highest rate in the market, we're probably not the bank for them. If somebody is looking for the absolute lowest loan rate in the market, we're probably not the right bank**. We're relationship-driven. We want the full benefits of both sides of the customer's relationship." – 2006 Q2 Earnings Transcript

[8] "**When we are looking at banks and we are modeling out acquisitions and where we are, you know, we believe we make money off of the deposit base. We believe that's where the value in a franchise is in the deposit base**, and so, you know, holding deposits and growing deposits are important to us. I think you're right. **I think we are sitting in a great spot where we don't have to chase high-cost deposits. We don't have to feel pressure to fund up.**" – David Zalman, Prosperity's CEO 2004 Q4 Earnings Transcript

[9] "Well, we -- as you know, we are looking at everything. We are on the FDIC list, and, gosh, we probably get three to five a week, I guess. So we are looking at a lot. I would tell you up to this point in time, though, that **a lot of the banks that we are seeing are banks that we're not necessarily interested in, simply because when we look at them, they were banks that were started in the last five to 10 years and 60% and 70% of their money is C&D money**. But if we ever find a bank that's really a good core bank with a good core relationship that's been around for a long time that fits into that category, we will certainly consider it." – David Zalman, Prosperity's CEO, 2009 Q4 Earnings Transcript

[10] "**On November 7, 2008, Prosperity Bank completed the assumption of approximately $3.6 billion in deposits from the FDIC acting as receiver for Franklin Bank. Approximately $1.6 billion was brokered money and has since exited the bank**. We acquired certain assets from the FDIC including approximately $350 million in US treasury and agency securities. In addition, we had the exclusive right to purchase any Franklin Bank loan we wanted at book value. After a thorough review of loans originated and managed in the Franklin Bank community banking offices, we purchased approximately $350 million of high quality performing loans." – David Zalman, Prosperity's 2008 Q4 Earnings Transcript

[11] "When we bought the Franklin Bank, **we got about $2 billion in deposits and we felt that we would have probably $700 million to $800 million loss on that**." – David Zalman, Prosperity's CEO, 2009 Q3 Earnings Transcript

[12] "Brett Rabatin, Analyst: Couple questions -- mostly wanted to talk about the deposits, was impressed with the DDA [demand deposit account] and a lot of banks this quarter

are -- the title escrow deposits are lower and you guys had, in the period, 11% link-quarter annualized growth and the averages were up. Why are you guys being more successful than a lot of the other institutions out there in growing your core deposits like that?

David Zalman, Prosperity's CEO: Well, first of all, Brett -- David Zalman -- I don't think our bank really in the past, historically, has relied on higher cost deposits. **As interest rates have gone up, I think you have seen the deposits that were really so interest-rate sensitive that other banks continue to pay higher rates on. I think we just didn't do it**, and, again, we don't -- I think our clientele, with our good core funding, or core deposits, we're not as high. Not that people aren't sensitive to interest rates, because they are -- you can't be too much off, but, again, our -- our company and our -- and **our customers are not just -- just completely banking with us just because of interest rates, in my opinion.**

Dan Rollins, Prosperity's SVP: I think we are -- we are focused on relationships, Brett, and as we are talking with customers, **we are telling customers on a regular basis, if you want us to pay higher rates on interest-bearing deposits, you need to move more free money and you need to have more relationship with us**. So, when you are focused on those relationships, I think that builds core deposits.

David Hollaway, Prosperity's CFO: I would make -- David Hollaway -- I will make one last observation, **as we continue to evolve as an organization coming out of the rural areas, and being refocused to more urban-based and starting to add more larger commercial deposit relationships, that brings a lot of non-interest bearing money**. It is just showing the fruits of the work that we have been doing in the past couple of years." – Prosperity's 2006 Q1 Earnings Transcript

[13] "Just kind of adding some color to that, that being what David is saying. It is interesting. I mean, **when you project forward, becoming more of a commercial-type bank doing more commercial credits, so, yes, the thought process going forward is you'll see the higher cost monies not sticking with the bank but the Non-interest bearing monies probably on average will increase**, and that's what David was alluding to in the first quarter on average, it seasonally tends to go down a little bit and it will start coming back over the next few quarters." – David Hollaway, Prosperity's CFO, 2005 Q1 Earnings Transcript

[14] "Many banks open de novo branches. **We've done a couple of de novo locations as well, but we prefer to buy whole banks**. It just seems that for us it has worked a lot better to buy banks and try to retain existing management. **That has been a lot faster as an expansion method for us. When you start a de novo location it's more of a slow process, it usually takes three to five years just to get up to**

maybe $20 million in deposits and loans. We have found that we would really like all of our locations ' and they're not all there ' to grow to somewhere between $40 and $60 million. In summary, **we have found that it's a lot faster to acquire banks, rather than starting up new locations.**" – David Zalman, The Wall Street Transcript Interview, 25 September 2001

[15] "**So historically, on an organic basis, we've grown about 8% to 9% organically on loans and 4% to 6% on deposits, and that's over a 20-year average history.**" – David Zalman, KBW Regional Bank Conference, 26 February 2014

[16] "We remain committed to relationship banking with true customer service. With **our three-point service commitment of greet the customer with a smile, address the customer by name and try to say yes instead of no**, we will continue to create long-term customer relationships and value for our shareholders." – David Zalman, Prosperity's CEO, 2004 Q3 Earnings Transcript

[17] "We are looking for a relationship lender. You heard Tim talk about it on the one-to-four family side. You heard David talk about it when he was talking about rates a little earlier.

We want the lenders that have relationships with their customer, and that lender can do anything and everything that that customer wants. Remember, we are still not siloed up. We don't have a CRE department and a C&I department and a one-to-four family department and a construction department. **We have a lender, and that lender can take care of whatever he needs to help you take care of.**

He may need to get some assistance from other folks in our Company. But that lender is going to be your primary relationship, and he is going to take care of everything you need.

That appeals to a lot of lenders out there today. That is why I think, David, in this quarter I think we added four or five lenders in the quarter spread out across the state. " – Dan Rollins, Senior Vice President, Prosperity Bancshares, 2011 Q3 Earnings Transcript

[18] "I think if you're looking at the staffing levels, we have hired -- I don't know how many lenders this quarter -- five or six probably. And when you look at where we are hiring from, and not just this quarter, but if you go back two or three quarters, we have hired some from Whitney, we have hired some from Compass, we have hired some from Sterling. We have hired some from lots of little community banks. So you wouldn't recognize a lot of them.

We are typically looking for the lender that can fit into our model, which is a generalist that wants to play in the game that we like to play. So as David says,

we are not out trying to raid a big team and bring a big group of people over here to change our process. That is not us. We are looking for the one-off guy that can fit in the model." – Dan Rollins, Senior Vice President, Prosperity Bancshares, 2011 Q1 Earnings Transcript

[19] "We have had numerous meetings with all of our loan people throughout the state. **We have emphasized the need for the growth in quality loans, and I underscore quality**. I don't think that our approval process has gotten any weaker. I think we're looking at loans the same way we always have. We typically have a disciplined process in everything that we do, and that's certainly the case when it comes to loan approvals. **We're encouraging our people to get out of their chairs, get out of the marketplace, meet with existing customers and potential customers and bring business in** and I think that renewed focus and that level of encouragement that we give them is showing that it is paying dividends." – David Zalman, Prosperity's CEO, 2010 Q4 Earnings Transcript

[20] "I would say also that, again, we are not a bank that deals directly based on transactions. If -- I would say we're not the **-- we're never charging the highest price on or paying the most on a CD; we're not charging the lowest on a loan. But what we try to do is we try to really know our customer and not be just a transaction account.**

We really want to know who you are. We want to know your kids. We want to know everything about you. Again, we are not going to try to just bid on a big share of national credit just to get your business and operate off a very thin margin. That's just not the way we operate." – David Zalman, Prosperity's CEO, KBW Community Bank Conference, 29 July 2014

[21] "We know the business in the state. Our people have been there a long time. We know probably the business, I would say, better than anybody else that -- over there. **And I think, because we've been there so long, we know the customers. We even know the customers' customers. So we think we do a really good job**." – David Zalman, Prosperity's CEO, KBW Community Bank Conference, 29 July 2014

[22] "Well, for us at the size that we are at today -- and **not that we make these kinds of loans, but we have a loan limit that exceeds over $100 million**. So the customer, **we can grow with the customer. We have the products the big guys have. We have the treasury management, the cash management. And also, a lot of times as your business is growing, you need a -- you need some -- probably one of the things that we find most interesting is they have a profit-sharing plan or a pension plan, and need someone to manage that**. And so we have a trust company that can do that also." – David Zalman, Prosperity's CEO, KBW Community Bank Conference, 29 July 2014

[23] "Unidentified Participant: I don't know, this first one is kind of a softball for you guys. But when I think about **your bank, I think about that 42%, 43% efficiency ratio and the culture that drives of getting that, it's such a rare thing**. Most banks are trying to get down to 60 or below 60 or high 50s, and that's probably a big part of the secret sauce that's made you so successful. Can you talk about I guess what you guys do differently versus other banks, or how do you generate that kind of efficiency ratio in this kind of environment?

David Zalman, Prosperity's CEO: Well, **it's real easy. It's a product we've got; it's named David Hollaway. And David doesn't pay anything, it's no -- nothing for everybody**, so that's where you start off with but the -- no, I mean, we really watch our costs. We watch our costs a lot. And again, we don't -- most of us own shares in the Company, that we look at it as our own Company and we don't try to abuse it in everything that we do. **We just make sure that it makes a lot of sense. Dave watches all the expenses, and it just -- we're kind of a plain-vanilla deal**. We're not esoteric in anything we do." – KBW Regional Bank Conference, 26 February 2014

[24] "I think one of the best things is the strict discipline that's been put in place**. Every single banking center, all 238 of them, get a daily -- a balance sheet, an income statement. Everything is tracks and budgets. People are rewarded for adhering to budget and can be penalized for not doing so**. **But once you really take a look at the things that you thought were important and then you realize they really weren't, you can control those dollars**." – Eddie Safady, Prosperity's Area Chairman of Central Texas, KBW Regional Bank Conference, 26 February 2014

[25] "David Zalman, Prosperity's CEO: I'll give you just a little story, and I shouldn't, but I will anyway. One of the banks we first bought, I think, and that really got us going in the Houston market was the Heritage Group, and their president -- I was walking in the lobby one day, and Dave was on the speaker box on his phone. I heard all this ranting and raving and hollering. I said -- what the heck is going on in here? And **the president was hollering because David had taken away -- I don't know if it was his popcorn or what. And then he said -- well, what about the hot chocolate or something. And David said -- well, is that for the customer or is that for the employees? And then he was ranting and raving again**. So that's how this stuff all works. **I did get him to buy some better toilet paper, though**. That other stuff was too many right there.

Unidentified Participant: All right, so he does have -- he can be pushed a little bit.

David Zalman, Prosperity's CEO: He can be pushed a little bit.

David Hollaway, Prosperity's CFO: **We tried to get it to where you'd bring it from your house, but that didn't work.**

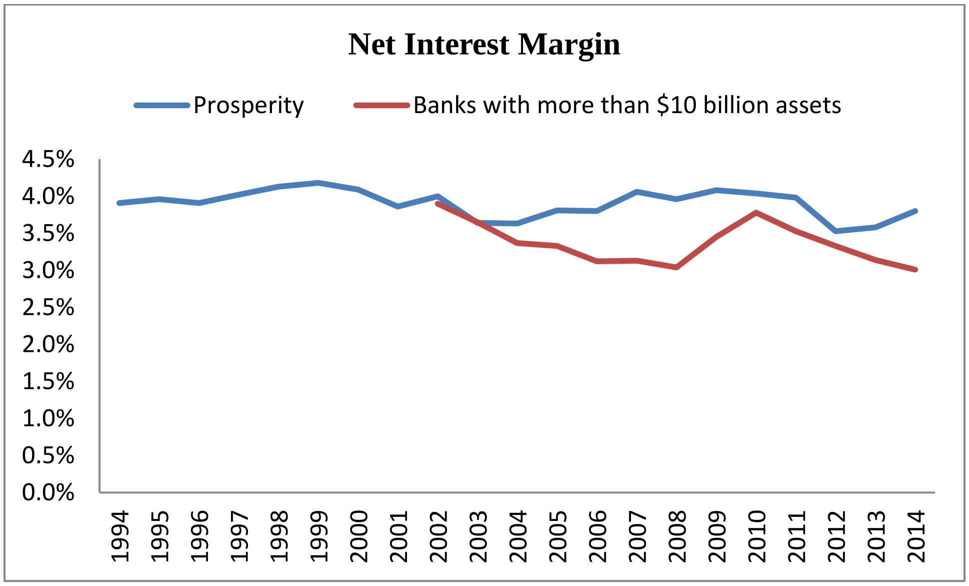
David Zalman, Prosperity's CEO: Still, today it's a real issue because **we don't provide tissues and a lot of people want tissues**, and so it's a big issue because we won't buy Kleenex tissues for anybody.

Unidentified Participant: Eddie, was there one or two things that you can remember from your integration that you guys gave up that --?

Eddie Safady: Well, a lot of the -- we gave a lot of money away, charitable contributions and sponsorships and towards our advertising. So that was brought more into scale. We were a little bit overboard on that. But **I do remember the day we found out that we wouldn't get Kleenex. That raised a little bit of concern, and then that we wouldn't have personalized letterhead, and then you realize, well, you can type your name on there, it's not that big a deal**." KBW Regional Bank Conference, 26 February 2014

Quality

Long-term Amortizing Loans and Bonds Helps Stabilize Net Interest Margin



Prosperity held up net interest margin held up much better than the industry

- **Biggest Negative**:
    - Prosperity is less sensitive to interest rates than other banks
        - Won't benefit as much as other banks if interest rates increase
- **Michael Porter Questions**
    - (-) means low
    - (=) means medium
    - (+) means high
    - **For the industry**
        - Can the industry charge a high price?
            - **(=)** The industry charge a stable "Net Interest Spread" over cost of money
        - Does the industry have low costs?
            - **(-)** Banks have the lowest cost of money
                - Lower cost of money than pension funds or bond funds
        - Does the industry have low need for assets?
            - **(+)**The industry is capital-intensive
                - Rely on high leverage
                - Leverage depends on regulatory capital ratios
    - **For the company**

            - Can the company charge a higher or lower price than the industry?
                - **(+)** Prosperity get higher net loan yield than other banks
                    - By focusing on less competitive, smaller loans
            - Does the company have higher or lower cost than the industry?
                - **(-)** Prosperity has lower cost than the industry
                    - Low cost of funding
                    - Low operating cost
            - Does the company have more or less need for NTA than the industry?
                - **(-)** Prosperity is comfortable with lower Tangible Equity/Assets
                    - Thanks to high quality of assets
- The industry's net interest margin is very stable
    - Net interest spread = yield on earning assets – cost of funding earning assets
    - Based on data of all FDIC-insured institutions
    - Net interest margin was about 3.6% in the 1996-2014 period
        - Min: 3.14%
        - Max: 4.06%
        - Median: **3.60%**
        - Mean: 3.61%
        - Standard deviation: 0.30%
        - Variation: 0.08 (very stable)
    - NIS is stable because the industry have lower cost of money than competitors
        - Banks can get funding from
            - Non-interest bearing deposit
                - free
            - Time deposit
                - Cost less than Fed funds
            - Other borrowings
        - Bank's average net operating cost is
            - Banks with assets over $10 billion: **1.1%**
            - Banks between $1 billion and $10 billion: **1.83%**
        - => Banks total cost of money is about **1-2%** more than Fed funds
            - Not far from risk-free rates
            - 1954-2014 Median (10-year treasury yield – Fed funds) is **1.06%**
        - => Banks have lower costs than competitors
            - Bond funds
            - Pension funds
            - Etc.

- Prosperity's cost of funding is lower than the industry
  - Deposits are **89%** of total earning assets
  - Low-cost core deposits are **84%** of total deposits
  - Its funding sources as a % of average earning assets
    - Noninterest-bearing deposits, liabilities, and equity: **29%**
      - $5.5 billion
    - Interest-bearing demand deposits: **21%**
      - $3.9 billion
    - Savings account: **10%**
      - $1.8 billion
    - Money market savings: **19%**
      - $3.7 billion
    - Time deposit: **15%**
      - $2.8 billion
    - Other borrowings: **6%**
      - $1.2 billion
      - Mostly FHLB advances and repos
    - Total earning assets: **$19 billion** (average balance in Q3 2015)
  - Interest-bearing demand deposit and savings accounts cost less than **50%** of Federal fund rates (FFR)
    - Historical average cost as a % of FFR was
      - Interest-bearing demand deposit: **40%**
      - Savings account: **45%**
    - Many banks pay about 40-50% of FFR for these types of deposits
      - Commerce Bancshares: less than 40% of FFR
      - U.S. Bancorp: 40% of FFR
      - Wells Fargo: 54% of FFR
  - Money market savings cost about **65%** of FFR
  - Time deposit and other borrowings have similar cost to Fed funds
  - => Prosperity's cost of funding is less than **50%** of FFR
    - 31% * 50% + 19% * 65% + 21%= 49%
  - The industry's liabilities consist of
    - (Based on McKinsey report in 2012)
    - Free funding: **22%**
      - Noninterest-bearing deposit
      - Equity
    - Interest-bearing deposits: **37%**

            - On average cost about 75-80% of fed funds
        - Other liabilities: **41%**
            - Cost much more than fed funds
        - => the industry's cost of funding would exceed **70%** of fed funds
            - 22% * 0% + 37% * 75% + 41% * 100% = 69%
    - => Prosperity's funding cost advantage is about **20%** of FFR
        - 3% FFR results in more than **0.60%** cost advantage
        - Other things equals, 0.60% cost advantage results in ROE of about **6%** higher than average
    - Example in 2005
        - Average FFR: 3.21%
        - Prosperity's cost of funding: 1.74%
        - Banks with more than $10 billion assets: 2.30%
        - => **0.56%** cost advantage for Prosperity
            - Prosperity relied on expensive funding more than it does today
                - (Time deposits + other borrowings)/earning assets was
                    - 2005: 39%
                    - Today: 21%
- Prosperity's yield on loan is great
    - Prosperity's loan yield is higher than peers, except for Wells Fargo
        - Average Prosperity's loan yield advantage since 1996
            - First Financial: 0.10%
            - Frost: 0.84%
            - BOK Financial: 0.97%
            - Commerce Bancshares: 0.86%
            - US Bancorp: 0.63%
            - Wells Fargo: -0.19%
    - Prosperity has lower net charge offs than peers
    - So, Prosperity's net loan yield is higher all peers
        - Average Prosperity's net loan yield advantage since 1996
            - First Financial: 0.10%
            - Frost: 1.18%
            - BOK Financial: 1.20%
            - Commerce Bancshares: 1.34%
            - US Bancorp: 1.21%
            - Wells Fargo: 0.69%

- Prosperity's loan yield was lower than most peers in 1996-2001
  - Higher than peers since 2002
- Possible reasons for superior loan yield
  - Prosperity makes more **real estate** loans than peers
    - Historically, 75-80% of loans are real estate
  - Prosperity makes **smaller loans** than regional peers
    - Rate competition is lower for small loans[1]
      - Prosperity's average loan size is about $157,000
        - Average CRE loans is around $400,000
      - Competition isn't as strong for $100,000-$400,000 loans
      - Prosperity works with owner-operators
        - They won't switch because of 0.1% move in the rate
      - There're more players in the multimillion dollar transaction
        - Not really a relationship
    - Regional peers are focused on $20-40 million credits[2]
      - Prosperity isn't[3]
- Prosperity's loan yield is more stable than peers
  - Loan yield since 1996 was
    - Min: 5.85% (in 2014)
    - Max: 8.82% (in 2000)
    - Median: 7.00% (in 2008)
    - Mean: 7.26%
    - Standard deviation: 1.10%
    - Variation: 0.15
      - **Very stable** for a bank
- This is because Prosperity's loan portfolio has long duration
  - 75-80% of loans are real estate loans
    - These loans have long contractual maturity
      - In 2014, loans matures after 5 years were
        - 91% of 1-4 family residential loans
        - 76% of CRE loans
        - **63%** of total loan portfolio
      - By comparison, regional banks tend to short-term loans
        - Mature in less than 5 years
  - Prosperity's real estate loans are amortizing credits[4]
    - Start at 80% LTV
    - And moves down

        - Average life is less than contractual maturities
            - Because principal payment is made monthly
        - Mortgage loan duration is perhaps close to 3 years
            - Similar to PB's securities portfolio
        - Interest rates has a slower impact on Prosperity than peers
            - Because of longer duration
- Historical average can be a good estimate of Prosperity's normal interest margin
    - Prosperity is like an amortizing-type credit lender
        - 75-85% of loans are on an amortizing basis[5]
        - 95% of the securities portfolio is MBS
            - Also amortize monthly
    - Yield in each year is possibly impacted by 3-year trailing average Fed funds
    - Normal interest income margin was extremely stable
        - Was about 3.96% since 1996[6]
            - Min: 3.53%
            - Max: 4.18%
            - Median: **3.96%**
            - Mean: 3.90%
            - Standard variation: 0.19%
            - Variation: 0.05
            - 2014: **3.90%**
- Prosperity can make **2.84%** Return on Earning Assets (ROEA)
    - Net interest income margin: 3.96%
    - Net charge-offs/Average earning assets: 0.05%
    - Net operating cost: **1.07%**
        - Was 1.16% in 2014
        - But Prosperity made a lot of acquisition in 2013-2014
            - Earning asset increased 63% in 2 years
                - 2012: $10,948 million
                - 2014: $17,855 million
        - Prosperity can reduce operating expense overtime
            - It's reasonable to use the minimum level
                - Achieved in 2013
    - => ROEA = 3.96% - 0.05% - 1.07% = **2.84%**
- ROE isn't a useful measure of profitability for Prosperity
    - Prosperity has a lot of goodwill and intangibles
        - In 2014

        - Equity: $3.08 billion
        - Goodwill and intangibles: $1.9 billion
  - Prosperity didn't pay cash for goodwill
    - Issued a lot of shares to make acquisitions
    - Prosperity's share multiple was higher than that of banks it acquired
      - => The cost was overstated
        - Goodwill was overstated
  - Return on Tangible Equity is a more relevant measure
    - Prosperity maintain a high level of leverage
      - Earning Assets/Tangible Equity was between 14 and 22
      - Currently 14.6
    - => Return on Tangible Equity was about **40%**
    - If Earning Assets/Tangible Equity is 10x
      - => Return on Tangible Equity is **28%**
    - We can expect **30-40%** pre-tax Return on Tangible Equity
- 8 dimensions of quality
  - Relative size
    - Great relative to customers
      - Commerce focuses on small business
      - Its bread and butter is making loans below $10 million
    - Great size relative to supplier of money
      - Consumers
      - Commercial customers
  - Focus
    - Prosperity is focused on Texas and Oklahoma
    - Prosperity is focused on traditional banking products
      - Deposit
      - Lending
  - Customer engagement
    - High
  - Cross-selling
    - High
      - Personal account
      - Business account
      - Mortgage
      - Car loans

- Retention
    - High
- Words of mouth
    - No information
- Reinvestment rate
- Stock's popularity
    - Short-interest: 7.92%
    - Share turnover: 153%
        - 3-month average daily volume: 400 thousand shares
        - Float: 65.82 million shares

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[1] "Scott Alaniz, Analyst: I want to follow up that Burt and Joe and Greg talked about pricing on the loan side in particular. And as I look at it and what I want to you to talk about is, how in the world is it going to get any easier? I really don't see it getting any easier out there. And if you were to look out a year, I mean, how -- how challenging of an environment could it be from a loan pricing standpoint?

Dan Rollins, Prosperity's SVP: I think that -- that there's multiple parts. I think you have a lot of moving parts here. Let's talk about some of the loan transactions that we are looking at that we've missed. **We have historically been a under-the-radar-screen lender. We are looking at smaller credits**. When you look at our loan portfolio today, let me give you some numbers we haven't talked about. **We've said from the very beginning of time our average loan was a little less than $100,000 when you lay on the FirstCapital Group our average loan today is $108,000**. So we didn't move the needle very far.

When you drill further into the portfolio, the largest loans we have are in the commercial real estate transaction category. **Average commercial real estate loan today is right at $400,000. The pricing on a $400,000 commercial real estate transaction is not in the same ballpark as a multimillion dollar transaction**. So where we've been not playing the game as well or not playing the rate game as aggressively as some of our peers in the market has been in the multimillion dollar category, and **when you look at the five or six loans that we missed that totaled up to a little less than $30 million the question comes back should we have made those $30 million loans at a lower rate, basically the same rate as we can get in the bond portfolio or are we better off not making those loans and keeping that money in the bond portfolio** and continuing to work with the lenders to find the loans that we can get a better rate on.

Scott Alaniz, Analyst: Got you.

Dan Rollins, Prosperity's SVP: There are loans out there -- we are making loans. I don't remember the number that Tim threw out, but roughly 50 million a month is the average loan production number. **We are making loans at the higher rates. We are just not feeling the need to chase those loan rate loans just like we are not feeling the need to chase the low rate -- or the high rate deposits**.

Scott Alaniz, Analyst: So you **haven't seen the same degree of competition on your bread and butter type, the 100 to $400,000-type loans**.

David Hollaway, Prosperity's CFO: Not as much and you normally would not. **It is the larger more what I will call sophisticated commercial loans where you see the focus of that aggressiveness.**

Dan Rollins, Prosperity's SVP: And again, we are a relationship lender. So **when we are working with the owner-operators, or the small investors that want to build a relationship with a lender that they have confidence in, that they know can take care of what their needs are those transactions aren't going to move over a 10-basis point move in the rate, where your multimillion dollar transaction, you are going to have more players in the game up front and it is really not a relationship**. It is a you buy the business." – Prosperity 2005 Q1 Earnings Transcript

[2] "So, remember, Dave, when you look at our balance sheet, while we are doing larger loans than we've ever done in the history of our bank, **we are still playing in a smaller size, or smaller bite-size, for many of our regional peers**. **And if they are looking at $20 million and $30 million and $40 million credits on a regular basis, the competition is a lot higher than it is in our average ticket size.**" – Dan Rollins, Senior Vice President, Prosperity Bancshares, 2009 Q3 Earnings Transcript

[3] "I think that when we talk about competition for us it is again important for us to talk about the customer base that we are after. **We continue to hear stories in the market about the guys that are chasing the $30 million and $40 million revolving credit C&I loans. We are really not playing in that market**.

We continue to hear that there's people chasing that stuff very aggressively on pricing. I don't know that is something we have been chasing or playing in. So I am not sure we are a good gauge of what is really happening on the C&I side." – Dan Rollins, Senior Vice President, Prosperity Bancshares, 2011 Q1 Earnings Transcript

[4] "The pluses in that commercial real estate book for us is -- remember, **our Bank is more of an amortizing type credit originator. So when you look at that commercial real estate book, those are amortizing credits**. They have been on the books for a while. We are getting principal payments or principal reductions on a monthly basis on the majority of that.

The LTV that is in that book, we started at 80 and moved down from there. So I think when you look at the overall commercial real estate book today and the amortizing nature of that book, you've got credits that have been on the books for three to five to 10 years or more. Those loans are paid down significantly.

So the overall LTV in that commercial real estate book is relatively low. I think you can see that when you look at the net charge-off information that we provided this morning, that shows that over the last 15 months we are in a net recovery position in the commercial estate book.

So again we all understand the focus that is on the commercial real estate today. I think what David was saying and what I'm saying is I don't think that is where we are the most concerned today." – Dan Rollins, Senior Vice President, Prosperity Bancshares, 2009 Q3 Earnings Transcript

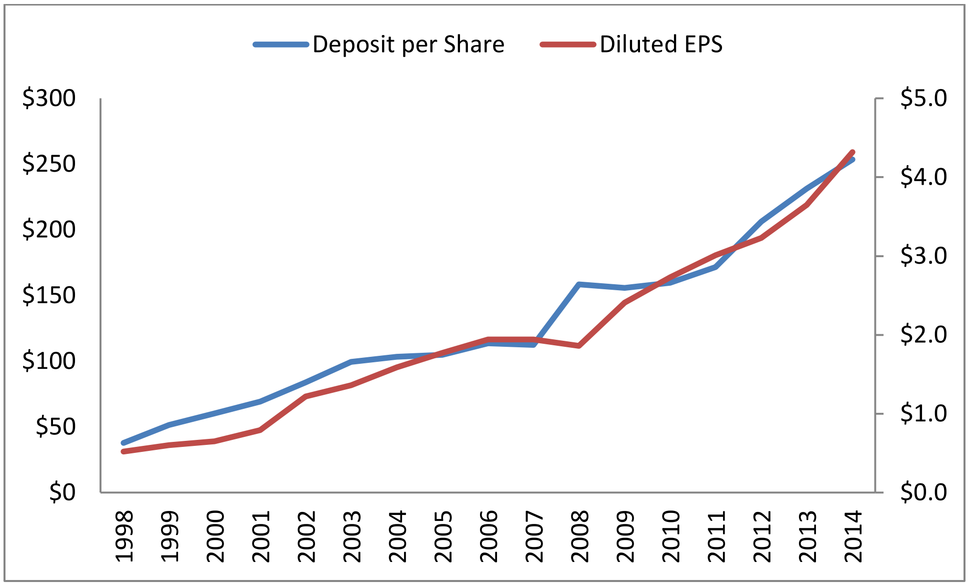
[5] "The beauty of our loan portfolio compared to many others, want to kind of back up and fly a little higher. **When you look at our loan portfolio, our loan portfolio is hugely amortizing. So when you look at the $3.2 billion portfolio, 75%, 85% of that is on an amortizing basis.**" – Dan Rollins, Prosperity's SVP, 2008 Q3 Earnings Call Transcript

[6] "The net interest margin, again you are seeing a chart that goes really just from the first quarter of 2009 to the second quarter of 2011, and you can see that the net interest margin is probably our 4%.

If you took this chart and went all the way back for 10 and 15 years through interest rates going up and interest rates going down, you would see the same thing. You would see that our net interest margin has always been maintained at around a 4% net interest margin -- some higher, some lower depending on how you go. So we have been able to navigate through low interest rates and high interest rates at the same time." – David Zalman, Prosperity's CEO, KBW Community Bank Conference, 02 August 2011

Capital Allocation

Smart Acquisitions Result in Almost 13% Annual Growth in Intrinsic Value



Deposit per share and Diluted ESP grew by about 13% annually

- **Biggest Negative**:
  - No negative
- Share-based compensation results in **0.52%** dilution
  - Average shares issued/number of shares: 0.8%
  - Net of proceeds from stock option exercise and noncash expense: 0.52%
  - Compensation includes
    - Base salary
    - Annual incentive bonus
      - For CEO: up to 150% of base salary
      - For CFO: up to 120% of base salary
      - For 3 other Executive Vice President: 75% of base salary
      - Annual incentive bonus is paid by
        - Cash, or
        - Restricted stock
      - Performance goal is quantitative
        - 9 indicators
          - Total return
          - Increase in EPS
          - Increase in deposits

            - Increase in assets
            - Increase in loans
            - ROE
            - Efficiency ratio
            - Increase in dividends
            - Asset quality
                - Or net charge-offs as a % of average loans
        - A calculation factor is calculated for each of the 9 factors
            - Example:
            - Prosperity targets 8% increase in EPS for 2014
                - Add 2% for each 1% above the target
                - Actual result: 18% growth
                - => **20%** calculation factor
            - Prosperity targets 0.5% asset quality for 2014
                - Add 1% for each 0.01% below the target
                - Actual result: 0.05%
                - => **45%** calculation factor
        - Weight is assign to the calculation factor of each factor
            - 15% for
                - Total return
                - EPS
                - Efficiency ratio
                - ROE
                - Asset quality
            - 10% for increase in dividend
            - 5% for
                - Increase in deposit
                - Increase in asset
                - Increase in loan
    - Long-term equity-based incentive compensation
- Prosperity's compensation is lower than peers
    - 3-year average of total compensation
        - CEO:
            - Prosperity: **$2.3 million**
            - Commerce Bancshares: $3.8 million
            - BOK Financial: $4.5 million
            - Frost: $4.7 million

                - CFO
                    - Prosperity: **$1.1 million**
                    - Commerce Bancshares: $1.4 million
                    - BOK Financial: $3.5 million
                    - Frost: $1.5 million
- Management's interests are aligned with shareholders
    - After the 1998 IPO, Directors and Executive Officer owned **20.25%** of Prosperity
    - After merging with Commercial Bancshares in 2001
        - Directors and Executive Officer owned **32.06%** of Prosperity
            - Ned S. Holmes owned **12.69%**
                - Ned Holmes served as Chairman of Prosperity
                    - From 2001 to 2006
                - He was chairman of Commercial Bancshares
                    - From 1991 to 2001
    - Today, Directors and Executive Officer own **5.96%** of Prosperity
        - Two reasons for the decline
            - Ned Holmes reduced his ownership by about **80%** overtime
                - Owned about 2 million shares in 2001
                - Reduced to
                    - 1.3 million shares in 2004
                    - 0.43 million shares today
            - Prosperity issued shares to make acquisitions
                - Reduce ownership of existing shareholders
        - Other executives didn't sell many shares
            - Over **75%** of net worth of most of the management team is tied up in Prosperity's stock[1]
- Prosperity creates value through acquisitions
    - Most of PB's deals have been private community banks[2]
        - Not publicly traded banks
        - Owners want to pick a partnership
    - Prosperity is the first guy to call if you want to sell a bank[3]
        - (In Texas or Oklahoma)
        - Maybe Frost
            - But Frost said maybe that's not what they want to do
    - Significantly cut costs of banks it acquires
        - Prosperity usually targets 25% cost cut at banks it acquires

        - But did better many times
    - Acquired banks usually have 60-80% efficiency ratio[4]
        - Prosperity brings down to below 50%
- Prosperity is careful about assets of acquired banks
    - Usually asks the acquired banks to exit some loans as part of a deal
    - Prosperity usually looks at up to 90% of loan portfolio of an acquired target[5]
        - Always try to outsource or exit some of the loans
            - Even if they're performing
    - Bought $500 million deposits from First Bank[6]
        - But got only $100 million loans
        - Similarly bought failed banks in 1980s
    - Asked American State Bank to sell long-term bond before acquiring[7]
        - They sold $500 million
    - Prosperity usually exit some types of loans that acquired banks make[8]
        - Usually see 15-20% decrease in loans in a 1- or 2-year period after the acquisition
    - Reduced loans at First Victoria and F&M by 15%[9]
        - Prosperity doesn't like some loans
- Acquires banks at low core deposit premium
    - Prosperity looks at what it can make off of the deposit base[10]
        - The value in a franchise is in the deposit base
            - Holding deposits and growing deposits are important
    - Prosperity usually looks at core deposit premium
        - Core Deposit Premium = (Price – Tangible Equity)/Core deposits
        - Core deposits = deposits excluding CDs over $100,000
    - Prosperity can make 2.4% return on deposits
        - Since 1996
        - Pre-tax income/average deposits was
            - Min: 1.83%
            - Max: 2.80%
            - Median: 2.38%
            - Mean: 2.41%
            - Standard Deviation: 0.30%
            - Variation: 0.12
    - => Prosperity can make 10% pre-tax return if it pays less than 24% core deposit premium

        - Prosperity paid about 11% core deposit premium
            - (based on 32 acquisitions it made since 1998)
            - Min: 3%
            - Max: 24%
            - Median: 9%
            - Mean: 11%
            - Standard Deviation: 5%
            - Variation: 0.47
- Prosperity used shares to make acquisition when it trades at a higher multiple[11]
    - Acquired F&M Bancorporation
        - In 2014
        - F&M represents 13% of the merged entity
        - Prosperity paid
            - $34 million cash
            - $197 million stock
                - 3,298,022 shares
                - $59.69 each
        - F&M traded at **7%** core deposit premium
        - Prosperity traded at **18%** core deposit premium
    - Acquired First Victory National Bank (FVNB)
        - In 2013
        - FVNB represents 13% of the merged entity
        - Prosperity paid
            - $91 million cash
            - $283 million stock
                - 5,570,667 shares
                - $50.78 each
        - FVNB traded at **12%** core deposit premium
        - Prosperity traded at **16%** core deposit premium
    - Acquired American State Financial (ASF)
        - In 2012
        - ASF represents 31% of the merged entity
        - Prosperity paid
            - $179 million cash
            - $351 million stock
                - 8,524,835 shares

            - $41.14 each
    - ASF traded at **11%** core deposit premium
    - Prosperity traded at **15%** core deposit premium
- Acquired Texas United Bancshares (TUB)
    - In 2007
    - AUB represents 28% of the merged entity
    - Prosperity paid
        - $0 million cash
        - $354 million stock
            - 10,770,000 shares
            - $32.83 each
    - TUB traded at **24%** core deposit premium
        - This is Prosperity's most expensive acquisition
        - Other acquisitions were made at **19%** core deposit premium or less
    - Prosperity traded at **24%** core deposit premium
- Acquired SNB Bancshares
    - In 2006
    - SNB represents 24% of the merged entity
    - Prosperity paid
        - $93 million cash
        - $149 million stock
            - 4,448,000 shares
            - $33.59 each
    - SNB traded at **19%** core deposit premium
    - Prosperity traded at **26%** core deposit premium
- Acquired First Capital Bankers (FCB)
    - In 2005
    - FCB represents 22% of the merged entity
    - Prosperity paid
        - $0 million cash
        - $142 million stock
            - 5,079,000 shares
            - $28.04 each
    - SNB traded at **19%** core deposit premium
    - Prosperity traded at **22%** core deposit premium
- Acquired Paradigm Bancorporation

    - In 2002
    - Paradigm represents 18% of the merged entity
    - Prosperity paid
        - $0 million cash
        - $44 million stock
            - 2,580,000 shares
            - $17.03 each
    - SNB traded at **17%** core deposit premium
    - Prosperity traded at **17%** core deposit premium
  - Acquired Commercial Bancshares
    - In 2001
    - Paradigm represents 37% of the merged entity
    - Prosperity paid
        - $0 million cash
        - $53.3 million stock
            - 2,768,610 shares
                - Equivalent to 5,537,220 today shares
                - (adjusted for 2-for-1 stock split)
    - Commercial traded at **6.8%** core deposit premium
    - Prosperity traded at **12%** core deposit premium
  - Prosperity usually has high leverage
    - Tangible Equity/ Assets is between **4.5%** and **7%**
    - If Prosperity acquires banks with lower leverage
        - It doesn't have to add cash to maintain the leverage level
        - Its leverage actually declines after the acquisition
        - Acquisition since 2012 added
            - **$9,797** million assets
            - $700 million tangible equity
            - **7.15%** Tangible Equity/Assets
                - Lower leverage than Prosperity
- It's not useful to look at ROE
  - Prosperity has a lot of goodwill and intangibles
    - In 2014
        - Equity: $3.08 billion
        - Goodwill and intangibles: $1.9 billion
  - Prosperity didn't pay cash for goodwill
    - Issued a lot of shares to make acquisitions

            - Prosperity's share multiple was higher than that of banks it acquired
                - => The cost was overstated
                    - Goodwill was overstated
- Deposit per share growth is the best measure of value creation
    - Grew 12.6% annually over the last 17 years
        - 1998: $38
        - 2014: $253
- Prosperity can increase dividend payout ratio
    - Organic growth: about 5%
    - Return on tangible equity: **40%**
        - (**26%** after-tax)
    - At 10x leverage: 28%
        - (**18%** after-tax)
    - => Prosperity can payout 75-80% of earnings
    - Current dividend payout ratio stayed around **23%** over the last 10 years
    - Earning Assets/Tangible Equity has declined as a result
        - 2004: 22.2
        - 2014: 14.6
        - 2015 Q3: 12.5x
            - => need to retain only $304 million to reach 10x leverage
            - Or less than earnings of one year
    - It's unlikely that Prosperity will continue to deleverage
        - Prosperity is comfortable with high leverage[1][2]
            - Prosperity control risk by asset quality
                - Similar to Progressive

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[1] "I think **the other thing that's really unique for us is that our management team, what I consider our executive committee, the majority of our net worth, I would say 75%-plus for most of us, is tied up in Prosperity Bancshares stock. And so I think that we are aligned with the investor**. We are not here just as management people, and trying to make money and the highest salary that we can. Our real reward comes basically when you as shareholders do good, we as shareholders do good at the same time.

I would also say that if you look at our top management team, our executive committee, and **our management committee, which consists of about 30 people, I think that all of them have 20 to 30 years of experience, if not with us, with the banks that**

have joined us. So we have a very experienced group of people." – David Zalman, KBW Community Bank Conference, 29 July 2014

[2] "**Most of our transactions have been private community banks, not publicly traded banks. And sometimes the emotions behind selling a private bank are different than selling a public bank. In this particular case Mr. Collier has been with the Bank since 1959. He's put a lot of his blood, sweat and tears into this organization and he needed to pick a partnership that he thought would be good.**

And I don't want to put words in his mouth, but I think he picked us because he felt like this would be a good fit for him and his team and the emotions that come with when you've grown this thing for the last 50 years and you're wanting to hand it off and let somebody else come in and talk about it, there's emotions that are there. And whether it's a transaction of this size or smaller transactions the emotional part for the sellers is where you've got to build that bridge." – Dan Rollins, Prosperity's SVP, KBW Regional Bank Conference, 01 March 2012

[3] "Really the people that want to join us, we have people -- again, we don't want to brag or anything. But I think **if you really want to sell your bank in Texas or Oklahoma, we are going to be the first guys you are going to come to. Maybe Frost, but Frost has said maybe that's not what they want to do**. So we are probably the Company that you're going to come from." – David Zalman, Prosperity's CEO, KBW Regional Bank Conference 25 February 2015

[4] "You can see in the last two years that our efficiency ratio was 50 and 51 percent. And that's against the backdrop of these nine acquisitions. **So what that's telling us is as we bring these new partners on -- and they're typically running 60, 70, 80 percent efficiency ratio -- is that we integrate them into our culture and we bring them down to the 50 percent mark, which is our target, by the way**. We are targeting a 50 percent efficiency ratio." – David Hollaway, Prosperity's CFO, Gulf South Bank Conference, 27 April 2004

[5] "Again, we mentioned about we have a lot of acquisitions and one of the things that's unique to Prosperity is as we buy these banks and take them down and, I should point this out, in the M&A we send in our own team to do due diligence on that loan portfolio. **It's our own team that will look at up to 90% of that portfolio and once they view that; as part of the transaction, it's our intent a lot of times to try to outsource or exit some of those loans**. It's performing, but in our eyes could it sustain itself over different economic cycles and we can use a very specific example. **Our last transaction was an entity called F&M Bank out of Tulsa, it's a $2.4 billion ban**k. But when we went into it and we closed this thing about a year ago in 2014, **we knew that it wasn't a $2.4 billion bank after our due diligence.**

This was a bank that was started in the 1940s, but they grew rapidly over the last few years and the way this bank grew in new places and a lot of other stories; they hired a lot of lenders out of another institution, paid them a lot of extra money to bring them over, and they bought discounted loans to bring the loans over with some, then they paid up on deposits. **So this $2.4 billion bank ends up being maybe a $1.8 billion bank and when we bought it, the price that we paid was based on it being a $1.8 billion bank and so what happens is we need to come in and start cleaning up that portfolio**. So when you look at our loan numbers, if you're pulling our press release or our quarter release, **you'll see our loans coming down; but that's being impacted by this acquisition. We're going to need to clean it up and so we say we'd probably outsource roughly $400 million loans**." – David Hollaway, Prosperity's CFO, KBW Community Bank Conference, 28 July 2015

[6] "Our loan growth probably needs a little bit of explanation. Today we have a very low loan-to-deposit ratio, probably a little bit below 50%, but if you go back to 2008 you can see -- in 2007 we were at about 65%. In 2007 or at the end of 2008 we bought the failed Franklin Bank from the FDIC. And again that was about $2 billion in deposits; we really didn't have any loans at the time that came along with it.

Then in 2009 and 2010 First Bank out of Missouri they had -- again, they were trying to sell off some of their locations in the Houston/Dallas metro market so **we bought about $500 million of their deposits and only got about $100 million in loans at that time**. We also bought three banks from US Bank who acquired three banks in Texas through a failed transaction that was related to a Chicago firm. So we got $500 million there.

So you can see that we got a lot of deposits and we didn't have a whole lot of loans. But again this is not unusual for us. In the '80s we bought a lot of failed banks and again our loan-to-deposit ratio fell this low and it took us three to four years to build our loan to deposit ratio back up to about 65%. A lot of banks would think 65% is low, but again our bank that is probably a target for us 65% to 70%." – David Zalman, Prosperity's CEO, KBW Community Bank Conference, 02 August 2011

[7] "We pre-bought a lot, but again a lot of this was in preparation for the merger with American State Bank. So, a lot of it depends -- they have repositioned some of their portfolio, so -- **they had some longer-term bonds that really hadn't -- real final maturities of as much as 10 and 11 years**, **and it really didn't fit necessarily in our portfolio.**

So, we had asked them to sell them before they closed, and they did. So, in essence they bought about -- they sold about $500 million, and they just bought some real short-term treasury bills that actually mature next month. So, right now our balance sheet looks a little beefed up with additional bonds that were bought, but again, once we merge these two banks together, it will stabilize and we'll be back where we are at." – David Zalman, Prosperity's CEO, 2012 Q2 Earnings Transcript

[8] "I would answer that and say that it's not unusual that whenever we merge with another bank, that we do see a reduction in loan dollar amounts. **It's just simply loans that we might have identified that they may not typically fit our model**, or something like that. **It's not unusual to see as much over a year or two-year period, as much as a 15% to 20% decrease in the loans that a bank that joins us may have before they start picking back up.**" – David Hollaway, Prosperity's CFO, 2013 Q2 Earnings Transcript

[9] "**When you look at First Victoria and you look at F&M bank as they come on, again, I think in the first year you could have anywhere from 10% to 20%, maybe 15% just because the kind of loans that they may had that we may want or not want**. You may see those gone. So I think in our history that's just it is what it is, I would say." – David Zalman, 2013 Q3 Earnings Transcript

[10] "**When we are looking at banks and we are modeling out acquisitions and where we are, you know, we believe we make money off of the deposit base. We believe that's where the value in a franchise is in the deposit base**, and so, you know, holding deposits and growing deposits are important to us. I think you're right. **I think we are sitting in a great spot where we don't have to chase high-cost deposits. We don't have to feel pressure to fund up.**" – David Zalman, Prosperity's CEO 2004 Q4 Earnings Transcript

[11] "Unidentified Participant: I mentioned how quickly you guys are growing capital and you could double your capital in three years if you wanted to. But the reality probably is you are going to put it to work doing [something]. You expanded your boundaries a little bit, (inaudible) a big stake out there that are showing a little bit. So can you just talk again about your criteria, how much excess capital you think we have and how you think about --?

David Zalman, Prosperity's CEO: I think the question you probably heard is our capital is growing at such a fast pace. It's funny because throughout our years we have been known as a serial acquirer, but **I always said we would run out of money before we would run out of deals**.

So today our stock price is trading at a pretty good multiple, and especially compared to tangible capital. So we have a very good currency so in doing deals we are probably lucky because our stock price has held up better than anybody else's so when we are out doing a deal and we can use our stock any deal that we do is extremely accretive.

Having said that, at the same time if we can throw a little juice in it, if it's a 25% or 30% cash portion into it, it can even make it more accretive. So we will continue to build capital, it's nice. We are also increasing dividends. If you look over the last several years, our dividends have been increasing over 10% or better a year so you will see us using that money for acquisitions.

You will see us -- we will continue to make acquisitions. I know a lot of people have asked the question you haven't done anything in a year. It's funny because in prior years when we had two or three acquisitions a year everybody said where is your organic loan growth at, where is your organic growth at?

We have always told everybody, well, **organically we still always grew the loans at about 8% a year and 6% a year on the deposit side. It was always hard to see because it was always camouflage through all the acquisitions that we had**. So now we are really able to show all the organic loan growth that we have and organic deposit growth that we have, and now everybody is saying when are you going to do the next acquisition.

So I would tell you that we are going to do acquisitions. There is plenty of deals out there. We really don't want to grow just to grow. **It's very important for us to see accretion. I like to see when we do a deal, I like about a -- I would like a double digit number on the accretion number.**

So we will do deals, we always have a number of deals working. **We bid on the Sterling deal; we lost on that, which was a big deal in our backyard**. Again the price that was paid probably some of our investors are glad we didn't get it.

We also bid on the failed bank in New Mexico. Our bid was about the same as US Bank's bid was as far as a discount, about $300-and-something-million. **The difference was we still wanted the loss share**. We thought if we called it wrong that there could be $100 million one way or another if we called it wrong.

So we wanted some loss share where US Bank had the same discount as we did, but again they didn't ask the government for the type of loss share. So $100 million for us would have been a big deal if we called it wrong, $100 million to US Bank wasn't a very big deal, so we didn't get that. But we are still working on deals. We are working on some significant deals and so we will be successful." – KBW Community Bank Conference, 02 August 2011

[12] "<u>Nick Adams, Analyst</u>: And again, I would not be worried if you kind of had the tangible ratio that most of the competition has, the 6, 7, 8 percent tangible. But when

you start at 4.5, at least that's what I get when I do the division. And you start getting hits on the HTM portfolio, it seems low to me.

Dan Rollins, Prosperity's SVP: **I think you've got to factor in asset quality in that picture as a piece of where the risk model is. I think our risk model is very low compared to our peers.**

David Zalman, Prosperity's CEO: Yes, I mean when you look at our total classified assets to total assets, what is it, like 7 or 0.07, 7 basis points. So I mean it's extremely low.

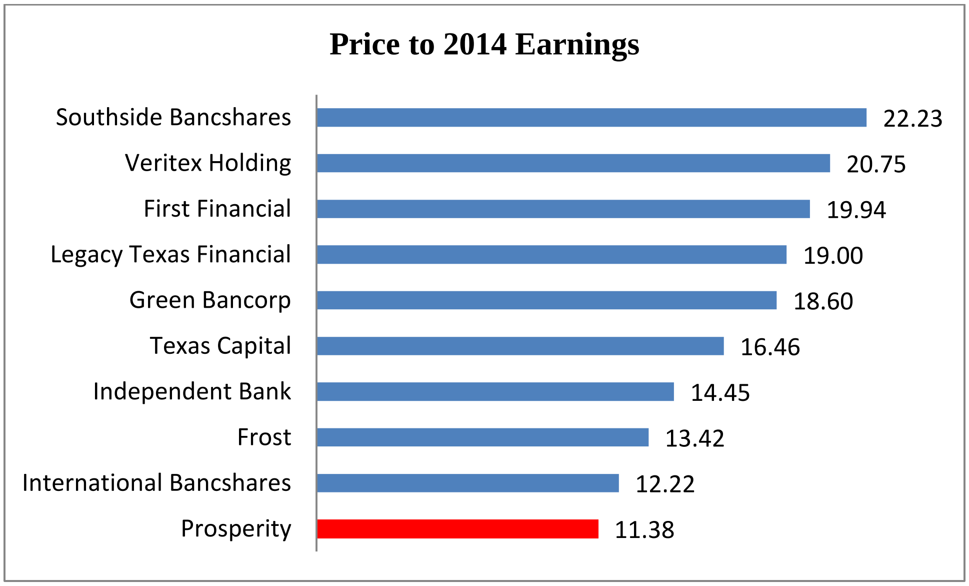
Nick Adams, Analyst: And it is for most of your peers, too. And one of the other things I worry about is as rates rise, that maybe this commercial real estate portfolio that everybody has built up quite rapidly over the last several years does not behave quite as benignly. But again, my prejudice, I'm probably overly concerned about nothing.

David Zalman, Prosperity's CEO: I think you are, Nick. The other option is to have a secondary issue and there has been **many firms that have wanted us to do a secondary issue and doing 50 or $100 million secondary issue and beefing up our capital position. On the other hand, as a shareholder and a larger shareholder myself, I don't know if I am as willing to give away, from a shareholder standpoint, the dilution or not**.

Nick Adams, Analyst: There just comes a point where leverage can hurt from unforeseen circumstances that may come anybody's way. But again, that's my prejudice. It should not be yours. Thank you, guys." – Prosperity 2004 Q2 Earnings Transcript

Value

Prosperity Is Cheap Even Based on 2014 Earnings



Based on 2014 earnings, Prosperity is the cheapest bank stock in Texas

- **Biggest Negative**:
- Key inputs
  - Share price: **$48** per share
  - Outstanding shares: 70.03 million
  - Market cap: $3,361 million
  - Short-term investments: $55 million
  - Securities: $9,706 million
  - Loans: $9,157 million
  - Earning Assets: $18,918 million
  - Deposit: $16,919 million
- Pre-tax Owner Earnings is **$537 million**
  - Historical average can be a good estimate of normal interest margin
    - Prosperity is like an amortizing-type credit lender
      - 75-85% of loans are on an amortizing basis[1]
      - 95% of the securities portfolio is MBS
        - Also amortize monthly
    - Yield is mostly impacted by 3-year trailing average Fed funds
    - Normal interest income margin was extremely stable
      - Was about **3.96%** since 1996[2]

          - Min: 3.53%
          - Max: 4.18%
          - Median: **3.96%**
          - Mean: 3.90%
          - Standard variation: 0.19%
          - Variation: 0.05
          - 2014: **3.90%**
    - Prosperity can make **2.84%** Return on Earning Assets (ROEA)
      - Net interest income margin: 3.96%
      - Net charge-offs/Average earning assets: 0.05%
      - Net operating cost: **1.07%**
        - Was 1.16% in 2014
        - But Prosperity made a lot of acquisition in 2013-2014
          - Earning asset increased 63% in 2 years
            - 2012: $10,948 million
            - 2014: $17,855 million
        - Prosperity can reduce operating expense overtime
          - It's reasonable to use the minimum level
            - Achieved in 2013
      - => ROEA = 3.96% - 0.05% - 1.07% = **2.84%**
    - Earnings asset is $18,918 million
    - Pre-tax Owner Earnings is $537 million
      - $18,918 million * 2.84% = $537 million
- Prosperity's current valuation is
    - EV/Deposit: **0.20**
    - EV/2014 EBT: 7.40
    - EV/Normal EBT: **6.26**
- Peer valuation
    - We picked 5 Texas banks that have the most years of financial data
    - Frost (CFR)
      - Frost is the most similar peer
        - Frost is the biggest Texas-based bank
          - Prosperity is the second biggest
        - Frost and Prosperity focuses on small commercial customers
        - Both have great customer services
        - Both enjoy great growth
          - Frost grew deposits by **10%** annually

        - Prosperity grew deposits by **25%** annually
      - Prosperity had better deposit per share growth
        - Frost: 9%
        - Prosperity: 12.6%
      - Frost has lower funding cost than Prosperity
        - Noninterest-bearing deposits are 41% of total deposits
      - Prosperity had lower operating cost than Frost
        - Prosperity: 1.07%
        - Frost: 1.41%
      - Frost is more interest rate sensitive than Prosperity
        - Frost makes more short-term C&I loans
        - Prosperity makes more long-term real estate loans
    - Frost's current valuation
      - Share price: $60.00
      - EV: $3,884 million
      - EV/Deposit: **0.16**
      - EV/2014 EBT: 8.50
      - EV/Normal EBT: **5.32**
        - (Using **2.81%** ROEA)
  - Texas Capital (TCBI)
    - TCBI has a different business models than other peers
    - TCBI doesn't rely on a large branch network[3]
      - Offers
        - 13 banking centers
          - Over $1 billion deposit per branch
          - They have one branch in Caymay Island
            - Serve U.S.-based customers
        - Courier services
        - Online banking
      - Has only 12 ATMs
        - ATMs don't accept deposits
    - TCBI was founded in 1998
      - With $80 million capital
        - The largest in U.S. history at that time
    - TCBI calls themselves "The Best Business Bank in Texas"
    - **81%** of deposits are originated out of TCBI's Dallas metropolitan banking centers

        - TCBI has a small number sources of deposits[4]
            - A significant volume of demand deposits is from
                - Financial service companies
                - Mortgage finance customers
            - Over half of deposits is from customers whose balances exceed $250,000
            - => TCBI has to pay high rates on deposit
                - TCBI pays more than Fed fund rates for
                    - Saving deposits
                    - Time deposits
                    - Other borrowings
        - TCBI grew mostly organically
        - Deposit grew 22% annually from 2001 to 2014
        - But TCBI issued a lot of shares
            - 2002: 18.5 million shares
            - 2014: 45.7 million shares
        - Deposit per share grew about 14%
        - TCBI's problem is high funding cost
            - about **0.68%** higher than Prosperity
        - TCBI wasn't able to reduce operating cost as they grew
        - Median ROEA was **1.17%**
            - Only 14% pre-tax ROE using 11x leverage
            - Way inferior to Prosperity's 2.84% ROEA
        - TCBI's current valuation is
            - Share price: $49.42
            - EV: $2,416 million
            - EV/Deposit: **0.16**
            - EV/2014 EBT: 11.39
            - EV/Normal EBT: **11.44**
                - (Using 1.17% ROEA)
    - First Financial Bancshares (FFIN)
        - FFIN tend to have 30-40% market share in very small markets
        - FFIN has very similar cost profile to Frost
            - Similar funding cost
            - Similar operating cost
                - Similar Noninterest Expense/Earning Assets
        - Net Interest Income/Earning Assets was **4.41%**

        - (From 1992 to 2014)
        - Min: 4.11%
        - Max: 4.68%
        - Median: 4.41%
        - Mean: 4.43%
        - Standard Deviation: 0.14%
        - Variation: 0.03
            - Extremely stable
    - Operating cost is about 1.4%
    - => **3.01%** ROEA
    - FFIN's current valuation is
        - Share price: $30.17
        - EV: $1,990 million
        - EV/Deposit: **0.40**
        - EV/2014 EBT: 14.42
        - EV/Normal EBT: **11.09**
            - Using **3.01%** ROEA
- Southside Bancshares (SBSI)
    - Southside's disadvantage is high funding cost
        - About **0.90%** higher than Prosperity
    - Southside wasn't able to reduce operating cost
    - => ROEA is just 1.30%
    - Southside uses high leverage to achieve a high ROE
        - 14x leverage
        - => 19% pre-tax ROE
    - Southside's current valuation is
        - Share price: $24.02
        - EV: $609 million
        - EV/Deposit: **0.18**
        - EV/2014 EBT: 17.92
        - EV/Normal EBT: **10.55**
            - (Using 1.30% ROEA)
- International Bancshares (IBOC)
    - IBOC is an inferior peer
    - 10-year CAGR of deposits was only 2.3%
    - IBOC has about **0.64%** higher funding cost than Prosperity

        - IBOC has a strong focus on noninterest income
            - => only about **1.12%** operating cost
        - Noninterest Income has declined significantly
            - Due to recent changes in regulation
            - Noninterest income was
                - 2010: $219 million
                - 2014: $178 million
        - IBOC can makes 2.16% return on pretax income
        - IBOC's valuation is
            - Share price: $25.70
            - EV: $1,706 million
            - EV/Deposit: **0.20**
            - EV/2014 EBT: 7.42
            - EV/Normal EBT: **7.60**
                - (Using 2.16% ROEA)
- Prosperity is cheaper than peers
    - Texas Capital, First Financial and Southside all trade above 10x EV/EBT
    - International trades at 7.60x EV/EBT
        - It deserves a low valuation
        - 10-year CAGR of deposits was only 2.3%
    - Only Frost is cheaper than Prosperity
- Prosperity's historical price was between 13x and 20x P/E
    - Or between 8.5x and 13x EV/EBT
    - Historical valuation implies value between $4,565 million and $6,981 million
        - Or between $65.19 and $99.69 per share
- Prosperity deserves 20x P/E
    - It can grow deposit per share by 7-10% annually
        - While maintaining 35-55% dividend payout rate

[1] "The beauty of our loan portfolio compared to many others, want to kind of back up and fly a little higher. **When you look at our loan portfolio, our loan portfolio is hugely amortizing. So when you look at the $3.2 billion portfolio, 75%, 85% of that is on an amortizing basis.**" – Dan Rollins, Prosperity's SVP, 2008 Q3 Earnings Call Transcript

[2] "The net interest margin, again you are seeing a chart that goes really just from the first quarter of 2009 to the second quarter of 2011, and you can see that the net interest margin is probably our 4%.

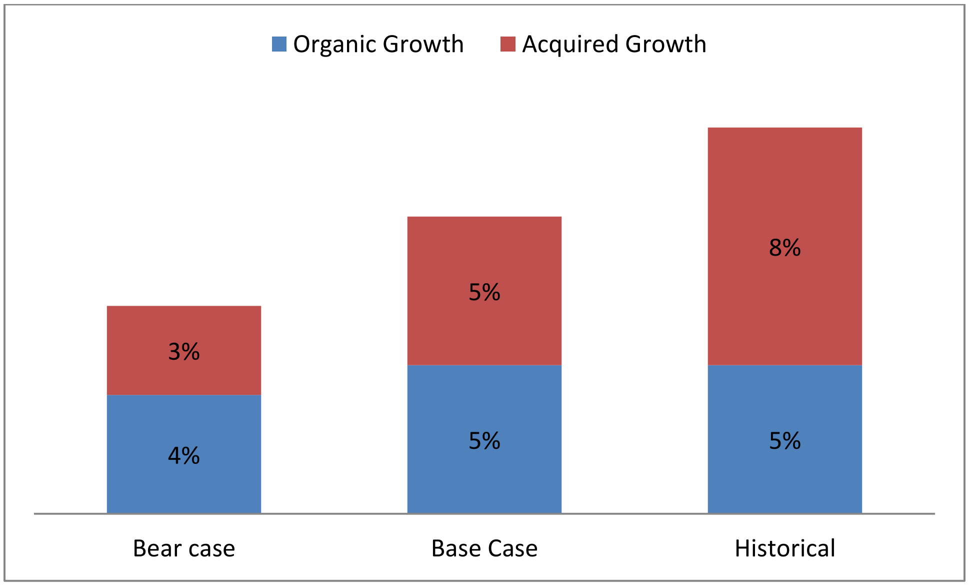
If you took this chart and went all the way back for 10 and 15 years through interest rates going up and interest rates going down, you would see the same thing. You would see that our net interest margin has always been maintained at around a 4% net interest margin -- some higher, some lower depending on how you go. So we have been able to navigate through low interest rates and high interest rates at the same time." – David Zalman, Prosperity's CEO, KBW Community Bank Conference, 02 August 2011

[3] "We compete for deposits by offering a broad range of products and services to our customers. While this includes offering competitive interest rates and fees, the primary means of competing for deposits is convenience and service to our customers. However, **our strategy to provide service and convenience to customers does not include a large branch network. Our bank offers thirteen banking centers, courier services and online banking. BankDirect, the Internet division of our bank, serves its customers on a 24 hours-a-day, 7 days-a-week basis solely through Internet banking.**" – Texas Capital's 2014 Annual Report

[4] "**Our bank sources a significant volume of its demand deposits from financial services companies, mortgage finance customers and other commercial sources, resulting in a larger percentage of larger deposits and a smaller number of sources of deposits than would be typical of other banks in our markets**. **In recent periods over half of our total deposits have been attributable to customers whose balances exceed the $250,000 FDIC insurance limit**. Many of these customers actively monitor our financial condition and results of operations and could withdraw their deposits quickly upon the occurrence of a material adverse development affecting our bank. **One potential source of liquidity for our bank consists of "brokered deposits" arranged by brokers acting as intermediaries, typically larger money-center financial institutions**. We receive deposits provided by certain of our customers in connection with our delivery of other financial services to them or their customers which are subject to the regulatory classification of "brokered deposits" even though we consider these to be relationship deposits and they are not subject to the typical risks or market pricing associated with conventional brokered deposits." – Texas Capital 2014 Annual Report

Growth

Prosperity Can Grow Deposit per Share by 7-10% While Maintaining 35-55% Dividend Payout Ratio



Past deposit per share growth was about 13%, consisting of 5% organic growth and 8% acquired growth

- **Biggest Negative**:
    - Deposit per share growth of more than 12% will require share issuances
- Texas has **1%** higher growth than the U.S.
    - A diversified economy
        - Energy is just 11% of the economy
    - 11th largest economy in the world
        - $1.6 trillion GDP
    - Texas is a pro-business state
        - No state tax
    - Texas has great infrastructure[1]
        - A lot of raw land
            - Population density is 103.1 people per square mile
                - Ranks 26 in the U.S.
        - Easy access to the cities
        - Didn't have a housing bubble[2]
            - The % of homes were affordable to median income families
                - In Los Angeles

        - 1999: 64%
        - 2006: 2%
    - In Dallas
        - 1999: 66%
        - 2006: 64%
  - Texas population is 27 million in 2014
    - Has grown **2.34%** annually since 1950
      - 7.7 million in 1950
    - Has grown **1.94%** annually since 1990
      - 17 million in 1990
    - About **1%** higher than the U.S.
      - Job growth has been 1% higher than the U.S. for 30 years
  - The population is projected to double by 2050[3]
    - To 54 million
    - => about **2%** growth
  - => Texas's economic growth continues to outpace the U.S.
- The banking industry should match GDP growth in the long run
  - Total deposits in Texas grew 7.1% annually over the last 22 years
    - 1994: $173 billion
    - 2015: $730 billion
- Expectation for deposit growth in Texas: **6%**
- Prosperity has grown impressively
  - Deposit grew 25% annually over the last 21 years
    - 1994: $198 million
    - 2014: $16,6980 million
  - Growth was very consistent
    - There were only 3 years with growth of less than 14%
    - There were 16 5-year periods
      - Min CAGR of these periods were 16%
    - There were 11 10-year periods
      - Min CAGR of these periods were 22%
- Prosperity's growth comes from
  - Organic growth
  - Acquisition
    - Prosperity prefers making acquisitions over opening new branches[4]
      - It takes 3-5 years for a new branch gets $20 million deposits
      - It's faster to grow through acquisition

- Potential organic growth: **5%**
  - 20-year organic growth in deposits was 4-6%[5]
    - Prosperity opened few branches
    - => 4-6% is a very good organic performance
      - Deposit per office of all banks in Texas grew about 3-4% annually
        - 3% between 1994 and 2007
          - 1994: $45 million
          - 2007: $68 million
        - 4.3% between 1994 and 2015
          - 1994: $45 million
          - 2015: $108 million
  - Prosperity should have organic growth potential like Frost
    - Prosperity is similar to Frost
    - Prosperity is the second biggest Texas-based bank in Texas
      - Large banks focus on large customers
      - Prosperity and Frost focuses on smaller customers
      - Prosperity has products the big guys have[6]
        - Treasury management
        - Trust company
    - Prosperity has great customer service
      - 3-point service commitment[7]
        - Greet customers with a smile
        - Address customers by name
        - Try to say yes instead of no
      - There's no call center
        - Customers call directly to branches
          - And works with bankers in the branches
      - Prosperity's lenders have close relationship with customers[8]
        - Can do anything and everything that customers wants
        - Lending isn't siloed up
          - No CRE department
          - No C&I department
          - No residential mortgage department
          - No construction department
        - Prosperity looks for lenders who are generalists[9]
          - Fit into Prosperity's model
        - Encourages loan producers to get out of their chairs[10]

            - Meet with existing customers and potential customers
        - Tries to know customers[11]
            - Not be just a transaction account
            - Want to know who you are
            - Want to know your kids
            - Want to know everything about you
        - Even know the customers' customers[12]
  - Acquisition is still Prosperity's priority in foreseeable future
    - Let's assume **5%** organic growth
    - Prosperity must retain **20-25%** of earnings for 5% organic growth
      - After-tax return on tangible equity is 20-25%
- Acquisition can contributes at least **3-5%** growth
  - At current size, acquiring a bank with $1 billion asset will add 5% growth
  - If Prosperity grows 10% annually for the next 10 years
    - Acquiring $2.5 billion asset will still add 5% growth in 2026
  - To have 10% annual growth in earning assets
    - Consists of
      - 5% organic growth
      - 5% acquired growth
    - Prosperity needs to acquire $15 billion assets in the next **10 years**
      - About **150%** of total assets Prosperity acquired since 2012
        - $10.3 billion
    - 5% acquired growth in deposits requires retaining **25%** of earnings
      - Prosperity can make more than 2.4% pre-tax return on deposits
        - 19-year average: 2.41%
        - 5-year average: 2.68%
      - => pre-tax earnings is more than 2.4% of deposits
        - After-tax earnings is more than **1.56%** of deposits
      - Prosperity pays about 11-12% core deposit premium
        - Makes about 20% pre-tax return on investment
          - **13%** after-tax
      - => 5% acquired growth requires investment of **0.55-0.60%** of deposits
        - => less than **40%** of earnings
  - To have 7% annual growth in earning assets
    - Consists of

            - 4% organic growth
            - 3% acquired growth
        - Prosperity needs to acquire $8 billion assets in the next **10 years**
            - Less than
            - About **80%** of total assets Prosperity acquired since 2012
        - 3% acquired growth in deposits requires retaining **25%** of earnings
            - Earnings is more than **2.4%** of deposits
            - Prosperity pays about 11-12% core deposit premium
            - => 3% acquired growth requires investment of **0.33-0.36%** of deposits
                - => less than **25%** of earnings
    - 3-5% acquired growth is very realistic
        - 53 banks in Texas and Oklahoma have assets greater than $1 billion
        - Prosperity has only 2% deposit market share in Texas
            - Top 10 banks in Texas has 62% market share
        - Prosperity is the first guy to call if you want to sell a bank[13]
            - (In Texas or Oklahoma)
            - Maybe Frost
                - But Frost said maybe that's not what they want to do
    - Prosperity wants to increase assets in M&A by at least 10% a year[14]
- For **10%** annual growth, Prosperity needs to retain **65%** of earnings
    - 25% for 5% organic growth
    - 40% for 5% acquired growth
- For **7%** annual growth, Prosperity needs to retain **45%** of earnings
    - 20% for 4% organic growth
    - 25% for 3% acquired growth
- Growth more than 11.5% requires dilution
    - Current dividend payout: 25%
    - Prosperity needs to retain 25% for **5%** organic growth
    - => 50% of earnings is available for making acquisitions
        - Can get about **6.5%** growth
- Realistic expectation:
    - **7-10%** long-term deposit growth per share
    - **35-55%** dividend payout rate

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[1] "I think we're pretty fortunate to be in Texas. If you will look, **we don't have the escalation that the rest of the nation, particularly East and West Coast, and it's**

really from the simple fact that we have more raw land and it's easily accessed. You can commute easily into the big cities. So that's helped hold the costs down." – Dick Evans, Frost's CEO, 2006 Q1 Earning Call Transcript

[2] "To give you an idea of home affordability in Texas versus other areas of the country, **in Los Angeles in 1999, 43% of the homes were affordable to median income families, but only 2% at the end of 2006. Comparing that with Texas and Dallas in 1999, 64% of the homes were affordable. By 2006, the percentage had barely slipped to 62%**. In Austin, home prices actually became more affordable over this period of time in contrast to the U.S. as a whole. At this time, we don't see any other trends and homebuilders appear to be manageable." – Dick Evans, Frost's CEO, 2008 Q1 Earning Call Transcript

[3] "Texas' population is projected to double by 2050, **according to a report from Texas' Office of the State Demographer.**

According to the report, **Texas' population, currently estimated to be 26,230,098 residents, will grow to 54,446,355 residents by 2050**." - *Texas to see explosive growth: Population to double by 2050*, Michael Theis, Austin Business Journal, 06 March 2015

[4] "Many banks open de novo branches. **We've done a couple of de novo locations as well, but we prefer to buy whole banks**. It just seems that for us it has worked a lot better to buy banks and try to retain existing management. **That has been a lot faster as an expansion method for us. When you start a de novo location it's more of a slow process, it usually takes three to five years just to get up to maybe $20 million in deposits and loans**. We have found that we would really like all of our locations ' and they're not all there ' to grow to somewhere between $40 and $60 million. In summary, **we have found that it's a lot faster to acquire banks, rather than starting up new locations.**" – David Zalman, The Wall Street Transcript Interview, 25 September 2001

[5] "**So historically, on an organic basis, we've grown about 8% to 9% organically on loans and 4% to 6% on deposits, and that's over a 20-year average history.**" – David Zalman, KBW Regional Bank Conference, 26 February 2014

[6] "Well, for us at the size that we are at today -- and **not that we make these kinds of loans, but we have a loan limit that exceeds over $100 million**. So the customer, **we can grow with the customer. We have the products the big guys have. We have the treasury management, the cash management. And also, a lot of times as your business is growing, you need a -- you need some -- probably one of the things that we find most interesting is they have a profit-sharing plan or a**

pension plan, and need someone to manage that. And so we have a trust company that can do that also." – David Zalman, Prosperity's CEO, KBW Community Bank Conference, 29 July 2014

[7] "We remain committed to relationship banking with true customer service. With **our three-point service commitment of greet the customer with a smile, address the customer by name and try to say yes instead of no**, we will continue to create long-term customer relationships and value for our shareholders." – David Zalman, Prosperity's CEO, 2004 Q3 Earnings Transcript

[8] "We are looking for a relationship lender. You heard Tim talk about it on the one-to-four family side. You heard David talk about it when he was talking about rates a little earlier.

We want the lenders that have relationships with their customer, and that lender can do anything and everything that that customer wants. Remember, we are still not siloed up. We don't have a CRE department and a C&I department and a one-to-four family department and a construction department. **We have a lender, and that lender can take care of whatever he needs to help you take care of.**

He may need to get some assistance from other folks in our Company. But that lender is going to be your primary relationship, and he is going to take care of everything you need.

That appeals to a lot of lenders out there today. That is why I think, David, in this quarter I think we added four or five lenders in the quarter spread out across the state. " – Dan Rollins, Senior Vice President, Prosperity Bancshares, 2011 Q3 Earnings Transcript

[9] "I think if you're looking at the staffing levels, we have hired -- I don't know how many lenders this quarter -- five or six probably. And when you look at where we are hiring from, and not just this quarter, but if you go back two or three quarters, we have hired some from Whitney, we have hired some from Compass, we have hired some from Sterling. We have hired some from lots of little community banks. So you wouldn't recognize a lot of them.

We are typically looking for the lender that can fit into our model, which is a generalist that wants to play in the game that we like to play. So as David says, we are not out trying to raid a big team and bring a big group of people over here to change our process. That is not us. We are looking for the one-off guy that can fit in the model." – Dan Rollins, Senior Vice President, Prosperity Bancshares, 2011 Q1 Earnings Transcript

[10] "We have had numerous meetings with all of our loan people throughout the state. **We have emphasized the need for the growth in quality loans, and I underscore quality**. I don't think that our approval process has gotten any weaker. I think we're looking at loans the same way we always have. We typically have a disciplined process in everything that we do, and that's certainly the case when it comes to loan approvals. **We're encouraging our people to get out of their chairs, get out of the marketplace, meet with existing customers and potential customers and bring business in** and I think that renewed focus and that level of encouragement that we give them is showing that it is paying dividends." – David Zalman, Prosperity's CEO, 2010 Q4 Earnings Transcript

[11] "I would say also that, again, we are not a bank that deals directly based on transactions. If -- I would say we're not the **-- we're never charging the highest price on or paying the most on a CD; we're not charging the lowest on a loan. But what we try to do is we try to really know our customer and not be just a transaction account.**

We really want to know who you are. We want to know your kids. We want to know everything about you. Again, we are not going to try to just bid on a big share of national credit just to get your business and operate off a very thin margin. That's just not the way we operate." – David Zalman, Prosperity's CEO, KBW Community Bank Conference, 29 July 2014

[12] "We know the business in the state. Our people have been there a long time. We know probably the business, I would say, better than anybody else that -- over there. **And I think, because we've been there so long, we know the customers. We even know the customers' customers. So we think we do a really good job**." – David Zalman, Prosperity's CEO, KBW Community Bank Conference, 29 July 2014

[13] "Really the people that want to join us, we have people -- again, we don't want to brag or anything. But I think **if you really want to sell your bank in Texas or Oklahoma, we are going to be the first guys you are going to come to. Maybe Frost, but Frost has said maybe that's not what they want to do**. So we are probably the Company that you're going to come from." – David Zalman, Prosperity's CEO, KBW Regional Bank Conference 25 February 2015

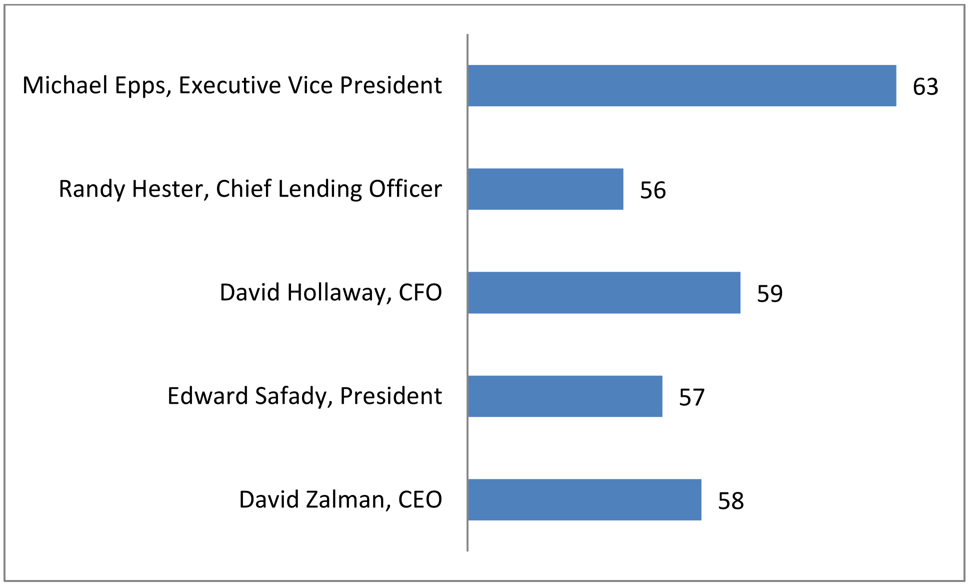
[14] "M&A, we are going to -- again, **if we are in Oklahoma, we are in Texas, surrounding states like Louisiana and things that are contiguous to us. We were only, before we went into Oklahoma, 10 miles away from the Oklahoma border. We're probably still only 10 miles from the Louisiana border.**

We like Texas. We still think there is a preference here in Texas and if we can build in Oklahoma that would be a preference too.

I think if you are going to see us, there will be more opportunities. I don't know that we'll land the well deals that we would like to deal. **But our goal is to increase our assets in M&A by at least 10% of our assets a year which would be around $2 billion. But that might be made up of one or two acquisitions a year.**” – David Zalman, Prosperity’s CEO, 2015 Q2 Earnings Transcript

Misjudgment

Culture Continuity Is Unclear but Prosperity's Management Is Relatively Young



Key executives are about 60 years old

- **Biggest Negative**:
  - Culture continuity is unclear
- Prosperity's management has a great record of controlling risk in the loan portfolio
  - Average net charge-offs was only **0.13%** over the last 21 years
  - Prosperity might benefit from being in Texas
    - 75-80% of the loan portfolio is real estate loans
    - Texas didn't have a big housing bubble over the period
  - But Prosperity had lower charge-offs than other banks
    - Its net charge-offs was only
      - 2008: 0.23%
      - 2009: 0.40%
      - 2010: 0.41%
      - 2011: 0.14%
    - Frost's net charge-offs was a bit higher
      - 2008: 0.24%
      - 2009: 0.58%
      - 2010: 0.52%
      - 2011: 0.54%
  - Prosperity also thrived throughout the 1980s crisis

        - Prosperity was formed in 1983
            - To acquire the former Allied Bank in Edna, Texas
        - 1983 was still a high time in Texas
            - Only 3 banks failed in 1983
        - The crisis really started around 1986
            - The number of bank failures increased to 175
            - 506 banks failed between 1982 and 1992
        - Prosperity took opportunity to acquire failed banks[1]
            - Prosperity has been profitable in every year of its existence
        - Grew assets by 10 times between 1988 and 1998
            - Total assets were
                - 1988: $40 million
                - 1994: $224 million
                - 1998: $436 million
- Prosperity's lending standard remained consistent despite many acquisitions
    - Usually asks the acquired banks to exit some loans as part of a deal
    - Prosperity usually looks at up to 90% of loan portfolio of an acquired target[2]
        - Always try to outsource or exit some of the loans
            - Even if they're performing
    - Bought $500 million deposits from First Bank[3]
        - But got only $100 million loans
        - Similarly bought failed banks in 1980s
    - Asked American State Bank to sell long-term bond before acquiring[4]
        - They sold $500 million
    - PB usually exit some types of loans that an acquired bank make[5]
        - Usually see 15-20% decrease in loans in a 1- or 2-year period after the acquisition
    - Reduced loans at First Victoria and F&M by 15%[6]
        - PB doesn't like some loans
- Loan size remains small despite astronomical growth
    - Average loan size is just about $150,000
- Prosperity only make loans when it's more profitable than buying bond
    - Prosperity consider additional cost for loans
        - Cost of additional risk
            - Wouldn't make loans at LIBOR + 1.5%[7]
                - It can buy bonds for the same yield
                    - And don't have the risk

        - Cost of hiring lenders[8]
            - A lot of companies are paying $50,000 to $70,000
                - Add the unemployment tax and the 401(k)
                - => really paying $100,000 a year
            - If that person can produce $10 million
                - => not even break even for the bank
            - Prosperity either
                - Buy investments: 3-year duration bonds, or
                - Go into the loans
                    - Hopefully floating loan
                        - Or fixed rates with 1% more than bond
                    - $10 million generates $100,000 additional revenue
                        - => just break even
            - => Prosperity try to find really good producers
                - Won't try to hire many
                - Reward handsomely people who really perform
            - Prosperity doesn't hire 15 loan producers at time[9]
                - Hire one person at a time
            - Prosperity has young lenders mentored by experienced lenders
- The management has been consistent
    - Management's interests are aligned with shareholders
        - Management owns **6%** of Prosperity
        - Over 75% of net worth of most of the management team is tied up in Prosperity's stock[10]
    - The management committee consist of 30 people
        - All have 20-30 years of experience in banking
    - Top executives have been with Prosperity for a long time
        - David Zalman
            - Joined Prosperity in 1986
                - As President
            - Has been Chairman and CEO since 2001
            - Before joining Prosperity
                - 1978 – 1986: Commercial State Bank
                    - In El Campo
                    - He started as a cashier
                    - And rose to become CEO
        - Randy Hester

            - Joined Prosperity in 1991
                - As Banking Center President
            - Has been Chief Lending Officer since 2001
            - Before joining Prosperity
                - 1978 – 1984: worked for Windsor Park Bank
                    - In San Antonio
                    - As a consumer lender
                - 1984 – 1989: First National Bank
                    - In Kerrville
                    - Was a commercial lender
        - David Hollaway
            - Joined Prosperity in 1992
                - As Senior Vice President
            - Was appointed CFO in 1998
        - H.E. Timanus
            - Vice Chairman and COO
            - Has been a director since 2001
            - 1986 – 2001: President and CEO of Commercial Bancshares
                - Commercial merged with Prosperity in 2001
- Prosperity is a safe bank to own under current management
    - It's unclear about continuity of its conservative culture
    - But Prosperity's management is still relatively young
        - David Zalman: 58 years old
            - (CEO)
        - David Hollaway: 59 years old
            - (CFO)
        - Randy Hester: 56 years old
            - (Chief Lending Officer)

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[1] "Operating under a community banking philosophy, **the Company seeks to develop broad customer relationships based on service and convenience while maintaining its conservative approach to lending and strong asset quality**. The Company has grown through a combination of internal growth, the acquisition of community banks, branches of banks and the opening of new banking centers. **Utilizing a low cost of funds and employing stringent cost controls, the Company has been profitable in every full year of its existence**, including the period of adverse economic conditions in Texas in the late 1980s. **From 1988 to 1992, as a**

sound and profitable institution, the Company took advantage of this economic downturn and acquired the deposits and certain assets of failed banks in West Columbia, El Campo and Cuero, Texas and two failed banks in Houston, which diversified the Company's franchise and increased its core deposits. The Company opened a full-service Banking Center in Victoria, Texas in 1993 and the following year established a Banking Center in Bay City, Texas. The Company expanded its Bay City presence in 1996 with the acquisition of an additional branch location from Norwest Bank Texas, and in 1997, the Company acquired the Angleton, Texas branch of Wells Fargo Bank. In 1998, the Company enhanced its West Columbia Banking Center with the purchase of a commercial bank branch located in West Columbia and acquired Union State Bank in East Bernard, Texas." – Prosperity's 2001 10-K

[2] "Again, we mentioned about we have a lot of acquisitions and one of the things that's unique to Prosperity is as we buy these banks and take them down and, I should point this out, in the M&A we send in our own team to do due diligence on that loan portfolio. **It's our own team that will look at up to 90% of that portfolio and once they view that; as part of the transaction, it's our intent a lot of times to try to outsource or exit some of those loans**. It's performing, but in our eyes could it sustain itself over different economic cycles and we can use a very specific example. **Our last transaction was an entity called F&M Bank out of Tulsa, it's a $2.4 billion ban**k. But when we went into it and we closed this thing about a year ago in 2014, **we knew that it wasn't a $2.4 billion bank after our due diligence.**

This was a bank that was started in the 1940s, but they grew rapidly over the last few years and the way this bank grew in new places and a lot of other stories; they hired a lot of lenders out of another institution, paid them a lot of extra money to bring them over, and they bought discounted loans to bring the loans over with some, then they paid up on deposits. **So this $2.4 billion bank ends up being maybe a $1.8 billion bank and when we bought it, the price that we paid was based on it being a $1.8 billion bank and so what happens is we need to come in and start cleaning up that portfolio**. So when you look at our loan numbers, if you're pulling our press release or our quarter release, **you'll see our loans coming down; but that's being impacted by this acquisition. We're going to need to clean it up and so we say we'd probably outsource roughly $400 million loans**." – David Hollaway, Prosperity's CFO, KBW Community Bank Conference, 28 July 2015

[3] "Our loan growth probably needs a little bit of explanation. Today we have a very low loan-to-deposit ratio, probably a little bit below 50%, but if you go back to 2008 you can see -- in 2007 we were at about 65%. In 2007 or at the end of 2008 we bought the failed Franklin Bank from the FDIC. And again that was about $2 billion in deposits; we really didn't have any loans at the time that came along with it.

Then in 2009 and 2010 First Bank out of Missouri they had -- again, they were trying to sell off some of their locations in the Houston/Dallas metro market so **we bought about $500 million of their deposits and only got about $100 million in loans at that time**. We also bought three banks from US Bank who acquired three banks in Texas through a failed transaction that was related to a Chicago firm. So we got $500 million there.

So you can see that we got a lot of deposits and we didn't have a whole lot of loans. But again this is not unusual for us. In the '80s we bought a lot of failed banks and again our loan-to-deposit ratio fell this low and it took us three to four years to build our loan to deposit ratio back up to about 65%. A lot of banks would think 65% is low, but again our bank that is probably a target for us 65% to 70%." – David Zalman, Prosperity's CEO, KBW Community Bank Conference, 02 August 2011

[4] "We pre-bought a lot, but again a lot of this was in preparation for the merger with American State Bank. So, a lot of it depends -- they have repositioned some of their portfolio, so -- **they had some longer-term bonds that really hadn't -- real final maturities of as much as 10 and 11 years**, **and it really didn't fit necessarily in our portfolio.**

So, we had asked them to sell them before they closed, and they did. So, in essence they bought about -- they sold about $500 million, and they just bought some real short-term treasury bills that actually mature next month. So, right now our balance sheet looks a little beefed up with additional bonds that were bought, but again, once we merge these two banks together, it will stabilize and we'll be back where we are at." – David Zalman, Prosperity's CEO, 2012 Q2 Earnings Transcript

[5] "I would answer that and say that it's not unusual that whenever we merge with another bank, that we do see a reduction in loan dollar amounts. **It's just simply loans that we might have identified that they may not typically fit our model**, or something like that. **It's not unusual to see as much over a year or two-year period, as much as a 15% to 20% decrease in the loans that a bank that joins us may have before they start picking back up.**" – David Hollaway, Prosperity's CFO, 2013 Q2 Earnings Transcript

[6] "**When you look at First Victoria and you look at F&M bank as they come on, again, I think in the first year you could have anywhere from 10% to 20%, maybe 15% just because the kind of loans that they may had that we may want or not want**. You may see those gone. So I think in our history that's just it is what it is, I would say." – David Zalman, 2013 Q3 Earnings Transcript

[7] "Jon Arfstrom, Analyst: Okay. Maybe for you, David Zalman, or Tim, just that there has been a little discussion on the SNC portfolio of F&M. **As you become a larger Bank,**

just what kind of comfort or appetite do you have for some of the larger loan opportunities that are out there in Texas?

David Zalman, Prosperity's CEO: As referred to Shared National Credits or just overall loans?

Jon Arfstrom, Analyst: I would say overall larger loans in general. You could touch on Shared National Credits as well, but I am more interested in just larger -- comfort for you with larger loans.

David Zalman, Prosperity's CEO: Well, it is probably not by design, but **I do sit at Loan Committee and now we don't see loans in there unless they are over $3.5 million. I would have to say that loans, because of our size, are just naturally getting larger**.

We are seeing larger and larger credits. Again I don't know that we are making [NHU's] credits, but overall you'd have to say because of our size that loans are getting bigger, and we have to adapt to that.

With regard to the Shared National Credits, it will take us some time, if we ever get used to Shared National Credit as much. It won't mean that we won't do them; but again, it would have to be major companies with good, good transparent numbers that we can really rely on and something like that. It won't be to all the mom-and-pop-shop types of Shared National Credits.

Tim Timanus, Prosperity's Vice Chairman: I would add that, I guess on a historical basis, we have done a few. We all know it has not been many, but we have done a few.

And the ones that we have done have virtually, I believe 100% of them, been to credits that we had in the Bank anyway. They may have been a Shared National Credit, but we had a relationship in several of these cases with the owner or owners of the business. So it wasn't totally arm's-length, in other words.

David Zalman, Prosperity's CEO: **I think a lot of it, though, Jon, too, is the pricing issue. If the pricing ever got realistic in some cases where it is worth the risk, we may be in more favor of them**.

But again when you are pricing some of these things at LIBOR plus 1.5, we can almost buy security and be about the same there and not have the risk. So if those things change or improve, we may be more open to that also." – Prosperity 2014 Q1 Earnings Transcript

[8] "Scott Alaniz, Analyst, Sandler O'Neill: Good morning, gentlemen. A few questions. First relates to the level of expansion that is going on in Dallas and Houston by a number of banks. And what I want to know is -- obviously, when banks come into a market, there's only so many quality bankers in a particular market. And I would like to know what steps Prosperity has taken, or is taking, to lock up its employees, if you will. And secondly, I would like to know if you all are beginning to see some wage inflation or an acceleration in wage inflation in either Houston or Dallas, and sort of where you may be seeing the most of that, if any at all?

Unidentified Speaker: We will probably all take a stab at that. David do you want to go first?

David Zalman, Prosperity's CEO: Yes, I can probably answer that, or at least start off with that. A lot of our associates -- first of all, let me say this -- there are a lot of bankers out there. And I think there are a lot of banks that probably consider hiring people, and they change from job to job. But **I think that there are only really -- there are a handful of what we consider really good bankers out there**. And I think you have to make a decision on the type of bankers that you're going to recruit. **A lot of the companies that are coming in, for example, are hiring somebody at the 50 to $70,000 level. And our experience at that level, a lot of times, is that -- for us, if you're paying somebody 50 to $70,000, by the time you add the unemployment tax and the 401(k)s and all that, you're really paying that person probably $100,000 a year. If that person can only produce $10 million for you, that's probably not even breaking even for the bank**. How we base that is that, I usually say we buy investments or we can go into the loans. **Usually, our investments are bond investments and have about a three year duration. And if you go into a loan -- hopefully, you're going to have a floating loan, and hopefully, if you lock, then you're going to have about 100 basis points more. So on 10 million, that would generate the bank 100,000. So, instead of us going out and trying to hire -- I'm not going to say subpar. We try to find the people that are really good producers**, and we probably don't have as many. But the ones that we have are extremely good." – Prosperity 2004 Q1 Earnings Transcript

[9] "Michael Rose, Analyst, Raymond James: Good morning, guys. Just had a question on market share opportunities. With the big banks maybe getting a little bit more stable here, is it getting harder to move market share or lenders or things like that? Are you guys actually looking to hire lenders? Any commentary there would be helpful. Thanks.

David Zalman, Prosperity's CEO: You know, I think really that has been happening over the last couple of years. I think your larger banks have seen a lot more stability and you are not seeing a whole lot run off from there.

I think you are seeing probably more people moving around from acquisitions than probably anything else. You have pretty big acquisitions with Sterling and Comerica –

Dan Rollins, Prosperity's SVP: Or problem banks.

David Zalman, Prosperity's CEO: Or problem banks. So I think you are seeing more people. But we are still -- again, **we are not the kind of guys that really go out and hire 15 bankers at one time**. I know there are some people that do that.

We are really more of a onesies and twosies. We continue every month -- I would say monthly -- picking up one or two people every month that are really quality people. But again we are doing it one person at a time.

Dan Rollins, Prosperity's SVP: I have been intimately involved in that process, Mike, and David is exactly right**. We have hired a new senior lender just in the last month that joined us in Dallas. We have got another lender coming on here in Houston. Some of these are coming out of the bigger banks that want to play in a more community bank environment like we provide to them**. We have hired some folks in the Central Texas market that are coming out of some more community banks that the banks might be not in as healthy shape as they want to be, and the lenders aren't happy.

But David is exactly right. We are looking for a relationship lender. You heard Tim talk about it on the one-to-four family side. You heard David talk about it when he was talking about rates a little earlier.

We want the lenders that have relationships with their customer, and that lender can do anything and everything that that customer wants. Remember, we are still not siloed up. We don't have a CRE department and a C&I department and a one-to-four family department and a construction department. We have a lender, and that lender can take care of whatever he needs to help you take care of.

He may need to get some assistance from other folks in our Company. But **that lender is going to be your primary relationship, and he is going to take care of everything you need.**

That appeals to a lot of lenders out there today. That is why I think, David, in this quarter I think we added four or five lenders in the quarter spread out across the state. We also had a couple retirements. When you look back over the last quarter we had two people this quarter that had both been with our Bank or a predecessor through an acquisition for 30-plus years that just through the natural life occurrences decided it was time to retire. So we have lost a few folks on the retirement side, but we are still hiring good lenders to join our team.

<u>Michael Rose, Analyst, Raymond James</u>: Well, just as a follow-up to that, has there been any change in the complexion of the loan officers that you are hiring? I.e., do they have bigger books of business? Are they doing bigger loans? Or as it similar to what you have done historically?

<u>Dan Rollins, Prosperity's SVP</u>: No, we are not looking to change stripes. I think one of the things we have been very consistent at -- **the level of insider ownership that we carry here, we have been very consistent in our model**.

We like community bankers. We certainly want to go after the bigger customers, and we like those bigger customers. **But we are not actively soliciting somebody that only makes loans of $30 million or more, or somebody that only does a certain type of loan. We are looking for the relationships**.

And the size of the book that a lender can bring to the table typically is dependent upon their tenure in the business and their experience level. So **if we are hiring somebody that is younger and hasn't been in banking more than 10 years, our expectation is that they are not going to have a $100 million book to move over with them**. If we are hiring somebody that is more experienced and more tenured in the banking industry, then the expectation would be that they would bring a larger book with them. And quite frankly, they demand a larger salary to come with that.

<u>David Zalman, Prosperity's CEO</u>: One of the bright spots that I see, Dan, and we don't talk about it a lot. A few years ago we didn't, but **we started an analyst program where we are bringing in a number of young people**. I see all the young people we are training. I don't know [how many] in the program. **There's nine right now.**

Again, they are coming out into the field in Dallas and Houston and Austin, all parts of Texas, Corpus, and **they are really helping the lenders that are really mature lenders that have been around for a long time, that their books have been built up so much.**

So these more mature lenders are really sharing their knowledge with a lot of the younger lenders. And they have a lot of pee and vinegar, and I think they are willing to get out there.

And I look at that as a bright spot. **We have a lot of younger people from the colleges that are really trying to get into our program. It's just the number of people we can accept at any one time**.

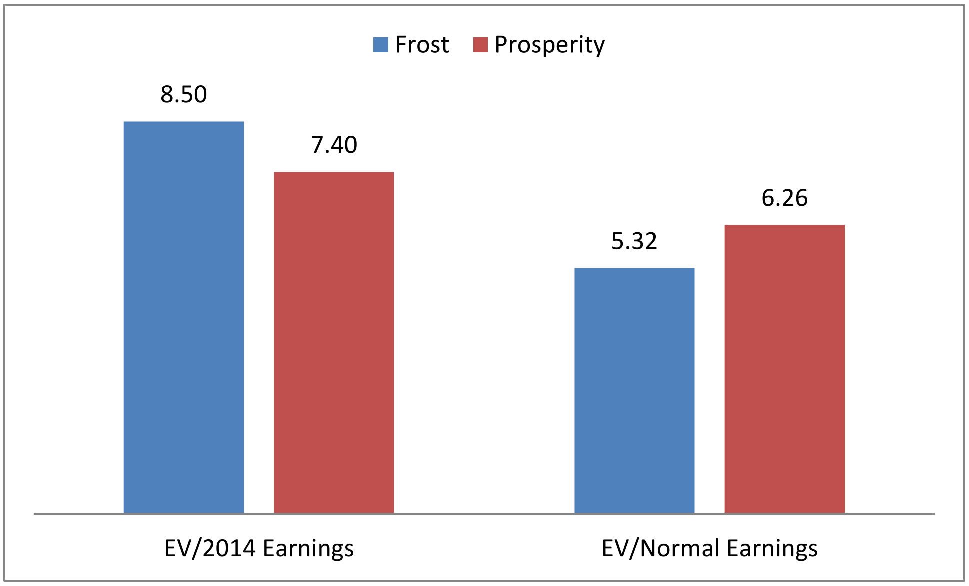
Dan Rollins, Prosperity's SVP: Yes, C**hris Bagley runs that for us and is our Chief Credit Officer, and we have had some great successes. We have got three or four or five lenders that have come out of that program that are doing a great job for us across the space.**" – Prosperity's 2011 Q3 Earnings Transcript

[10] "I think **the other thing that's really unique for us is that our management team, what I consider our executive committee, the majority of our net worth, I would say 75%-plus for most of us, is tied up in Prosperity Bancshares stock. And so I think that we are aligned with the investor**. We are not here just as management people, and trying to make money and the highest salary that we can. Our real reward comes basically when you as shareholders do good, we as shareholders do good at the same time.

I would also say that if you look at our top management team, our executive committee, and **our management committee, which consists of about 30 people, I think that all of them have 20 to 30 years of experience, if not with us, with the banks that have joined us**. So we have a very experienced group of people." – David Zalman, KBW Community Bank Conference, 29 July 2014

Conclusions

Prosperity and Frost Can Form a Great Bank Stock Portfolio



Prosperity is currently cheaper than Frost, but has low upside if interest rates increase

- **Biggest Negative**:
  - Prosperity doesn't have huge upside if interest rates increase
- Capital allocation can give investors 15% long-term return
  - Organic growth has 30-40% Pre-tax Return on Tangible Equity
    - Or **19-25%** After-tax Return on Tangible Equity
  - Acquired growth has about **13%** after-tax return on investment
  - => the average return on retained earnings should be **15%** or more
  - Return on dividends depends on how investors reinvest dividends
- Current price is great
  - $48 per share
  - **2.5%** dividend yield
  - Diluted EPS grew 12% annually since 2007
    - 2007: $1.92 per share
    - 2014: $4.32 per share
    - Despite headwind in interest rates
      - Daily average Fed funds declined
        - 2007: 5.02%
        - 2014: 0.09%
  - **7-10%** annual deposit per share growth is very realistic

        - In this case, dividend payout rate will be 35-55%
            - Increase by 50-100% from current level
                - Current payout rate is just 23%
    - Prosperity isn't only cheap based on its normal earnings
        - But also cheap based on current earnings
            - **7.4x** 2014 EBT
            - Or **11.4** P/E
- There's no obvious reasons why Prosperity is cheap
    - There can be some (unreasonable) reason for Frost's low price
        - Energy loans are 15% of Frost's loan portfolio
        - Frost's current P/E is around 14x
            - Frost's is very sensitive to interest rates
            - It's very cheap if interest rates increase
            - But interest rate can stay low for a while
    - These reasons aren't valid for Prosperity
        - Energy loans are only **5.5%** of Prosperity's loan portfolio
            - **2.7%** of earning assets
        - Prosperity's current P/E is around 11x
            - Prosperity is less sensitive to interest rates
            - Since 2007, diluted EPS grew 12% annually
                - 2007: $1.92 per share
                - 2014: $4.32 per share
- Prosperity and Frost can form a great bank portfolio
    - Frost has the highest upside if interest rates increase
        - But isn't a great investment if interest rates stay low
            - Price is just about 14x last year's earnings
    - Prosperity doesn't have huge upside if interest rates increase
        - Prosperity makes longer term loans
            - Its net interest margin is much more stable than Frost
        - But Prosperity can still be a great investment if interest rates stay low
            - Price is **7.4x** 2014 EBT
            - Or **11.4** P/E