

Hilltop Holdings Inc.
Form 10-Q
October 27, 2016
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2016

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

Commission File Number: 1-31987

Hilltop Holdings Inc.

(Exact name of registrant as specified in its charter)

Maryland
(State or other jurisdiction of incorporation or organization)

84-1477939
(I.R.S. Employer Identification No.)

200 Crescent Court, Suite 1330

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Dallas, TX
(Address of principal executive offices)

75201
(Zip Code)

(214) 855-2177

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes No

The number of shares of the registrant's common stock outstanding at October 27, 2016 was 98,539,056.

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HILLTOP HOLDINGS INC.

FORM 10-Q

FOR THE QUARTER ENDED SEPTEMBER 30, 2016

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HILLTOP HOLDINGS INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(in thousands, except share and per share data)

(Unaudited)

	September 30, 2016	December 31, 2015
Assets		
Cash and due from banks	\$ 528,519	\$ 652,036
Federal funds sold	40,419	17,409
Securities purchased under agreements to resell	138,284	105,660
Assets segregated for regulatory purposes	173,840	158,613
Securities:		
Trading, at fair value	402,104	214,146
Available for sale, at fair value (amortized cost of \$551,827 and \$670,003, respectively)	563,720	673,706
Held to maturity, at amortized cost (fair value of \$369,746 and \$331,468, respectively)	365,934	332,022
	1,331,758	1,219,874
Loans held for sale	1,673,069	1,533,678
Non-covered loans, net of unearned income	5,674,655	5,220,040
Allowance for non-covered loan losses	(52,625)	(45,415)
Non-covered loans, net	5,622,030	5,174,625
Covered loans, net of allowance of \$729 and \$1,532, respectively	292,031	378,762
Broker-dealer and clearing organization receivables	1,340,617	1,362,499
Premises and equipment, net	190,645	200,618
FDIC indemnification asset	73,351	91,648
Covered other real estate owned	61,988	99,090
Other assets	657,805	565,813
Goodwill	251,808	251,808
Other intangible assets, net	47,112	54,868
Total assets	\$ 12,423,276	\$ 11,867,001
Liabilities and Stockholders' Equity		
Deposits:		
Noninterest-bearing	\$ 2,232,813	\$ 2,235,436
Interest-bearing	4,797,772	4,717,247
Total deposits	7,030,585	6,952,683

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Broker-dealer and clearing organization payables	1,251,839	1,338,305
Short-term borrowings	1,265,022	947,373
Securities sold, not yet purchased, at fair value	164,633	130,044
Notes payable	313,313	238,716
Junior subordinated debentures	67,012	67,012
Other liabilities	481,504	454,743
Total liabilities	10,573,908	10,128,876
Commitments and contingencies (see Notes 12 and 13)		
Stockholders' equity:		
Hilltop stockholders' equity:		
Common stock, \$0.01 par value, 125,000,000 shares authorized; 98,540,676 and 98,896,184 shares issued and outstanding, respectively	985	989
Additional paid-in capital	1,570,025	1,577,270
Accumulated other comprehensive income	8,039	2,629
Retained earnings	266,048	155,475
Deferred compensation employee stock trust, net	900	1,034
Employee stock trust (15,496 and 22,196 shares, at cost, respectively)	(309)	(443)
Total Hilltop stockholders' equity	1,845,688	1,736,954
Noncontrolling interests	3,680	1,171
Total stockholders' equity	1,849,368	1,738,125
Total liabilities and stockholders' equity	\$ 12,423,276	\$ 11,867,001

See accompanying notes.

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HILLTOP HOLDINGS INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share data)

(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Interest income:				
Loans, including fees	\$ 97,590	\$ 111,315	\$ 287,591	\$ 295,670
Securities borrowed	9,037	10,116	22,952	29,809
Securities:				
Taxable	5,935	6,262	19,136	19,538
Tax-exempt	1,518	1,683	4,692	4,981
Other	1,183	1,169	3,248	3,878
Total interest income	115,263	130,545	337,619	353,876
Interest expense:				
Deposits	3,996	3,719	11,872	11,934
Securities loaned	6,954	7,110	17,857	21,505
Short-term borrowings	1,497	1,189	3,974	3,356
Notes payable	2,793	2,524	7,993	5,482
Junior subordinated debentures	673	605	1,973	1,785
Other	180	187	543	544
Total interest expense	16,093	15,334	44,212	44,606
Net interest income	99,170	115,211	293,407	309,270
Provision for loan losses	3,990	5,593	36,273	8,438
Net interest income after provision for loan losses	95,180	109,618	257,134	300,832
Noninterest income:				
Net realized gains on securities	—	—	—	4,403
Net gains from sale of loans and other mortgage production income	175,412	137,303	469,721	405,023
Mortgage loan origination fees	26,807	22,647	71,417	58,194
Net insurance premiums earned	38,747	41,196	117,201	121,081
Securities commissions and fees	39,722	39,070	118,481	123,201
Investment and securities advisory fees and commissions	31,129	27,667	84,302	82,254
Bargain purchase gain	—	—	—	81,289
Other	42,641	28,586	116,716	75,270
Total noninterest income	354,458	296,469	977,838	950,715

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Noninterest expense:				
Employees' compensation and benefits	225,194	200,620	625,353	583,415
Loss and loss adjustment expenses	16,055	17,335	75,225	77,436
Policy acquisition and other underwriting expenses	11,064	11,784	33,632	35,198
Occupancy and equipment, net	27,460	29,341	82,264	89,368
Other	84,360	74,422	240,213	215,878
Total noninterest expense	364,133	333,502	1,056,687	1,001,295
Income before income taxes	85,505	72,585	178,285	250,252
Income tax expense	33,017	25,338	65,879	58,895
Net income	52,488	47,247	112,406	191,357
Less: Net income attributable to noncontrolling interest	556	353	1,833	1,111
Income attributable to Hilltop	51,932	46,894	110,573	190,246
Dividends on preferred stock	—	—	—	1,854
Income applicable to Hilltop common stockholders	\$ 51,932	\$ 46,894	\$ 110,573	\$ 188,392
Earnings per common share:				
Basic	\$ 0.53	\$ 0.47	\$ 1.12	\$ 1.89
Diluted	\$ 0.53	\$ 0.47	\$ 1.12	\$ 1.88
Weighted average share information:				
Basic	98,490	98,676	98,367	99,297
Diluted	98,625	99,556	98,573	100,191

See accompanying notes.

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HILLTOP HOLDINGS INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(in thousands)

(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Net income	\$ 52,488	\$ 47,247	\$ 112,406	\$ 191,357
Other comprehensive income:				
Net unrealized gains (losses) on securities available for sale, net of tax of \$(420), \$3,222, \$3,004 and \$3,847, respectively	(743)	5,697	5,410	6,755
Reclassification adjustment for gains included in net income, net of tax of \$(1,589)	—	—	—	(2,814)
Comprehensive income	51,745	52,944	117,816	195,298
Less: comprehensive income attributable to noncontrolling interest	556	353	1,833	1,111
Comprehensive income applicable to Hilltop	\$ 51,189	\$ 52,591	\$ 115,983	\$ 194,187

See accompanying notes.

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HILLTOP HOLDINGS INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

(in thousands)

(Unaudited)

Preferred Stock	Common Stock		Additional	Accumulated	Retained	Deferred	Employee	Total	
Amount	Shares	Amount	Paid-in	Other	Earnings	Compensation	Stock Trust	Hilltop	
			Capital	Comprehensive	(Accumulated	Employee	Shares	Stockholders'	
				Income	Deficit)	Trust,	Amount	Equity	
						Net			
\$ 114,068	90,182	\$ 902	\$ 1,390,788	\$ 651	\$ (45,957)	\$ —	—	\$ —	\$ 1,460,452
—	—	—	—	—	190,246	—	—	—	190,246
—	—	—	—	3,941	—	—	—	—	3,941
—	10,113	101	199,932	—	—	—	—	—	200,033
—	—	—	6,278	—	—	—	—	—	6,278
—	8	—	173	—	—	—	—	—	173
—	(19)	—	(75)	—	—	—	—	—	(75)
—	—	—	—	—	(1,854)	—	—	—	(1,854)
(114,068)	—	—	—	—	—	—	—	—	(114,068)
—	(1,391)	(14)	(22,327)	—	(7,687)	—	—	—	(30,028)
—	—	—	—	—	—	1,182	30	(590)	592
—	—	—	—	—	—	—	—	—	—

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\$ —	98,893	\$ 989	\$ 1,574,769	\$ 4,592	\$ 134,748	\$ 1,182	30	\$ (590)	\$ 1,715,690
\$ —	98,896	\$ 989	\$ 1,577,270	\$ 2,629	\$ 155,475	\$ 1,034	22	\$ (443)	\$ 1,736,954
—	—	—	—	—	110,573	—	—	—	110,573
—	—	—	—	5,410	—	—	—	—	5,410
—	538	5	4,134	—	—	—	—	—	4,139
—	—	—	7,274	—	—	—	—	—	7,274
—	17	—	325	—	—	—	—	—	325
—	(94)	(1)	(2,710)	—	—	—	—	—	(2,711)
—	(816)	(8)	(16,268)	—	—	—	—	—	(16,276)
—	—	—	—	—	—	(134)	(7)	134	—
—	—	—	—	—	—	—	—	—	—
\$ —	98,541	\$ 985	\$ 1,570,025	\$ 8,039	\$ 266,048	\$ 900	15	\$ (309)	\$ 1,845,688

See accompanying notes.

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HILLTOP HOLDINGS INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(Unaudited)

	Nine Months Ended September 30,	
	2016	2015
Operating Activities		
Net income	\$ 112,406	\$ 191,357
Adjustments to reconcile net income to net cash used in operating activities:		
Provision for loan losses	36,273	8,438
Depreciation, amortization and accretion, net	(37,616)	(67,557)
Net realized gains on securities	—	(4,403)
Bargain purchase gain	—	(81,289)
Deferred income taxes	4,878	11,459
Other, net	11,661	(91)
Net change in securities purchased under agreements to resell	(32,624)	(39,148)
Net change in assets segregated for regulatory purposes	(15,227)	29,372
Net change in trading securities	(187,958)	39,367
Net change in broker-dealer and clearing organization receivables	149,674	(680,699)
Net change in FDIC Indemnification Asset	18,486	38,561
Net change in other assets	(50,760)	(90,417)
Net change in broker-dealer and clearing organization payables	(117,398)	708,838
Net change in other liabilities	32,977	3,138
Proceeds from sale of mortgage servicing rights asset	7,586	—
Net gains from sales of loans	(469,721)	(405,023)
Loans originated for sale	(11,995,553)	(10,628,783)
Proceeds from loans sold	12,292,342	10,965,234
Net cash used in operating activities	(240,574)	(1,646)
Investing Activities		
Proceeds from maturities and principal reductions of securities held to maturity	141,485	51,838
Proceeds from sales, maturities and principal reductions of securities available for sale	367,307	599,737
Purchases of securities held to maturity	(175,781)	(167,284)
Purchases of securities available for sale	(250,896)	(22,769)
Net change in loans	(465,542)	16,205
Purchases of premises and equipment and other assets	(31,119)	(23,410)
Proceeds from sales of premises and equipment and other real estate owned	58,490	94,680

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Proceeds from redemption of bank owned life insurance	—	822
Net cash paid for Federal Home Loan Bank and Federal Reserve Bank stock	(6,807)	(9,292)
Net cash from acquisition	—	41,097
Net cash provided by (used in) investing activities	(362,863)	581,624
Financing Activities		
Net change in deposits	108,834	(788,907)
Net change in short-term borrowings	317,649	(16,446)
Proceeds from notes payable	208,794	150,078
Payments on notes payable	(134,052)	(37,787)
Redemption of preferred stock	—	(114,068)
Proceeds from issuance of common stock	4,139	—
Payments to repurchase common stock	—	(30,028)
Dividends paid on preferred stock	—	(3,280)
Net cash distributed from (to) noncontrolling interest	676	(760)
Taxes paid on employee stock awards netting activity	(2,406)	(75)
Other, net	(704)	(227)
Net cash provided by (used in) financing activities	502,930	(841,500)
Net change in cash and cash equivalents	(100,507)	(261,522)
Cash and cash equivalents, beginning of period	669,445	813,075
Cash and cash equivalents, end of period	\$ 568,938	\$ 551,553
Supplemental Disclosures of Cash Flow Information		
Cash paid for interest	\$ 42,399	\$ 41,368
Cash paid for income taxes, net of refunds	\$ 53,899	\$ 112,282
Supplemental Schedule of Non-Cash Activities		
Conversion of loans to other real estate owned	\$ 14,894	\$ 45,996
Common stock issued in acquisition	\$ —	\$ 200,626
Additions to mortgage servicing rights	\$ 20,309	\$ 23,121

See accompanying notes.

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements

(Unaudited)

1. Summary of Significant Accounting and Reporting Policies

Nature of Operations

Hilltop Holdings Inc. (“Hilltop” and, collectively with its subsidiaries, the “Company”) is a financial holding company registered under the Bank Holding Company Act of 1956. The Company’s primary line of business is to provide business and consumer banking services from offices located throughout Texas through PlainsCapital Bank (the “Bank”). In addition, the Company provides an array of financial products and services through its broker-dealer, mortgage origination and insurance subsidiaries.

The Company provides its products and services through three primary subsidiaries, PlainsCapital Corporation (“PlainsCapital”), Hilltop Securities Holdings LLC (“Securities Holdings”) and National Lloyds Corporation (“NLC”). PlainsCapital is a financial holding company, headquartered in Dallas, Texas, that provides, through its subsidiaries, traditional banking, wealth and investment management and treasury management services primarily in Texas and residential mortgage lending throughout the United States. Securities Holdings is a holding company, headquartered in Dallas, Texas, that provides, through its subsidiaries, investment banking and other related financial services, including municipal advisory, sales, trading and underwriting of taxable and tax-exempt fixed income securities, equity trading, clearing, securities lending, structured finance and retail brokerage services throughout the United States. NLC is a property and casualty insurance holding company, headquartered in Waco, Texas, that provides, through its subsidiaries, fire and homeowners insurance to low value dwellings and manufactured homes primarily in Texas and other areas of the southern United States.

On January 1, 2015, Hilltop completed its acquisition of SWS Group, Inc. (“SWS”) in a stock and cash transaction (the “SWS Merger”), whereby SWS’s broker-dealer subsidiaries, Southwest Securities, Inc. and SWS Financial Services, Inc., became subsidiaries of Securities Holdings, and SWS’s banking subsidiary, Southwest Securities, FSB (“SWS FSB”), was merged into the Bank. On October 5, 2015, Southwest Securities, Inc. and SWS Financial Services, Inc. were renamed “Hilltop Securities Inc.” (“Hilltop Securities”) and “Hilltop Securities Independent Network Inc.” (“HTS Independent Network”), respectively.

On October 22, 2015, the Financial Industry Regulatory Authority (“FINRA”) granted approval to combine First Southwest Company, LLC (“FSC”) and Hilltop Securities, subject to customary conditions. FSC, Hilltop Securities and

HTS Independent Network operated as separate broker-dealers, under coordinated leadership from the date of the SWS Merger until January 22, 2016, when FSC was merged into Hilltop Securities to form a combined firm operating under the “Hilltop Securities” name. We use the term “Hilltop Broker-Dealers” to refer to FSC, Hilltop Securities and HTS Independent Network prior to January 22, 2016 and Hilltop Securities and HTS Independent Network after such date.

Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States (“GAAP”), and in conformity with the rules and regulations of the Securities and Exchange Commission (the “SEC”). In the opinion of management, these financial statements contain all adjustments necessary for a fair statement of the results of the interim periods presented. Accordingly, the financial statements do not include all of the information and footnotes required by GAAP for complete financial statements and should be read in conjunction with the audited consolidated financial statements and notes thereto included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2015 (“2015 Form 10-K”). Results for interim periods are not necessarily indicative of results to be expected for a full year or any future period.

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Estimates regarding the allowance for loan losses, the fair values of financial instruments, the amounts receivable from the Federal Deposit Insurance Corporation (the “FDIC”) under loss-share agreements (the “FDIC Indemnification Asset”), reserves for losses and loss adjustment expenses (“LAE”), the

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

mortgage loan indemnification liability, and the potential impairment of assets are particularly subject to change. The Company has applied its critical accounting policies and estimation methods consistently in all periods presented in these consolidated financial statements.

Hilltop owns 100% of the outstanding stock of PlainsCapital. PlainsCapital owns 100% of the outstanding stock of the Bank and 100% of the membership interest in PlainsCapital Equity, LLC. The Bank owns 100% of the outstanding stock of PrimeLending, a PlainsCapital Company (“PrimeLending”).

PrimeLending owns a 100% membership interest in PrimeLending Ventures Management, LLC (“Ventures Management”). Ventures Management is the managing member and owns 51% of the membership interest in both PrimeLending Ventures, LLC (“Ventures”) and Mutual of Omaha Mortgage, LLC.

PlainsCapital also owns 100% of the outstanding common securities of PCC Statutory Trusts I, II, III and IV (the “Trusts”), which are not included in the consolidated financial statements under the requirements of the Variable Interest Entities Subsections of the Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”), because the primary beneficiaries of the Trusts are not within the consolidated group.

Hilltop has a 100% membership interest in Securities Holdings, which operates through its wholly-owned subsidiaries, Hilltop Securities, HTS Independent Network and First Southwest Holdings, LLC (“First Southwest”). Hilltop Securities is a broker-dealer registered with the SEC and FINRA and a member of the New York Stock Exchange (“NYSE”), HTS Independent Network is an introducing broker-dealer that is also registered with the SEC and FINRA, and First Southwest Asset Management, LLC, a wholly-owned subsidiary of First Southwest, is a registered investment advisor under the Investment Advisors Act of 1940. As discussed above, prior to January 22, 2016, Securities Holdings’ subsidiaries also included FSC, First Southwest’s principal subsidiary and formerly a broker-dealer registered with the SEC and FINRA and a member of the NYSE.

Hilltop also owns 100% of NLC, which operates through its wholly owned subsidiaries, National Lloyds Insurance Company (“NLIC”) and American Summit Insurance Company (“ASIC”).

The consolidated financial statements include the accounts of the above-named entities. Intercompany transactions and balances have been eliminated. Noncontrolling interests have been recorded for minority ownership in entities

that are not wholly owned and are presented in compliance with the provisions of Noncontrolling Interest in Subsidiary Subsections of the ASC.

Certain reclassifications have been made to the prior period consolidated financial statements to conform with the current period presentation. In preparing these consolidated financial statements, subsequent events were evaluated through the time the financial statements were issued. Financial statements are considered issued when they are widely distributed to all stockholders and other financial statement users, or filed with the SEC.

2. Acquisition

On January 1, 2015, Hilltop completed its acquisition of SWS in a stock and cash transaction, whereby each outstanding share of SWS common stock was converted into the right to receive 0.2496 shares of Hilltop common stock and \$1.94 in cash, equating to \$6.92 per share based on Hilltop's closing price on December 31, 2014 and resulting in an aggregate purchase price of \$349.1 million, consisting of 10.1 million shares of common stock, \$78.2 million in cash and \$70.3 million associated with Hilltop's existing investment in SWS common stock. The operations of SWS are included in the Company's operating results beginning January 1, 2015. Such operating results include a bargain purchase gain of \$81.3 million and are not necessarily indicative of future operating results. SWS's results of operations prior to the acquisition date are not included in the Company's consolidated operating results.

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

The SWS Merger was accounted for using the acquisition method of accounting, and accordingly, purchased assets, including identifiable intangible assets, and assumed liabilities were recorded at their respective acquisition date fair values. The components of the consideration paid are shown in the following table (in thousands).

Fair value of consideration paid:	
Common stock issued	\$ 200,626
Cash	78,217
Fair value of Hilltop's existing investment in SWS	70,282
Total consideration paid	\$ 349,125

The resulting fair values of the identifiable assets acquired, and liabilities assumed, in the SWS Merger at January 1, 2015 are summarized in the following table (in thousands).

Cash and due from banks	\$ 119,314
Federal funds sold and securities purchased under agreements to resell	44,741
Assets segregated for regulatory purposes	181,610
Securities	707,476
Non-covered loans, net	863,819
Broker-dealer and clearing organization receivables	1,221,793
Other assets	159,906
Total identifiable assets acquired	3,298,659
Deposits	(1,287,509)
Broker-dealer and clearing organization payables	(1,109,978)
Short-term borrowings	(164,240)
Securities sold, not yet purchased, at fair value	(140,409)
Notes payable	(76,643)
Other liabilities	(89,466)
Total liabilities assumed	(2,868,245)
Bargain purchase gain	(81,289)
	349,125
Less Hilltop existing investment in SWS	(70,282)
Net identifiable assets acquired	\$ 278,843

The bargain purchase gain represents the excess of the estimated fair value of the underlying net tangible assets and intangible assets over the merger consideration. The SWS Merger was a tax-free reorganization under Section 368(a) of the Internal Revenue Code; therefore, no income taxes were recorded in connection with the bargain purchase gain. The Company used significant estimates and assumptions to value certain identifiable assets acquired and liabilities assumed. The bargain purchase gain was primarily driven by the Company's ability to realize acquired deferred tax assets through its consolidated core earnings and the decline in the price of the Company's common stock between the date the fixed conversion ratio was agreed upon and the closing date.

Included within the fair value of other assets in the table above are identifiable intangible assets recorded in connection with the SWS Merger. The allocation to intangible assets is as follows (dollars in thousands).

	Estimated Useful Life (Years)	Gross Intangible Assets
Customer relationships	14	\$ 7,300
Core deposits	4	160
		\$ 7,460

In connection with the SWS Merger, Hilltop acquired loans both with and without evidence of credit quality deterioration since origination. The acquired loans were initially recorded at fair value with no carryover of any

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

allowance for loan losses. Acquired loans were segregated between those considered to be purchased credit impaired (“PCI”) loans and those without credit impairment at acquisition.

The following table presents details on acquired loans at the acquisition date (in thousands).

	Loans, excluding PCI Loans	PCI Loans	Total Loans
Commercial and industrial	\$ 178,603	\$ 9,850	\$ 188,453
Real estate	324,477	62,218	386,695
Construction and land development	14,708	1,391	16,099
Consumer	3,216	—	3,216
Broker-dealer (1)	269,356	—	269,356
Total	\$ 790,360	\$ 73,459	\$ 863,819

(1) Represents acquired margin loans to customers and correspondents associated with acquired broker-dealer segment operations.

The following table presents information about the PCI loans at acquisition (in thousands).

Contractually required principal and interest payments	\$ 120,078
Nonaccretable difference	32,040
Cash flows expected to be collected	88,038
Accretable difference	14,579
Fair value of loans acquired with a deterioration of credit quality	\$ 73,459

The following table presents information about the acquired loans without credit impairment at acquisition (in thousands).

Contractually required principal and interest payments	\$ 901,672
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Contractual cash flows not expected to be collected	39,721
Fair value at acquisition	790,360

3. Fair Value Measurements

Fair Value Measurements and Disclosures

The Company determines fair values in compliance with The Fair Value Measurements and Disclosures Topic of the ASC (the “Fair Value Topic”). The Fair Value Topic defines fair value, establishes a framework for measuring fair value in GAAP and expands disclosures about fair value measurements. The Fair Value Topic defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. The Fair Value Topic assumes that transactions upon which fair value measurements are based occur in the principal market for the asset or liability being measured. Further, fair value measurements made under the Fair Value Topic exclude transaction costs and are not the result of forced transactions.

The Fair Value Topic creates a fair value hierarchy that classifies fair value measurements based upon the inputs used in valuing the assets or liabilities that are the subject of fair value measurements. The fair value hierarchy gives the highest priority to quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs, as indicated below.

- Level 1 Inputs: Unadjusted quoted prices in active markets for identical assets or liabilities that the Company can access at the measurement date.
- Level 2 Inputs: Observable inputs other than Level 1 prices. Level 2 inputs include quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

not active, inputs other than quoted prices that are observable for the asset or liability (such as interest rates, yield curves, prepayment speeds, default rates, credit risks and loss severities), and inputs that are derived from or corroborated by market data, among others.

- Level 3 Inputs: Unobservable inputs that reflect an entity's own assumptions about the assumptions that market participants would use in pricing the assets or liabilities. Level 3 inputs include pricing models and discounted cash flow techniques, among others.

Fair Value Option

The Company has elected to measure substantially all of PrimeLending's mortgage loans held for sale and retained mortgage servicing rights ("MSR") asset at fair value, under the provisions of the Fair Value Option. The Company elected to apply the provisions of the Fair Value Option to these items so that it would have the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. At September 30, 2016 and December 31, 2015, the aggregate fair value of PrimeLending's mortgage loans held for sale accounted for under the Fair Value Option was \$1.63 billion and \$1.46 billion, respectively, and the unpaid principal balance of those loans was \$1.56 billion and \$1.41 billion, respectively. The interest component of fair value is reported as interest income on loans in the accompanying consolidated statements of operations.

The Company holds a number of financial instruments that are measured at fair value on a recurring basis, either by the application of the Fair Value Option or other authoritative pronouncements. The fair values of those instruments are determined primarily using Level 2 inputs. Those inputs include quotes from mortgage loan investors and derivatives dealers and data from independent pricing services.

The following tables present information regarding financial assets and liabilities measured at fair value on a recurring basis (in thousands).

	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
September 30, 2016				
Trading securities	\$ 7,387	\$ 394,717	\$ —	\$ 402,104
Available for sale securities	19,480	544,240	—	563,720

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Loans held for sale	—	1,585,942	42,577	1,628,519
Derivative assets	—	85,451	—	85,451
MSR asset	—	—	43,751	43,751
Securities sold, not yet purchased	87,693	76,940	—	164,633
Derivative liabilities	—	39,001	—	39,001

	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
December 31, 2015				
Trading securities	\$ 21,807	\$ 192,338	\$ 1	\$ 214,146
Available for sale securities	17,409	656,297	—	673,706
Loans held for sale	—	1,434,955	25,880	1,460,835
Derivative assets	—	35,676	—	35,676
MSR asset	—	—	52,285	52,285
Securities sold, not yet purchased	27,648	102,396	—	130,044
Derivative liabilities	—	5,426	—	5,426

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

The following tables include a rollforward for those financial instruments measured at fair value using Level 3 inputs (in thousands).

	Balance at Beginning of Period	Purchases/ Additions	Sales/ Reductions	Total Gains or Losses (Realized or Unrealized) Included in Net Income	Included in Other Comprehensive Income (Loss)	Balance at End of Period
Three months ended September 30, 2016						
Trading securities	\$ 1	\$ —	\$ —	\$ (1)	\$ —	\$ —
Loans held for sale	45,645	8,066	(8,686)	(2,448)	—	42,577
MSR asset	33,491	10,416	—	(156)	—	43,751
Total	\$ 79,137	\$ 18,482	\$ (8,686)	\$ (2,605)	\$ —	\$ 86,328
Nine months ended September 30, 2016						
Trading securities	\$ 1	\$ —	\$ —	\$ (1)	\$ —	\$ —
Loans held for sale	25,880	51,105	(23,817)	(10,591)	—	42,577
MSR asset	52,285	20,309	(7,586)	(21,257)	—	43,751
Total	\$ 78,166	\$ 71,414	\$ (31,403)	\$ (31,849)	\$ —	\$ 86,328
Three months ended September 30, 2015						
Available for sale securities	\$ 16	\$ —	\$ —	\$ (15)	\$ —	\$ 1
Loans held for sale	19,123	11,466	(2,769)	(1,116)	—	26,704
MSR asset	44,985	11,025	—	(8,483)	—	47,527
Total	\$ 64,124	\$ 22,491	\$ (2,769)	\$ (9,614)	\$ —	\$ 74,232
Nine months ended September 30, 2015						
Available for sale securities	\$ —	\$ 7,301	\$ (3,397)	\$ (3,903)	\$ —	\$ 1
Loans held for sale	9,017	40,075	(12,493)	(9,895)	—	26,704
MSR asset	36,155	23,121	—	(11,749)	—	47,527
Total	\$ 45,172	\$ 70,497	\$ (15,890)	\$ (25,547)	\$ —	\$ 74,232

All net realized and unrealized gains (losses) in the table above are reflected in the accompanying consolidated financial statements. Excluding the trading securities sold during the three months ended September 30, 2016, the unrealized gains (losses) relate to financial instruments still held at September 30, 2016.

For Level 3 financial instruments measured at fair value on a recurring basis at September 30, 2016, the significant unobservable inputs used in the fair value measurements were as follows.

Financial instrument	Valuation Technique	Unobservable Input	Range (Weighted-Average)
Loans held for sale	Discounted cash flow / Market comparable	Projected price	89 - 96 % (96 %)
MSR asset	Discounted cash flow	Constant prepayment rate	18.12 %
		Discount rate	10.93 %

The fair value of certain loans held for sale that cannot be sold through normal sale channels or are non-performing is measured using Level 3, or unobservable, inputs. The fair value of such loans is generally based upon estimates of expected cash flows using unobservable inputs, including listing prices of comparable assets, uncorroborated expert opinions, and/or management's knowledge of underlying collateral.

The MSR asset, which is included in other assets within the Company's consolidated balance sheets, is valued by projecting net servicing cash flows, which are then discounted to estimate the fair value. The fair value of the MSR asset is impacted by a variety of factors. Prepayment rates and discount rates, the most significant unobservable inputs, are discussed further in Note 7 to the consolidated financial statements.

The Company had no transfers between Levels 1 and 2 during the periods presented.

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Notes to Consolidated Financial Statements (continued)

(Unaudited)

The following tables present those changes in fair value of instruments recognized in the consolidated statements of operations that are accounted for under the Fair Value Option (in thousands).

	Three Months Ended September 30, 2016			Three Months Ended September 30, 2015		
	Net Gains (Losses)	Other Noninterest Income	Total Changes in Fair Value	Net Gains (Losses)	Other Noninterest Income	Total Changes in Fair Value
Loans held for sale	\$ 73	\$ —	\$ 73	\$ 18,531	\$ —	\$ 18,531
MSR asset	(156)	—	(156)	(8,483)	—	(8,483)