

Hilltop Holdings Inc.
Form 10-Q
May 06, 2015
[Table of Contents](#)

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

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

For the quarterly period ended March 31, 2015

- o **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
Dallas, TX

75201

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(Address of principal executive offices)

(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 May 6, 2015 was 100,289,492.

Table of Contents

HILLTOP HOLDINGS INC.
FORM 10-Q
FOR THE QUARTER ENDED MARCH 31, 2015

TABLE OF CONTENTS

PART I FINANCIAL INFORMATION

Item 1.	Financial Statements	
	<u>Consolidated Balance Sheets</u>	3
	<u>Consolidated Statements of Operations</u>	4
	<u>Consolidated Statements of Comprehensive Income</u>	5
	<u>Consolidated Statements of Stockholders' Equity</u>	6
	<u>Consolidated Statements of Cash Flows</u>	7
	<u>Notes to Consolidated Financial Statements</u>	8
<u>Item 2.</u>	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	54
<u>Item 3.</u>	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	86
<u>Item 4.</u>	<u>Controls and Procedures</u>	88

PART II OTHER INFORMATION

<u>Item 1.</u>	<u>Legal Proceedings</u>	88
<u>Item 1A.</u>	<u>Risk Factors</u>	88
<u>Item 2.</u>	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	90
<u>Item 6.</u>	<u>Exhibits</u>	90

Table of Contents**HILLTOP HOLDINGS INC. AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS****(in thousands, except share and per share data)****(Unaudited)**

	March 31, 2015	December 31, 2014
Assets		
Cash and due from banks	\$ 694,108	\$ 782,473
Federal funds sold	14,425	30,602
Securities purchased under agreements to resell	67,227	
Assets segregated for regulatory purposes	278,280	76,013
Securities:		
Trading, at fair value	320,153	65,717
Available for sale, at fair value (amortized cost of \$850,430 and \$924,755, respectively)	859,212	925,535
Held to maturity, at amortized cost (fair value of \$186,032 and \$118,345, respectively)	183,792	118,209
	1,363,157	1,109,461
Loans held for sale	1,215,308	1,309,693
Non-covered loans, net of unearned income	4,834,687	3,920,476
Allowance for non-covered loan losses	(39,365)	(37,041)
Non-covered loans, net	4,795,322	3,883,435
Covered loans, net of allowance of \$1,388 and \$4,611, respectively	550,626	638,029
Broker-dealer and clearing organization receivables	2,222,517	167,884
Premises and equipment, net	215,684	206,991
FDIC indemnification asset	107,567	130,437
Covered other real estate owned	137,703	136,945
Other assets	581,210	458,862
Goodwill	251,808	251,808
Other intangible assets, net	67,952	59,783
Total assets	\$ 12,562,894	\$ 9,242,416
Liabilities and Stockholders Equity		
Deposits:		
Noninterest-bearing	\$ 2,259,790	\$ 2,076,385
Interest-bearing	4,869,487	4,293,507
Total deposits	7,129,277	6,369,892
Broker-dealer and clearing organization payables	1,951,040	179,042
Short-term borrowings	999,476	762,696
Securities sold, not yet purchased, at fair value	139,481	48
Notes payable	108,682	56,684
Junior subordinated debentures	67,012	67,012
Other liabilities	385,607	345,803
Total liabilities	10,780,575	7,781,177
Commitments and contingencies (see Notes 11 and 12)		
Stockholders equity:		
Hilltop stockholders equity:	114,068	114,068

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Preferred stock, \$0.01 par value, 10,000,000 shares authorized; Series B, liquidation value per share of \$1,000; 114,068 shares issued and outstanding		
Common stock, \$0.01 par value, 125,000,000 shares authorized; 100,286,330 and 90,181,888 shares issued and outstanding, respectively	1,003	902
Additional paid-in capital	1,592,585	1,390,788
Accumulated other comprehensive income	5,750	651
Retained earnings (accumulated deficit)	67,445	(45,957)
Deferred compensation employee stock trust, net	1,189	
Employee stock trust (29,932 shares, at cost)	(597)	
Total Hilltop stockholders' equity	1,781,443	1,460,452
Noncontrolling interests	876	787
Total stockholders' equity	1,782,319	1,461,239
Total liabilities and stockholders' equity	\$ 12,562,894	\$ 9,242,416

See accompanying notes.

Table of Contents**CONSOLIDATED STATEMENTS OF OPERATIONS****(in thousands, except per share data)****(Unaudited)**

	Three Months Ended March 31,	
	2015	2014
Interest income:		
Loans, including fees	\$ 87,388	\$ 79,744
Securities borrowed	10,018	1,464
Securities:		
Taxable	7,049	7,588
Tax-exempt	1,741	1,242
Other	1,473	1,790
Total interest income	107,669	91,828
Interest expense:		
Deposits	4,315	3,759
Securities loaned	7,506	838
Short-term borrowings	1,024	397
Notes payable	669	648
Junior subordinated debentures	585	584
Other	178	181
Total interest expense	14,277	6,407
Net interest income	93,392	85,421
Provision for loan losses	2,687	3,242
Net interest income after provision for loan losses	90,705	82,179
Noninterest income:		
Net realized gains on securities	4,403	
Net gains from sale of loans and other mortgage production income	120,545	79,111
Mortgage loan origination fees	14,589	12,344
Net insurance premiums earned	39,567	40,319
Securities commissions and fees	43,051	6,998
Investment banking and advisory fees	24,922	14,337
Bargain purchase gain	82,816	
Other	24,479	16,991
Total noninterest income	354,372	170,100
Noninterest expense:		
Employees compensation and benefits	182,573	106,429
Loss and loss adjustment expenses	18,860	18,337
Policy acquisition and other underwriting expenses	11,674	11,687
Occupancy and equipment, net	29,185	26,338
Other	72,184	49,838
Total noninterest expense	314,476	212,629
Income before income taxes	130,601	39,650
Income tax expense	15,420	14,354
Net income	115,181	25,296
Less: Net income attributable to noncontrolling interest	353	110

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Income attributable to Hilltop		114,828		25,186
Dividends on preferred stock		1,426		1,426
Income applicable to Hilltop common stockholders	\$	113,402	\$	23,760
Earnings per common share:				
Basic	\$	1.13	\$	0.26
Diluted	\$	1.13	\$	0.26
Weighted average share information:				
Basic		99,741		89,707
Diluted		100,627		90,585

See accompanying notes.

Table of Contents

HILLTOP HOLDINGS INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(in thousands)

(Unaudited)

	Three Months Ended March 31,	
	2015	2014
Net income	\$ 115,181	\$ 25,296
Other comprehensive income:		
Net unrealized gains on securities available for sale and other, net of tax of \$4,454 and \$9,583, respectively	7,913	18,809
Reclassification adjustment for gains included in net income, net of tax of \$(1,589)	(2,814)	
Comprehensive income	120,280	44,105
Less: comprehensive income attributable to noncontrolling interest	353	110
Comprehensive income applicable to Hilltop	\$ 119,927	\$ 43,995

See accompanying notes.

Table of Contents

HILLTOP HOLDINGS INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY

(in thousands)

(Unaudited)

	Preferred Stock	Common Stock	Additional	Other	Accumulated	Retained	Deferred	Employee	Employee	Total	Noncontrolling	Total
	Shares	Amount	Shares	Amount	Paid-in	Comprehensive	Earnings	Compensation	Stock	Hilltop	Interest	Stockholders
					Capital	(Loss)	Accumulated	Trust, Net	Shares	Stockholder		Equity
Balance, December 31, 2013	114	\$ 114,068	90,176	\$ 902	\$ 1,388,641	\$ (34,863)	\$ (157,607)	\$		\$ 1,311,141	\$ 781	\$ 1,311,922
Net income							25,186			25,186	110	25,296
Other comprehensive income						18,809				18,809		18,809
Stock-based compensation expense					735					735		735
Common stock issued to board members			2		52					52		52
Dividends on preferred stock					(1,426)					(1,426)		(1,426)
Cash distributions to noncontrolling interest											(175)	(175)
Balance, March 31, 2014	114	\$ 114,068	90,178	\$ 902	\$ 1,388,002	\$ (16,054)	\$ (132,421)	\$		\$ 1,354,497	\$ 716	\$ 1,355,213
Balance, December 31, 2014	114	\$ 114,068	90,182	\$ 902	\$ 1,390,788	\$ 651	\$ (45,957)	\$		\$ 1,460,452	\$ 787	\$ 1,461,239
Net income							114,828			114,828	353	115,181
Other comprehensive income						5,099				5,099		5,099
Issuance of common stock			10,102	101	199,932					200,033		200,033
Stock-based compensation expense					1,814					1,814		1,814
Common stock issued to board members			2		51					51		51
Dividends on preferred stock							(1,426)			(1,426)		(1,426)
Deferred compensation plan								1,189	30	(597)	592	592
Cash distributions to noncontrolling interest											(264)	(264)
	114	\$ 114,068	100,286	\$ 1,003	\$ 1,592,585	\$ 5,750	\$ 67,445	\$ 1,189	30	\$ (597)	\$ 876	\$ 1,782,319

Balance,
March 31, 2015

See accompanying notes.

Table of Contents**HILLTOP HOLDINGS INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CASH FLOWS****(in thousands)****(Unaudited)**

	Three Months Ended March 31,	
	2015	2014
Operating Activities		
Net income	\$ 115,181	\$ 25,296
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Provision for loan losses	2,687	3,242
Depreciation, amortization and accretion, net	(14,486)	(20,615)
Net realized gains on securities	(4,403)	
Bargain purchase gain	(82,816)	
Deferred income taxes	(2,545)	4,878
Other, net	(3,813)	1,435
Net change in securities purchased under agreements to resell	(22,486)	
Net change in assets segregated for regulatory purposes	(20,657)	
Net change in trading securities	11,632	5,496
Net change in broker-dealer and clearing organization receivables	(1,062,969)	(88,613)
Net change in FDIC Indemnification Asset	23,376	912
Net change in other assets	(34,554)	(458)
Net change in broker-dealer and clearing organization payables	1,039,786	62,842
Net change in other liabilities	(52,528)	(34,759)
Net gains from sales of loans	(120,545)	(79,111)
Loans originated for sale	(2,904,331)	(1,954,133)
Proceeds from loans sold	3,094,705	2,227,917
Net cash provided by (used in) operating activities	(38,766)	154,329
Investing Activities		
Proceeds from maturities and principal reductions of securities held to maturity	6,329	351
Proceeds from sales, maturities and principal reductions of securities available for sale	449,892	31,845
Purchases of securities held to maturity		(31,334)
Purchases of securities available for sale	(2,623)	(46,024)
Net change in loans	267,275	(256)
Purchases of premises and equipment and other assets	(5,565)	(8,710)
Proceeds from sales of premises and equipment and other real estate owned	31,818	14,713
Net cash received for Federal Home Loan Bank and Federal Reserve Bank stock	4,044	
Net cash from acquisition	41,097	
Net cash provided by (used in) investing activities	792,267	(39,415)
Financing Activities		
Net change in deposits	(905,890)	(90,374)
Net change in short-term borrowings	72,540	149,319
Proceeds from notes payable	1,000	
Payments on notes payable	(23,904)	(862)
Dividends paid on preferred stock	(1,426)	(1,342)
Net cash distributed to noncontrolling interest	(264)	(175)
Other, net	(99)	(93)
Net cash provided by (used in) financing activities	(858,043)	56,473

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Net change in cash and cash equivalents	(104,542)	171,387
Cash and cash equivalents, beginning of period	813,075	746,023
Cash and cash equivalents, end of period	\$ 708,533	\$ 917,410

Supplemental Disclosures of Cash Flow Information

Cash paid for interest	\$ 14,325	\$ 6,934
Cash paid for income taxes, net of refunds	\$ 45,981	\$ (1,845)

Supplemental Schedule of Non-Cash Activities

Conversion of loans to other real estate owned	\$ 26,211	\$ 25,588
Common stock issued in acquisition	\$ 200,626	\$

See accompanying notes.

Table of Contents

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, as amended by the Gramm-Leach-Bliley Act of 1999. 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 operating subsidiaries, PlainsCapital Corporation (PlainsCapital), Hilltop Securities Holdings LLC (Hilltop Securities) and National Lloyds Corporation (NLC). PlainsCapital is a financial holding company, headquartered in Dallas, Texas, that provides, through its subsidiaries, traditional banking services, wealth and investment management and treasury management primarily in Texas and residential mortgage lending throughout the United States. Hilltop Securities 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, whereby SWS merged with and into Hilltop Securities, a wholly owned subsidiary of Hilltop initially formed for the purpose of facilitating this transaction (the SWS Merger). SWS's broker-dealer subsidiaries, Southwest Securities (Southwest Securities) and SWS Financial Services, Inc. (SWS Financial), became subsidiaries of Hilltop Securities. Immediately following the SWS Merger, SWS's banking subsidiary, Southwest Securities, FSB (SWS FSB), was merged into the Bank, an indirect wholly owned subsidiary of Hilltop. As a result of the SWS Merger, 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. Additionally, due to appraisal rights proceedings filed in connection with the SWS Merger, the merger consideration is subject to change, and is therefore, preliminary as of the date of this report. Based on preliminary purchase date valuations, the fair value of the assets acquired was \$3.3 billion, including \$707.5 million in securities, \$863.8 million in non-covered loans and \$1.2 billion in broker-dealer and clearing organization receivables. The fair value of liabilities assumed was \$2.9 billion, consisting primarily of deposits of \$1.3 billion and \$1.1 billion in broker-dealer and clearing organization payables.

Basis of Presentation

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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, 2014 (2014 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

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Table of Contents

Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

financial instruments, the amounts receivable under the loss-share agreements with the Federal Deposit Insurance Corporation (the FDIC) (FDIC Indemnification Asset), reserves for losses and loss adjustment expenses, the 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. As discussed in Note 2 to the consolidated financial statements, the SWS Merger purchase date valuations associated with loans, intangibles and taxes are considered preliminary because management's review and approval of certain key assumptions is not complete.

Certain reclassifications have been made to the prior period consolidated financial statements to conform with the current period presentation.

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), PCB-ARC, Inc. and RGV-ARC, Inc. and has a 100% membership interest in PlainsCapital Securities, LLC.

PrimeLending owns a 100% membership interest in PrimeLending Ventures Management, LLC, the controlling and sole managing member of PrimeLending Ventures, LLC (Ventures).

Hilltop has a 100% membership interest in Hilltop Securities, which operates through its wholly-owned subsidiaries, First Southwest Holdings, LLC (First Southwest), Southwest Securities and SWS Financial (collectively, the Hilltop Broker-Dealers). The principal subsidiaries of First Southwest are First Southwest Company, LLC (FSC), a broker-dealer registered with the Securities and Exchange Commission (the SEC) and the Financial Industry Regulatory Authority (FINRA) and a member of the New York Stock Exchange (NYSE), and First Southwest Asset Management, LLC, a registered investment advisor under the Investment Advisors Act of 1940. Southwest Securities is a broker-dealer registered with the SEC and FINRA and a member of the NYSE, and SWS Financial is an introducing broker-dealer that is also registered with the SEC and FINRA.

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. All significant 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 Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC).

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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 ASC, because the primary beneficiaries of the Trusts are not within the consolidated group.

2. Acquisition

SWS Merger

On January 1, 2015, Hilltop completed its acquisition of SWS in a stock and cash transaction as discussed in Note 1 to the consolidated financial statements. The operations of SWS are included in the Company's operating results beginning January 1, 2015. Such operating results include a preliminary bargain purchase gain of \$82.8 million and are not 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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Table of Contents

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

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

Cash and due from banks	\$ 119,314
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	159,753
Total identifiable assets acquired	3,298,506
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	(87,786)
Total liabilities assumed	(2,866,565)
Preliminary bargain purchase gain	(82,816)
	349,125
Less Hilltop's existing investment in SWS	(70,282)
Net identifiable assets acquired	\$ 278,843

The preliminary bargain purchase gain represents the excess of the preliminary estimated fair value of the underlying net tangible assets and intangible assets over the preliminary 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 preliminary bargain purchase gain. The Company used significant estimates and assumptions to value certain identifiable assets acquired and liabilities assumed. Because of management's review and approval of certain key assumptions not being complete, the purchase date valuations related to loans, intangibles and taxes are considered preliminary and could differ significantly when finalized. The preliminary bargain purchase gain was primarily driven by the Company's ability

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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.

Table of Contents

Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

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

	Estimated Useful Life (Years)	Gross Intangible Assets
Customer relationships	14	\$ 10,700
Core deposits	4	160
		\$ 10,860

During the three months ended March 31, 2015, transaction and integration related expenses of \$10.0 million associated with the SWS Merger are included in noninterest expense within the consolidated statement of operations. Such expenses were for professional services and other incremental employee costs associated with the integration of SWS's operations. SWS Merger-related transaction expenses during the three months ended March 31, 2014 were nominal.

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 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 (1)	\$ 447,959	\$ 9,850	\$ 457,809
Real estate	324,477	62,218	386,695
Construction and land development	14,708	1,391	16,099
Consumer	3,216		3,216
Total	\$ 790,360	\$ 73,459	\$ 863,819

(1) Acquired loans include margin loans to customers and correspondents of \$269.4 million associated with acquired broker-dealer operations, none of which are PCI loans.

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

Contractually required principal and interest payments	\$ 120,078
--------------------------------------------------------	------------

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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
Contractual cash flows not expected to be collected		39,721
Fair value at acquisition		790,360

Table of Contents

Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

Pro Forma Results of Operations

The results of operations acquired in the SWS Merger have been included in the Company's consolidated financial results since January 1, 2015. The following table discloses the impact of SWS on the Company's results of operations. The table presents pro forma results had the SWS Merger taken place on January 1, 2014 and includes the estimated impact of purchase accounting adjustments (in thousands). The purchase accounting adjustments reflect the impact of recording the acquired loans at fair value, including the estimated accretion of the purchase discount on the loan portfolio. Accretion estimates were based on the acquisition date purchase discount on the loan portfolio, as it was not practicable to determine the amount of discount that would have been recorded based on economic conditions that existed on January 1, 2014. The pro forma results do not include any potential operating cost savings as a result of the SWS Merger. Further, certain costs associated with any restructuring or integration activities are also not reflected in the pro forma results. Pro forma results exclude nonrecurring items resulting directly from the SWS Merger and that do not have a continuing impact on results of operations. The pro forma results are not indicative of what would have occurred had the SWS Merger taken place on the indicated date.

	Three Months Ended March 31, 2014
Net interest income	\$ 99,842
Other revenues	225,315
Net income	24,658

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.

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- *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 not active, inputs other than quoted prices that are observable for the asset or liability (e.g., interest rates, yield curves, prepayment speeds, default rates, credit risks, loss severities, etc.), 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.

Table of Contents

Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

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 March 31, 2015, the aggregate fair value of PrimeLending's mortgage loans held for sale accounted for under the Fair Value Option was \$1.19 billion, and the unpaid principal balance of those loans was \$1.14 billion. At December 31, 2014, the aggregate fair value of PrimeLending's mortgage loans held for sale accounted for under the Fair Value Option was \$1.27 billion, and the unpaid principal balance of those loans was \$1.22 billion. The interest component of fair value is reported as interest income on loans in the accompanying consolidated statements of operations.

On October 2, 2014, Hilltop exercised its warrant to purchase 8,695,652 shares of SWS common stock at an exercise price of \$5.75 per share (the SWS Warrant) and paid the aggregate exercise price by the automatic elimination of the \$50.0 million aggregate principal amount note due to Hilltop under its credit agreement with SWS. Following the exercise of the SWS Warrant, Hilltop owned approximately 21% of the outstanding shares of SWS common stock as of October 2, 2014. Contemporaneous with the exercise of the SWS Warrant, Hilltop changed the accounting method for its investment in SWS common stock and elected to account for its investment in accordance with the provisions of the Fair Value Option as permitted by GAAP. Hilltop had previously accounted for its investment in SWS common stock as an available for sale security. Under the Fair Value Option, Hilltop's investment in SWS common stock is recorded at fair value effective October 2, 2014, with changes in fair value being recorded in other noninterest income within the consolidated statement of operations rather than as a component of other comprehensive income. At December 31, 2014, the fair value of Hilltop's investment in SWS common stock was \$70.3 million and is included in other assets within the consolidated balance sheet.

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).

March 31, 2015	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
Trading securities	\$ 40	\$ 314,181	\$ 5,932	\$ 320,153
Available for sale securities	14,070	845,142		859,212
Loans held for sale		1,168,757	19,495	1,188,252
Derivative assets		49,649		49,649
MSR asset			31,648	31,648

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Trading liabilities	139,481	139,481
Derivative liabilities	22,048	22,048

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Table of Contents

Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

December 31, 2014	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
Trading securities	\$ 39	\$ 65,678	\$	\$ 65,717
Available for sale securities	13,762	911,773		925,535
Loans held for sale		1,263,135	9,017	1,272,152
Derivative assets		23,805		23,805
MSR asset			36,155	36,155
Investment in SWS common stock	70,282			70,282
Trading liabilities		48		48
Derivative liabilities		12,849		12,849

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	Included in Net Income	Total Gains or Losses (Realized or Unrealized) Included in Other Comprehensive Income (Loss)	Balance at End of Period
Three months ended						
March 31, 2015						
Trading securities	\$	\$ 7,301	\$	\$ (1,369)	\$	\$ 5,932
Loans held for sale	9,017	11,136	(271)	(387)		19,495
Mortgage servicing rights asset	36,155	2,690		(7,197)		31,648
Total	\$ 45,172	\$ 21,127	\$ (271)	\$ (8,953)	\$	\$ 57,075

	Balance at Beginning of Period	Purchases/ Additions	Sales/ Reductions	Included in Net Income	Total Gains or Losses (Realized or Unrealized) Included in Other Comprehensive Income (Loss)	Balance at End of Period
Three months ended						
March 31, 2014						
Available for sale securities	\$ 60,053	\$	\$	\$ 593	\$ 3,452	\$ 64,098
Loans held for sale	27,729	4,900	(5,594)	(209)		26,826
Mortgage servicing rights asset	20,149	7,432		2,358		29,939
Derivative liabilities	(5,600)			(350)		(5,950)
Total	\$ 102,331	\$ 12,332	\$ (5,594)	\$ 2,392	\$ 3,452	\$ 114,913

All net realized and unrealized gains (losses) in the table above are reflected in the accompanying consolidated financial statements. The available for sale securities noted in the table above reflect Hilltop's note receivable from SWS and the SWS Warrant. On October 2, 2014, as previously discussed, Hilltop exercised the SWS Warrant in full and paid the aggregate exercise price by the automatic elimination of the \$50.0 million aggregate principal amount note due to Hilltop under the credit agreement.

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For Level 3 financial instruments measured at fair value on a recurring basis at March 31, 2015, the significant unobservable inputs used in the fair value measurements were as follows.

Financial instrument	Valuation Technique	Unobservable Input	Range (Weighted-Average)
Trading securities	Discounted cash flow	Discount rate	8 - 17% (10%)
Loans held for sale	Discounted cash flow / Market comparable	Projected price	90 - 94% (93%)
Mortgage servicing rights asset	Discounted cash flow	Constant prepayment rate	14.95%
		Discount rate	10.98%

The fair value of certain loans held for sale that are either non-standard (i.e. loans that cannot be sold through normal sale channels) or non-performing is measured using 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.

Table of Contents

Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

Trading securities include corporate debt securities that are valued using a discounted cash flow model with observable market data; however, due to the distressed nature of these bonds, the Company has determined that these securities should be valued as a Level 3 financial instrument.

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.

The following table presents the changes in fair value for instruments that are reported at fair value under the Fair Value Option (in thousands).

	Three Months Ended March 31, 2015			Three Months Ended March 31, 2014		
	Net Losses	Other Noninterest Income	Total Changes in Fair Value	Net Gains	Other Noninterest Income	Total Changes in Fair Value
Loans held for sale	\$ (6,695)	\$	\$ (6,695)	\$ 4,518	\$	\$ 4,518
Mortgage servicing rights asset	(7,197)		(7,197)	2,358		2,358

The Company also determines the fair value of certain assets and liabilities on a non-recurring basis. In particular, the fair value of all of the assets acquired and liabilities assumed in the SWS Merger was determined at the acquisition date. In addition, facts and circumstances may dictate a fair value measurement when there is evidence of impairment. Assets and liabilities measured on a non-recurring basis include the items discussed below.

Impaired Loans The Company reports impaired loans based on the underlying fair value of the collateral through specific allowances within the allowance for loan losses. PCI loans with a fair value of \$172.9 million, \$822.8 million and \$73.5 million were acquired by the Company upon completion of the merger with PlainsCapital (the PlainsCapital Merger), the FDIC-assisted transaction (the FNB Transaction) whereby the Bank acquired certain assets and assumed certain liabilities of First National Bank (FNB) and the SWS Merger, respectively (collectively, the Bank Transactions). Substantially all PCI loans acquired in the FNB Transaction are covered by FDIC loss-share agreements. The fair value of PCI loans was determined using Level 3 inputs, including estimates of expected cash flows that incorporated significant unobservable inputs regarding default rates, loss severity rates assuming default, prepayment speeds on acquired loans accounted for in pools (Pooled Loans), and estimated collateral values.

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At March 31, 2015, estimates for these significant unobservable inputs were as follows.

	PlainsCapital Merger	PCI Loans FNB Transaction	SWS Merger
Weighted average default rate	47%	60%	52%
Weighted average loss severity rate	50%	39%	37%
Weighted average prepayment speed	0%	4%	0%

The resulting weighted average expected loss on PCI loans associated with the PlainsCapital Merger, FNB Transaction and SWS Merger was 24%, 23% and 19%, respectively.

Table of Contents