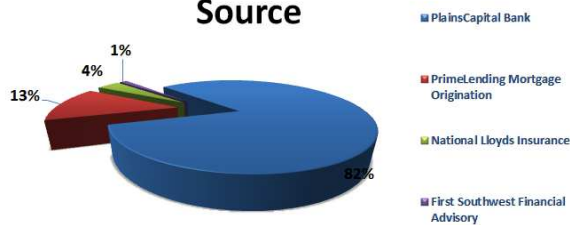


Hilltop Holdings Enjoys Strong Growth from Banking Acquisitions

Neutral

We are now Neutral on Hilltop Holdings (HTH). Ever since the [May 9, 2012 announcement](#) by Hilltop Holdings (HTH) that it was acquiring PlainsCapital Corporation, we were eagerly counting down the days towards when the deal would close last year. We even [published a comprehensive research](#) report analyzing and evaluating PlainsCapital and Hilltop, as well as the merger deal itself. Our long position in Hilltop Holdings jumped by nearly 23% on May 9 when Hilltop and PlainsCapital announced the deal announced and it increased by another 133% on top of that increase over the following 19 months. Although PlainsCapital was a private company, it still filed [public financial reports](#) with the SEC. That works out well for investors because they can see how PlainsCapital has performed. We can see that the market was very excited about this deal as HTH's 195% total return since the announcement on May 9 before the market opened greatly exceeded the 53% total return of the SPDR Financials ETF (XLF) during this period. We believe that Hilltop's share price is now within 10% of our fair value target price for its shares and that is why we are rating it as a Neutral.

HTH FY 2013 Pre-Tax Profits By Source



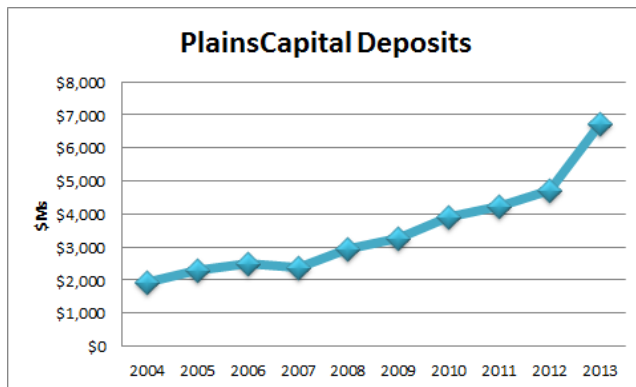
Source: [Hilltop Holdings Q4 2013 Supplement](#)

Hilltop Holdings' Key Business Segments:

Hilltop Holdings' Banking Segment includes the operations of PlainsCapital Bank, which offers a variety of personal and business banking products and services. PlainsCapital Bank was a legacy subsidiary of PlainsCapital Corporation before its acquisition by Hilltop Holdings.

PlainsCapital Bank enjoyed solid deposit and revenue growth from 2009 to 2012 and improving credit trends helped it generate strong pre-tax profit growth during this period. In 2013, PlainsCapital Bank had strong revenue growth and positive operating leverage, and incremental contributions from its September acquisition of First National Bank in Edinburg. This enabled it to generate 100%+ pre-tax profit growth year-over-year in 2013. PlainsCapital Bank generated an efficiency ratio of 42.58% for FY 2013. We believe that this is a combination of good

expense management and the fact that this only includes the impact of the PlainsCapital Bank operations whereas the efficiency ratios of many other mid-cap and large-cap banks include the impact of high expense to revenue businesses such as investment banking, investment management and mortgage lending. As of Q4 2013, PlainsCapital Bank exceeded all regulatory capital requirements with a total capital to risk weighted assets ratio of 14%, Tier 1 capital to risk weighted assets ratio of 13.38% and a Tier 1 capital to average assets, or leverage, ratio of 9.29%. PlainsCapital Bank generated a Net Interest Margin of 5.17% in 2013 and Hilltop Holdings generated a consolidated corporate-wide net interest margin of 4.47% during this period.



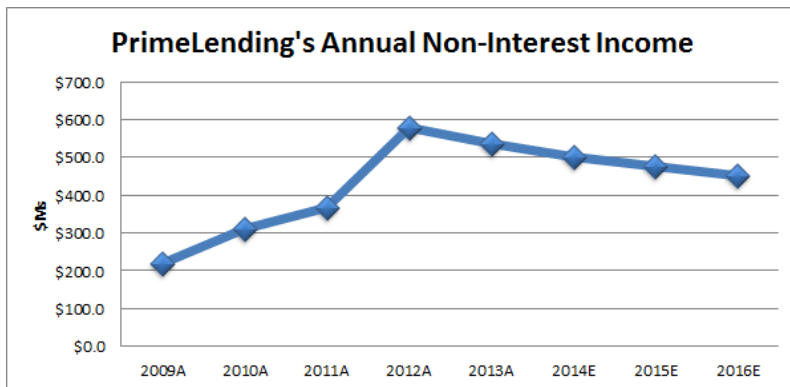
Sources: [PlainsCapital's 2009-11 Annual Reports](#) and [Hilltop's 2012-13 Annual Reports](#)

Near the end of Q3 2013, [Hilltop announced](#) that PlainsCapital Bank acquired substantially all of the liabilities, including all of the deposits, and acquired substantially all of the assets of Edinburg, Texas-based First National Bank from the Federal Deposit Insurance Corporation and reopened acquired branches of FNB under the PlainsCapital Bank brand name. FNB had \$2.6B in assets and \$2.4B in deposits however, that bank's loan portfolio suffered from numerous non-performing loans. When PlainsCapital took over FNB in September, it had to markdown the value of FNB's loan book by \$337.6M. We guess that is why the FDIC gave Hilltop/PlainsCapital \$45M as an initial cash payment, which is subject to future adjustment and settlement. In Q4 2013, legacy FNB contributed \$35M in revenue and \$12.3M in pre-tax profits and endured non-core deposit run-off of \$299M. PlainsCapital completed the conversion of legacy FNB's operations into the PlainsCapital operating platform in February and staffing levels of legacy FNB are down 9% due to attrition.

Hilltop Holdings' Mortgage Origination Segment includes the operations of PrimeLending, which offers a variety of loan products from offices in 42 states and generates revenue predominantly from fees charged on the origination of loans and from selling these loans in the secondary market. PrimeLending was a legacy subsidiary of PlainsCapital Corporation before its acquisition by Hilltop Holdings.

PrimeLending enjoyed explosive revenue and profit growth from 2009 to 2012 but its revenue plateaued in 2013. FY 2013 non-interest revenue declined by 7% year-over-year due to declines in home mortgage originations as well as gains on the sales of loans and origination

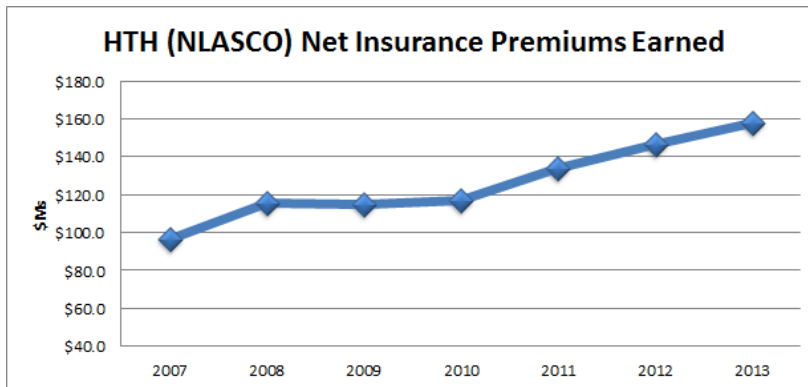
fees. PrimeLending's non-interest expenses declined by 5% in 2013 and this helped partially mitigate the non-interest revenue declines. PrimeLending's pre-tax profits declined by 52% year-over-year in 2013 versus the 2012 period as the division's decline in operating income was compounded by increased interest expenses. With interest rates expected to rise further, we believe that PrimeLending's revenues will decline by at least 5% annually over the next couple of years. Although PrimeLending accounts for the largest share of Hilltop's revenues, it has low margins due to the incentive-based commission compensation structure for its origination employees. PrimeLending initiated additional headcount reductions in Q4 2013 and is engaging in other operating cost reduction initiatives to stabilize its profits because that the mortgage market has peaked. We expect to see PrimeLending begin realizing the benefits of these measures during Q4 2013 however, this may not be enough to offset future origination volume declines.



Sources: [PlainsCapital's 2009-11 Annual Reports](#), [Hilltop's 2012-13 Annual Reports](#) and [Our Estimates](#)

Hilltop Holdings' Insurance Segment is composed of National Lloyds Corporation, formerly known as NLASCO, Inc. National Lloyds provides fire and homeowners insurance to low value dwellings and manufactured homes primarily in Texas and other areas of the southern United States. National Lloyds Company was a legacy subsidiary of Hilltop Holdings before Hilltop acquired PlainsCapital Corporation.

National Lloyds generated solid year-over-year revenue growth of 9.2% in 2013. Pre-tax income was \$7.6M during the year compared with a pre-tax loss of \$4.7M in 2012. The segment's improved results in 2013 versus the prior year's period were due to the incremental revenue growth as well as losses and loss adjustment expenses growing at a slower pace year-over-year relative to revenue. NLC's direct written premiums increased by 6.2% year-over-year in 2013 versus 2012. Revenue growth in its core homeowners, fire and mobile home markets more than offset the non-renewal of a commercial product line. Two of the three storms NLC endured in the Q2 2013 period exceeded its \$8M reinsurance retention so its reinsurers will assume any additional losses incurred by NLC.

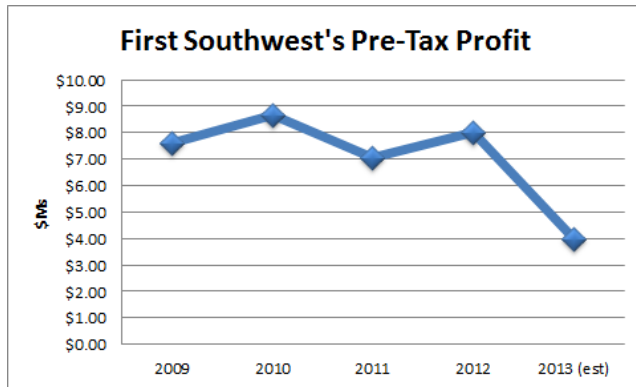


Sources: [Hilltop 2011-13 Annual Reports](#)

Hilltop Holdings' Financial Advisory Segment generates a majority of its revenues from fees and commissions earned from investment advisory and securities brokerage services at First Southwest Company. First Southwest was a legacy subsidiary of PlainsCapital Corporation before its acquisition by Hilltop Holdings.

First Southwest's revenue declined by \$7.3M from 2012 to 2013 as it was not the only brokerage firm that faced headwinds from the soft fixed income trading markets. Hilltop owns equity warrants representing 17% of SWS Group's outstanding shares and it faced the same issues that First Southwest faced regarding reduced sales of fixed income securities to institutional customers. First Southwest's net profits declined by \$2M year-over-year in 2013 versus 2012 as reductions in non-interest expenses were more than offset by its revenue declines.

Although this is Hilltop's smallest segment, it is disappointing to see pedestrian performance from this business since I expected more out of First Southwest due to the high margin investment banking, brokerage and advisory operations of this business. PlainsCapital sold its 60% controlling ownership in Hester Capital Management for its book value in July 2012. We previously said that if Hilltop can't find a way to generate significant growth in its First Southwest financial advisory business, it should either acquire a similarly sized regional brokerage competitor (like SWS Group) and merge the two organizations together in order to enjoy economies of scale or sell First Southwest to a larger competitor. Lo and behold, Hilltop announced a deal in January to acquire SWS Group for \$7/share, half in cash and half in Hilltop shares. In February, [Esposito Global](#), a diversified financial services firm founded by former SWS employee Mark Esposito announced that it would acquire SWS for \$8/share. SWS is in the process of reviewing both offers.



Sources: [PlainsCapital's 2009-11 Annual Reports](#) and [Hilltop's 2012-13 Annual Reports](#)

Hilltop Holdings' Investment in SWS Group:

Hilltop invested \$50M in a loan and equity warrant in SWS Group (SWS) in 2011, which is the parent of Dallas area brokerage firm Southwest Securities. Hilltop led a \$100M strategic investment in SWS in order to help it shore up its capital due to losses. Hilltop and Oak Hill each lent SWS \$50M at 8% for 5 years and received 8.7M SWS share warrants that it can exercise at \$5.75/share. Regardless of how SWS's share price performs, we did not expect Hilltop to exercise the warrants until it saw demonstrated improvements in SWS's revenue trends, though the pending acquisition proposal could potentially render this moot.

HTH Investment Rollforward: SWS	\$M
Original Investment: July 29th, 2011	\$50.00
Original Issue Discount Accrued	\$4.74
Net Gains/Losses	\$5.31
Interest Received	\$9.70
Ending Value: December 31, 2013	\$69.75
Total Return	39.50%

Source: [Hilltop's 2013 10-K Report](#)

Regulatory Developments:

On Tuesday December 10, the Federal Reserve and Federal Deposit Insurance Corporation both voted unanimously to adopt the Volcker Rule, which would bar banks from proprietary trading and limit their ability to invest in hedge funds and private equity funds. In July, the Federal Reserve approved a final rule that will substantially amend the risk-based capital rules applicable to Hilltop and the Bank. The final rule implements the "Basel III" regulatory capital reforms and changes required by the Dodd-Frank Act. The final rule includes new minimum risk-based capital and leverage ratios, which will be effective for Hilltop and PlainsCapital Bank on January 1, 2015, and refines the definition of what constitutes "capital" for purposes of calculating these ratios. Hilltop has \$177M in unrestricted cash and cash equivalents as of Q3 2013 that it can use to acquire other banks or return to shareholders.

The new minimum capital requirements will be: (i) a new common equity Tier 1 capital ratio of 4.5%; (ii) a Tier 1 to risk-based assets capital ratio of 6% (increased from 4%); (iii) a total capital

ratio of 8% (unchanged from current rules); and (iv) a Tier 1 leverage ratio of 4%. The final rule also establishes a “capital conservation buffer” of 2.5% above the new regulatory minimum capital ratios and will result in the following minimum ratios: (i) a common equity Tier 1 capital ratio of 7.0%; (ii) a Tier 1 to risk-based assets capital ratio of 8.5%; and (iii) a total capital ratio of 10.5%. The new capital conservation buffer requirement would be phased in beginning in January 2016 at 0.625% of risk-weighted assets and would increase each year until fully implemented in January 2019. PlainsCapital Bank’s Tier 1 capital to average assets is 11.05%, its Tier 1 capital to risk-weighted assets is 12.76%, its total capital to risk-weighted assets is 13.36% and this exceeds the new standards.

In addition, the Federal Reserve Board published an interim final rule in September 2013 that clarifies how companies should incorporate the Basel III regulatory capital reforms into their capital and business projections during the next cycle of capital plan submissions and stress tests. For companies and their subsidiary banks with between \$10.0B and \$50.0B in total consolidated assets, the initial capital planning and stress testing cycle began on October 1, 2013 and continues through the fourth quarter of 2015, which overlaps with the implementation of the Basel III capital reforms beginning on January 1, 2015. At December 31, 2013, Hilltop and PlainsCapital Bank had approximately \$8.9B and \$8B, respectively, in total consolidated assets. Accordingly, Hilltop and the Bank are not subject to this capital planning and stress testing cycle. If PlainsCapital Bank grows to have more than \$10.0B in assets through additional acquisitions or organic growth, it may become subject to future capital planning and stress testing cycles, which would likely increase its cost of regulatory compliance.

Large Shareholders

Gerald J Ford is the sole general partner of Diamond A Financial, LP and Diamond A Financial owns 15M shares of Hilltop Holdings, which it has held since 2008. This represented nearly 27% of Hilltop’s shares before its acquisition of PlainsCapital and 18% of its shares after the deal closed. Other notable shareholders include the following firms:

- Burgundy Asset Management (4.66M shares, 5.16% of Hilltop)
- Ranger Investment Management (1.23M shares, 1.37% of Hilltop)
- Royce & Associates (765K shares, 0.85% of Hilltop)
- Bandera Partners (788K shares, 0.94% of Hilltop)
- Highfields Capital Management (624K shares, 0.74% of Hilltop)
- Hodges Capital Management (518K shares, 0.61% of Hilltop)

Risks to Hilltop Holdings include the following:

- Increased severity of weather-related events impacting its insurance division
- Continued weakness in the fixed income and mortgage markets impacts its First

Southwest investment banking division and its PrimeLending mortgage unit

- Economic weakness resulting in loan loss headwinds

In conclusion, we remain Neutral on Hilltop Holdings. We were pleased with the pro forma performance of PlainsCapital Bank in 2013 versus 2012. We were encouraged that Hilltop chose to acquire PlainsCapital last year because PlainsCapital continues to show strong growth and operational improvements. We were waiting a long time for Gerald and Jeremy Ford to execute a strategic deal. We thought that the SWS Loan and Warrant package in 2011 was a good start towards putting its cash pile to work. We got irritated with Hilltop's performance in the wake of its weak Q1 2012 results until we heard the good news that it announced the PlainsCapital deal. We are also looking to see if the Ford Family will be able to execute its proposed acquisition of SWS. Finally, we were happy that the National Lloyds insurance business generated a pre-tax underwriting profit in 2013 after years of losses. However, we believe that the Ford Family should be more proactive in improving it or selling it to another firm who can manage it better.

VALUATION ANALYSIS

DCF/NPV Pro Forma Model Summary									
Fiscal Year	2009A	2010A	2011A	2012A	2013A	2014E	2015E	2016E	
Insurance Operations Legacy Hilltop									
Insurance Premiums Earned	\$115.2	\$117.2	\$134.0	\$146.7	\$157.5	\$165.4	\$173.7	\$182.4	5% Growth
Net Investment Income	\$6.5	\$7.7	\$10.5	\$4.4	\$7.4	\$7.8	\$8.2	\$8.6	5% Growth
Other Income	\$6.9	\$6.7	\$6.8	\$7.4	\$8.7	\$9.1	\$9.6	\$10.0	6% Growth
Gains & Losses on Investments	\$0.3	\$0.1	\$0.8	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0	NM
Total Revenue	\$128.8	\$131.7	\$152.2	\$158.5	\$173.6	\$182.3	\$191.4	\$201.0	
Loss and loss adjustment expenses	\$70.3	\$70.9	\$96.7	\$109.2	\$110.8	\$116.3	\$122.1	\$128.2	5% Growth
Policy Acquisition and underwriting Exp	\$43.2	\$44.2	\$47.4	\$43.7	\$46.3	\$48.6	\$51.0	\$53.6	5% Growth
General and administrative expenses	\$7.2	\$7.4	\$8.9	\$8.9	\$9.0	\$9.1	\$9.2	\$9.3	1% Growth
Depreciation and amortization	\$2.0	\$1.8	\$1.7	\$1.4	\$0.0	\$0.0	\$0.0	\$0.0	NM
Interest Expense	\$9.7	\$9.0	\$9.0	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0	NM
Insurance Operating Income	-\$3.5	-\$1.6	-\$11.5	-\$4.7	\$7.6	\$8.3	\$9.1	\$9.9	
Income Tax Expense (Benefit)	-\$1.3	-\$1.0	-\$5.0	-\$2.4	\$2.7	\$2.9	\$3.2	\$3.5	35% Tax Rate
Preferred Stock Dividend & Redemption	\$10.3	\$12.9	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0	Redeemed 2010
Hilltop Net Income Available to Common Shareholders									
	-\$12.4	-\$13.5	-\$6.5	-\$2.3	\$4.8	\$5.4	\$5.9	\$6.4	
Banking & Financial Services Legacy PlainsCapital									
Banking Segment									
Net Interest Income	\$157.2	\$175.5	\$174.8	\$209.73	\$293.3	\$337.24	\$374.3	\$415.52	10% Growth
Provision for loan losses	\$66.7	\$82.6	\$22.0	\$20.0	\$37.1	\$33.4	\$30.1	\$27.1	10% Decline
Noninterest income	\$22.7	\$37.5	\$28.4	\$40.0	\$71.0	\$75.3	\$79.8	\$84.6	6% Growth
Noninterest expense	\$101.9	\$114.6	\$127.6	\$145.0	\$155.1	\$164.4	\$174.3	\$184.7	6% Growth
Banking Segment Operating Income	\$11.2	\$15.8	\$53.6	\$84.7	\$172.1	\$214.7	\$249.8	\$288.3	
Banking Segment Income Tax	\$3.6	\$5.0	\$19.1	\$30.2	\$61.3	\$76.5	\$89.0	\$102.7	35% Tax Rate
Banking Segment Net Income	\$7.6	\$10.8	\$34.5	\$54.5	\$110.8	\$138.2	\$160.8	\$185.6	
Mortgage Origination Segment									
Noninterest income	\$219.1	\$309.3	\$365.4	\$578.8	\$537.5	\$499.9	\$474.9	\$451.1	5% Decline
Noninterest expense	\$184.6	\$262.8	\$325.5	\$497.1	\$472.3	\$448.7	\$426.2	\$404.9	5% Decline
Provision for loan losses	\$0.0	\$0.6	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0	NM
Net Interest Expense	\$7.0	\$21.8	\$16.3	\$24.4	\$37.8	\$32.16	\$30.6	\$29.0	5% Decline
Mortgage Segment Operating Income	\$27.5	\$24.1	\$23.7	\$57.3	\$27.4	\$19.0	\$18.1	\$17.2	
Mortgage Segment Income Tax	\$8.8	\$7.6	\$8.4	\$20.4	\$9.9	\$6.9	\$6.5	\$6.2	35% Tax Rate
Mortgage Segment Net Income	\$18.7	\$16.4	\$15.3	\$36.9	\$17.5	\$12.2	\$11.6	\$11.0	
Financial Advisory Segment									
Noninterest income	\$98.9	\$103.1	\$96.3	\$110.00	\$102.7	\$253.9	\$414.1	\$439.0	6% Growth plus SWS Deal
Noninterest expense	\$96.3	\$103.3	\$102.0	\$117.0	\$112.4	\$259.1	\$414.6	\$439.5	6% Growth plus SWS Deal
Provision for loan losses	\$0.0	\$0.0	-\$0.2	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0	NM
Net interest Income	\$5.0	\$8.9	\$12.5	\$12.50	\$12.1	\$12.8	\$13.6	\$14.4	6% Growth
Advisory Segment Operating Income	\$7.6	\$8.7	\$7.0	\$5.5	\$2.4	\$7.6	\$13.0	\$13.8	
Advisory Segment Income Tax	\$2.4	\$2.8	\$2.5	\$2.0	\$0.9	\$2.7	\$4.7	\$5.0	35% Tax Rate
Advisory Segment Net Income	\$5.2	\$5.9	\$4.5	\$3.5	\$1.5	\$4.8	\$8.3	\$8.8	
Corporate & Other Net	\$0.1	\$0.1	\$0.5	-\$6.6	-\$7.8	-\$8.2	-\$8.6	-\$9.1	5% Growth
Total Net Income Before Minority Interest and Preferred Stock Dividends									
Minority Interest	\$0.2	\$0.8	\$1.7	\$1.7	\$1.4	\$1.5	\$1.6	\$1.7	
Preferred Dividends	\$5.7	\$5.6	\$7.5	\$4.0	\$4.3	\$4.0	\$4.0	\$4.0	
Plains Capital Net Income Available to Common Shareholders									
	\$25.6	\$26.8	\$45.7	\$82.6	\$116.3	\$141.6	\$166.5	\$190.7	
Pro Forma Net Income HTH & PCC	\$13.2	\$13.4	\$39.2	\$80.4	\$121.1	\$147.0	\$172.4	\$197.1	
Pro Forma Shares Outstanding	84.0	84.0	84.0	83.9	88.1	93.3	96.0	96.0	
Diluted EPS	\$0.16	\$0.16	\$0.47	\$0.96	\$1.40	\$1.58	\$1.80	\$2.05	
DVD/Share	\$0.20	\$0.20	\$0.24	\$0.24	\$0.00	\$0.00	\$0.00	\$0.00	No Dividend
PV of Dividend Stream	N/A	N/A	N/A	N/A	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00
Terminal Value of Stock				PE	2016 Stock Price				\$26.20
Cumulative PV of Stock & DVD				17	\$34.91				\$26.20
Current Price									\$23.65
Net Present Value									\$2.55
Discount to Estimated Intrinsic Value									
Estimated Annual Total Return									9.73%
Discount Rate/Cost of Capital									15.50%
									11%

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Disclosure: Our firm is long HTH

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