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Q3 2023 Southside Bancshares Inc Earnings Call

EVENT DATE/TIME: OCTOBER 26, 2023 / 4:00PM GMT

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Graham Conrad Dick *Piper Sandler & Co., Research Division - VP & Research Analyst*
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PRESENTATION

Operator

Hello, and welcome to Southside Bancshares, Inc. Third Quarter 2023 Earnings Conference Call. (Operator Instructions).

I would now like to hand the conference over to Lindsey Bailes, Vice President of Investor Relations. You may begin.

Lindsey Bailes ***Southside Bancshares, Inc. - VP & IR Officer***

Thank you, Towanda. Good morning, everyone, and welcome to Southside Bancshares' Third Quarter 2023 Earnings Call. A transcript of today's call will be posted on southside.com under Investor Relations.

During today's call and in other disclosures and presentations, I'll remind you that any forward-looking statements are subject to risks and uncertainties. Factors that could materially change our current forward-looking assumptions are described in our earnings release and our Form 10-K.

Joining me today are Lee Gibson, President and CEO; and Julie Shamburger, CFO. First, Lee will share his comments on the quarter, and then Julie will give an overview of our financial results.

I will now turn the call over to Lee.

Lee R. Gibson ***Southside Bancshares, Inc. - President, CEO & Director***

Thank you, Lindsey. Good morning, everyone, and welcome to Southside Bancshares' Third Quarter Earnings Call.

This morning, we reported net income of $18.4 million, earnings per share of $0.60, a return on average tangible common equity of 13.17%, and continued strong asset quality metrics. During the quarter, we recorded a provision for credit losses of $7 million due primarily to increased concerns reflected in the CECL economic forecast related to the commercial real estate market and repricing risk associated with the overall higher interest rate environment.

Linked quarter, we experienced loan growth of $91.6 million and deposit growth of $231.9 million. Our deposit growth was driven by higher cost public fund deposits of $265.8 million from 2 of our contractual municipalities. These higher cost deposits, combined with overall higher funding cost pressure, were largely responsible for the 15 basis point decrease in linked quarter in our net interest margin.

During October, we swapped an additional $100 million to help mitigate further funding cost pressures. Our current loan pipeline is less robust than earlier this year. However, we still anticipate that we will end the year with high single-digit loan growth. The markets we serve remain healthy and continue to grow and perform well. I look forward to answering your questions following Julie's remarks.

I will now turn the call over to Julie.

Julie N. Shamburger ***Southside Bancshares, Inc. - CFO***

Thank you, Lee. Good morning, everyone. Welcome to our call. We reported third quarter net income of $18.4 million, a decrease of $6.4 million on a linked-quarter basis and diluted earnings per common share of $0.60, a decrease of $0.21 or 25.9% linked quarter. We had loan growth of $91.6 million or 2.1% linked quarter, driven by a $63.2 million increase in construction loans and a $17 million increase in commercial real estate loans.

The interest rate of loans funded during the quarter was on average approximately 7.6%. As of September 30, our loans with oil and gas industry exposure were $102 million or 2.3% of total loans. Our allowance for credit losses increased by $6.1 million for the linked quarter, to $45.6 million. The increase was driven by a loan loss provision of $6.3 million and a provision for off-balance sheet credit exposures of $0.6 million for the third quarter. And when combined, increased $7.1 million from prior quarter. The increase in provision was driven by the increased economic and repricing concerns forecasted in our CECL model.

Asset quality metrics remain strong with nonperforming assets of $4.4 million or 0.05% of total assets on September 30.

On September 30, our allowance for loan losses as a percentage of total loans was 0.94%, an increase compared to 0.84% at June 30, due to the increased provision. Our securities portfolio decreased $4.8 million or 0.2% on a linked-quarter basis. There were no transfers of AFS securities during the third quarter.

On September 30, we had a net unrealized loss in the AFS securities portfolio of $137 million compared to $69.7 million last quarter, an increase of $67.3 million, primarily in the municipal securities portfolio due to higher interest rates.

As of September 30, the unrealized gain on the fair value hedges in municipal securities was approximately $42.2 million compared to $27.9 million linked quarter which partially offset the unrealized losses in the AFS securities portfolio.

Our AOCI on September 30, 2023, was a net loss of $155 million compared to a net loss of $115.7 million on June 30, 2023. The net loss on September 30, 2023, was composed of a net loss on our securities and swap derivatives of $135.9 million and a $19.1 million loss related to our retirement plans.

As of September 30, the duration in the total securities portfolio was 9.7 years, and the duration of the AFS portfolio was 8 years. Our mix of loans and securities shifted slightly to 63% and 37%, respectively, compared to 62% and 38% on June 30. Deposits increased $231.9 million or 3.8% on a linked-quarter basis, driven by an increase in public fund deposits of $265.8 million.

Our capital ratios remained strong with all capital ratios well above the capital adequacy and well-capitalized threshold. Liquidity resources remained solid with $2.4 billion in liquidity lines available as of September 30.

During the third quarter, we purchased 212,388 shares of common stock at an average price of $29.39, pursuant to our stock repurchase plan. Since quarter end and through October 24, we have purchased 141,480 shares at an average price of $28.56.

Our tax equivalent net interest margin decreased 15 basis points on a linked-quarter basis to 3.02% from 3.17%. The decrease is largely driven by the 55 basis point increase in interest-bearing deposits, more than offsetting the increase in loan yields of 17 basis points. The tax equivalent net interest spread decreased for the same period by 24 basis points to 2.31%, down from 2.55%.

For the 3 months ended September 30, net interest income decreased $643,000 or 1.2% compared to the linked quarter. The purchased loan accretion recorded this quarter was $70,000.

Noninterest income, excluding the net loss on the sales of AFS securities and equity securities decreased $452,000 or 4% for the linked quarter, driven by nonrecurring income recorded in the second quarter relating to the gain on the purchase of $5 million of our subordinated debt.

Noninterest expense increased $560,000 on a linked-quarter basis to $35.6 million. For the fourth quarter, we have budgeted approximately $35.5 million in noninterest expense. Our fully taxable equivalent efficiency ratio increased to 52.29% as of September 30, from 51.06% as of June 30.

Income tax expense decreased $1.4 million to $3.1 million, and our effective tax rate decreased to 14.5% for the third quarter from 15.5% in the previous quarter. We currently estimate an annual effective tax rate of 14.9% for 2023.

Thank you for joining us today. This concludes our comments, and we will open the line for your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Brady Gailey with KBW.

Brady Matthew Gailey ***Keefe, Bruyette, & Woods, Inc., Research Division - MD***

So the margin is still above 3%, but it keeps moving down every quarter. When do you think we're going to hit the bottom on the net interest margin? Do you think it dips below 3%?

Lee R. Gibson ***Southside Bancshares, Inc. - President, CEO & Director***

Yes. We are -- I mean, we did swap another $100 million. So we think that will take a little bit of the pressure off. At this point, any loans we make over $2.5 million are going to be floating or they have to be swapped. And we're looking at different funding costs and really our public fund costs to see if we just need to potentially run some of those deposits off, to pick up some cheaper funding elsewhere.

So -- I would -- in answer to your -- it's a long answer. But in answer to your question, and I think there's still some more margin compression coming. A lot of it probably has to do with how much we can have in loan growth moving forward, especially in '24, this quarter, I think we'll have decent loan growth, but it's really going to be dependent on how much loan growth we have next year.

But I would anticipate that we're probably looking at some additional NIM pressure. And I wouldn't say just slightly below 3%. I'd say that it potentially can get 25 or so basis points below 3% at some point.

Brady Matthew Gailey ***Keefe, Bruyette, & Woods, Inc., Research Division - MD***

Right. And then -- so once the NIM hits that bottom and funding costs have plateaued, because there some banks talking about asset repricing that could -- assuming rates are flat from here, some banks are talking about asset repricing where the NIM could hit that bottom and then assets reprice, then the NIM starts to inflect higher at some point next year. Do you think that is a likely scenario for Southside?

Lee R. Gibson ***Southside Bancshares, Inc. - President, CEO & Director***

We will have some loans that reprice next year. It really just depends -- what the Fed does. If the Fed has another interest rate increase out there, then not sure there's enough -- there's a fair amount of assets that will reprice. It's possible by late next year. I wouldn't anticipate that's going to happen in the first 6 months. It's possible with all that asset repricing that we could see that later in the year, that the NIM would actually go the other direction.

Brady Matthew Gailey ***Keefe, Bruyette, & Woods, Inc., Research Division - MD***

Okay. AlRight. And then I heard Julie talk about expenses basically being flat next quarter at this $35.5 million level. As we look to 2024, how are we thinking about expense growth next year?

Lee R. Gibson ***Southside Bancshares, Inc. - President, CEO & Director***

We have not set a final budget together. I'll tell you that. I would anticipate expense growth -- we'll have some expense growth but we'll probably try to keep it in the 3% realm, somewhere in that range. But we're going to have some higher wages and things of that nature.

Julie N. Shamburger ***Southside Bancshares, Inc. - CFO***

And earlier in the year, in the first couple of quarters, I projected out that our budgeted expense was $35.5 million. I've pretty much said that all year and it just -- this last quarter has finally hit that amount.

And one other thing I would add, we've done a lot of the heavy lifting on a lot of the technology that's already embedded in here, in these numbers. So I'm expecting to see that -- maybe not the steep escalation in that as much as we've seen this year.

Lee R. Gibson ***Southside Bancshares, Inc. - President, CEO & Director***

I'll say this. We haven't -- 2 things. We haven't put the budget together. We're having a meeting this afternoon with all the executive management team. And the message Julie and I are going to deliver is, if you want to spend more money next year, explain to us how that's going to make us money, where the revenue is coming from.

Brady Matthew Gailey ***Keefe, Bruyette, & Woods, Inc., Research Division - MD***

Yes. All right. And then finally for me, you guys have been a pretty consistent repurchaser of your shares over the last 3 or so years. Is there any reason to think that, that would slow down here? Or do you think the stock is on sale, we're going to continue to be active in the buyback as far as the eye can see?

Lee R. Gibson ***Southside Bancshares, Inc. - President, CEO & Director***

What I would say is we have a little over 600,000 shares left to repurchase. I don't see us slowing down on repurchasing until that's used up, and then it'll -- we'll go to the Board and there'll be a discussion, then we'll make a decision at that point if there's going to be additional purchases.

Operator

(Operator Instructions) Our next question comes from the line of Graham Dick with Piper Sandler.

Graham Conrad Dick ***Piper Sandler & Co., Research Division - VP & Research Analyst***

So I just wanted to circle to the reserve. I know it was CECL-driven this quarter. I just wanted to hear your -- yall's perspective on the drivers behind that. It sounded like repricing risk and some CRE-related stuff. Do you see repricing risk and CRE risk in your loan book that this CECL reserve build is effectively capturing? Or is this sort of external to the -- to your all's bank and more of a factor outside of your control, I guess?

Lee R. Gibson ***Southside Bancshares, Inc. - President, CEO & Director***

Well, I'll tell you this. We -- every 6 months, we go through and look at all the CRE loans that are going to reprice, whether they're going to reprice next year or 3 or 4 years from now. And we determine whether or not we feel like they're close, or whether or not -- they're fine if they reprice at current rates and we stress them.

There's a few loans that we put on the watch list mainly because they're close. But I will tell you that I'd like to see all the CRE loans reprice immediately. And because the few loans that are close, it just means they're close. It doesn't mean they can't chin the bar, but they're close in terms of meeting their debt service coverage ratios.

A lot of these that are 2 and 3 years out, and I wish my ouija board was good enough to know if rates are going to be higher or lower at that point in time. But what I can tell you is every 6 months, we're going to be looking at this based on current rates and stressing them to determine if there is some risk in the portfolio.

So long story short, we're not seeing it and -- but the economic forecast reflects concern in that arena and reflects concern around the commercial real estate market, especially around office. And we're just not seeing it in our portfolio, but there's so much uncertainty out there in the overall market nationwide. We just didn't feel comfortable adjusting the economic forecast to our specific portfolio. Does that help answer your question?

Graham Conrad Dick ***Piper Sandler & Co., Research Division - VP & Research Analyst***

Yes, absolutely. And so I guess as you think about the reserve from here, it sounds like the adjustments from the CECL forecast were sort of driven by the higher for longer outlook.

So if we don't get any more rate hikes and really the rate outlook doesn't change materially, do you think that provisioning maybe returns to a level -- more normal level, I guess, going forward? Or is there a potential for more CECL-related reserve build to take the ACL over 1% of loans?

Lee R. Gibson ***Southside Bancshares, Inc. - President, CEO & Director***

Well, one thing I think that is important to note is, we have about 11% of our loans roughly are in municipal loans. And that mostly have ad valorem tax pledges, and we virtually have no reserve against those under the CECL model simply because they have ad valorem tax pledges.

So if we normalize and took those out of the equation, we would be over 1% currently as opposed to 0.94%. In answer to your question, as long as the economic forecast remains consistent where it is today, I don't see a huge buildup in any 1 quarter like this. Now if the economic forecast changes, then all bets are off, because that's the big driver in the CECL model, is what the economic forecast is. If I didn't totally answer your question, feel free to dig in some more.

Graham Conrad Dick ***Piper Sandler & Co., Research Division - VP & Research Analyst***

No. It's perfect. All right. And I guess on loan growth, it sounds like you're going to hit that target you guys set out at the beginning of the year, high single digit, but the pipelines are getting a bit smaller.

What are your thoughts on growth in 2024? Are we talking about more of a mid-single-digit growth level? Or do you think you might be able to maintain the high single-digit pace you'll see -- that you saw this quarter and then also -- that you saw for the full year?

Lee R. Gibson ***Southside Bancshares, Inc. - President, CEO & Director***

Right now based on where rates are and the ability of loans to meet our credit guidelines, and it's primarily the debt service coverage ratios with the current rates and how much equity needs to go into deals, I think the mid-single digits is probably more likely for next year than what we've experienced this year.

Now if things change and rates change, then our markets are strong. It's just people are -- when you go to them and tell them it's going to take 50% equity in their deal or in some cases, more than that. Their numbers don't work on their end and for their equity folks. So that's really what we're seeing. It's not a credit concern. It's more of ability for them to cash flow with the amount of equity they want to put in the deal.

Graham Conrad Dick ***Piper Sandler & Co., Research Division - VP & Research Analyst***

Okay. Great. That makes sense. And then I guess just lastly on the funding side. I think you guys picked up some BTFP this quarter. Just wondering what you guys are thinking about that right now, maybe the potential to do more of it going forward and replace some of the higher cost borrowings on balance sheet and maybe even some broker deposits that might cost a bit more. Do you guys have any appetite for that?

Lee R. Gibson ***Southside Bancshares, Inc. - President, CEO & Director***

Okay. You mentioned, what did we pick up? You used an acronym.

Graham Conrad Dick ***Piper Sandler & Co., Research Division - VP & Research Analyst***

Bank Term Funding Program.

Lee R. Gibson ***Southside Bancshares, Inc. - President, CEO & Director***

Oh. We have taken out all the Bank Term Funding Program dollars that we can. Obviously, when it gets closer to maturity, if we want to reprice that for another year, we can at that point in time. But at this point, we -- ours is locked in at a rate around 4.46%. And so we don't have any additional collateral that meets the threshold to take out additional funding on that.

But that will -- those will mature sometime in March, April. And I think there may be a little bit that matures in May. But we'll make that decision at that point in time based on what those rates are.

Graham Conrad Dick ***Piper Sandler & Co., Research Division - VP & Research Analyst***

Okay. All right. That's helpful. And then I guess just the last question I have would be on the funding side, the deposit side. Seems like the municipal deposits drove their growth this quarter. But just wondering if you think that you might be able to at least keep pace with loan growth on the deposit side, whether that be core deposit generation maybe back to the brokerage side.

Lee R. Gibson ***Southside Bancshares, Inc. - President, CEO & Director***

That is our major focus for the next quarter and for all of 2024 and maybe beyond, is mainly non-maturity deposit growth. And so that's going to be the focus. That's where incentives are going to be heavily skewed because that's what we need. And it's out there. We just have to go get it.

Operator

Our next question comes from the line of Matt Olney with Stephens.

Matthew Covington Olney ***Stephens Inc., Research Division - MD & Analyst***

Going back to margin discussion. Deposit costs. Just any updated targets or thoughts on deposit betas for the cycle, where -- given the pressure you mentioned earlier, where do you think these betas could move towards, over the next few quarters?

Lee R. Gibson ***Southside Bancshares, Inc. - President, CEO & Director***

I think if we look historically, the betas continue to move up more. Where betas right now are nowhere near the historical norms of where they get to in terms of the amount of Fed increases. And -- but it's different and different in each market. But -- so I'm not sure exactly how much that beta is going to move up. But we're going to be looking at a lot of different things. We may look at some more swaps. And we're just going to -- we're going to look at our highest cost deposits to make a decision whether or not it makes sense to retain those, or if there's a better way to go out and tie that money up some other way.

So -- but the beta is definitely going to go up. It's just a matter of how much and how much we can offset it and mitigate it on the other side, in terms of loans and a little bit on the security side.

Matthew Covington Olney ***Stephens Inc., Research Division - MD & Analyst***

Okay. And then specifically on the time deposits, any color you can provide as far as the maturities that are coming up in the near term. I don't know if Julie has that for the fourth quarter, volumes and repricing details behind that.

Lee R. Gibson ***Southside Bancshares, Inc. - President, CEO & Director***

I know this quarter, we have $80 million in CDs that come due, and I don't have the exact rates, just a second, they are handing it to me. Yes. It looks like the rates are on average, I'm going to say, 4.80%, is it at the bottom? Okay. Well, I got real close, 4.79%. I was looking at the 3 months. They have them grouped together in quarters.

So there's $80.7 million that comes due in this quarter, and the average rate on those is 4.79%. So that will move up some. And then we have another $65 million in the first quarter that's at 4.91%, another $96 million that's almost in the second quarter that's almost at 5%.

So there'll be some repricing risk associated with those, but it's not going to be like it's going up 1% or 2% or anything like that, we're probably looking at 0.25% on average for those CDs that are going to renew. Is that -- help? Yes.

Operator

I'm showing no further questions in the queue. I would now like to turn the call back over to Lee Gibson for closing remarks.

Lee R. Gibson ***Southside Bancshares, Inc. - President, CEO & Director***

Thank you, everyone, for joining us today. We appreciate the opportunity to answer your questions along with your interest in Southside Bancshares.

In closing, we are looking forward to our prospects for the remainder of 2023 and look forward to reporting fourth quarter results to you during our next earnings call in January. Thank you again.

Operator

Ladies and gentlemen, this concludes today's conference call. Thank you for your participation. You may now disconnect.