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SBSI - Q3 2016 Southside Bancshares Inc Earnings Call

EVENT DATE/TIME: OCTOBER 28, 2016 / 2:00PM GMT

THOMSON REUTERS

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Brady Gailey *KBW - Analyst*

Kevin Fitzsimmons *Hovde Group - Analyst*

Brad Milsaps *Sandler O'Neill - Analyst*

Michael Young *SunTrust Robinson - Analyst*

PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Southside Bancshares, Inc. third-quarter earnings call.

(Operator Instructions)

As a reminder, this conference is being recorded. I would like to introduce the host for today's call Ms. Deborah Wilkinson, Executive Vice President, Investor Relations. Ma'am, you may begin.

Deborah Wilkinson - *Southside Bancshares, Inc. - IR*

Thank you, Amanda. Good morning, everyone, and thank you for joining Southside Bancshares third-quarter earnings call.

The purpose for this call is to discuss the Company's results for the quarter just ended and our outlook for upcoming quarters. 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 will remind you that any forward-looking statements made are subject to risk and uncertainties. Factors that could materially change our current forward-looking assumptions are described in our earnings release and in our Form 10-K.

Joining me today to review Southside Bancshares third-quarter results are Julie Shamburger, our CFO, and Lee Gibson, our President. Our agenda today is as follows: first you will hear Julie discuss an overview of financial results for the third quarter of 2016 including loan growth, oil and gas exposure and our loan portfolio and an update on our securities portfolio and our cost savings, then Lee will share his comments on the quarter.

I will now turn the call over to Julie.

Julie Shamburger - *Southside Bancshares, Inc. - EVP & CFO*

Thank you, Deborah. Good morning everyone. Welcome to Southside Bancshares 2016 third-quarter earnings call.

We had a solid third quarter with net income of $12.9 million. Our diluted earnings per share for the third quarter ended September 30, 2016 were $0.49 per share, an increase of 11.4% compared to the same period last year. Our diluted earnings per share for the nine months ended September 30, 2016 were $1.43, an increase of 18.2% compared to the same period in 2015.

On a linked-quarter basis we reported a $99 million increase in loans. This was primarily driven by increases in our commercial real estate and construction loan portfolios, largely offsetting the continued rolloff in the indirect automobile portfolio of approximately $10.5 million. This increase in loans during the third quarter reinforces our belief that we will see loan growth during the balance of 2016 based on our existing pipeline of approved unfunded loans.

At September 30, 2016 our loans with oil and gas industry exposure remain very minimal at 1.1% of our loans. We recorded loan-loss provision expense during the third quarter of $1.6 million, down from $3.8 million in the second quarter which was related to the two large impaired commercial loans charged down last quarter to the estimated net selling price of the remaining assets.

During the third quarter we sold the nonperforming assets related to both of these loans and incurred approximately $400,000 in net expense related to the sale of these assets. As a result of these two charge-offs in the third-quarter sales of the related nonperforming assets, total nonperforming assets decreased just over 50% from $32.5 million at December 31, 2015 to $16 million at September 30, 2016. And our ratio of nonperforming assets to total assets decreased to 0.29% at September 30, 2016 from 0.63% at December 31, 2015.

Next I will give a brief update on our securities portfolio. At September 30, 2016 we had a net unrealized gain in the securities portfolio of $66 million. The duration of the securities portfolio at September 30 increased to five years compared to the prior quarter's duration of 4.52 years as we temporarily increased the size of the securities portfolio to offset the interest expense of the sub debt offering. As loan growth occurs we will gradually reduce the securities portfolio.

We anticipate continuing to utilize a barbell approach for our securities purchases using US agency CMOs for the short end and treasury notes, agencies, commercial mortgage-backed securities and Texas municipal securities for the longer end. During the third quarter our net interest margin decreased 16 basis points to 3.19% and our net interest spread decreased 18 basis points to 3.06% on a linked-quarter basis.

Average loan yields decreased primarily as a result of a decrease in purchase accretion of $487,000 compared to the second quarter. Average security yields decreased due to the increase in the securities portfolio previously mentioned and the overall lower interest rate and an increase in our cost of funds, primarily the increase in the cost of time deposits.

During the three months ended September 30, 2016 our noninterest expense increased primarily due to the prepayment and early termination of the lease on our Fort Worth operations facility that we had recently vacated. We prepaid this lease at approximately 59% of the remaining lease payments. And we anticipate a monthly savings and lease expense of approximately $45,000.

Overall cost containment efforts were consistent during the quarter. We anticipate cost-containment initiatives that we are currently implementing will result in additional cost savings in future quarters.

We are also pleased to mention that in September we issued $100 million of 5.50% fixed to floating rate subordinated notes due in 2026. This debt initially bears interest at a fixed rate of 5.5% through September 29, 2021 and thereafter adjusts quarterly at a floating rate equal to three-month LIBOR plus 429.7 basis points. We believe the issuance of the subordinated notes will strengthen our capital position and provide for loan and franchise growth.

Thank you. And I will turn the call over to Lee.

Lee Gibson - *Southside Bancshares, Inc. - President*

Thank you, Julie. The third quarter saw net income grow 9.4% over last year and nine-months net income increased 16.9% over the first nine months of 2015. Southside showed solid financial results by almost every measure during the first nine months, primarily resulting from successful cost-containment efforts, increasing revenues and strong asset quality with a nonperforming asset to total asset ratio of 0.29% at the end of the quarter.

The loan expansion we expected this year began during the third quarter as the loan commitments made throughout 2016 funded at a greater pace with loans increasing approximately $100 million. We expect this to continue during the fourth quarter and into 2017 as our loan pipeline remains solid. Opportunities to review new loan requests and approve quality loans persist in all of our markets.

As loan growth occurs and we are able to replace securities with loans our margins should improve. The additional capital we raised during the quarter expands our options to enhance the franchise. We continue to find areas for cost containment as our efforts to automate and streamline processes are bearing fruit.

The DFW and Austin economies remain robust fueled primarily by job growth and Company relocations. The Tyler economy reflects a slower but steady growth pattern. We look forward to closing out the year with a solid fourth quarter and entering 2017 with promising loan growth prospects, a strong balance sheet and a lower cost structure.

At this time we will conclude our prepared remarks and open the lines for your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Brady Gailey, KBW.

Brady Gailey - *KBW - Analyst*

Hey, it's Brady. Good morning guys. So just looking at the margin the bond yield was down, loan yield was down, funding cost was up a little bit most of the time, that's everything headed in the wrong direction for the margin.

How do you think about the margin going forward? I know some of the bond yield issues were because of some added securities. How do you think about the margin going forward and especially into 2017?

Lee Gibson - *Southside Bancshares, Inc. - President*

I think on the bond side we are not going to be adding to that bond portfolio. We did that to offset those costs on the sub debt offering. As we add additional loans and loan growth occurs in the future quarters we are going to be gradually reducing that securities portfolio.

So I would anticipate that the securities portfolio yields should remain fairly consistent and the loan portfolio yields on average are much higher than the securities portfolio yield. So we should start to see some pickup in the overall asset yield.

Brady Gailey - *KBW - Analyst*

Okay and then on the funding side, do you think the funding cost will continue to rise from here on out? Are you seeing competitive pressure to rise deposit cost?

Lee Gibson - *Southside Bancshares, Inc. - President*

The only place we are seeing any competitive pressure is in that time deposit area. The rest of it we are just not seeing any pressure at all. There's a little bit of pressure in that time deposit arena, and if the Fed does raise rates in December with our balance sheet and all the floating rate loans that we have, that also will be a positive effect for us.

Brady Gailey - *KBW - Analyst*

Okay. Then on the loan growth side previously you all guided to 7% to 9% loan growth for this year, which maybe you will hit the lower end of that. Do you think as we go into 2017 that's still an appropriate level of growth kind of the high single-digit area?

Lee Gibson - *Southside Bancshares, Inc. - President*

Yes, I think the 7% to 9% for 2017 is probably appropriate. I think for this year we know that we have a couple of payoffs in the fourth quarter. So I think something probably similar to what we saw in the third quarter is what we are probably looking at in terms of loan growth for the fourth quarter.

Brady Gailey - *KBW - Analyst*

Okay, and then last for me just an update on M&A. Are you all having more conversation with targets or less conversation? Just an update on general M&A in Texas.

Lee Gibson - *Southside Bancshares, Inc. - President*

We are seeing more things come across our desk. And there seems to be more opportunities out there. Some of them look interesting and some of them are in market areas that we are just really not interested in.

Brady Gailey - *KBW - Analyst*

All right great. Thanks, Lee.

Operator

Kevin Fitzsimmons, Hovde Group.

Kevin Fitzsimmons - *Hovde Group - Analyst*

Hi, good morning. Just wanted to touch on loan growth again.

You alluded to it, Lee, that I guess the fundings accelerated over the course of the quarter and I'm assuming maybe you had some paydowns in third quarter, as well, you just I think alluded to that, as well. So is that really what explains what was a pretty sharp difference between average loan growth linked quarter which was pretty low and end-of-period loan growth linked quarter which was more substantial?

Lee Gibson - *Southside Bancshares, Inc. - President*

That is correct.

Kevin Fitzsimmons - *Hovde Group - Analyst*

I think you mentioned on last quarter's call that you guys tend to see this seasonality of your loans just increasingly funding in the back half of the year, right?

Lee Gibson - *Southside Bancshares, Inc. - President*

We have for the last two years. We saw this in 2015 and we are seeing it this year. I don't know that we could explain it.

We've talked to our loan officers and we are perplexed by it. But I don't know if it's the heavy rains we've received in the spring and some of our construction projects get pushed back and the heavy equity that's going into some of those. We're not sure what it is, but that has happened the last two years.

Kevin Fitzsimmons - *Hovde Group - Analyst*

And when you just said for fourth quarter you'd expect loan growth to be like the third quarter. Are you talking about average loan growth or you're talking about end-of-period loan growth?

Lee Gibson - *Southside Bancshares, Inc. - President*

I'm sorry, I'm talking about end-of-period loan growth. I think average loan growth should be much better than what we saw in the third quarter.

Because you are right, average loan growth was only about $10 million. And we've put on a couple of really good size loans I think it was in late August, early September.

Kevin Fitzsimmons - *Hovde Group - Analyst*

Okay, and just a quick question on the expense run rate. So if we pull out the $1.8 million on the leasing, the leases rather, and maybe pull out that $400,000 of dealing with the sale of the nonperformers, is that a decent run rate to think of going into fourth quarter? It still seemed like it went up second to third even making those adjustments, but just wondering if there's other items in there?

Lee Gibson - *Southside Bancshares, Inc. - President*

Actually down there in other expense associated with the sale of the assets there was about a little over $900,000 in expense and losses down there in other expense. And then up in other income we actually had a gain on the sale of part of the assets of that ended up in other income. So the net $400,000 is the net between those two.

So there were a lot of things up there in other income that went both ways but there was about $480,000 I think in gains up there and then a little over $900,000 down there in expense. So that was the big driver in other expense going up.

Kevin Fitzsimmons - *Hovde Group - Analyst*

Got it. Okay, that's helpful. Thank you.

Okay, that's all I had. Thank you.

Operator

(Operator Instructions) Brad Milsaps, Sandler O'Neill.

Brad Milsaps - *Sandler O'Neill - Analyst*

Good morning, guys. You guys have addressed most everything but, Lee, maybe just back to the balance sheet for a bit. Would you think that the overall size of the balance sheet would likely stay the same size?

I know you pre-invested a little bit this quarter with the sub debt coming on late in the quarter, but it looked like short-term borrowings were up quite a bit, too. Is that all related? And just curious how you expect the overall size of the balance sheet to move through the rest of the year and into next?

Lee Gibson - *Southside Bancshares, Inc. - President*

I think the overall size of the balance sheet will probably stay the same. We actually had some extra cash on the balance sheet at the end of the quarter, a little over $100 million. So I think we definitely would look for the balance sheet to stay about the same, potentially maybe even shrink a little bit with that extra cash on there.

Brad Milsaps - *Sandler O'Neill - Analyst*

And just curiously, back to Brady's question about the funding cost. At this point why would you fight to keep those time deposits? Why not let those run if you are having to you said that's the most competitive spot but just given all your liquidity why pay up or compete for those?

Lee Gibson - *Southside Bancshares, Inc. - President*

If you look, the average the size of the time deposits has decreased. So we aren't -- I wouldn't say we are fighting to keep them. It's just the ones we do keep the cost of keeping them is going up.

Brad Milsaps - *Sandler O'Neill - Analyst*

Sure, sure.

Lee Gibson - *Southside Bancshares, Inc. - President*

We are letting them -- we are letting them wind down.

Brad Milsaps - *Sandler O'Neill - Analyst*

Yes, I guess I was looking more year over year. Okay, and then maybe finally just always the mystery number and hard to get exact, but the tax rate, do you think it migrates up closer to 20% or you think you are still sort of in this high teens kind of run rate?

Julie Shamburger - *Southside Bancshares, Inc. - EVP & CFO*

I suspect we are going to stay in this 18%, maybe hit 19% rate is my expectation right now.

Brad Milsaps - *Sandler O'Neill - Analyst*

All right great. Thank you, guys.

Operator

Michael Young, SunTrust.

Michael Young - *SunTrust Robinson - Analyst*

Good morning. Just good to see the credit costs coming back down after last quarter.

It seems like we've got those issues behind us now. But just wanted to get your outlook maybe going forward or even into next year about how much reserve build you need for loan growth and what rate maybe you are provisioning for on new loan growth?

Lee Gibson - *Southside Bancshares, Inc. - President*

I think we're probably budgeting somewhere in the neighborhood of $700,000 to $750,000 a month.

Michael Young - *SunTrust Robinson - Analyst*

Okay. And I guess last one for me, just wanted to see your thoughts now on capital and capital returns. Obviously, you did the sub debt issue, but any thoughts going forward in terms of increasing the dividend and the stock dividend? Should we expect those things to continue as per normal?

Lee Gibson - *Southside Bancshares, Inc. - President*

We're really not looking at -- the stock dividend is something we've consistently done I think since 1993. I don't know that we have any plans to do anything different on that front.

The cash dividend we look at, we don't normally look at it this time in terms of the regular quarterly dividend. So we will look at that probably next year. We do look at a special dividend about this time of year and the Board will probably be considering that in the near future.

Michael Young - *SunTrust Robinson - Analyst*

Okay great. Thanks.

Operator

At this time I'm showing no further questions. I would like to turn the call back over to Mr. Lee Gibson, President.

Lee Gibson - *Southside Bancshares, Inc. - President*

All right, well, thank you for joining us today on today's call and we appreciate you taking the time to join us. And we look forward to a very solid fourth quarter and you joining us in late January for our next earnings call. Thank you again.

Operator

Ladies and gentlemen, thank you for your participation in today's conference. This concludes the program.

You may now disconnect. Everybody have a great day.