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SBSI - Q4 2016 Southside Bancshares Inc Earnings Call

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## CORPORATE PARTICIPANTS

**Deborah Wilkinson** *Southside Bancshares Inc - EVP and IR Officer*

**Julie Shamburger** *Southside Bancshares Inc - CFO*

**Lee Gibson** *Southside Bancshares Inc - President and CEO*

## CONFERENCE CALL PARTICIPANTS

**Brad Milsaps** *Sandler O'Neill & Partners - Analyst*

**Michael Young** *SunTrust Robinson Humphrey - Analyst*

**Mike Belness** *Keefe, Bruyette & Woods - Analyst*

**Stan Westhoff** *Walthausen & Co - Analyst*

## PRESENTATION

**Operator**

Good day, ladies and gentlemen, and welcome to the Southside Bancshares fourth-quarter and year-end 2016 earnings conference call.

(Operator Instructions)

As a reminder, this conference is being recorded.

I would like to introduce your host for today's conference, Mrs. Deborah Wilkinson. You may begin.

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**Deborah Wilkinson** - *Southside Bancshares Inc - EVP and IR Officer*

Thank you, Tiara. Good morning, everyone, and thank you for joining Southside Bancshares' fourth-quarter and year-end 2016 earnings call. The purpose for this call is to discuss the company's results for the quarter and year 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' fourth-quarter and year-end 2016 results are Lee Gibson, our President and CEO, and Julie Shamburger, our CFO. Our agenda today is as follows: first you'll hear Julie discuss an overview of financial results for the fourth quarter and the year ended 2016, including loan growth, asset quality, oil and gas exposure, an update on our securities portfolio, and an update on our public offering that was completed in December of 2016. Then Lee will share his comments on the quarter.

I will now turn the call over to Julie

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**Julie Shamburger** - *Southside Bancshares Inc - CFO*

Thank you, Deborah. Good morning, everyone. Welcome to Southside Bancshares' 2016 fourth-quarter and year-end earnings call.

We reported fourth-quarter net income of $11.6 million compared to fourth-quarter 2015 net income of $11.7 million, a 1% decrease. Excluding the gain and loss on sales of securities from both quarters, net income during the fourth quarter 2016 increased $1.8 million or 15.2% compared to the same period in 2015. We are pleased to report record net income of $49.3 million for the year ended December 31, 2016, an increase of $5.4 million or 12.2% when compared to $44 million for the year ended 2015.

Our diluted earnings per share for the fourth quarter ended December 31, 2016, were $0.43 per share, a decrease of $0.01 or 2.3% compared to $0.44 per share for the same period last year. For the year ended December 31, 2016, diluted earnings per common share increased $0.21 or 12.7% to $1.86, as compared $1.65 for the year ended 2015.

On a linked-quarter basis, we reported an increase in total loans of $73 million. For the year ended December 31, 2016, total loans increased by $124.8 million or 5.1% when compared to December 31, 2015. The growth primarily resulted from an increase in our commercial real estate loan portfolio, and, to a lesser extent, we increased the municipal loan portfolio.

We continue to see roll-off in the indirect consumer portfolio, approximately $44 million during 2016. The indirect portfolio decreased to $36 million at the end of the year, and we do not anticipate the roll-off in this category will significantly impact our efforts to grow the loan portfolio during 2017.

As we stated in our earnings release today, our loan pipeline remains strong, and we expect consistent loan growth throughout 2017. At December 31, 2016, our loans with oil and gas industry exposure remained very minimal at 1.1% of our total loan portfolio.

We recorded loan loss provision expense during the fourth quarter of $2.1 million, an increase from $1.6 million in the third quarter, which was related to loan growth and additional reserve on a few classified loans. During the year ended December 31, 2016, the allowance for loan loss decreased $1.8 million or 9.2% to $17.9 million or 0.70% of total loans when compared to 0.81% at December 31, 2015, primarily as a result of the charge-offs of two large impaired commercial borrowing relationships we previously reported during the second quarter of 2016.

Nonperforming assets decreased during the year ended December 31, 2016, by $17.4 million or 53.5% to $15.1 million or 0.27% of total assets compared to 0.63% of total assets at December 31, 2015.

Next I will give a brief update on our securities portfolio. At December 31, 2016, we had a net unrealized loss in the securities portfolio of $29.2 million. The duration of the securities portfolio at December 31, 2016, and September 30, 2016, was approximately five years. On a linked-quarter basis the size of the securities portfolio remained virtually the same, as the securities only increased $19.3 million during the fourth quarter.

During the fourth quarter we sold $45 million of our lowest-yielding US treasury notes at a loss of approximately $2.7 million. As the loan portfolio continues to grow, we will gradually reduce the securities portfolio. We anticipate continuing to utilize a barbell approach for our security purchases using US agency CMOs for the short end and treasury notes, agency, and commercial mortgage-backed securities for the longer end.

During the fourth quarter we reported our net interest margin at 3.03% and our net interest spread at 2.90%, both decreases of 16 basis points on a linked-quarter basis. The decrease in both the net interest margin and yield were a direct result of the sub debt outstanding during the fourth quarter, offset somewhat by the increase in our average loan balance and yield, as well as the increase in the average securities portfolio.

During the three months ended December 31, 2016, our non-interest expense decreased $2.6 million or 9% when compared to the fourth quarter 2015, primarily due to cost containment in almost all non-interest expense categories. We anticipate cost containment initiatives that were implemented in 2016 will result in additional cost savings in 2017.

We are also pleased to mention that in December we issued 2.185 million shares of our common stock at a price of $36.50 per share, resulting in net proceeds of $76 million after deducting the underwriting discount and related expenses. We believe this transaction strengthened our capital position and provides for loan and franchise growth.

Thank you, and I will now turn the call over to Lee.

**Lee Gibson** - *Southside Bancshares Inc - President and CEO*

Thank you, Julie. 2016 was an exceptional year by any measure, primarily due to increased revenues and improvements in expense control.

A 12.2% increase in net income resulting in record earnings highlighted our financial performance during 2016. During the year we added $125 million in loans, and we were successful in significantly improving our asset quality, with nonperforming assets to total assets decreasing over 50% to 0.27% at year end.

We continue to experience bottom-line results in our cost containment efforts during 2016, resulting in a 52% efficiency ratio during the fourth quarter. Our goal is for this ratio to average 50% or less during 2017.

In early December, with our stock price up over 65% year-to-date, we issued common stock, netting $76 million of additional capital for future growth and potential acquisitions.

We are excited about our prospects for 2017 and look forward to a year filled with additional opportunities. Our loan pipeline is strong, and we believe loan growth during 2017 will be more consistent. Solid asset quality, loan concentration levels below regulatory guidelines, and additional capital provide a balance sheet well-positioned to lend into the growing dynamic markets we serve.

The DFW and Austin economies remain very healthy and the prospects for 2017 continue to look promising. DFW is projected to lead the US in total job growth during 2017, and Austin's job growth projections remain solid.

It appears we are beginning 2017 with an administration bent on reducing regulation and an interest rate environment that is potentially more net-interest-margin-friendly. This potential new interest rate environment, along with projected loan growth, should improve our net interest margin over time.

On the acquisition front, we are receiving more inbound calls from sellers in our areas of interest. The additional capital we raised coupled with our currency level positions us well for the right opportunity.

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

## QUESTIONS AND ANSWERS

**Operator**

Thank you.

(Operator Instructions)

Brad Milsaps, Sandler O'Neill

**Brad Milsaps** - *Sandler O'Neill & Partners - Analyst*

Hello, good morning.

**Lee Gibson** - *Southside Bancshares Inc - President and CEO*

Good morning, Brad.

**Brad Milsaps** - *Sandler O'Neill & Partners - Analyst*

Lee, Julie, I was curious if you could maybe give a little more color around the margin, how much this quarter was impacted by loan discount accretion income.

And then I know you guys don't buy a lot of premium CMOs anymore, but was there anything other than just the rate environment affecting the yield on the securities book? It was up about 5 basis points, but just kind of curious what your outlook would be for recovery in that getting back closer to where it had been running right around 2%.

**Lee Gibson** - *Southside Bancshares Inc - President and CEO*

I think the biggest thing that impacted the net interest margin was the sub debt offering that we had -- that we did in September. We had almost a month's worth of that impacting the third quarter, but we had the full three months impact in the fourth quarter. And so on a linked-quarter basis that increased our borrowing cost quite a bit. And so that had the biggest impact on the net interest margin.

In terms of the securities book, we do anticipate that -- and we're seeing it -- that the securities portfolio we should see the CMOs and things of that nature begin to improve in yield quite a bit with the slowing of the prepayments. And we've seen quite a bit of that already.

**Brad Milsaps** - *Sandler O'Neill & Partners - Analyst*

Do you happen to have the impact of accretion for the quarter?

**Julie Shamburger** - *Southside Bancshares Inc - CFO*

Yes, Brad. The loan accretion was flat over the quarter. It ran about $478,000 in the fourth quarter compared to about $480,000 in the third quarter.

**Brad Milsaps** - *Sandler O'Neill & Partners - Analyst*

Okay great. Julie, just one more maybe on expenses. I think I heard your comments you expect to realize -- where the cost savings will continue to come through in 2017. Does that mean you could hold expenses flattish from the 2016 annual number, or do you think that they have the ability to go lower kind of from where Q4 2016 was? Just kind of curious on framing some of your comments around expenses.

**Julie Shamburger** - *Southside Bancshares Inc - CFO*

I do think they will probably remain flat for the most part. I think there's some potential for them to go down somewhat, but I think mostly it will be a flat level like it was in 2016.

**Lee Gibson** - *Southside Bancshares Inc - President and CEO*

Yes, for Q4.

**Julie Shamburger** - *Southside Bancshares Inc - CFO*

Yes, correct.

**Brad Milsaps** - *Sandler O'Neill & Partners - Analyst*

Got it. Okay, thank you.

**Operator**

Michael Young, SunTrust

**Michael Young** - *SunTrust Robinson Humphrey - Analyst*

Hello, good morning.

**Lee Gibson** - *Southside Bancshares Inc - President and CEO*

Good morning.

**Michael Young** - *SunTrust Robinson Humphrey - Analyst*

I wanted to touch on the loan growth topic. It's been back-end weighted the last two years, and you guys had made comments before that you though it would be more balanced this year. Could you maybe just update us on what you're seeing thus far into the year and any change in your loan growth outlook for the year?

**Lee Gibson** - *Southside Bancshares Inc - President and CEO*

Right now, we have some things that we believe are actually going to fund in the first quarter. And then we have a number of construction projects that the equity has gone in, and we expect to begin to fund on those. So that's why we believe that we should see a more balanced approach to the funding on our loans this year compared to the past two years.

**Michael Young** - *SunTrust Robinson Humphrey - Analyst*

Okay. And I think before you talked about potentially hiring some maybe C&I producers or something like that. Would that be incorporated in the efficiency ratio and expense outlook you provided, or would that be [added on top of that]?

**Lee Gibson** - *Southside Bancshares Inc - President and CEO*

That is incorporated in there. We have hired a couple, but we also -- in the fourth quarter there was some expense in there for some people that were let go. So basically we are trading dollars, and we have added some new C&I lenders very experienced in the DFW market.

**Michael Young** - *SunTrust Robinson Humphrey - Analyst*

Okay. And just last one for me. On M&A, just curious what you're seeing in the pipeline. I assume you're still looking in the same triangle you guys have talked about in the past. But any update just in terms of conversations that you may be having or increased activity in the market?

**Lee Gibson** - *Southside Bancshares Inc - President and CEO*

We are just -- there seem to be more -- basically we're getting more inbound calls, and there are more actionable deals that are coming across the desk. Two or three of them look very interesting at this point in time, so we're taking a look at those very seriously. And they are in the areas of interest, which is that triangle from East Texas, over to Fort Worth, down to Austin and back again.

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**Michael Young** - *SunTrust Robinson Humphrey - Analyst*

Okay. Thank you, Lee.

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**Lee Gibson** - *Southside Bancshares Inc - President and CEO*

All right.

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**Operator**

Mike [Belness], KBW

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**Mike Belness** - *Keefe, Bruyette & Woods - Analyst*

Good morning.

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**Lee Gibson** - *Southside Bancshares Inc - President and CEO*

Good morning, Mike.

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**Mike Belness** - *Keefe, Bruyette & Woods - Analyst*

Most of my questions have been answered, but I wanted to revisit the NIM. Nice to see that loan yields have increased relative to the third-quarter, but want to get your thoughts on the deposit side and pricing regarding that, in particular on time deposits.

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**Lee Gibson** - *Southside Bancshares Inc - President and CEO*

On the pricing side, we're not seeing a real change there. If anything, some of the pricing -- we're able to get a little better pricing than what we have in the past. It really just depends if we get to a point where we are seeing 50% equity, then the pricing gets a little more skinny. But our typical deals -- 35% to 40% equity in deals -- the pricing has remained pretty consistent, and in some cases has improved.

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**Mike Belness** - *Keefe, Bruyette & Woods - Analyst*

Appreciate it. And I've seen that time deposits have been increasing quarter over quarter. Are you guys seeing more competition there? Should we expect this trend to continue or stabilize in the near term?

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**Lee Gibson** - *Southside Bancshares Inc - President and CEO*

I would say that it would stabilize. Some of that is we have some public fund deposits, and we have quite a few entities that we are their depository. And this time of year they are depositing a lot of money, and in some cases they want to put it in time deposits. So that's I think what you're seeing there is an increase in time deposits related to some of those public fund entities that we're their depository.

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**Mike Belness** - *Keefe, Bruyette & Woods - Analyst*

Thanks. Last question for me, and more of a housekeeping item, I saw the tax rate came in lower this quarter. Is about 18% in the right area going forward?

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**Julie Shamburger** - *Southside Bancshares Inc - CFO*

Yes, that is what we would expect next year.

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**Lee Gibson** - *Southside Bancshares Inc - President and CEO*

If you take out the loss on the sale of securities, the tax rate for the fourth quarter would have been a little over 17%.

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**Julie Shamburger** - *Southside Bancshares Inc - CFO*

17.1%.

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**Mike Belness** - *Keefe, Bruyette & Woods - Analyst*

Got it. Appreciate it, guys.

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**Lee Gibson** - *Southside Bancshares Inc - President and CEO*

All right. Thank you.

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**Operator**

(Operator Instructions)

Stan Westhoff, Walthausen & Co

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**Stan Westhoff** - *Walthausen & Co - Analyst*

Good morning, everyone.

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**Lee Gibson** - *Southside Bancshares Inc - President and CEO*

Good morning.

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**Stan Westhoff** - *Walthausen & Co - Analyst*

I just want to touch on the loss on the securities book there you took this quarter, and I guess how it relates to the unrealized losses you had in the securities book and then in the discussion that you had with selling them off as we progress through 2017. Do we expect to see some more of these securities losses on the sale?

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**Lee Gibson** - *Southside Bancshares Inc - President and CEO*

It really just depends what transpires during the year. We decided to sell off those treasuries at the end of the year. They were the lowest yielding treasuries we had, and that was a decision that we made.

At this point in time, we don't anticipate any sales of securities at a loss. And it's a decision that we make based on the environment at the time.

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**Stan Westhoff** - *Walthausen & Co - Analyst*

Okay. And then just touching on the growth in the CRE book that we had this quarter. It was pretty significant year-over-year and quarter-over-quarter here. Can you talk about what went into that -- what kind of properties went into that? And did some of the decline in construction that we had go into that -- like say permanent financing for the CRE?

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**Lee Gibson** - *Southside Bancshares Inc - President and CEO*

Yes. Some of the decline in the construction definitely goes into the CRE bucket. And the CRE bucket is a wide variety of things: it's office buildings, it's retail space, it's multifamily, it's -- I think I said retail. I'm getting a list here. But it's a wide variety of things that make up that commercial real estate bucket.

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**Stan Westhoff** - *Walthausen & Co - Analyst*

Well, I was just looking to -- was there anything that stood out in the quarter?

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**Lee Gibson** - *Southside Bancshares Inc - President and CEO*

No, it was pretty diversified. And typically we try to limit any single property to around $15 million, $20 million. Sometimes on occasion it may get up in the $20 million, $25 million range, but any one single project we try to limit.

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**Stan Westhoff** - *Walthausen & Co - Analyst*

Okay. All right, that's all I had. Thanks.

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**Lee Gibson** - *Southside Bancshares Inc - President and CEO*

All right. Thank you.

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**Operator**

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

**Lee Gibson** - *Southside Bancshares Inc - President and CEO*

All right, thank you. Record net income, strong asset quality, additional capital, and dynamic growing markets provide an excellent foundation for us to further expand the Southside franchise during 2017.

Thank you for joining us today, and we look forward to next quarter's call.

**Operator**

Ladies and gentlemen, thank you for your participation in today's conference. This does conclude the program, and you may now disconnect. Everyone have a great day.