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SBSI - Q2 2017 Southside Bancshares Inc Earnings Call

EVENT DATE/TIME: JULY 28, 2017 / 2:00PM GMT

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to Southside Bancshares Inc. Second Quarter 2017 Earnings Conference Call. (Operator Instructions) As a reminder, this conference is being recorded. I would now like to turn the call over to Senior Vice President and Chief Risk Officer, Suni Davis. Please go ahead.

Suni Davis - *Southside Bancshares, Inc. - Senior VP and CRO*

Thank you, Andrew. Good morning, everyone, and thank you for joining Southside Bancshares' Second Quarter 2017 Earnings Call. The purpose for this call is to discuss the company's results for the quarter 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' second quarter 2017 results are: Lee Gibson, President and CEO; and Julie Shamburger, Senior EVP and CFO. Our agenda today is as follows; first, you will hear Julie discuss an overview of financial results for the second quarter, including loan activity, asset quality, and an update on our securities portfolio. Then, Lee will share his comments on the quarter, including an update on the merger with Diboll State Bancshares, Inc. I will now turn the call over to Julie.

Julie N. Shamburger - *Southside Bancshares, Inc. - Senior EVP and CFO*

Thank you, Suni. Good morning, everyone. Welcome to Southside Bancshares' 2017 Second Quarter Earnings Call. We had a strong second quarter with net income of $14.5 million compared to second quarter 2016 net income of $11.4 million, a 27.1% increase. For the 6 months ended June 30, 2017, we reported net income of $29.5 million, an increase of $4.6 million or 18.3% when compared to $24.9 million for the same period in 2016. Our diluted earnings per share for the second quarter ended June 30, 2017, were $0.49 per share. An increase of $0.07 or 16.7% compared to $0.42 per share for the same period last year. For the 6 months ended June 30, 2017, diluted earnings per share increased $0.08 or 8.7% to $1 as compared to $0.92 for the same period in 2016. On a linked quarter basis, we reported an increase in total loans of $71.3 million or 2.8%. For the 6 months ended June 30, 2017, total loans increased $53.7 million or 2.1% when compared to December 31, 2016. The growth was a result of increases in our commercial real estate loan portfolio, construction loans, and the municipal loan portfolio. The indirect portfolio decreased to $21.5 million at the end of June. We continue to see roll-off in the indirect consumer portfolio, however, the pace of the decline is slowing, approximately $14 million year-to-date. As we stated in our earnings release today, most of the loan growth for the second quarter occurred later in June, and we expect to see the impact of this growth in interest income in the coming quarters. At June 30, 2017, our loans with oil and gas industry exposure remained minimal at 1.1% of our total loan portfolio. We recorded loan-loss provision expense during the second quarter of $1.3 million, an increase from $1.1 million in the first quarter, which was related to loan growth in additional reserve on a few classified loans. During the 6 months ended June 30, 2017, the allowance for loan loss increased $1.3 million or 7.4% to $19.2 million or 0.74% of total loans when compared to 0.70% at December 31, 2016. We are pleased to report our nonperforming assets decreased during the 6 months ended June 30, 2017, by $5.9 million or 39.3% to $9.2 million or 0.16% of total assets compared to 0.27% of total assets at December 31, 2016, primarily due to the payoff of several nonaccrual commercial loans.

Next, I'll give a brief update on our securities portfolio. At June 30, 2017, we had a modest net unrealized gain in the securities portfolio of $0.3 million. The duration of the securities portfolio at June 30, 2017, and December 31, 2016, was approximately 5.1 years. On a linked-quarter basis, the size of the securities portfolio decreased $50.5 million during the second quarter. And for the first 6 months of 2017, the size of the portfolio decreased $93.7 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 U.S. agency CMOs for the short end in treasury notes, agency in commercial mortgage-backed securities for the longer end. During the second quarter, our net interest margin decreased 1 basis point to 3.07%, and our net interest spread decreased 4 basis points to 2.89% on a linked-quarter basis. The decrease in both the net interest margin and yield were a direct result of higher funding cost during the second quarter, offset somewhat by the increase in our average yield on our average earning assets. During the 3 months ended June 30, 2017, our noninterest expense decreased slightly compared to both the first quarter of 2017 and the comparable quarter of 2016. We are pleased to report that our noninterest expense has decreased slightly over the last 3 linked quarters, and we continue to see improvements in our efficiency ratio, down to 50.26% for the second quarter of 2017. We expect our core noninterest expense to remain consistent, although, we do expect to see additional merger expense in the upcoming quarters of 2017.

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

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

Thank you, Julie. We had an extremely productive second quarter that culminated with strong financial results and the announced acquisition of Diboll State Bancshares. We experienced excellent loan growth during the second quarter of $71.3 million. As Julie noted, much of this loan growth occurred in June with $14.6 million, booked during the last 2 days of June. The late second quarter loan growth combined with a healthy pipeline bodes well for our third quarter loan revenue prospects. Asset quality ratios remained strong with our nonperforming assets to total assets ratio declining to 0.16% from an already strong level of 0.2% at the end of the first quarter. Cost containment and process improvement efforts continue to show results as our efficiency ratio during the second quarter declined to 50.26%, very close to our target of 50% for all of 2017. Our pending acquisition of Diboll State Bancshares, announced on June 12, is progressing as planned. We are excited about this strategic acquisition, given the contiguous markets we will now serve in East Texas. Diboll's tremendous low-cost deposit franchise and the talent they bring to Southside. All of the regulatory applications have been filed, and we anticipate filing our preliminary registration statement on Form S-4 with the SEC within the next 2 weeks. Merger teams from both banks are meeting on a regular basis to ensure a smooth integration following the consummation of the merger and to plan for the subsequent core conversion. The economic conditions in all 3 of the markets we serve, East Texas, Dallas/Fort Worth, and Austin remain healthy. Austin and Dallas/Fort Worth fueled primarily by job growth and company relocations continue to perform exceptionally well.

We are well positioned for the future given the dynamic markets we serve, our strong balance sheet, capital position, credit quality and foremost, our outstanding team members. At this time, we will conclude the prepared remarks and open the lines for your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question come from the line of Brady Gailey with KBW.

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

What-- One on the margin? I was just wondering -- I think last quarter the discount accretion was around $0.5 million. Was that roughly the same in the second quarter?

Julie N. Shamburger - *Southside Bancshares, Inc. - Senior EVP and CFO*

Yes. It was, Brady. It was flat.

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

Okay. And then, I know in the past, we've talked about loan growth of kind of 7% to 9%, if you look at this quarter, you're a little over that, I realized, 1Q you're a little under that. So is 7% to 9% still kind of the right range to think about for loan growth?

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

Yes, I think so. I think on balance for the year, we're still targeting that 7% with a -- stretch in the 9% for overall annual loan growth.

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

Okay. And the tax rate, I think last quarter we've talked about, around 17.5%, it was a little on top of that this quarter. But is 17.5% still the right way to think about the tax rate going forward?

Julie N. Shamburger - *Southside Bancshares, Inc. - Senior EVP and CFO*

You know, Brady I think, year-to-date, it crept up to about 18.3%. So I really think our tax-free income is a down sum on a linked-quarter basis from the prior period. And so I think, we probably are going to end up more in the 18.5%-range by the end of the year, if earnings stay at this pace. And that's our expectation. So...

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

Okay. And then you have funding cost, kind of, continue to move up a little bit each quarter. One of your Texas peers talked about kind of increasing their rates pretty notably across the board yesterday. Are you all seeing a lot of deposit rate pressure today?

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

We're seeing some. It's primarily on the CD side, and we're also seeing some on the public funds side. But those are really the 2 areas. The nonmaturity deposits, that's not really an issue at this point in time. And we increased very little with the June Fed increase in the nonmaturity deposits.

Operator

And our next question comes from the line of Brad Milsaps with Sandler O'Neill.

Bradley Jason Milsaps - *Sandler O'Neill + Partners, L.P., Research Division - MD of Equity Research*

Just to follow up quickly on the net interest margin. If the loan growth doesn't come through -- I mean, is it kind of locked in this range? I mean, it seems like you guys have had and continue to have a tremendous opportunity to remix. But otherwise, would you kind of consider -- still consider yourself pretty neutral in terms of kind of the margins relates to higher rates?

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

Well, I mean the ability to increase the margin is definitely dependent on our ability to remix and additional loan growth. So if we did not have additional loan growth, then yes, I think we'd be locked into this type of margin. But we feel good about the back-ended loan growth in the second quarter, and so we think that, that's going to be really -- a real positive for us in the third quarter. And then with the pipeline and things that have already closed in July, we feel really good about that loan revenue stream so that -- but you are correct, it's going to be the loan growth that's going to drive the margin.

Bradley Jason Milsaps - *Sandler O'Neill + Partners, L.P., Research Division - MD of Equity Research*

And based on that, would you think that bond portfolio it would be, sort of at a peak at this point? Obviously, if we get some lift in the long end -- I wouldn't be surprised if you guys add some more, but all us equal, do you think you're kind of -- it would be at a steady state and then lower to the extent the loan growth comes through?

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

That is correct. We're not looking to add to the securities portfolio with the rates where they are at this point in time.

Bradley Jason Milsaps - *Sandler O'Neill + Partners, L.P., Research Division - MD of Equity Research*

Great. And then I appreciate the color on the tax rate, kind of over back half of the year. But what happens when you add Diboll into the mix in 2018? I presume -- I think they have a higher tax rate than you guys. So I'm just kind of curious kind of what the combined company would like from a tax perspective?

Julie N. Shamburger - *Southside Bancshares, Inc. - Senior EVP and CFO*

They do have a higher tax rate. We're expecting the close to come later in the year. So at most, you would have some impact in the fourth quarter, should we be able to close the deal in fourth quarter. But I think -- for '18, I would expect it to drive up somewhat because their tax for securities I believe are...

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

They were relatively minimal.

Julie N. Shamburger - *Southside Bancshares, Inc. - Senior EVP and CFO*

We also had BOLI income that also reduces our tax rate significantly. So I do expect an increase for '18, for sure. Maybe some, depending on when we close in at the end of the year.

Bradley Jason Milsaps - *Sandler O'Neill + Partners, L.P., Research Division - MD of Equity Research*

Got it. But you're not planning anything -- any changes to how they're set up from a tax perspective. In other words, it would just be kind of their weighted-average tax rate combined with yours and that would kind of be a good place to start?

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

That is correct. Yes, we're not planning on -- we're going to bring their loans over, and we're not planning on major changes in their securities portfolio in terms of the tax free, taxable mix.

Operator

And our next question comes from the line of Brian Zabora with Hovde Group.

Brian James Zabora - *Hovde Group, LLC, Research Division - Director*

Just a question on salaries. Was the improvement all or mostly from your seasonal benefits like payroll taxes? Or are there other factors that caused that decrease?

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

Part of it were the payroll taxes. Some of it is just aditional reduction in some of our workforce, and then some of our retirement expenses actually went down in the...

Julie N. Shamburger - *Southside Bancshares, Inc. - Senior EVP and CFO*

Year-to-date...

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

Yes.

Julie N. Shamburger - *Southside Bancshares, Inc. - Senior EVP and CFO*

They had to do with the earlier retirement. A lot of it was driven by the early retirement package in January of '16. That was about a $1.7 million expense.

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

And I don't know if you're looking at this on a linked-quarter basis or if you're looking back.

Julie N. Shamburger - *Southside Bancshares, Inc. - Senior EVP and CFO*

Yes, the bigger decline is on the 6 months.

Brian James Zabora - *Hovde Group, LLC, Research Division - Director*

I was looking more at the linked quarter. But -- so this is a fairly good run -- there wasn't any -- it doesn't sound like there's any reversal of accruals or anything. It sounds like this might be a pretty good run rate going forward. Is that fair?

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

I think so. I think it's relatively close to what we should expect to see for the next 2 quarters.

Brian James Zabora - *Hovde Group, LLC, Research Division - Director*

Great. All right, then just a question on loan pay downs or payoffs. Does that pace change at all from first quarter?

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

Yes. We had significant number of loan pay downs in the first quarter. We did have loan pay downs in the second quarter, but the dollar volume of them was not as high and then the fundings that we had, we're significantly more to offset that. So it was a combination of both the payoffs while the volume may have been the same. The dollar amounts were not quite as high and the fundings were just up significantly.

Operator

And I'm showing no more questions at this time. With that said, I'll like to turn the conference back over to President and CEO, Lee Gibson, for any closing remarks.

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

Thank you. Our Diboll acquisition, our strong loan growth late in the second quarter, cost containment, near pristine asset quality, a healthy loan pipeline, and our success in replacing securities with higher-yielding loans leaves us feeling good about our second half prospects for 2017. Thank you for being on the call today, and we look forward to hosting our next earnings call in October.

Operator

Ladies and gentlemen, thank you for participating in today's conference. This does conclude the program, and you may all disconnect. Everyone, have a wonderful day.
