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SBSI - Q4 2017 Southside Bancshares Inc Earnings Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Southside Bancshares Inc. Fourth Quarter and Year-End 2017 Earnings Conference Call. (Operator Instructions) As a reminder, this conference call is being recorded.

I would now like to turn the conference over to your host, Suni Davis, Senior Vice President and Chief Risk Officer. Please go ahead.

Suni Davis - *Southside Bancshares, Inc. - Chief Risk Officer*

Thank you, Andrew. Good morning, everyone, and thank you for joining Southside Bancshares' fourth quarter and year-end 2017 earnings call. The purpose for this call is to discuss the company's results for the quarter and year-end as well as 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 2017 results are Lee Gibson, President and CEO; and Julie Shamburger, Senior EVP and CFO. Our agenda today is as follows: First, you'll hear Julie discuss an overview of financial results for the quarter and year-end, including loan activity, asset quality, an update on our securities portfolio and the impact of tax reform. Then, Lee will share his comments on 2017, including our progress with integrating Diboll State Bancshares as a result of the November 30, 2017 merger.

I will now turn the call over to Julie.

Julie N. Shamburger - *Southside Bancshares, Inc. - CFO, Principal Accounting Officer & Senior EVP*

Thank you, Suni. Good morning, everyone. Welcome to Southside Bancshares' 2017 fourth quarter and year-end earnings call. We had a solid fourth quarter with net income of $10.3 million after the impact of both the Diboll State Bancshares acquisition expense and the write-down of our net deferred tax asset to the reduced corporate rate of 21% from 35%, both occurring in the fourth quarter.

For the year ended December 31, 2017, we reported net income of $54.3 million, an increase of $5 million or 10.1% compared to $49.3 million for the same period in 2016.

Our diluted earnings per share for the fourth quarter ended December 31, 2017 were $0.33 per share, a decrease of $0.09 or 21.4% compared to $0.42 per share for the same period in 2016.

For the year ended December 31, '17, diluted earnings per share were $1.81, the same as for the year ended 2016. When combined, both the impact of the acquisition expense, net of tax and the write-down of the net deferred tax asset directly to income tax expense negatively impacted our earnings per share $0.16 and $0.19 per fully diluted share for the fourth quarter and year of 2017, respectively.

For the year ended December 31, 2017, total loans, excluding acquired loans increased $116.5 million or 4.6%, when compared to December 31, 2016.

The organic growth occurred in the commercial real estate, construction and municipal loan portfolios, while the loans acquired in the Diboll acquisition increased all categories. Our indirect portfolio continued to roll off, decreasing $3.5 million during the fourth quarter and $23 million during 2017, leaving a remaining balance of approximately $12.9 million at the end of December.

At December 31, 2017, our loans with oil and gas industry exposure were 1.5% of our total loan portfolio. We recorded loan loss provision expense during the fourth quarter of $1.3 million, an increase of $311,000 from the third quarter.

During the year ended December 31, 2017, the allowance for loan losses increased $2.9 million or 16% to $20.8 million or 0.63% of total loans, when compared to 0.7% at December 31, 2016.

Nonperforming assets decreased during the year ended December 31, 2017 by $4.6 million or 30.7%, down to $10.5 million or 0.16% of total assets compared to $15.1 million or 0.27% of total assets at December 31, 2016. This decrease was primarily due to the payoff of several nonaccrual commercial loans during the first half of the year.

Next, I will give a brief update on our securities portfolio. Excluding securities acquired in the acquisition, our securities portfolio increased $11.9 million for the fourth quarter and decreased $203.3 million for the year. We also recorded an impairment charge of $234,000 during the fourth quarter, related to $109 million of U.S. agency debentures we sold during January of '18. The duration of the securities portfolio at December 31, 2017 was approximately 4.8 years, a decrease from 5 years at September 30, 2017 and 5.1 years at December 31, 2016.

At December 31, 2017, we had a net unrealized loss in the securities portfolio of $8.3 million. As loan growth occurred during the year, we gradually reduced the size of the securities portfolio. These changes combined with the Diboll acquisition resulted in a shift in the mix of our loans and securities to 57% loans, 43% securities at the end of the fourth quarter compared to 51% loans, 49% securities at December 31, 2016, moving toward our longer range goal of a 70-30 mix.

We expect to continue with the barbell approach for future security purchases using U.S. agency CMOs for the short end and treasury notes, agency and commercial mortgage-backed securities for the longer end.

During the fourth quarter, our net interest margin increased 10 basis points to 3.12%, and our net interest spread increased 9 basis points to 2.91% on a linked-quarter basis. The increase in both the net interest margin and spread were a direct result of an increase in the average yield on our average earning assets.

During the fourth quarter of 2017, we incurred additional merger expense of approximately $3.5 million in connection with the closing of the Diboll transaction on November 30, 2017. Approximately half of this expense was in connection with contract terminations. Additionally, in connection with the merger, we incurred additional amortization expense associated with an increase in our intangible assets in connection with the acquisition.

While our noninterest expense increased during the 3 months ended December 31, 2017, on a linked-quarter basis, we continue to see an improvement in our efficiency ratio down to 49.42% for the fourth quarter of '17 from 49.99% last year. For the year ended December 31, 2017, our efficiency ratio decreased to 50.3% from 54.08% for the year ended 2016. As a result of the Tax Cuts and Jobs Act passed in December, we are currently estimating our effective tax rate for 2018 will be approximately 12.4%.

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

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

Thank you, Julie. We enjoyed another excellent quarter, highlighted by the completion of the Diboll State Bancshares acquisition. After 2 full months of combined operations, the merger is proceeding smoother than we originally projected. Customer transition has gone extremely well due to advanced planning and the similarity of our two cultures. The expanded contiguous markets we now serve in East Texas, the addition of Diboll's outstanding talent, the overall low cost deposit franchise and the quality loan portfolio are some of the reasons why we are so excited about this strategic transaction.

Conversion and transition teams are meeting weekly to ensure continued smooth integration and to plan for the core conversion in late April. The decrease in the securities portfolio during the third quarter of $121 million, mostly through the sales of longer duration securities combined with the subsequent sale of $109 million of U.S. agency debentures during January of this year provide us additional balance sheet flexibility in this currently higher interest rate environment.

Should the anticipated Fed interest rate increases occur, the Diboll acquired core deposit franchise should provide a more stable and profitable funding source. We are not wavering on our credit underwriting standards, and our asset quality ratios remained strong as reflected by our nonperforming assets to total assets ratio of 0.16%.

Cost containment and process improvement efforts continue to be major areas of focus. As Julie pointed out, our efficiency ratio during the fourth quarter declined to 49.4% and our efficiency ratio for the year declined to 50.3%, very close to the stated target of 50% for all of 2017.

The economic conditions in all 3 of the markets we serve: East Texas, the Dallas/Fort-Worth area and Austin, remain healthy. The Austin and DFW markets fueled primarily by job growth and company relocations, continue to perform exceptionally well. We're excited about our prospects for 2018, given the newly acquired balance sheet and market area; benefits associated with the reduced corporate tax rates, the dynamic growing markets we serve, our strong balance sheet, capital position, credit quality and foremost, our outstanding team members.

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

QUESTIONS AND ANSWERS

Operator

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

Michael Tatsuo Belmes - *Keefe, Bruyette, & Woods, Inc., Research Division - Associate*

Mike Belmes on for Brady. I guess, my first question is, you guys had some nice NIM expansion this quarter. Could you maybe give some color in certain terms of how much acquired loans benefited that? And then secondly, related to the NIM, with tax reform, how should we think about the FTE NIM going forward?

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

Okay. Julie, you want to talk about the loan accretion?

Julie N. Shamburger - *Southside Bancshares, Inc. - CFO, Principal Accounting Officer & Senior EVP*

Yes. The accretion that we reported during the third, excuse me, during the fourth quarter was roughly $438,000. Approximately $185,000 of that was directly related to the Diboll acquisition, and the remainder was the Omni acquisition of purchased loans.

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

And as for the moving forward NIM and spread on a full -- on a fully taxable equivalent basis, we are anticipating that the non-GAAP measures associated with that will decrease the NIM and the spread about 12 basis points, due to the reduction in the tax rate from 35% down to 21%.

Michael Tatsuo Belmes - *Keefe, Bruyette, & Woods, Inc., Research Division - Associate*

Very helpful. Appreciate it. And one more question from me, if I may. You guys closed Diboll and you plan conversions in late April. How should we think about the expense base? Is -- around 32 to 33, kind of the right range for maybe Q1?

Julie N. Shamburger - *Southside Bancshares, Inc. - CFO, Principal Accounting Officer & Senior EVP*

No, we are estimating closer to around 30. 29.9 roughly.

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

And that would be for the first quarter, then we'll have some gradual reduction in the second quarter. And then, by the third quarter, we'll be able to provide better update as to what we think that's going to be probably at the -- at our first quarter earnings call.

Operator

Our next question comes from Brad Milsaps with Sandler O'Neill.

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

Lee, maybe, could you talk a little bit about the core sort of Southside organic loan growth in the quarter. I know you guys usually have a pretty good end of the year, but obviously, you're focused on bringing the acquisition in and other things, Tax Reform, etcetera. Can you talk a little bit about the loan pipeline and kind of what happened in the quarter and how you feel about 2018?

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

Okay. Yes, we -- basically payoffs exceeded our fundings in the fourth quarter slightly, so the organic loan growth was actually down, I think, about 1%, 1.5% during the fourth quarter. For 2018, the pipeline looks good. It's -- we do anticipate some additional payoffs that will come in. But we're budgeting for 7% loan growth in 2018.

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

Okay, that's helpful. And then Julie, just back to your expense guidance, does that include the new, kind of CDI run rate of around $700,000-or-so quarterly going forward?

Julie N. Shamburger - *Southside Bancshares, Inc. - CFO, Principal Accounting Officer & Senior EVP*

That is correct. Yes, it does.

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

Okay. And I was thinking, I maybe wrong here, but Diboll was like may be a $7 million quarterly run rate in expenses. Based on your guidance, it seems like you'll be much less than that. Is that more reflective of getting cost saves out sooner at the acquisition? Or I know you guys have had some big efficiency plans internally? Can you just kind of talk about kind of how those 2 numbers square?

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

Basically, what we looked at is, I mean, one, we've done a budget. And two, we looked at the run rate of about $30 million in December with $3.5 million of that being acquisition expense. We don't expect acquisition -- ongoing acquisition expense to be that much. And then the run rate moving -- we have 1 month of run rate of Diboll in the fourth quarter, and so we'll have 2 additional months of that. So combined, it's going to be somewhere close to about $5 million.

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

Okay, got it. I'm sorry. I didn't understand it correctly. You're including the merger expense, in other words, that will be -- that will go away, but that'll be replaced by the other 2 months. I got it. I understand.

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

That's correct. That's correct.

Julie N. Shamburger - *Southside Bancshares, Inc. - CFO, Principal Accounting Officer & Senior EVP*

Additional organizational expense.

Operator

Our next question comes from Brett Rabatin with Piper Jaffray.

Brett D. Rabatin - *Piper Jaffray Companies, Research Division - Senior Research Analyst*

Wanted to -- my line broke up a little bit when you are closing comments. Just wanted to go back to tax reform. Lee, what are you expecting your tax rate to be proforma here in first quarter?

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

We're projecting it to be 12.4%.

Brett D. Rabatin - *Piper Jaffray Companies, Research Division - Senior Research Analyst*

Okay. And then on fee income, you had some nice growth in the Trust. I'm just curious how you're thinking about the opportunities with the acquisition? And may be your outlook for fee income this year?

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

In the Trust department, that with the acquisition basically our Trust assets under management doubled. So we are anticipating that Trust income will be up nicely this year, close to double, what it was in 2017. Deposit services income, it looks like we're -- with the acquisition that's going to be up nicely. And then, I would expect the gains on sale of loans to be about the same as well as the other items that you see there.

Brett D. Rabatin - *Piper Jaffray Companies, Research Division - Senior Research Analyst*

Okay. And then maybe one -- just last one, if I can. You talked about in the press release some -- and customers being more optimistic, and you've added some commercial producers with the deal. Is the growth that you're expecting in 2018, is that going to be, you think more C&I focused? And can you talk maybe about what is -- what you're trying to grow portfolio in '18 in terms of the segments?

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

We are seeing some additional opportunities in C&I. You know, the optimism comes from the reduced regulation and obviously, the tax cuts that were implemented effective January 1 of this year. So we do anticipate additional C&I business, but also we'll have some commercial real estate. We anticipate good continued muni loan growth. And those probably would be the areas of focus.

Operator

Our next question comes from Michael Young with SunTrust.

Michael Masters Young - *SunTrust Robinson Humphrey, Inc., Research Division - VP and Analyst*

Lee, I wanted to ask just about the securities book kind of plans to continue to reinvest there, given higher rates. And any change in terms of how you may reinvest in terms of your municipal bond interest?

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

We're -- we've kind of sat on the sidelines now for about 4 months. We've invested a little bit, but for the most part, we just continue to reduce our home loan bank advances and save the money for loans. If rates reach certain levels, if the 10 year gets to 3 or something like that, we may invest some portion of the proceeds. But I really don't look for the securities book to be a position of significant asset growth at this point in time. I would expect it to remain fairly stable to down through most of the year as loan growth takes over the asset growth and the earning assets.

Michael Masters Young - *SunTrust Robinson Humphrey, Inc., Research Division - VP and Analyst*

And just looking at the loan pipeline kind of as it stands now. We've had several years of slower growth in the first half and kind of the pick up in the second half. Do you -- just kind of how you see it today? Do you envision that being the same trend this year? Or are there things that contradict that?

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

Last year, we had our growth in the second and third quarters. So it's really kind of hard to predict. We do have some anticipated payoffs that are going to occur throughout the year. And it really just depends -- some of these are projects that are potentially going to sell and it really just depends when those come to fruition, when those paydowns will occur. Other than that, we're anticipating fairly stable fundings throughout the year. It'll really be the impact of the paydowns that'll determine when the growth occurs in the various quarters.

Michael Masters Young - *SunTrust Robinson Humphrey, Inc., Research Division - VP and Analyst*

One last one maybe, if I can just on capital. Obviously, lower tax rate, higher capital formation. Do you plan to maintain kind of the dividend payout ratio? Or how are you thinking about capital priorities from here?

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

We've always had a fairly high dividend payout ratio. We are anticipating keeping it close to the same, but maybe reducing it down closer to 45% to 50%. We're not going to reduce the dividend. But as earnings grow, maybe, gradually reducing the payouts.

Operator

Our next question comes from Brian Zabora with Hovde.

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

Just a question on the margin. You mentioned the step down with the lower FTE, with the change in tax rate, but just could you give us an update on how the balance sheet looks post-Diboll as far as how, if we do get Fed rates hikes, how you may see the impact on the NIM going forward?

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

I think the impact on the NIM will be positive after the adjustment for the FTE. And going forward, the Diboll loan portfolio was a little bit shorter than ours, and then they have a really -- had a really strong core funding base. So I think that's going to do nothing but improve the prospects for the NIM and the spread going forward.

Operator

I'm showing no further questions. I would now like to turn the call back to Mr. Lee Gibson for any further remarks.

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

All right. Thank you for joining us today. The anticipated benefits associated with the newly completed Diboll transaction, cost containment success, near pristine asset quality, dynamic growing markets ripe with quality loan growth potential, our success in replacing securities with higher-yielding loans combined with the tax reform that is effective December -- January 1, 2018, provide a foundation for an excellent start for this year. Thank you for being on the call today, and we look forward to hosting our next earnings call in April.

Operator

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