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SBSI - Q2 2018 Southside Bancshares Inc Earnings Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Southside Bancshares Second Quarter 2018 Earnings Conference Call. (Operator Instructions) As a reminder, today's conference is being recorded.

I would like to introduce your host for today's conference, Ms. Suni Davis, Senior Vice President and Chief Risk Officer. Ma'am, please go ahead.

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

Thank you, Michelle. Good morning, everyone, and thank you for joining Southside Bancshares' Second Quarter 2018 Earnings Call. The purpose of this call is to discuss the company's results for the quarter 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 risks 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 2018 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, including loan activity, asset quality, an update on our securities portfolio and noninterest income and expense items for the quarter. Then Lee will share his comments on the quarter, including the loan pipeline and the completion of the Diboll State Bancshares, Inc. integration.

I will now turn the call over to Julie.

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

Thank you, Suni. Good morning, everyone, and welcome to Southside Bancshares' second quarter 2018 earnings call. We had a strong second quarter with net income of $20.2 million compared to second quarter 2017 net income of $14.5 million, a 39.5% increase. Our diluted earnings per share for the second quarter ended June 30, 2018, were $0.57 per share, an increase of $0.08 or 16.3% compared to $0.49 per share for the same period last year.

During the second quarter, our net interest margin remained consistent at 3.19%, and our net interest spread decreased 5 basis points to 2.90% on a linked-quarter basis. We recorded $824,000 of loan accretion this quarter, a decrease on a linked-quarter basis due to the early payoff in the first quarter of 3 purchased impaired loans resulting in approximately $329,000 of accretion.

We recorded loan loss provision expense during the second quarter of $1.3 million, a decrease of $2.5 million compared to provision expense recorded in the first quarter. The higher first quarter provision expense was a result of the 2 commercial real estate loan relationships placed on nonaccrual status in the first quarter of the year.

During the 3 months ended June 30, 2018, our noninterest income, excluding net losses on AFS securities, increased $902,000, primarily from increases in trust income and bank and life insurance income. During the same period, we recorded losses on the sale of available-for-sale securities of $332,000, a decrease from the losses recorded in the first quarter of 2018.

During the call last quarter, we mentioned the adoption of the revenue recognition accounting standard on January 1. In connection with the guidance for the 3 and 6 months ended June 30, 2018, we netted debit card expense of $988,000 and $1.8 million, respectively, previously included in ATM and debit card expense with deposit services income. Also, for the 3 and 6 months ended June 30, 2018, we netted brokerage service expense of $151,000 and $302,000, respectively, previously included in other noninterest expense with brokerage services income.

Due to the guidance under the modified retrospective method, prior periods have not been adjusted and are not comparable.

During the 3 months ended June 30, 2018, our noninterest expense decreased $2.4 million or 7.6% on a linked-quarter basis, primarily due to a decrease in salary and employee benefits.

You may recall, during the first quarter, we paid onetime $1,000 bonuses to certain employees in response to the benefits received from the Tax Cuts and Jobs Act, totaling $744,000. And during the second quarter, we experienced a decrease in retirement expense included in salary and employee benefits of approximately $834,000, primarily a result of the reversal of the split dollar and postretirement liability associated with the death of a retired executive.

Also in the second quarter, we recorded additional acquisition expense of $1 million in connection with the Diboll acquisition, consisting of $541,000 of professional fees, most of which were associated with the systems integration that occurred at the end of April. And the remaining $441,000 included changing control payment accruals and severance payments. We expect the third quarter noninterest expense run rate to be in total approximately $29.5 million that includes approximately $200,000 of third quarter acquisition expense.

We are pleased to report improvements in our efficiency ratio for the 3 months ended June 30, 2018, down to 47.56% from 51.28% for the first quarter of 2018. The effective tax rate for the 3 and 6 months ended June 30, 2018, was 14.3% and 13%, respectively. At this point, we are estimating an effective tax rate for 2018 of approximately 13%.

During the second quarter, we experienced a decrease in total loans of $38.7 million or 1.2% on a linked-quarter basis, more than offsetting the increase of $15.3 million in the first quarter of 2018, a direct result of payoffs exceeding originations. At June 30, 2018, our loans with oil and gas industry exposure remain minimal at 1.55% of our total loan portfolio. Nonperforming assets totaled $42.4 million or 0.68% of total assets as of the quarter ended June 30, 2018, virtually the same on a linked-quarter basis and a $32 million increase from December 31, 2017.

Next, I'll give a brief update on our securities portfolio. On a linked-quarter basis, the size of the securities portfolio decreased $25.1 million. And since December 31, 2017, the size of the portfolio decreased $246 million. At June 30, 2018, we had a net unrealized loss in the securities portfolio of $58.9 million. The duration of the securities portfolio at June 30, 2018, remained at 5.3 years on a linked-quarter basis, an increase from 4.8 years at December 31, 2017, primarily a result on the sale of lower-yielding short-duration agency debentures sold in the first quarter of 2018. The mix of our loans and securities remained at 60/40 on a linked-quarter basis, compared to a 57/43 mix at year-end and a 53/47 at June 30, 2017.

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

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

Thank you, Julie. I would like to thank everyone for joining us this morning.

We were very pleased with this quarter's results. We had excellent second quarter returns on average tangible common equity of 16.13% and on average assets of 1.3%. We reported record net income during the second quarter of $20.2 million, representing a 39.5% increase compared to 2017. Our continued focus on cost containment resulted in the efficiency ratio improving and reaching a new low of 47.6%.

The only disappointment for the quarter was the slight decline in our loan totals. The current loan pipeline looks promising for the remainder of the year. However, we expect additional payoffs that will offset a portion of the new fundings. Loan growth remains our top priority, and we are laser focused on achieving that goal, consistent with our current underwriting standards. Considering the life of loan growth this quarter and the increasing deposit costs, we are pleased that we were able to maintain our net interest margin at 3.19%.

During the quarter, we completed the integration of Diboll State Bancshares. As a result, we expect to realize substantially all of the cost savings associated with this transaction during the third quarter.

At the end of the second quarter, nonperforming assets were virtually unchanged. The 2 commercial real estate loan relationships that were placed on nonaccrual during the first quarter continue to pay as agreed, and occupancy levels for one of the loan relationships has improved.

The Texas economy continues to experience excellent growth, bolstered by additional diversity of business, company relocations, job growth, a business-friendly environment and an improving energy industry. We are excited about our prospects for the second half of 2018, given the completed integration of Diboll, the benefits associated with reduced corporate taxes, the dynamic markets we serve, our solid balance sheet, strong capital position and 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) Our first question comes from the line of Brady Gailey with KBW.

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

It's Mike Belmes on for Brady. So I guess, just to start on the expense side. I mean, great quarter, saw the efficiency ratio come down. Kind of could you maybe give some color on the drivers of the nice reduction? And what are the opportunities to continue to see efficiencies and profitability improvement going forward?

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

Well, I think the drivers are that we've done most of the integration of Diboll now, and we've been working for several years now on cost efficiencies. And so at this point, there are some additional opportunities out there, but I would say most of the heavy lifting has been done associated with the cost saves. And we expect to be able to maintain this efficiency ratio close to this range going forward.

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

Got it. So maybe then from the third quarter core expense base, we'll just call it $29 million maybe $29.5 million, we should expect growth on that point going forward then in the expense base.

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

Yes, it's possible that we'll see some additional expense growth. Hopefully, as loan growth returns and we continue to grow the bank, obviously, there'll have to be some additional expenses moving forward. But we think that we'll be able -- whatever that increase in expense is, we would offset it with revenue to be able to maintain this continued efficiency ratio level.

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

Got it. I guess, just one last one for me on loan growth. I know you guys highlighted some elevated payoffs that continued to win growth. But kind of how has production been? And are the pipelines are where they -- you expect them to be when we started this year?

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

They're not. The pipeline is where I expected it to be. The payoffs are higher than where I expected them to be. Some of the pipeline for the third quarter includes some C&I growth, which typically is more stable in the funding going forward. So we're pleased and looking at that. But the pipeline looks good. It's just the payoffs have exceeded our expectations at this point.

Operator

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

Peter Finley Ruiz - *Sandler O'Neill + Partners, L.P., Research Division - Director*

This is actually Peter Ruiz on for Brad. I guess, just maybe, first, we could just touch on the margin. I guess, you saw a little bit of core NIM expansion there this quarter with the higher loan yields. I just -- I wanted to get your thoughts maybe on the dynamics here with your loan-to-deposit ratio still in the low 70s, with deposit costs up 12 basis points and kind of sluggish loan growth. What are the dynamics at play here? Are you still feeling pressure to raise rates from here? Or can you kind of maybe take a breather and kind of maybe let the loan-to-deposit ratio move higher here and limit deposit costs?

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

I think on the deposit costs, we have some deposits that we will have to move, to some extent, some of the public fund deposits, primarily. The rest of the deposits, I think, we can begin to slow down some of those increases. The NIM, it's really going to depend on our ability to grow loans. That's why it's our top priority right now. If we can increase loans in future quarters, then I think the NIM will take care of itself. Otherwise, there's going to be some pressure on that.

Peter Finley Ruiz - *Sandler O'Neill + Partners, L.P., Research Division - Director*

Okay. And maybe just a little bit more color on the paydowns here. Is that primarily CRE prepayments? And are you seeing maybe increased levels of businesses being sold? Or what are -- what's really driving the elevated paydowns here?

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

The real -- it's primarily CRE. We actually had a slight increase in C&I, and it's -- projects will be completed. They'll reach stabilization, and the owners will sell the projects or obtain long-term financing through CMBS or something like that, that we're just not able to compete with.

Operator

And our next question comes from the line of Brett Rabatin with Piper Jaffray.

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

Wanted to first ask, Lee, I guess, want to make sure that the tax rate increased a little bit this quarter with the deal, and then just thinking about going forward. Can you maybe give us some color on what you expect that to look like in the back half of the year?

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

The -- on the tax rate?

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

Right.

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

Yes. We're projecting a tax rate for all of 2018 of 13%. We had originally forecasted something in the low 12s, but our tax-free income as a percentage of total revenue is not what we had anticipated. I think everybody's aware that the tax-free issuance is down nationwide pretty significantly. And so that's been a driver of that slight increase in the tax rate for the remainder of the year.

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

So 13% for the full year.

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

That's correct.

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

Okay. So it does dip back down a little bit in the back half of the year.

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

Correct. Because you're looking at the 14% in the second quarter.

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

Right.

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

Right, if you make an estimate at the beginning of the year, and as we've gained more information and we're making a new estimate, you have to have a catch up if you were behind a little bit in the first quarter, based on your new estimate at the end of the second quarter. And so that's the difference between the 2 tax rates in the first and second quarter. But based on the information we have now and re-projecting the tax-free income going forward, we think the entire tax rate's going to be around 13%.

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

Okay, okay. And then wanted to ask, Lee, the yield curve's a lot flatter. What are you doing in the securities portfolio at this point? And kind of how should we think about possibly reinvesting cash flow in that from here relative to the current portfolio?

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

At this point, Brett, we're being very careful. The securities portfolio is down quite a bit this year. I don't really expect this, until we get a little more definition around what exactly is going to occur with the yield curve, to grow the securities portfolio. At this point, we're at a stabilization to potentially declining situation in the securities portfolio because if it inverts, then we'll take a look at some things. But right now, it's just extremely flat and seems to be grinding flatter each month. So we're just kind of in a wait-and-see posture, but we're not aggressively investing.

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

Okay. And then was also just curious maybe for your updated thoughts on M&A. And how you see the environment? And if you guys see opportunities in the back half of the year to maybe add anything else to the platform you guys have?

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

We're continuing to look. There's some opportunities out there, some of them outside our footprint with -- would be something we probably wouldn't be interested in. But we continue to look and expect to be a player in the M&A game in terms of acquisitions as those opportunities avail themselves.

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

Okay. But you're primarily kind of focused more on in-market-type franchises?

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

Yes. Our focus is kind of down to Austin, down to the Southeast Texas area and over to Interstate 35, maybe 40, 50 miles west of Interstate 35.

Operator

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

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

A question on the loan growth potential. Last quarter, you thought that maybe 5% would be the potential growth for the year. With the paydowns that you're seeing, could it be a bit lower than you're initially expecting?

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

Yes. At this point, with loans down slightly through the first 6 months, I think if we could achieve 3% loan growth overall for the year, that would be a real positive for us.

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

Okay. And then the paydowns that you're seeing, how are the trends in Diboll? Are you seeing any paydowns from that -- the acquired portfolio versus kind of the legacy portfolio? Any different trends?

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

The acquired portfolio, we're not seeing the level of paydowns. There's a few, but we're not seeing the level of paydowns there that we're seeing in our legacy portfolio.

Operator

And I'm showing no further questions at this time. And I would like to turn the conference back over to President and CEO, Mr. Lee Gibson.

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

Thank you. We believe Southside is well positioned for the future and look forward to reporting the results for the second half of 2018. 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 great day.