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Q3 2018 Southside Bancshares Inc Earnings Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Southside Bancshares, Inc. Third Quarter 2018 Earnings Call. (Operator Instructions) As a reminder, this conference call may be recorded.

I would now like to turn the conference over to Chief Risk Officer, Suni Davis. Please go ahead.

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

Thank you, George. Good morning, everyone, and thank you for joining Southside Bancshares' Third 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 our Form 10-K.

Joining me today to review Southside Bancshares' Third 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 noninterest income and expense items, loan activity, asset quality and an update on our securities portfolio. Then Lee will share his comments on the quarter, including the financial performance and the loan pipeline.

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' Third Quarter 2018 Earnings Call. We are pleased to report a strong third quarter with net income of $20.3 million compared to third quarter 2017 net income of $14.5 million, a 39.9% increase. Our diluted earnings per share for the third quarter ended September 30, 2018, were $0.58 per share, an increase of $0.09 or 18.4% compared to $0.49 per share for the same period last year.

During the third quarter, we reported a net interest margin of 3.14% and a net interest spread at 2.82%, decreases of 5 basis points and 8 basis points, respectively, on a linked-quarter basis. We recorded $478,000 of loan accretion this quarter, a decrease from last quarter and a 3 basis point decrease in the net interest margin for the quarter on a linked-quarter basis. We recorded loan loss provision expense during the third quarter of $975,000, a decrease of $306,000 compared to $1.3 million of provision expense recorded in the previous quarter.

During the 3 months ended September 30, 2018, our noninterest income, excluding net losses on AFS securities, decreased $576,000, a result of less bank-owned life insurance income due to a debt benefit recorded last quarter. During the same period, we recorded losses on the sale of available-for-sale securities of $741,000, an increase of $409,000 on a linked-quarter basis.

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During the 3 months ended September 30, 2018, our noninterest expense, excluding acquisition and amortization expense, increased $326,000 or 1.2% on a linked-quarter basis, due to the increase in salaries and employee benefits, partially offset by decreases reflected in most of the remaining noninterest expense categories. Last quarter, we reported a decrease in salary and employee benefit expenses due to a nonrecurring reversal of a split dollar and postretirement liability associated with the debt of a retired executive of approximately $834,000. At this time, we believe fourth quarter salary and employee benefit expense should be consistent with the third quarter. We expect total noninterest expense of approximately $29 million for the fourth quarter.

We continue to maintain cost efficiencies with an efficiency ratio of 48.91% for the 3 months ended September 30, 2018, compared to 47.56% last quarter and 51.28% for the first quarter of 2018. The effective tax rate for the 3 and 9 months ended September 30, 2018, was 9.7% and 11.9%, respectively. We recorded a discrete tax benefit of $800,000 associated with the remeasurement of our deferred taxes in connection with the Tax Cuts and Jobs Act, which lowered our effective tax rate by 3.6% and 1.2%, respectively, for the 3 and 9 months ended September 30, 2018. Excluding the net impact and discrete tax items, our effective tax rate was approximately 13.6% and 13.4% for the 3 and 9 months ended September 30, 2018, respectively. At this time, excluding the net impact of discrete tax items, we are estimating the final effective tax rate for 2018 at approximately 13.4%.

During the third quarter, we experienced a slight increase in total loans of $3.6 million compared to the decrease of $38.7 million reported in the second quarter. Nonperforming assets totaled $39.6 million or 0.65% of total assets at September 30, 2018, a decrease of $2.8 million from June 30, 2018.

Next, I'll give a brief update on our securities portfolio. We further reduced the size of the securities portfolio by $99.6 million during the third quarter...

Operator

Ladies and gentlemen, please standby.

(technical difficulty)

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

Thank you. I will start back with the slight increase in total loans for the third quarter. During the third quarter, we experienced a slight increase in total loans of $3.6 million compared to the decrease of $38.7 million reported in the second quarter. Nonperforming assets totaled $39.6 million or 0.65% of total assets at September 30, 2018, a decrease of $2.8 million from June 30, 2018.

Next, I'll give a brief update on our securities portfolio. We further reduced the size of the securities portfolio by $99.6 million during the third quarter. Since December 31, 2017, the size of the portfolio has decreased $345.6 million. At September 30, 2018, we had a net unrealized loss in the securities portfolio of $77.6 million. The duration in the securities portfolio at September 30, 2018, increased slightly from 5.3 to 5.4 years on a linked-quarter basis. Due to the decrease in the securities portfolio, the mix of our loans and securities increased to 61% loans and 39% securities from a 60-40 on a linked-quarter basis compared to a 57-43 mix at year-end.

On October 25, 2018, our Board of Directors approved the stock repurchase plan, authorizing the purchase of up to 1.5 million shares of common stock in open market purchases and privately negotiated transactions at prevailing market rate. We believe purchasing our shares at current market prices is prudent at this time. We have no obligation to repurchase any shares under the stock repurchase plan and may suspend or discontinue it at any time.

Thank you very much, and I will turn the call 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 had a solid third quarter, highlighted by record net income of $20.3 million, a return on average tangible common equity of 15.7%

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and a 48.91% efficiency ratio. Loans were relatively flat on a linked-quarter basis, reflecting a slight increase of $3.6 million. During 2018, we have experienced payoffs in excess of our original projections. We anticipate that trend will continue during the fourth quarter, which could offset most, if not all, of the projected new loans funded during the quarter.

In previous years, we experienced nice growth in our commercial real estate loan portfolio. That has not been the case during 2018. This year, we have seen nonbank lenders and financiers competing more aggressively by reducing equity requirements for borrowers and allowing thinner debt service coverage requirements. At a time when cap rates are low and valuations are high, we do not believe that it is prudent to change our underwriting standards and models to meet this competition. Partially offsetting this, we have successfully grown our C&I loans, which tend to be stickier and provide more deposit opportunities. We anticipate additional growth in this portfolio during the fourth quarter.

The absence of overall loan growth during 2018 did put some pressure on our net interest margin this quarter, which decreased 5 basis points on a linked-quarter basis. As we look out today, our loan pipeline is solid. Thanks to our lending team that is doing a great job of working on markets and our customer relationships. As a result, we continue to see several new loan opportunities that meet our underwriting standards. When the current level of payoffs slows, loan growth should return.

Against the backdrop of a gradually slider yield curve, we have continued to strategically reduce the size of the securities portfolio with a corresponding decrease in borrowings from the Federal Home Loan Bank. At quarter end, our Federal Home Loan Bank advances decreased to $561 million from $1 billion at December 31, 2017. Of note, $270 million of our Federal Home Loan Bank advances at quarter end are swapped with an average fixed rate of 1.68% and an average maturity of 5 years. This represents 48% of our quarter end advances and provides us attractive long-term fixed rate funding as the fed continues to increase short-term interest rates.

During 2019, our top priorities will include further developing our internal team members, loan growth, consistent with our current credit models and core deposit growth. In addition, we will continue to focus on cost containment and process efficiencies. The economies in each of our markets continue to perform well with two of those markets, Dallas-Fort Worth and Austin, consistently ranking near the top and overall performance in the United States.

We look forward to finishing out an excellent year, where we have successfully completed the integration of Diboll that expanded our franchise in the new contiguous market areas, while reporting record net income through the first 9 months.

Julie mentioned the common stock repurchase authorization. We believe repurchasing shares of common stock of a company we know very well, Southside Bancshares, at current market prices is prudent.

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 comes from the line of Brady Gailey with KBW.

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

The volume was fluctuating a little bit during the first part of the call. And I was wondering, Julie, I think you said, the effective tax rate for full year 2018 should be -- did you say 13%?

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

I said 13.4%, if you exclude the discrete items.

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

Okay. All right. That's...

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

Sorry about that.

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

Yes. No worries, no worries. And then, last quarter, the yield accretion, I think, was around $800,000. I wonder if what that was in the third quarter, the accretable yield number?

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

It was -- you're right. Last quarter, we recorded $824,000. In this quarter, it was around $478,000. So it did decrease, had about 3 basis point impact on the net interest margin.

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

Okay. And then, I understand that the payoff pressure for this year, sounds like next quarter is going to be kind of a flat quarter too. We know you talked about growing loans kind of longer term in that 6% to 7% range. Do you think that you will be able to get back up to that level next year in 2019?

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

Brady, at this point, we're taking a look at 2019. We're looking at the competitive pressures out there, and trying to get a handle on what potential payoffs might be for the first and second quarter. It's hard to estimate much beyond that. And so we don't really have a loan growth target at this point in time, but we hope to come up with one in the next month or so. But I'm not sure that it's going to be up in that range. It's probably going to be a little bit lower than that.

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***

Julie, I apologize, again. As Brady mentioned, the volume was a little tough there at the beginning of the call. But I think you already said, $29 million in expenses for the fourth quarter. Did you -- was there any other items this quarter aside from the ones that you noted with some of the BOLI and I think the retirement reversal last quarter? Just kind of curious to make sure that $29 million number was clean. And then you guys have done a lot of work trying to bring out efficiencies from the franchise over the last couple of years. As you think about revenue pressure, anything else you can do on the expense side? Are you still like you got pretty much all those realized in the run rate?

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

Go ahead.

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

On the expense side, yes, I did say, the expectation for fourth quarter was around $29 million. I'm trying to -- you asked quite a few things and from the standpoint of other items, I think most of our categories actually declined in the third quarter over second quarter. I do think the salaries are going to be fairly consistent in the fourth quarter with what we reported in the third quarter because we had to have that nonrecurring credit last month or last quarter. So I do think $29 million should probably be pretty close. That would have put us at -- I think $28.5 million -- I calculated earlier with amortization and any minimal acquisition expense. So I do think $29 million should be pretty close for the fourth quarter. Cost efficiencies, we -- it's top of mind, all the time there with loan growth. We continue to look at areas for cost efficiencies, but I do think we have probably realized most of those today.

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

And I think that most of the heavy-lifting has been done there. What we're doing at this point in time, we're looking at some of the process efficiencies through automation. And we may be able to achieve some additional cost savings there. But, I think, for the most part, most of it's been done at this point in time. But as Julie said, it continues to be top of mind, and we continue to look behind every nook and cranny for any potential cost savings.

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

It's great. That's helpful. And just as one follow-up, anything new or update on the loans that went to nonaccrual earlier this year? Anything new that you can share? You had like a small uptick this quarter, but didn't like there is any real change in kind of the overall balance of those larger loans that went on earlier this year?

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

Correct. And there really hadn't been a lot of change. They continue to perform. They continue to make their payments. The two memory care units have continued to lease up. One of them is near full occupancy and the other one has leased up very nicely and continues towards -- moving towards that full occupancy. But other than that, there really hadn't been a lot of change other than they continue to make their payments, and we continue to watch them carefully to make sure that they continue to perform like we want them to perform, and then we'll reevaluate them as appropriate moving forward.

Operator

And our next question comes from the line of Michael Young with SunTrust.

Brandon Thomas King ***SunTrust Robinson Humphrey, Inc., Research Division - Associate***

This is Brandon King filling in for Michael Young. And with the new share repurchase authorization, I was wondering if you could provide any color or thoughts on the potential timing and magnitude of that? And also for instance, let's say, if loan growth starts to pick back up or didn't change the valuations, how that might change your thought process behind that?

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

Basically, we'll begin probably middle part of next week, taking a look at stock repurchases. The rate at which that'll be done will be dependent totally on what stock is available at market prices that we believe are prudent to buy back the stock. So if it -- if there's plenty of volume available, we'll be looking at it as we're allowed to take a look at it, whether it's the daily volume or whether it's blocks. In terms of loan growth, if loan growth were to pick up substantially, that would be wonderful. And we'd look forward to that. We anticipate with the flatter yield curve that we're not going to be growing our securities portfolio and most likely, will probably continue to gradually decrease. So that would take up some of the space for the loan growth. Anything above that, we certainly would look at our capital levels to make sure that the stock buyback was appropriate, given the size of the balance sheet.

Brandon Thomas King ***SunTrust Robinson Humphrey, Inc., Research Division - Associate***

Okay. That's very helpful. And then also just switching topics here, could you provide any color as far as your NIM outlook for the 4Q and also going into 2019? Especially knowing how payouts really affect loan growth and increasing rise in deposit pressures?

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

Right. I would say that -- absent loan growth, the NIM will probably continue to be under some slight pressure. If we see some additional loan growth, then that NIM, we would expect it to increase. But it's really all going to be dependent on that loan growth. The other thing is that the more volatile liabilities like the Federal Home Loan Bank advances, we have decreased those significantly. And we're down to a point where, as a percentage of those that are volatile, it's a fairly relatively small number compared to the number at year-end. So that acts positively in terms of NIM compression on the other side. So we have some things going for us on the liability side. The ability to grow loans is really going to determine what happens to the NIM.

Operator

And I show no further questions at this time. I would like to turn the call back over to Mr. Lee Gibson for closing remarks.

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

Thank you for joining us today. We look forward to finishing out a good year-end. And we look forward to hosting our next call in late January and discussing the financial results for the fourth quarter and all of 2018.

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Operator

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

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