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Q1 2019 Southside Bancshares Inc Earnings Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Southside Bancshares, Inc. First Quarter 2019 Earnings Conference Call. (Operator Instructions) As a reminder, today's conference is being recorded.

I would now like to introduce your host for this conference call. Lindsey Bibby, you may begin.

Lindsey Bibby ***Southside Bancshares, Inc. - VP & IR Officer***

Thank you, Kevin. Good morning, everyone, and welcome to Southside Bancshares First Quarter 2019 Earnings Call. 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 uncertainty. Factors that could materially change our current forward-looking assumptions are described in our earnings release and our Form 10-K.

Joining me today are Lee Gibson, President and CEO; and Julie Shamburger, Senior Executive Vice President and CFO. Our agenda today is as follows: first, you'll hear Julie discuss an overview of our financial results, including loan loss provision and an update on our nonperforming assets. Then Lee will share his comments on the quarter, including financial performance and an update on our securities portfolio.

I will now turn the call over to Julie.

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

Thank you, Lindsey. Good morning, everyone, and welcome to Southside Bancshares First Quarter 2019 Earnings Call. We are pleased to report net income of $18.8 million for the first quarter, an increase of $1.4 million or 8.3% on a linked-quarter basis and $2.6 million or 15.8% compared to the same period in 2018. For the quarter ended March 31, 2019, our diluted earnings per share increased $0.10 or 21.7% to $0.56 per share compared to the same period in 2018 and increased $0.06 per share or 12% on a linked-quarter basis.

During the first quarter, we experienced a decrease in loans of $7.7 million or 0.2% on a linked-quarter basis. During the first quarter, we sold 3 commercial real estate loans that totaled approximately $16.7 million that were placed in nonaccrual status during the first quarter of 2018. In connection with the sale, we charged off $1.2 million and recorded a partial reversal of loan loss provision.

Total nonperforming assets decreased $4.8 million or 11.2% to $38.1 million or 0.61% of total assets at March 31, 2019, compared to $42.9 million or 0.7% of total assets at December 31, 2018.

Nonaccrual loans decreased $18.1 million or 50.5%, primarily a result of the loans sale previously mentioned. Restructured loans increased $5.6 million due to the restructure of a commercial real estate loan. Additionally, during the first quarter, our accruing loans past due 90 days or more included a $7.9 million loan relationship that was in the process of collection and subsequently paid off in full on April 15, 2019.

The allowance for loan loss decreased by $2.9 million on a linked-quarter basis, primarily driven by the charge-off related to the nonaccrual loans sold in the first quarter and the partial reversal of provision.

Our securities portfolio decreased to $128.7 million or 6% for the quarter ended March 31, 2019. Throughout the month of March 2019, we sold approximately $524 million of our lower-yielding securities, consisting primarily of municipal securities, and to a lesser extent, lower-yielding mortgage-backed securities and replaced a portion of the securities sold with higher-yielding Texas municipals and mortgage-backed securities. Subsequent to March 31, 2019, we have purchased approximately $183 million in additional securities. We expect a positive impact on our net interest margin in future quarters as a result of the securities purchased in the first quarter and subsequent to quarter end.

At March 31, 2019, we had a net unrealized gain in the securities portfolio of $7.7 million and a duration of 6.5 years, an increase from 5.5 years at year-end, a result of the sale of lower-yielding and shorter-duration securities in the first quarter of 2019. The mix of our loans and securities shifted slightly to 62% loans and 38% securities at March 31, 2019, compared to a 61% and 39% mix at year-end, a direct result of the sale of selected securities during the first quarter.

Our net interest margin for the first quarter of 2019 decreased 14 basis points to 3.07% from 3.21% in the previous quarter, which was a result of higher rates paid on interest-bearing liabilities, the increase in average wholesale funding during the quarter and a loss on a fair value hedge interest rate swap of $509,000 recorded in interest income.

Loan accretion recorded this quarter was $597,000, an increase of approximately $132,000 from the prior quarter.

For the first quarter, we recorded a partial reversal of loan loss provision at $918,000 compared to $2.4 million of provision expense in the previous quarter. The reversal of provision was largely related to the first quarter sale of the nonaccrual loans mentioned earlier.

Linked-quarter, our noninterest income, excluding net gains on available-for-sale securities, decreased $791,000 or 7.9% due to a decrease in deposit services income and a partial loss recorded of $427,000 on a fair value hedge instrument in which the hedge relationship was discontinued due to the sale of the hedges items and the subsequent fair value loss after the sale was recorded in noninterest income.

During the first quarter, we recorded a gain on the sale of available-for-sale securities of $256,000, an increase of $195,000 on a linked-quarter basis. During the quarter ended March 31, 2019, our noninterest expense decreased $569,000 or 1.9% from the previous quarter.

Linked-quarter, the efficiency ratio increased to 53.66% compared to 52.18% due primarily to the decrease in net interest income.

Income tax expense increased $616,000 compared to last quarter, and the effective tax rate for the first quarter was 14.3%, an increase from expectations due to lower tax exempt income as a percentage of pretax income. At this time, we're estimating noninterest expense of approximately $30 million for the second quarter and an effective tax rate for that same period of 14.5%.

Thank you very much, and I will 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 had an excellent first quarter, highlighted by a 15.44% return on average tangible common equity, a 15.8% increase in net income and a 21.7% increase in diluted earnings per share. During the quarter, nonperforming assets declined 11.2% to 0.61% of total assets due to the sale of 3 nonperforming loans. And as Julie discussed, another 21% of the nonperforming assets at quarter end paid off in April. The charge-off associated with the sale of these nonperforming loans was less than originally anticipated and resulted in a net reversal of $918,000 in allowance for loan losses. Our net interest margin reflected a decrease of 14 basis points on a linked-quarter basis, primarily due to higher funding cost and a loss of $509,000 on hedges recorded in municipal income.

During our last earnings call, I mentioned that due to the fed clarifying their stance on interest rates, you would likely see an increase on a linked-quarter basis in the size of the securities portfolio. While we were not anticipating much of an increase in long-term interest rates during the first quarter, we did not anticipate the significant decrease in long-term interest rates that occurred during March. As a result of the change in interest rates, we proactively sold more than $520 million of lower-yielding securities. Over $390 million of the securities sold were lower-yielding municipal securities with shorter calls. Throughout the quarter, we purchased over $420 million of securities with higher yields than those sold. Subsequent to quarter end, we've purchased more than $180 million in additional securities. The restructuring of the securities portfolio will positively impact the overall yield of the securities portfolio in the second quarter.

Economic conditions in our markets remains positive as both job and population growth are continuing.

Our average loans on a linked-quarter basis increased. However, linked-quarter total loans decreased $7.7 million due to the sale of the nonperforming loans during the last half of the quarter. We also experienced other large loan prepayments during the first quarter. Our pipeline looks solid. And other than the nonperforming loan that paid off in April, at this time, we are not aware of many large loan payments during the second quarter.

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.

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

So I appreciate all the color on what you all had done with the bond book last quarter and even quarter-to-date. As we look at -- I don't know if you want to talk about it in terms of the bond book, yield or the overall net interest margin. But how much do you think we could see asset yields rebound in 2Q with these restructure? Like how much upside to NIM would you expect in 2Q?

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

Just in the securities portfolio, we are estimating that the interest income in the securities portfolio will probably be up somewhere close to $1 million in the second quarter. And then, of course, we'll have the nonperforming assets that were sold -- they were nonaccrual loans that were sold in March. And those, obviously, become earning assets. And so that will have a nice impact in the second quarter as well.

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

Okay. And then when you look at loan growth, balances were obviously down a little bit this quarter due to the factors that you talked about with the sales of the nonperforming loans, etcetera. I know in the past we've talked about a 4% loan growth rate being the right forward run rate for you all. I mean does that -- I know you had another large pay-down so far this quarter and the second quarter. But outside of that, do you think 4% is a good run rate for loan growth for you all?

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

I do. The loan pay-down we had this quarter, so far, is only $8 million. And we've had some good funding so far this quarter. And so I do think that 4% is very achievable for the year.

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

All right. And then finally for me, the duration of your bond book has gone up a lot over the last year or 2. I mean it's now at 6.5 years. That's above average. So how do you think about the trend of the duration of that bond book going forward?

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

I don't see it going up from here. I think we will see some pickup in prepayments on mortgage-backed securities, so that will have some impact on the duration as well as the yield. And so we've tried to calculate that in as well. And the bonds we've been buying are not at huge premiums, so the pickup in prepayments isn't going to have that big of a change on the yields, but it will obviously affect the duration.

Operator

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

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

It's actually Peter Ruiz on for Brad. I just wanted to maybe get some clarification on just the fair value hedge interest rate swaps. So if I have it right, there was $0.5 million in net interest -- in interest income that you're pulling out there, and then there's an additional $0.5 million within fees. Do I have that right?

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

That is correct. And what -- let me -- I'll explain that. We sold 3 municipals that had a hedge on it, and so the loss on the hedge at that point in time goes through interest income. And then you fair value the hedge at the end of the quarter, and the -- any change in that fair value from the point of sale to the end of the quarter is reflected there in noninterest income. I will tell you that we did unwind the swap as interest rates increased a little bit in April. And we have, I think, around $180,000 gain on the unwinding of that swap that will be recorded in the second quarter.

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

Great. I appreciate the color. And then maybe just following up on just the nonaccrual loans that were sold. Can you give us an idea of what the original balance was for those and just any additional color there?

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

The balance on those loans at 12/31 were around $16.7 million, and they were placed in nonaccrual. Those 3 particular loans were placed in nonaccrual in the first quarter of 2018, and the balance changed somewhat over the course of the year. But that was the balance of 12/31.

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

Okay, okay. And so if I remember correctly, were those the memory care facility that you previously mentioned?

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

That is correct. And we put them out for sale. And the bids that came in, in the first quarter were much better than what we had anticipated based on the reserve we had at year-end.

Operator

Our next question comes from Will Curtiss with Hovde Group.

William Davis Curtiss ***Hovde Group, LLC, Research Division - Director***

Wanted to follow up on the securities restructuring. And are you able to share what the difference in yield was there from want you guys sold and bought?

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

On the municipal securities, the yield was around -- and this was the tax effective yield was around a 2.92%, and that was a little over $390 million. And on the taxable securities, they were a little over $132 million of those, and the yield on those was around 2.32%. What we purchased on average probably has a yield of around 3.5% to maybe 3.60%, somewhere in that range. It somewhat depends on what the prepayments come in.

William Davis Curtiss ***Hovde Group, LLC, Research Division - Director***

Okay. Also wanted to ask about the fee income expectations. I suspect the seasonality played a role with the service charges, but just any thoughts on how you see fees trending this year would be helpful.

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

I would think deposit service fees would increase in the second quarter compared to the first quarter simply because of the number of days. And we also did raise a few of our fees, so we expect to see some increase as a result of that.

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

And those increases were affected beginning in April, so they would not have been reflected in any form in the first quarter.

Operator

And I'm not showing any further questions at this time. I'd like to turn the call back over to Lee Gibson.

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

All right. Thank you. I am very pleased with our first quarter earnings. Given the restructuring of over $520 million of securities at higher yields, potential second quarter loan growth, combined with the reduction in nonaccrual loans, we are looking forward to reporting second quarter results in July. Thank you again for joining us this morning.

Operator

Ladies and gentlemen, that does conclude today's presentation. You may now disconnect and have a wonderful day.