Southside Bancshares, Inc. (Q2 2019 Earnings)

July 26, 2019

Corporate Speakers:

- Lindsey Bibby; Southside Bancshares, Inc.; VP & IR Officer
- Julie Shamburger; Southside Bancshares, Inc.; Senior EVP & CFO
- Lee Gibson; Southside Bancshares, Inc.; President, CEO & Director

Participants:

- Brett Rabatin; Piper Jaffray Companies; Senior Research Analyst
- William Curtiss; Hovde Group, LLC; Director
- Wood Lay; Keefe, Bruyette, & Woods, Inc.; Associate
- Graham Dick; Sandler O'Neill + Partners, L.P.; Analyst

PRESENTATION

Operator: Good day, ladies and gentlemen, and welcome to the Southside Bancshares, Inc. Second Quarter 2019 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. Lindsey Bibby, Vice President of Investor Relations. Ma'am, you may begin.

Lindsey Bibby: Thank you, Michelle. Good morning, everyone, and welcome to Southside Bancshares' Second 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 activities and an update on our nonperforming assets. Then Lee will share his comments on the quarter, including financial performance and our loan pipeline.

I will now turn the call over to Julie.

Julie Shamburger: Thank you, Lindsey. Good morning, everyone, and welcome to Southside Bancshares' Second Quarter 2019 Earnings Call.

We reported net income of $18.6 million for the second quarter, a decrease of $207,000 or 1.1% on a linked-quarter basis and a decrease of $1.6 million or 7.9% compared to the same period in 2018. For the quarter ended June 30, 2019, our diluted earnings per share were $0.55, a decrease of $0.01 on a linked-quarter basis and a decrease of $0.02 compared to the same period in 2018.

We are pleased to report solid loan growth during the second quarter with an increase of $155 million or 4.7% to $3.46 billion on a linked-quarter basis. We experienced most of the loan growth in our commercial real estate portfolio with an increase of $146.9 million or 13.3% during the second quarter and, to a lesser extent, growth in both our commercial and municipal portfolios. Our allowance for loan loss increased $550,000 or 2.3% on a linked-quarter basis primarily driven by the increase in loans during the second quarter.

We continue to see improvements in nonperforming assets, and our overall credit quality remains strong. Our nonperforming assets decreased $8.8 million or 23% to $29.4 million or 0.46% of total assets at June 30, 2019, compared to $38.1 million or 0.61% of total assets at March 31, 2019. The decrease in nonperforming assets was largely driven by the full payoff of the $7.9 million loan reported as past due 90 days or more at the end of March.

Our securities portfolio increased by $212.2 million or 10.5% for the quarter ended June 30, 2019. We expect a positive impact on our net interest margin in future quarters as a result of the restructuring in the securities portfolio over the first and second quarter. At June 30, 2019, we had a net unrealized gain in the securities portfolio of $43.5 million; and a duration of 5.8 years, a decrease from 6.5 years at the end of March.

Our mix of loans and securities shifted slightly this quarter end, with loans at 61% and securities at 39% compared to a mix of 62% loans and 38% securities at the end of March. This slight increase in securities was due to the additional purchases in the second quarter.

Our net interest margin for the second quarter of 2019 increased 10 basis points to 3.17% from 3.07% in the previous quarter. This increase was driven by the increase in our average loans during the quarter and a nonrecurring loss on the fair value hedge of $507,000 recorded through interest income during the first quarter.

We also experienced a 10 basis point increase in our net interest spread for the second quarter to 2.81% compared to 2.71% in the first quarter of 2019 due to the increase in average yield on our earning assets together with a slight decrease in the average rate paid on the interest-bearing liabilities.

We recorded $685,000 of loan accretion this quarter, an increase of $88,000 from the prior quarter.

During the second quarter, we recorded provision expense of $2.5 million, a $3.4 million increase when compared to the reversal of provision of $918,000 in the previous quarter.

Approximately $1.3 million of the provision recorded was related to the loan growth experienced during the quarter.

Linked-quarter, our noninterest income, excluding net security gains, increased $1.6 million or 16.7% primarily due to an increase in deposit services income, swap fee income and a nonrecurring partial loss on a fair value hedge instrument recorded in the prior quarter. During the second quarter, we sold lower-yielding U.S. agency mortgage-backed securities, resulting in a net gain on sale of available-for-sale securities of $416,000, an increase of $160,000 on a linked-quarter basis.

During the quarter ended June 30, 2019, our noninterest expense increased slightly by $73,000 from the previous quarter. Linked-quarter, we experienced an improvement in our efficiency ratio down to 51.44% compared to 53.66% due primarily to the increase in both net interest income and noninterest income during the quarter.

Income tax expense increased $432,000 compared to last quarter, reflecting an effective tax rate of 16.1% for the second quarter, an increase from expectations due to lower tax-exempt income as a percentage of pretax income. For the quarter, our estimated noninterest expense remains at approximately $30 million. We are adjusting our effective tax rate to 15.4%.

Thank you so much. And I will return the call over to Lee.

Lee Gibson: Thank you, Julie. I would like to thank everyone for joining us on our call this morning.

We enjoyed an outstanding second quarter highlighted by a linked-quarter annualized 18.8% increase in loans, a 10 basis point linked-quarter increase in our net interest margin and a 24.6% linked-quarter decrease in nonperforming assets as a percentage of total assets to 0.46%. Our strong second quarter loan growth resulted from a combination of funding a number of loans that have been in our pipeline for some time and a reduction in large prepayments.

During the first 6 months, loan growth has been 4.45%, slightly ahead of the 4% guidance for all of 2019. We now believe loan growth of at least 6% for 2019 is achievable absent unexpected prepayments. Our current pipeline is steady, but we are expecting additional prepayments during the third quarter when compared to the second quarter.

All of our regions experienced loan growth during the second quarter, with the largest growth occurring in our DFW and Austin markets. We expect to add lending officers in our higher-growth markets in the last half of the year that should further enhance our loan growth opportunities.

As Julie explained, the linked-quarter 10 basis point increase in our net interest margin and spread primarily resulted from higher-yielding loans increasing as a percentage of average earning assets and overall funding costs decreasing 1 basis point during the second quarter.

During the third quarter, the margin could continue to improve as third quarter average earning assets fully reflect second quarter loan growth; and funding costs should remain stable to down, consistent with the decline in all areas of the treasury curve, along with the highly anticipated decrease in overnight funding by the Federal Reserve during the third quarter. The restructuring of the securities portfolio during the first quarter was largely responsible for the 13 basis point linked-quarter increase in the average yield of total securities.

During the second quarter, we sold approximately $180 million of lower-yielding agency commercial mortgage-backed security. Throughout the quarter, we purchased over $380 million of securities with higher yields than those sold. These changes should further positively impact the overall yield of the securities portfolio in the third quarter.

I'm also pleased to announce that we're expanding our footprint and opening a branch in Kingwood, a community located northeast of Houston and approximately 15 miles south of our Splendora branch. On the acquisition front, we are learning about more banks in our desired footprint that are seriously considering selling. Economic conditions in our markets remain positive, as both job and population growth are continuing.

At this time, we're going to conclude our prepared remarks and open the lines for your questions.

QUESTIONS AND ANSWERS

Operator: (Operator Instructions) Our first question comes from the line of Brett Rabatin with Piper Jaffray.

Brett Rabatin: I wanted to ask. This is obviously the first quarter where we've seen some good loan growth and a function of commercial real estate and lower payoffs. Lee, I'm just curious. What gives you confidence in the back half of the year in terms of lower payoffs presumably? And then can you just talk about the lender hires that you're planning to make, what they'll be in? Will it be C&I, or will they be in other areas of the bank?

Lee Gibson: I think they'll be -- some of them will be C&I, but obviously they'll -- some will be commercial real estate related. In terms of the confidence, we -- just we continue to have some things in our pipeline that we expect to fund. We have some payoffs that we have already experienced in the third quarter, but we also have fundings in the third quarter.

So at this point, we're not anticipating robust loan growth last half of the year, but we are anticipating some potential loan growth the last half of the year. So our -- we're in good markets. We're seeing a lot of opportunities out there. So the economy continues to be extremely good in the markets we're in.

Brett Rabatin: Okay. And then I wanted to talk about the margin. You talk about it being up. Can you just talk about what you're doing, one, in the securities book? And then two, I assume that the margin being up is a function of flattish funding costs from here and the continued improvement on the asset side. Just wanted to hear your thoughts on the funding base and if you can keep that flat or if you think you can actually lower it in the third quarter.

Lee Gibson: I -- looking at our funding costs, especially on the wholesale funding side, it looks like we will be able to potentially lower it on the wholesale funding side. In terms of the deposit side, I would expect to be able to hold it flat to potentially down because we've been able to lower CD rates significantly. And we're picking up CDs on the retail side, with the CD rates down dramatically. So I would expect -- depending on what the fed does next week, I would expect that overall rates, funding costs potentially could be down in the third quarter.

Brett Rabatin: Okay. And then maybe one last one for me, just on fee income. The other lines have been volatile over the past year. Can you just talk about the back half of the year in terms of fee income; and if the 2Q rates, including the noise, is a good run rate for the back half of the year; or if anything impacts that?

Lee Gibson: Julie...

Julie Shamburger: Okay. On the -- this quarter, like I mentioned, we experienced swap fee income. We had, we booked about $387,000 of swap fee income. And as you know, that have -- some quarters, we have some. Some, we don't. We do expect more of that in the third quarter. I can't really speak to that in the fourth, but we do expect more of that in the third quarter.

And on deposit services specifically, we saw an increase there for the quarter, and that was about probably $370,000 of that increase this quarter was related to overdraft fees. We did raise our fees slightly in the second quarter, in April. And so we did pretty much get a full quarter impact from that. And the remainder of that deposit service fee income was in the ATM interchange-type income arena.

So I do think -- certainly I do expect most of that to continue. I'm thinking that deposit services -- based on what I've been provided with, the deposit services income is going to remain in that -- at that rate for the rest of the year. And those were the bigger 2 swings there in -- deposit services and swap fee income.

Operator: And our next question comes from the line of Will Curtiss with Hovde Group.

William Curtiss: I wanted to go back to Brett's question about the margin. And I think, Lee, you had mentioned earlier that the -- you expect it can improve. I just want to make sure I understand what kind of assumptions are in there in terms of rate cuts. And then maybe more broadly, how do you see the margin kind of playing out if in fact we do get a couple rate cuts in the back half of this year?

Lee Gibson: Well, I mean one thing I was trying to point out was that the average earning assets, the loan growth in the second quarter was only -- about half of that was figured into the overall yield in the earning assets during the second quarter. So we'll have that full impact in the third quarter.

We did further tweak the securities portfolio by moving out some lower-yielding securities, more than replacing them with some higher-yielding securities, so we expect securities yield to move up slightly. So those 2 things, combined with funding costs being at least flat to potentially down in the third quarter, we could see further improvement in the margin.

William Curtiss: Okay. And then I guess the -- a question on accretion. So I think it was up from last quarter. Any sense for how it should trend over the course of the back half of this year?

Julie Shamburger: It was up during this quarter about $88,000, about 15% actually over last quarter. We recorded $597,000 last quarter. It fluctuates certainly with payoffs. You can have one payoff with a larger than -- "a little out of the ordinary" discount, and it all creeps up. And that happens. So I can't -- I don't know that we're going to maintain $685,000 every quarter.

I would feel more comfortable probably with last quarter's number on a go-forward basis, but you just really -- the Omni accretion -- the remaining discount on the Omni loans is about 15% or 20% of what remains of our overall discount, so it's going to slow on a monthly basis naturally just because it's getting smaller. So -- and I'm thinking more along with the first quarter probably.

William Curtiss: Okay. And then the last one for me: I think you mentioned expenses for the third quarter to be $30 million, so it's pretty consistent with where it's been. And curious, if we look a little further out, maybe heading into 2020, should we expect the expense base to remain relatively stable going forward? Or are there some other things we should consider as we look to next year?

Julie Shamburger: I think at this point we -- I would say that they should remain stable. If you start going into 2020, then sometimes, of course, you have adjustments to your salary and employee benefit numbers. So potentially you could see some increase there in a new year. I would think it would stay pretty flat for the remainder of this year, though.

Operator: (Operator Instructions) Our next question comes from the line of Woody Lay with KBW.

Wood Lay: So looking closer at expenses. With the Kingwood branch announcement in 4Q, can we expect any incremental expenses with that branch opening?

Lee Gibson: It's an in store -- it'll be an in-store branch. So the buildout of an in-store will be relatively inexpensive and will -- it will be capitalized. The personnel costs will be relatively small because it doesn't require a lot of personnel to staff that, maybe 3 to 4 at most. So I wouldn't anticipate that there'll be a significant expense amount that will show up.

Wood Lay: Got it. And then with the current M&A strategy, with the Kingwood branch announcement, you're kind of inching your way closer to the Houston metro market. Is that a market you would be interested in expanding to either through M&A, or is it really just focused on the current footprint right now?

Lee Gibson: I think that, in terms of M&A, there's other markets that I think we'd be more interested in, but the Houston market certainly is a good market. And we make a lot of loans in that market currently. And we touch the outskirts of it with our First Bank & Trust East Texas acquisition. They had plenty of tentacles into the Houston market. So we see a lot of things in the Houston market, but in terms of M&A and -- I'm not sure that that's primary focus for us. But we do look at the Houston market quite a bit.

Operator: Thank you. 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 Gibson: Thank you. I'm extremely -- excuse me.

Operator: I'm sorry. We did just have somebody queue up. Did you guys want to take their question?

Lee Gibson: Sure.

Operator: Okay. We have a question from the line of Graham Dick with Sandler O'Neill.

Graham Dick: Sorry about that, guys. I thought I was queued up and realized at the last minute I wasn't. I'm on for Brad today but just had one question. You guys posted some pretty strong loan growth this quarter, and I'm kind of just wondering what kind of yields you guys saw on the new loans. It looks like the core loan yield held in pretty well at 5%, lower 5%.

Lee Gibson: And that's pretty well where the average loan yield was that we put on. It was in that very low 5% type yield because a lot of -- probably close to half of it was floating-rate loans.

Operator: Thank you. And now I am showing no further questions; and would like to turn the conference back over to President and CEO, Mr. Lee Gibson.

Lee Gibson: All right, thank you very much. I'm extremely pleased with our second quarter results given the $155 million second quarter loan growth; 10 basis point net interest margin increase, with anticipated additional increases in the third quarter; and further fine-tuning of the securities portfolio. We look forward to reporting third quarter results in October. Thank you again for joining us this morning.

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.