THOMSON REUTERS

EDITED TRANSCRIPT

Q3 2019 Southside Bancshares Inc Earnings Call

EVENT DATE/TIME: OCTOBER 25, 2019 / 2:00PM GMT

CORPORATE PARTICIPANTS

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

CONFERENCE CALL PARTICIPANTS

Bradley Jason Milsaps *Sandler O'Neill + Partners, L.P., Research Division - MD of Equity Research*
Brandon Thomas King *SunTrust Robinson Humphrey, Inc., Research Division - Associate*
Brett D. Rabatin *Piper Jaffray Companies, Research Division - Senior Research Analyst*
Wood Neblett Lay *Keefe, Bruyette, & Woods, Inc., Research Division - Associate*

PRESENTATION

Operator

Ladies and gentlemen thank you for standing by and welcome to the Southside Bancshares, Inc. Third Quarter 2019 Earnings Conference Call. (Operator Instructions) Please be advised that today's conference is being recorded. (Operator Instructions) I would now like to hand the conference over to your speaker today Ms. Bibby -- Ms. Lindsey Bibby, Vice President of Investor Relations. Ma'am, please go ahead.

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

Thank you, Michelle. Good morning, everyone, and welcome to Southside Bancshares Third 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 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, then Lee will share his comments on the quarter and an update on our nonperforming assets.

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' Third Quarter 2019 Earnings Call.

We reported net income of $19.8 million for the third quarter, an increase of $1.2 million or 6.4% on a linked-quarter basis and a decrease of $511,000 or 2.5% compared to the same period in 2018. For the quarter ended September 30, 2019, our diluted earnings per share were $0.58, an increase of $0.03 on a linked-quarter basis and consistent with the same period in 2018.

While we're pleased to report additional loan growth during the quarter with an increase of $39.8 million to $3.5 billion on a linked-quarter basis. The additional loan growth during the quarter brings our year-to-date loan growth to 5.6%.

During the third quarter, we experienced most of the loan growth in our construction portfolio and to a lesser extent, growth in both, our 1-4 residential and municipal portfolios.

Our allowance for loan loss increased $424,000 or 1.7% to $25.1 million from June 30, 2019. Our credit quality remained strong with a slight decrease in nonperforming assets as a percentage of total assets to 0.45% at September 30 compared to 0.46% as of June 30, 2019, with only a slight increase in nonperforming assets of $384,000 or 1.3% to $29.7 million at the end of third quarter.

Our securities portfolio increased $145.5 million or 6.5% for the quarter ended September 30, 2019, due to purchases in our municipal and mortgage-backed securities portfolios. At September 30, 2019, we had a net unrealized gain in the securities portfolio of $62.8

million in a duration of 4.7 years, a decrease from 5.8 years at the end of June due to the increase in prepayments of mortgage-backed securities during the quarter.

Our mix of loans and securities shifted slightly this quarter end and with loans at 60% and securities at 40% compared to a mix of 61% loans and 39% securities at the end of the second quarter. This slight shift was due to our growth in the securities portfolio outpacing our loan growth.

Our net interest margin for the third quarter of 2019 decreased 14 basis points to 3.03% from 3.17% in the previous quarter. The net interest margin was compressed by lower interest rates, resulting in a lower yield on average assets of 14 basis points. This decrease in the yield on average assets more than offset the 1 basis point decrease in the cost of interest-bearing liabilities, resulting in the 13 basis point decrease in our net interest spread for the third quarter of to 2.68% compared with 2.81% in the second quarter of '19.

Linked quarter, our net interest income decreased $758,000 or 1.8%. Our loan accretion this quarter decreased $395,000 from the second quarter of 2019, resulting in $290,000 of loan accretion recorded during the quarter. The decrease in accretion reduced our NIM by 3 basis points as well as reducing net interest income.

During the third quarter, we recorded provision for loan loss expense of $1 million, a linked-quarter decrease of $1.5 million. Linked quarter, our noninterest income, excluding net security gains increased $231,000 or 2.1%, primarily due to increases in deposit services income, swap fee income and brokerage services.

For the 3 months ended September 30, 2019, our noninterest expense decreased $674,000 or 2.3% primarily driven by the FDIC Small Bank Assessment Credit. We have approximately $1.2 million remaining in credits to be applied at some point in the future to our FDIC insurance.

We experienced an improvement in our efficiency ratio down to 50.53% compared to 51.44% on a linked-quarter basis due primarily to the decrease in noninterest expense.

For the fourth quarter, absent the FDIC assessment credit, we estimate our noninterest expenses will be consistent with the second quarter of 2019, approximately $29.7 million.

Income tax expense increased $92,000 compared to the last quarter, reflecting an effective tax rate of 15.6% for the third quarter. We expect to end the year with an effective tax rate consistent with the third quarter at 15.6%.

Thank you so much, and I will now 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 on our call this morning. We enjoyed a very good third quarter that was highlighted by 4.6% linked-quarter loan growth, a return on average tangible equity of 14% and an efficiency ratio that improved to 50.5%. We continue to experience solid third quarter loan growth in spite of the headwinds of several large loan prepayments that we experienced during the quarter. Annualized loan growth during the first 3 quarters was 5.9%, which is consistent with the revised loan growth guidance of 6% that we provided during last quarter's earnings call.

During the third quarter, we were successful in hiring additional lenders in the Austin and East Texas markets. Prospects for our fourth quarter loan growth appear promising given our solid loan pipeline, the hiring of additional lenders and few currently known fourth quarter loan prepayments.

As Julie explained, we experienced a linked-quarter 14 basis point decrease in our net interest margin. Third quarter average loan and security growth was largely funded by higher cost FHLB advances.

In addition, during the third quarter, prepayments on our mortgage-backed securities increased as long-term interest rates declined significantly, resulting in increase in amortization expense. We anticipate our fourth quarter funding cost should benefit from the recent late third quarter and early fourth quarter decrease in short-term interest rates. Since September 30, long-term treasury yields have increased slightly with the 10-year up approximately 10 basis points while the short term treasury yields have decreased with the 3 months treasury yield down approximately 15 basis points. An overall shift in the yield curve of 25 basis points, which should benefit our fourth quarter cost of funds. A more positively sloped yield curve during the fourth quarter, combined with historically slower late fall and winter mortgage-backed security prepayment speeds could also reduce or stabilize amortization expense. As a result, we anticipate our NIM should be stable to higher during the fourth quarter.

Our credit quality remains solid, and we're not currently seeing additional areas of concern. One of our 2 largest nonaccrual loans reflected significant improvement during the third quarter as the real estate associated with this loan that was significantly damaged by Hurricane Harvey reopened for business last quarter. We will continue to monitor this loan for possible consideration for upgrade.

Economic conditions in the Texas markets we serve remain solid with our Austin and DFW markets performing well above average. We anticipate continuing to add additional revenue producers during the coming quarters with a special focus in the higher growth Texas markets. We look forward to opening our newest branch in Kingwood, a high-growth area just north of Houston next month. We continue to explore opportunities for further growth opportunities, resulting from either an acquisition or through organic growth.

I will now conclude my comments, and we will open the lines for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first 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***

Lee, I was writing quickly during your NIM commentary. I appreciate all the color, but want to make sure I kind of heard the final guidance. You kind of expect it to be stable to slightly up. I'm just curious if you could quantify the amount of amortization expense you had in the quarter on the bond portfolio, maybe versus where it was in the second? And I'm sorry if I missed that, I was trying to write everything down quickly.

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

We will have to get that number for you, Brad, and we will have that out. We'll send that out. I know it's up because I know the prepayments increased and I know our amortization expense was up and it impacted the NIM, but we don't have that exact number right now.

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

Okay. Great. And then, yes, that will be great if we could follow up on that. And then just in terms of repricing of the Federal Home Loan Bank advances. I know you'll have updated info in the Q, but anything major rolling off in the fourth quarter?

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

We have a lot of -- we've kept all the Home Loan Bank advances, not all, though we have -- we do have $260 million or $280 million hedged -- that we've had hedged for a long time, but all of the rest we have kept relatively short. I don't know that we've gone out much past 3 months on anything. Most of it's been either overnight or 28 days advances. So it will reprice fairly quickly.

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

Okay. Great. And then in terms of your commentary around loan growth. Obviously, it sounds like the fourth quarter will be a little bit better from a payout perspective and it sounds like you hired some new lenders this quarter. Still feel comfortable kind of as you look out in the next year or kind of at that mid-single-digit pace? Or might we see some acceleration with some of the folks you brought over?

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

I think right now, we're looking at 6% for 2020, but we don't expect to revise that down for 2020. If anything, we might -- when we come in January, we might have a slightly higher number, but it's not going to deviate from that very much.

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 just go back to prepayments for a second. Could you quantify the amount of prepayments you had in the quarter? And was that in commercial real estate? And then just thinking about any visibility you might have into prepayments from here? I know that's been a bit of challenge for you for growth.

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

Most of it was in the CRE portfolio. And it's credits that moved out of construction and into permanent. And they sold properties and things of that nature. A little bit in the C&I space, but I think it was mostly centered in the CRE space. The magnitude, it was probably close to $50 million, maybe as high as $60 million during the quarter, versus we had very little in the second quarter.

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

Okay. And then Lee, as you look at your existing commercial real estate book from here, do you kind of see a pipeline that might be susceptible to prepayments or can you give us any color of how you think about that going forward?

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

Well, as you look at our construction book, some of that -- and we know that going in, some of that, once it -- once they finish construction on the property and lease it up or stabilize the property, some of our borrowers are going to hold it and some of them are just simply going to sell it, which is -- and we know the ones that typically sell the properties going in. So I anticipate that we'll continue to see prepayments in the future quarters. It's just some quarters, it's heavier than others.

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

Okay. And then you mentioned buying municipals and and buying municipals and buying securities during the quarter. And can you talk about what you bought average rate? And then how you're trying to insulate the securities portfolio from this environment?

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

We bought a lot of municipal securities. We also bought some mortgage-backed securities. And we're kind of operating on both sides. We were able to find some mortgage-backed securities that we're paying 60%, 70% and buy them at reasonably nice yields and realizing that they probably will not continue to pay it, 60%, 70%, for very long and our downside is very, very small versus the upside's really good. We have brought also some longer-duration mortgage-backed securities where the principal is locked out for a period of time. So that the amortization expense associated with that should prepayments kick up, will be less. On the municipal side, we just continue to buy good quality credits here in Texas. And our municipal book had decreased pretty significantly the first of the year when we sold a lot of the really, really short stuff that was going to have a call -- be called away pretty quickly. And we're replacing that with newer securities with 8- to 10-year calls on them.

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

Okay. And then one last housekeeping issue. What was the discount accretion for the quarter?

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

It's $290,000 and it was down about $395,000.

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

Okay. And that accounted for 3 basis points to the 14 basis point decrease in the NIM.

Operator

And our next question comes from the line of Woody Lay with KBW.

Wood Neblett Lay ***Keefe, Bruyette, & Woods, Inc., Research Division - Associate***

It's nice to hear you think the NIM can remain flat to may be up a couple basis points. Do you think that would still hold through if we saw another rate cut in the fourth quarter?

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

Yes. And it's mainly because the slope of the yield curve has actually moved in the favor of banking, from the standpoint of, it was heavily inverted pretty much all the way along the yield curve except for the 30-year and now it's -- there is a positive slope to the yield curve. It's still partially inverted a few places but, not anything like it was at the end of August or even in early September.

Wood Neblett Lay ***Keefe, Bruyette, & Woods, Inc., Research Division - Associate***

Got it. That's helpful. And then touching on the discount accretion again. Do you think this is a pretty good run rate going forward? Or do you think we could see that number pick up next quarter and throughout 2020?

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

I expect that number to pick up and it was significantly lower than what we had seen historically the last 2 quarters. In most of that, how that's spread out during the quarter is, it was the very lowest -- the lowest month of the quarter was the first month quarter and it did pick up. So I do anticipate a pick up during the -- I believe it was -- would have been July, we had several loans that paid off, that had actually had premiums on them. So that was really more of the offsetting factor than necessarily having a decrease in accretion, but the result was a decrease. So it picked up as the quarter went on. So I would think closer to $400,000 to $500,000 is what my expectation would be, if I could judge the last couple of months of the quarter.

Wood Neblett Lay ***Keefe, Bruyette, & Woods, Inc., Research Division - Associate***

Got it...

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

But again you never know for sure, what's going to pay off.

Wood Neblett Lay ***Keefe, Bruyette, & Woods, Inc., Research Division - Associate***

And then last from me, just looking at that FDIC benefit, it's nice to hear you'll -- get some more down the road, but I was just wondering if you could quantify how much you received the end of third quarter?

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

We received a credit of $413,000 for the third quarter. It was basically -- it's paid in arrear, so it is based on the prior quarters reserve ratio, but it was $413,000. So we would expect it to be about that much each month that we -- or each quarter that we get to use the credit.

Operator

(Operator Instructions) 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 on for Michael Young. And I wanted to touch expenses. So I know your prepared remarks, expenses are expected to be relatively stable going forward, but with the hiring of additional lenders, are you expecting to offset some of the hiring with cost saves in other areas? Or just want to get a picture of what the magnitude of hiring is going forward?

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

We do expect to see some cost saves first quarter, but beyond that, I don't know that we'll have a lot, and so going into next year, the quarterly expense, may start to move up slightly, but the hope would be that these revenue producers would produce additional net interest income and fees that would more than offset that.

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

That's helpful. And then going to share repurchase plan authorized in September. I saw you repurchased 25,000 shares so far in 4Q. And the share price is up around 3% since you announced the repurchase plan. I just want to know if you plan on purchasing using all of that this quarter or what the pace is going forward into next year if you planning on using some of that or stretching out to farther in 2020?

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

That really depends on what the stock does in price. It's -- the last time we did one of these stock repurchases in late 2018, it was very easy to find stock. Now it's much more difficult to find it. So I don't anticipate at this point that we would use it all up in the fourth quarter, but it's hard to know. We end up with another December like we did last year, then who knows, we could.

Operator

Thank you. And I'm showing no further questions, 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 for joining us today. We look forward to being with you in January to report year-end and fourth quarter results. And this concludes our comments.

Operator

Ladies and gentlemen, thank you for participating in today's conference. You may all disconnect.