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Q1 2020 Southside Bancshares Inc Earnings Call

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to the Southside Bancshares, Inc. First Quarter 2020 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, Lindsey Bailes, Vice President of Investor Relations. Thank you. Please go ahead, madam.

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

Thank you, Hadi. Good morning, everyone, and welcome to Southside Bancshares' First Quarter 2020 Earnings Call. A transcript of today's call will be posted on southside.com under Investor Relations.

During today's call and other disclosures and presentations, I will remind you that any forward-looking statements 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 are Lee Gibson, President and CEO; and Julie Shamburger, CFO. First, Lee will share his comments around the COVID-19 pandemic and an update on our securities portfolio. Then Julie will give an overview of our financial results.

I will now turn the call over to Lee.

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

Thank you, Lindsey. I'd like to welcome everyone, and thank you for listening to our First Quarter 2020 Call.

Like everyone else on this call, when COVID-19 became a reality in the United States, it quickly changed our daily routines, commerce, methods of conducting business and the economic forecast. We feel very fortunate that we entered this crisis from a position of strength with strong asset quality, capital, liquidity and a low level of nonperforming assets. In addition, Southside has a deep experienced management team adept at navigating challenges.

For the first quarter ended March 31, 2020, we reported net income of $4 million and earnings per share of $0.12 after recording a $25.2 million provision for credit losses. During the quarter, we adopted the accounting standard, often referred to as CECL, which resulted in an increase in Southside's allowance for loan losses to $53.6 million from $24.8 million at the end of the fourth quarter 2019. We believe this significantly higher allowance further enhances our position to successfully navigate through potential unexpected outcomes.

One of the assumptions that heavily impacts CECL results for a given quarter is the economic forecast. We utilize the Moody's economic forecast with their recommended scenario allocations, all of which, at quarter end, anticipated a significant economic downturn resulting from the pandemic. Our provision for credit losses recorded this quarter was largely a result of these negative economic forecasts.

On a linked-quarter basis, nonperforming assets as a percent of total assets decreased to 0.24%, and our tax equivalent net interest margin improved 5 basis points. During the first quarter, we had solid loan growth of $32.8 million. However, given the negative economic forecast and uncertainty surrounding when the economy may begin to recover, other than short-term PPP loan growth, we do not anticipate meaningful loan growth for the remainder of the year.

Due to the significant declines in short- and long-term interest rates, we entered into an additional $400 million of swaps to lock in longer-term interest rates on funding. At March 31, 2020, these interest rate swap contracts had an average interest rate of 32 basis points with an average weighted maturity of 5.2 years.

During March, as volatility in equity markets persisted, U.S. agency mortgage-backed securities and highly rated municipal bonds also began to experience volatility, primarily due to illiquidity. When this occurred, given our reduced expectations for loan growth, we increased our securities portfolio of approximately $450 million by purchasing $490 million of largely AAA-rated municipal bonds, of which $8 million were taxable. Due to the timing of these transactions, the full impact on interest income and interest expense will be reflected in future quarters.

During the first quarter, Southside also repurchased 869,723 shares of its common stock at an average weighted price of $29.71.

I want to thank all of the Southside team members for their outstanding attitudes and continued dedication to Southside during this challenging time. They eagerly adapted to changes in operational methods and delivery channels while continuing to deliver the high level of quality service our customers expect and deserve. When the Paycheck Protection Program was announced, our lending and credit teams, together with assistance from team members from several additional departments in the bank, began processing over 2,000 PPP loans, providing over $300 million in much needed funding to small businesses.

Over the last 60 years, we've seen growth not only in the balance sheet and capital position, but also in the relationships we formed in the communities we serve. We still believe the underpinnings of the Texas markets we serve are sound and will recover once this economic downturn caused by COVID-19 subsides. As a result, we believe we are well positioned to navigate these difficult times and emerge ready to help our customers achieve their financial goals.

I will now turn the call over to Julie.

Julie N. Shamburger *Southside Bancshares, Inc. - CFO*

Thank you, Lee. Good morning, everyone, and welcome to our call this morning. Despite the adoption of CECL and the COVID-19 pandemic-related disruptions beginning in March, we reported net income of $4 million for the first quarter, which includes the $25.2 million in provision for credit losses, primarily in response to the economic uncertainties surrounding COVID-19. We reported diluted earnings per share of $0.12 per share as of March 31, 2020, a decrease of $0.39 per share or 76.5% on a linked-quarter basis.

We implemented CECL during the first quarter, resulting in a day 1 cumulative effect adjustment that decreased retained earnings by $7.8 million net of tax. The adjustment was the result of a $5.3 million increase in the allowance for loan losses from $24.8 million at December 31, 2019, to $30.1 million upon adoption, including $231,000 for purchased loans with credit deterioration. And a $4.8 million increase to the allowance for off-balance sheet credit exposures reported in other liabilities in our consolidated balance sheet. With the implementation of CECL and expected impacts resulting from COVID-19, the allowance for loan losses increased by $28.8 million to 1.49% of total loans as of first quarter compared to 0.69% of total loans at December 31, 2019.

Our nonperforming assets were $17.4 million, essentially flat linked quarter with just a $46,000 decrease. However, due to the increase in our balance sheet, our nonperforming assets to total assets decreased to 0.24% compared to 0.26% at year-end. As mentioned in our earnings release earlier today, we began originating loans to qualified small businesses through the Payroll Protection Program, or PPP, in April under the provisions of the CARES Act. These PPP loans may be eligible for loan forgiveness for certain costs incurred related to payroll, group healthcare benefit costs and qualifying mortgage, rent and utility payments. The remaining loan balance after forgiveness is fully guaranteed by the SBA. The SBA will pay participating lenders, a processing fee tiered by the size of the loan. We are pleased to report, as of April 30, we had submitted and received approval on approximately 2,000 loans for a total of just over $300 million. We expect to recognize approximately $10 million in PPP loan-related fees as a yield adjustment over the terms of these loans.

The COVID-19 pandemic has negatively impacted the global economy, disrupted global supply chains and increased unemployment levels. The resulting temporary closure of many businesses and the implementation of social distancing and sheltering-in-place policies may impact many of our customers. In addition to participation in the Paycheck Protection Program, we are also assisting our borrowers that may be experiencing financial hardship due to COVID-19-related challenges with payment deferrals.

Generally, these deferrals are for up to 3 months. As of April 30, 2020, we have granted deferrals totaling approximately $176.7 million of outstanding balances. The largest categories include commercial real estate of $112.7 million and 1-4 family residential] loans of $47.2 million and together, make up approximately 90% of the total. Additionally, of these deferrals, approximately 29% consists of private households, primarily the 1-4 family residential, 22% in hotels, 17% retail commercial real estate and 5% restaurants.

At March 31, 2020, our loans with oil and gas industry exposure were approximately $103 million or 2.86% of our total loan portfolio and deferrals granted from this category approximate 0.43% of all deferrals granted. We began the year with loan growth, reporting a $32.8 million or 0.9% increase on a linked-quarter basis to $3.6 billion. The increase was driven by growth in our commercial real estate portfolio of $100.6 million and partially offset with decreases primarily in construction loans and commercial loans of $41 million and $17.5 million, respectively.

Certainly, as a result of our participation in the Paycheck Protection Program, we will see a significant increase in loans during the second quarter. However, we expect that most of this increase will have paid off by the end of the third quarter. Due to the uncertainty of the full economic impact of COVID-19, we do not believe additional loan growth is likely for 2020.

As Lee mentioned in his remarks, our securities portfolio increased by $454.1 million or 18.2% for the quarter ended March 31, 2020. We recognized approximately $5.5 million in net securities gains on the sales of AFS securities during the first quarter. At March 31, 2020, we had a net unrealized gain in the securities portfolio of $114 million and a duration of 5.9 years, an increase from 4.4 years at the end of 2019.

Our mix of loans and securities shifted to 55% loans and 45% securities compared to a mix of 59% loans and 41% securities at year-end. The shift was driven by our strategic purchases in the securities portfolio during the quarter.

Net interest income increased $1.5 million, driven by lower interest expense directly related to the decrease in interest rates on interest-bearing liabilities. Linked quarter, our net interest margin increased 5 basis points to 3.03% from 2.98%. The margin benefited from lower deposit and funding costs, which more than offset negative impacts on lower rates on interest-earning assets. We had a 10 basis point increase in the net spread linked quarter to 2.76% as a result of the lower deposit and funding costs.

We recorded $437,000 in loan accretion this quarter, an increase of $100,000 or 30% from the prior quarter. Noninterest income, excluding net gain on available for sale securities, decreased $466,000 or 4.5% for the linked quarter, primarily due to decreases in deposit services and trust fees. For the 3 months ended March 31, 2020, our noninterest expense decreased $424,000 or 1.4% for the linked quarter, primarily due to a $600,000 loss on disposition of certain assets recognized last quarter, offset with a small increase in salaries and employee benefits of $237,000.

We used additional FDIC credits in the amount of $439,000 in the first quarter, and we had $327,000 in remaining credits.

Our efficiency ratio decreased to 51.91% compared to 53.87% on a linked-quarter basis, primarily due to the increase in net interest income.

Income tax expense decreased $2.4 million or 83.2% linked quarter, driven primarily by the decrease in pretax income and the linked quarter increase in tax-free municipal income. Our effective tax rate decreased to 10.8% from 14.1% for the first quarter, primarily due to higher tax-exempt income as a percentage of pretax income than the prior quarter. Additionally, we recorded a discrete tax benefit of $52,000 or 1.2%, a more significant impact on the effective tax rate than usual due to the lower pretax income.

Regarding our estimate on noninterest expense, absent COVID-19, we were estimating noninterest expense of approximately $30.5

million, however, at this time, we expect it may be in the $31 million range for the second quarter. We do expect some additional overtime pay as a result of processing the PPP loans. At this time, we are estimating an effective tax rate of 12%.

During the first quarter, we increased our stock repurchase plan authorization by an additional 1 million shares for a total authorization of 2 million shares. And purchased approximately 870,000 shares of our stock bringing our total purchase to approximately 895,000 shares at an average price of $29.82. We have not purchased any shares subsequent to March 31, and approximately 1.1 million shares remain authorized for purchase.

Thank you for joining us today. This concludes our comments, and we will open it up for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) The first question comes from the line of Brad Milsaps with Piper Sandler.

Bradley Jason Milsaps ***Piper Sandler & Co., Research Division - MD & Senior Research Analyst***

Julie, I was writing quickly when you were sort of running through some of the loan portfolio stats. Just curious if you could go over again that -- I think were you giving exposure to hotel and restaurant and energy? Or is that as a percentage of the deferrals that you had granted? But I'm curious to know kind of what the total exposure would be to sort of some of those kind of higher risk category, hotel, restaurant, retail, CRE and energy.

Julie N. Shamburger ***Southside Bancshares, Inc. - CFO***

Sure. Okay. To be clear, in -- what I was stating in my script was referring to the deferrals. So did you get all of those percentages?

Bradley Jason Milsaps ***Piper Sandler & Co., Research Division - MD & Senior Research Analyst***

Would love for you to run through those maybe one more time, and then the actual -- the composition would be great, too.

Julie N. Shamburger ***Southside Bancshares, Inc. - CFO***

Okay, sure. Okay. Specifically to the deferrals, 29% private households, 22% hotels, 17% commercial real estate and 5% restaurants. And then with respect to the portfolio...

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

Here, Brad, I can give you that.

Julie N. Shamburger ***Southside Bancshares, Inc. - CFO***

I've got it.

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

Okay. Go ahead.

Julie N. Shamburger ***Southside Bancshares, Inc. - CFO***

Retail investment real estate is 9%; and hotels are at 2%; retail trade, 2%; and food and restaurants at 2%; for a total with oil and gas of 17%.

Bradley Jason Milsaps ***Piper Sandler & Co., Research Division - MD & Senior Research Analyst***

Okay, great. That's very helpful. And then, Lee, maybe just moving to the balance sheet. Obviously, a lot of movement at the end of the quarter that wasn't necessarily reflected in kind of what you earned in the first quarter. Is it fair to say you would expect a pretty big boost in NII in the second quarter, even excluding PPP, but your margin will see some contraction? Just kind of curious kind of what yield were the bonds that you bought that came on during the quarter? Just trying to get a sense of kind of what's going to go on in the margin.

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

The bonds that we've put on in March, the yield was a -- tax equivalent yield was at 3.22%. And the funding, we locked in at $400 million at 32 basis points. So roughly, there's a spread there of about 2.9%. So yes, we will see -- and most of that occurred in the last probably 15 to 20 days of March.

Bradley Jason Milsaps ***Piper Sandler & Co., Research Division - MD & Senior Research Analyst***

Great. And I know the -- some of the existing borrowings that you have on the books are swapped also with LIBOR. Are there any other big pieces that are coming due over the near term that you could benefit from, being able to lower the rate on?

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

Yes. We have -- on our public funds, some of those are tied to tex pool. The tex pool rate in March, I think, averaged right around 1%. And I think it's around -- for April, it's going to be about 45 basis points. And those balances are, what, Julie, about $250 million, $300 million, somewhere in that range? And then a lot of those -- the brokerage CDs that are rolling off were basically going to Home Loan Bank. And then we also are borrowing from Fed on the PPP loans at the 25 basis points. And then all of our retail deposits, they have come down. The higher tiers have all come down pretty significantly.

Bradley Jason Milsaps ***Piper Sandler & Co., Research Division - MD & Senior Research Analyst***

Okay. Great. So kind of in the interim, you'll let the higher-cost stuff run off and maybe lean into the wholesale -- Federal Home Loan Bank advances until things can stabilize?

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

That is correct.

Operator

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

Michael Masters Young ***SunTrust Robinson Humphrey, Inc., Research Division - VP and Analyst***

I wanted to maybe just start on capital. You mentioned -- I know you all authorized kind of a share buyback late in the first quarter, which you were active on, but then you stopped subsequent to the quarter end. How should we think about that on a go-forward basis? Maybe what things are you kind of watching to decide whether to proceed with the remainder of that versus not?

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

I think we're going to watch the price of the stock. And we have that in our back pocket. Our capital levels, when you look at total capital, especially on our risk base -- from a risk-based standpoint, are extremely good. So we've got that in our back pocket. And if it makes sense, we'll pick up repurchasing some shares again.

Michael Masters Young ***SunTrust Robinson Humphrey, Inc., Research Division - VP and Analyst***

Okay. And maybe just overall margin this quarter, were there any significant prepayment fees or anything else running through the margin that aided it further this quarter that we shouldn't expect to recur going forward on a core basis?

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

No. No, there was really nothing unusual in the quarter other than interest rates just dropping significantly, short-term down close to 0.

Michael Masters Young ***SunTrust Robinson Humphrey, Inc., Research Division - VP and Analyst***

Okay. And then the last one for me, maybe just on the specific portfolios you mentioned, specifically CRE or construction, and some of the more at-risk areas. Could you give us a sense for sort of the underwriting criteria that you all stick to, and, what, maybe some of the LTVs or debt service coverage ratios would be in those books if you have that available?

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

The equity we typically look for in CRE is at least 30%, if not 40%, and it really depends on if there's a guarantor or not. And the strength of the guarantor, we do have some that have more equity than that, but that's not the typical thing. On the debt service coverage, for the most part, it has to have a 125% debt service coverage ratio. And those are basically the things that we look for. And we stress them to make sure that under different stress scenarios, they're able to meet certain things.

Operator

(Operator Instructions) Our next question comes from the line of Brady Gailey with SunTrust (sic) [KBW]

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

It's actually Brady Gailey with KBW. So on the bond purchases, it sounds like you saw an opportunity with the dislocation in the bond market and took advantage. How do you think about additional bond purchases from here?

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

So everything's pretty tight right now. The reason we went for munis was we could lock in a bond that we didn't have to worry about prepaying because of the call protection. We'll continue to look for things out there, but it's pretty tight right now. Munis have tightened in quite a bit from the mid-March levels. Mortgages are just razor-thin at this point in time with the Fed buying as much as they are. So we'll be -- that's the main reason we jumped in and bought basically the asset growth we were looking for, for the year.

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

All right. And then you mentioned the $10 million of pretax earnings from the PPP loans. That looks like about 330 basis points of fees or gains. When would you expect to realize that? It seems like most of those loans will be forgiven within the next quarter or 2. So is it right to think about that $10 million will flow through spread income in the next, call it, 2 quarters?

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

I think so. I think -- we don't know exactly how much of it's going to run through, but we're guessing close to 90% of it is going to run through. And if it does run through in this quarter, it will probably be the last 15 days of the quarter. But I think the bulk of it probably is -- and it really just depends on what the processes SBA has and how -- if it is as slow as getting loans on, it may be well into July getting them prepaid.

If that's helpful, I mean, we're thinking that whatever is going to be prepaid, probably 95% of it's going to happen by the end of July. There'll be very little that trickles past that, I would guess.

Operator

There are no further questions at this time. Would you like to make closing remarks?

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

Yes. Well, thank you for being on the call today. And given Southside's experienced management team, along with having entered the crisis with strong asset quality, capital, liquidity and low levels of nonperforming assets, we believe we're well positioned to deal with the challenges ahead.

Thank you for joining us today. We look forward to reporting second quarter results in July. This concludes our comments.

Operator

Ladies and gentlemen, this concludes today's conference call. Thank you for participating. You may now disconnect.