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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to Southside Bancshares, Inc., Second Quarter 2020 Earnings Call. (Operator Instructions) I would now like to turn the call over to Suni Davis, Chief Risk Officer. The floor is yours.

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

Thank you, Farteen. Good morning, everyone, and welcome to Southside Bancshares' Second 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 on the quarter, including the COVID-19 pandemic. 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***

Good morning, and welcome to Southside Bancshares Second Quarter Earnings call. I'm going to provide an overview of the quarterly results and how we're dealing with the pandemic and managing the bank in this current economic environment. Starting with our second quarter results, we reported net income of $21.6 million, earnings per share of $0.65 and an annualized return on average tangible equity of 15.24%. The provision for credit loss expense during the quarter was $5.2 million. Linked quarter, the allowance for loan losses increased $6.2 to $59.9 million, increasing the allowance as a percentage of total loans, net of PPP loans, 20 basis points to 1.69%. Nonperforming assets as a percent of total assets linked quarter remained unchanged at 0.24%, and the tax equivalent net interest margin decreased 1 basis point to 3.02% due to the PPP loans booked during the second quarter. Consistent loan underwriting standards and strong asset quality have long been a cornerstone of Southside's business model. Since the pandemic began in earnest, we have further intensified our focus on asset quality by significantly increasing the frequency and level of monitoring the loan portfolio.

In addition to our normal procedures, we are reviewing more detailed reports by industry, and we're conducting numerous Zoom meeting deep dives with the respective loan officers by industry within the loan portfolio on an individual loan basis. Overall, we're encouraged by what we have learned and observed relative to asset quality. We recently completed a deep dive to discuss which modified loans customers have indicated they will resume, making full normally scheduled payments once the initial 90-day modification period ends. Our modified loan total as of yesterday was approximately $326 million. This total has been trending downward, and we anticipate that trend should continue during the third quarter as many of the modified loans are expected to resume their normal payments. Julie will provide a more detailed review of modified loans by industry during her presentation.

The balance sheet moves we made during the first quarter purchasing highly rated largely Texas municipal securities, along with certain funding decisions, performed as expected during the second quarter. All of the second quarter loan growth resulted from PPP loans booked during the quarter and all of the $331 million increase in deposits occurred in our noninterest-bearing deposit categories. While potential loan growth during 2020 remains uncertain, we're encouraged by our pipeline and the opportunity to grow quality loans in future quarters. In June, we decided to freeze all future benefit accruals in our defined benefit retirement plan for remaining active employees. This required a remeasurement of the retirement liability at June 30, 2020. This resulted in the recording of a curtailment expense of $163,000. In addition, due primarily to the decrease in the discount rate to 2.78% at June 30 from 3.41% at December 31, 2019, there was a decrease to accumulated other comprehensive income included in shareholders' equity of approximately $6 million.

Due to the remeasurement, we anticipate retirement expense during the last half of 2020 will increase $450,000. During 2021, we anticipate overall retirement expense will decrease approximately $2 million when compared to 2020. As we continue operating the bank during this pandemic, our primary focus and concern remains the safety of our team members and customers. Again, I want to thank all the Southside team members for their outstanding attitudes and continued dedication to Southside and our customers during this challenging time.

Despite the impact of COVID-19, the underpinnings of the Texas markets we serve appear sound and should recover once this economic downturn caused by COVID-19 subsides. As a result, utilizing the strength of our balance sheet, liquidity and capital position, we believe, we are well positioned to successfully navigate these challenging times and grow our Texas franchise. 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. We reported net income of $21.6 million for the second quarter, an increase of $17.6 million or 445.3% on a linked-quarter basis and an increase of $2.9 million or 15.8% compared to the same period in 2019. For the quarter ended June 30, 2020, our diluted earnings per share were $0.65, an increase of $0.53 on a linked-quarter basis and an increase of $0.10 compared to the same period in 2019. During the second quarter, we originated loans to qualified small businesses through the Payroll Protection Program, or PPP, under the provisions of the CARES Act.

As of June 30, our loan portfolio included approximately $308 million in PPP loans to approximately 2,100 borrowers. We expect to recognize approximately $2 million in PPP loan-related fees as a yield adjustment over the terms of these loans. During the second quarter, we recorded approximately $1 million of these fees in interest income.

As a result of our participation in the Paycheck Protection Program, we reported an increase in loans of $251.6 million or 7% during the second quarter. However, excluding the PPP loans included in our commercial loan portfolio at June 30, we experienced a decrease on a linked-quarter basis of $56.8 million or 1.6%. The decrease occurred primarily in our construction loans, 1-4 family residential portfolio and the commercial portfolio, excluding those PPP loans, partially offset by an increase in the commercial real estate loan portfolio.

For the 6 months ended June 30, 2020, PPP loans excluded, our loan portfolio decreased $24 million or 0.7%. As Lee mentioned in his remarks, due to the uncertainty that remains around the full economic impact of COVID-19, loan growth is uncertain for 2020. Our allowance for loan loss increased $6.2 million or 11.6% on a linked-quarter basis, primarily driven by the economic uncertainties surrounding COVID-19. Our nonperforming assets were $17.6 million, an increase of $197,000 or 1.1% linked quarter. The nonperforming assets to total assets remained unchanged at 0.24% linked quarter and 2 basis points lower when compared to 0.26% at year-end.

Beginning in March and through most of the second quarter, we assisted our borrowers that were experiencing financial hardship due to COVID-19 related challenges with payment deferrals. Generally, these deferrals were up to 3 months. As of July 20, we have deferrals totaling approximately $326 million. The largest categories of deferrals include commercial retail centers of approximately $127.3 million; oil and gas, $57.1 million; hotels, $43.1 million; 1-4 residential, $41.6 million; and food service and restaurants, $3.7 million.

At June 30, 2020, our loans with oil and gas industry exposure were $118.5 million or 3.08% of total loans. Our securities portfolio decreased $147.6 million or 5% for the quarter ended June 30, 2020. We recognized approximately $2.7 million net securities gains on the sale of AFS securities during the second quarter. At June 30, 2020, we had a net unrealized gain in the securities portfolio of $137.9 million. At June 30, the duration of the portfolio was 4.7 years, an increase from 4.4 years at the end of 2019, and our mix of loans and securities shifted slightly to 56% loans, excluding PPP loans in 44% securities compared to a mix of 55% loans and 45% securities at March 31, 2020.

Our net interest margin decreased by 1 basis point to 3.02 from 3.03 for the quarter ended March 31, 2020. The margin continued to benefit from lower deposit and funding costs, which largely offset negative impacts on lower rates on interest-earning assets. We had a 6 basis point increase in net interest spread linked quarter to 2.82 as a result of the lower deposit and funding cost.

Net interest income increased by $2.6 million driven by lower interest expense directly related to the decrease in interest rates on interest-bearing liabilities. We recorded $352,000 in loan accretion this quarter, a decrease of $85,000 or 19.5% from the prior quarter. Also, as mentioned earlier, we recorded approximately $1 million in fees related to the PPP program in interest income this quarter.

For the 3 months ended June 30, 2020, noninterest income, excluding net gain on sale of AFS securities decreased $426,000 or 4.3% for the linked quarter due to the decrease in deposit services and trust fees, partially offset by the gain on sale of loans.

During April and May, we experienced decreases in overdraft income due to stimulus checks and reduced consumer spending. However, in June, we did see an increase when compared to May. Our noninterest expense decreased $664,000 or 2.2% for the linked quarter due to a decrease in salaries and employee benefits, partially offset by an increase in net occupancy expense. The decrease in salaries and employee benefits occurred primarily as a result of lower health claims expense during the second quarter.

For the third quarter of 2020, we are estimating noninterest expense of approximately $31 million. We are pleased to report our efficiency ratio decreased to 48.29% compared to 51.91% on a linked-quarter basis, primarily due to the increase in net interest income. Income tax expense increased $2.3 million or 486.4% linked quarter, driven by the increase in pretax income. Our effective tax rate increased to 11.5% from 10.8% in the first quarter of 2020. Last quarter's effective tax rate was positively impacted by a discrete tax benefit recorded of $52,000 or 1.2%, which had a significant impact, more than normal due to the lower pretax income reported in the first quarter. At this time, we are estimating an effective tax rate of 11.6% for the remainder of the year.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question comes from the line of Michael Young from SunTrust.

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

I was wondering if we could maybe follow up on the categories, Julie, that you provided a little additional detail on with the forbearance. Could you guys maybe just talk a little bit about what your thoughts are going forward on the specific categories in terms of how much do you expect to add an additional maybe 90 days of forbearance? And how much do you expect to return back to kind of just normal paying as agreed?

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

We did a meeting not too long ago where we went over all of them. We were very encouraged by the high percentage that are not anticipated to -- or the customers are not going to be asking for a second 90-day modification. Probably the category where we're seeing some additional modification request is in the hotel industry. That's the one that we have has probably been hit the hardest. And I think about 1/3 of our hotel portfolios in 1 loan, where we have a very good loan to value and it's extremely well-located and an excellent flag. And they have a lot of cash flow at this point in time to carry them through, but their occupancy is obviously down. And so we understand why they're asking for the modification at this point in time. But past that, we -- they're really -- it's kind of spotty in terms of who's going to ask for a second modification, but we anticipate a large percentage will not. And at this point in time, we think that, that number is -- it's trending down, and we expect it to continue to trend down through the third quarter.

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

And I guess, maybe in light of that and kind of what's built into the model now for the loan loss reserve, do you guys -- do you expect kind of the reserve to return to more normal levels going forward from here and be able to sustain that, maybe even with the increase in cases in Texas, et cetera?

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

Well, as I'm sure you're aware, the main thing that drives the CECL model is the economic forecast. And it's difficult to know what the economic forecast at the end of September is going to be. If it improves, then, yes, I think, we've returned to more of a normalized reserve. If it doesn't, we may continue to see some additions to the reserve. Right now when we look at -- after all these deep dives and we're continuing to do and once we finish, we start over at the beginning, we feel good about where we are relative to the amount of reserve we have at this point in time. So -- but it's all driven on the model, and the biggest thing is the economic forecast. So if things -- things are opening up -- have opened up considerably in Texas, and you are seeing other than the bars and the restaurants are at 50%, but you're seeing activity in commerce occur and people are pretty much learning how to operate in this COVID environment. So certainly, the traffic levels are up considerably from where they were even 1.5 months ago. So that's a difficult question to answer. I'm sorry.

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

No, that's okay. I know it's a challenging question, but I was interested to get at least your thoughts. And then I guess, maybe lastly, just kind of trying to think about capital going forward as it pertains to maybe the dividend, special dividend and/or any share repurchase in the future, I mean, this is more of a medium-term thought process. But what are you guys thinking as in terms of when you would look to return to maybe either share buyback or continue a special dividend on a go-forward basis? Are there certain things you're kind of watching for?

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

I think we're -- the main thing we're watching for is what the reserve requirements are going to be relative to the CECL model. If we continue to have quarters like this, we'll -- things will be back to normal in terms of what we'll do with in terms of share repurchase. We certainly don't anticipate at this point in time any impact to the dividend, but we feel good about our capital position. We just need to make sure that we have the earnings to be able to continue those things and to continue to -- or to make any stock repurchases at that point in time. But I think if you look at our balance sheet and consider the risk-based capital, I'd much rather have our capital position with our balance sheet and some that have larger percentages of capital.

Operator

Your next question comes from the line of Brad Milsaps from Piper Sandler.

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

Julie, I was curious if you had the average amount of PPP loans during the quarter, just the average balance.

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

Yes. The average balance for the quarter was around $240 million.

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

Okay. And I think I heard you say that you recognized $1 million in fees. Is that's just the fee portion, correct?

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

Yes. All in, we recorded about $1.6 million for the quarter on the PPP loans, and about $1 million of that was the net fees.

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

Okay. And you said you have about $2 million left to recognize. That seems maybe a little less than what I would have estimated. Is some of that coming through operating expense? Is it deduct to -- with FAS 91 or did I hear the $2 million incorrectly?

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

Yes. What I had intended to say was that we had said last quarter we expect to get $10 million from these loans, and we did, and we're accreting it over the yield. And we only accreted $1 million. We still have around $9 million left.

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

Okay, $9 million left. Okay.

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

Yes. Sorry about that.

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

No problem. There's really no impact on the expense line?

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

No. I mean, we paid some over time, but it was minimal compared certainly to the $1 million in fees.

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

Got it. Got it. Okay. All right. I appreciate that. And then, Lee, you made, obviously, a lot of moves in the bond book in the first quarter. Kind of how are you thinking about that going forward? Would you be more likely to use liquidity to maybe pay down borrowings or let some CDs run off? Just trying to get a sense of kind of how you're thinking about the balance sheet, the rate environment as it pertains to the margin and just kind of what you're thinking there and this very low interest rate environment?

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

Yes. Right now, there's just not a lot to do in securities. We do occasionally add a little bit. But net-net, I don't know that the securities portfolio is growing at this point in time or will grow unless there's another liquidity crisis in the bond market like we saw in March. And in terms of funding, yes, we're letting -- we're not paying up. And if CDs come due, and they can find something somewhere else, we're letting them go and we're continuing to decrease the overall funding costs associated with the bank. So we're getting a fair amount of mortgage prepayments at this point in time. And it's very difficult to reinvest that at a margin -- or a margin that's acceptable. So I'm not saying the balance sheet is going to shrink significantly, but it may gradually shrink unless something happens there. And basically, we'll pay off the higher funding and move forward.

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

Great. That's helpful. I think your average CD cost in the quarter around 163 basis points. Where are renewal rates for you guys at this point in time? And do you have some bigger pieces that are -- that will be coming off the books kind of in the back half?

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

I don't know that we're paying anything higher than 35 basis points, and a lot of the CDs we're doing are well below 25 basis points at this point in time. In the brokered market, we're able to issue the all-in cost is 15 basis points, but the cost to the end -- or the interest income to the end user is only 5 basis points. So we expect to drive that CD right down pretty significantly, especially as a lot of the public fund CD roll off and things of that nature.

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

So kind of all that, but against that backdrop, is that kind of -- obviously, loan growth will help you out, but that's a bit of an unknown. But do you think you can hold the NIM relatively stable, kind of given those things you talked about?

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

I think so. Obviously, we'll have a little more impact of the PPP loans in the third quarter. But yes, I think, it will hold relatively stable because the assets have pretty much all repriced down, and we still have additional liabilities that are going to reprice down. And most of our liabilities are relatively short term. They -- rarely do we see people go out much past a year on CDs. So we should continue to see that for the next 6 to 8 months.

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

Got it. And final question, just to follow up on Michael's question regarding some of those categories that you did list out there. Would it kind of be an order in terms of your area of biggest concern? Would you start with CRE retail and then sort of work your way down in size in terms of the areas that you're watching or most worried about or there be 1 specific sector within the portfolio that you're most concerned with at this point?

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

Retail represents the largest dollar amount from what we're seeing. Many of those that were modified in terms of retail are planning on resuming their normalized payments after their initial modification. I think I go back to probably the area -- if I were going to be concerned about an area, it would be the hotel loans, simply because of the uncertainty surrounding occupancy and when business travel is going to pick up and things of that nature.

Operator

(Operator Instructions) We have 1 more question from the queue from Wood Lay from KBW.

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

So it seems like you're a little bit more optimistic towards the loan pipeline. I think it's better than you might have thought it was going to be at this point. Do you think growing loans in the back half of the year in the low single-digit range could be achievable if you exclude any impact from PPP balances?

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

It's possible. We -- our pipeline right now, we're looking at some good solid loans in industries that really haven't been impacted that -- at all by COVID-19. And it just -- it just really depend -- some of them may not close this year, some of them may close early next year. It's just -- it's kind of uncertain at this point in time because most of our extremely good borrowers kind of sat on the sidelines for the first 3 or 4 months to determine, okay, what's happening, what's going to happen. Now that they've begun to see what sectors have been impacted, which ones haven't, some of them are starting to make some moves in those areas that have not been impacted and some of them have actually -- some sectors have actually benefited from COVID, as you're I'm sure aware. So it's possible. We're just -- we're I think uncertain about loan growth is the term we're using right now. It's possible.

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

That's helpful color. And then last for me. I know pre-COVID, you're planning to open an LPO in Houston, along with hiring some additional vendors for that market. Do you still intend to go forward with this plan in 2020? Or has it sort of been put on hold for the time being?

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

We do have -- we have hired 3 lenders down in the Houston area. They are actively working. They were active in the PPP process with us and brought us a lot of good PPP loans. We're looking at different loans for them down in that area. And we did put on hold hiring additional lenders in that market until we saw how this was going to impact different portions of the Texas economy, especially different market areas. But we definitely are in Houston at this point in time and intend to stay there. And once this thing begins to subside some, we will once again be actively looking for additional lenders down there.

Operator

Again, we have a question from Mr. Michael Young from SunTrust.

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

Just wanted to ask. I don't know if you have the number, but could you help us like understand the geographic breakup of the loan portfolio today? Maybe how much is in Tyler, Texas or other more rural areas versus how much is in Dallas, Fort Worth or Austin?

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

Yes. Hold 1 second.

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

And maybe while you are dropping that just...Go ahead. Sorry Julie.

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

No, that's fine. For all the loan portfolio, we had close to $1.4 billion in the DFW market and then about $900 million in the East Texas market. And in around $700 million, $750 million in the Austin market. Those are the 3 largest categories.

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

Okay. Perfect. And I guess just big picture, have you noticed differentiation in performance or risk factors from maybe different markets, maybe the East Texas market being relatively less impacted than the metro areas? Or is that not necessarily true?

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

I don't think we've seen a concentration of problems in 1 specific market. We're just -- it's really been more by industry. In our hotel portfolio, I think we have 11 hotels, and they're in a bunch of different markets. And almost all of them, but we have 1 hotel that happens to be located next to a government facility, that they continue to occupy pretty heavily. But the others, they saw pretty much the same downturn in occupancy rates and are all pretty much seeing the same gradual increases in the occupancy rate. So I don't know that we've seen a specific market that's really been hit harder than another.

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

Okay. And maybe just 1 last one. Just given that you're highlighting kind of the hotel portfolio, any other kind of risk mitigants for that portfolio, maybe the loan to values of the properties themselves pre-COVID or any other sort of mitigating factors that we should be thinking about as we think about loss rates, whether there's already a high loan-loss reserve, et cetera?

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

We're not big hotel lenders. And so we're always very cautious when we look at that. And we go with -- we try to go with extremely good flags, extremely good operators, and we require a fair amount of equity in those deals because we don't want to be operating a hotel. So we're -- we have conservative underwriting standards to begin with. But when we look at hotels, we look at it even more conservatively than we do some other categories.

Operator

There are no more questions from the queue, presenters, you may continue.

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

All right. Thank you. Southside had an excellent second quarter, highlighted by continued sound asset quality, solid core deposit growth, a stable net interest margin, a 20 basis point increase in the allowance for loan losses to total loans, net of PPP loans to 1.69% and an 18.2% increase in earnings per share.

Thank you for joining us today, and we look forward to reporting third quarter results in October. This concludes our comments.

Operator

This concludes today's conference call. Thank you, everyone, for joining. You may now disconnect. Have a great day. Goodbye.