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Q3 2020 Southside Bancshares Inc Earnings Call

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CORPORATE PARTICIPANTS

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Lee R. Gibson *Southside Bancshares, Inc. - President, CEO & Director*
Lindsey Bailes *Southside Bancshares, Inc. - VP & IR Officer*

CONFERENCE CALL PARTICIPANTS

Michael Masters Young *Truist Securities, Inc., Research Division - VP and Analyst*
Will Jones *KBW - Analyst*

PRESENTATION

Operator

Good morning, ladies and gentlemen, and welcome to the Southside Bancshares, Inc. Third Quarter 2020 Earnings Call. (Operator Instructions) Later, we will contact a question-and-answer session, and instructions will follow at that time. (Operator Instructions) As a reminder, this conference is being recorded.

I would now like to turn the conference over to your host today, Ms. Lindsey Bailes. Ma'am, please go ahead.

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

Thank you, Mel. Good morning, everyone, and welcome to Southside Bancshares Third 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; 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 third quarter earnings call. I'm going to provide an overview of the quarterly results, current loan demand and how we're managing the bank in this economic environment. During the quarter, we reported an annualized return on third quarter average tangible equity of 17.73%, as earnings per share increased 41.4% to $0.82, and net income increased 36.8% to $27.1 million compared to the same period in 2019. These increases were largely driven by a decrease in provision for credit losses and an increase in net interest income that were partially offset by the increase in noninterest expense. We recorded a partial reversal of the provision for credit losses of $4.7 million during the third quarter, largely driven by an improvement in the economic forecast and the decrease in commercial real estate loans. Approximately $650,000 of the increase in noninterest expense was related to branch closings and branch right sizing.

Our asset quality metrics further improved during the quarter. As nonperforming assets to total assets decreased to 0.23%, while COVID-19 modified loans decreased 76% and to $76.5 million, and represent 2.2% of total loans net of PPP loans. As the pandemic intensified, we knew this would be a true test of the strength of our consistent loan underwriting standards. We continue our earnest focus on asset quality through ongoing monitoring of the loan portfolio and the most at-risk categories. In addition to our normal procedures, we are reviewing more detailed reports by industry within the loan portfolio and, when appropriate, on an individual loan basis. Overall, we are encouraged by what we have learned and observed relative to asset quality and our underwriting standards.

Our net interest margin linked quarter was unchanged at 3.02%, and the net interest spread increased 2 basis points to 2.84%. The balance sheet moves we made during the first quarter, purchasing approximately $500 million of highly rated, largely Texas municipal securities, along with certain funding decisions, continue to perform as expected during the third quarter.

While potential loan growth during the fourth quarter remains uncertain due to anticipated loan payoffs, we are encouraged by our gradually increasing pipeline and the potential for loan growth in 2021. We are carefully considering loan growth projections for 2021. Despite the impact of COVID-19, the Texas markets we serve appear to be experiencing gradual increasing economic activity. When the impact caused by COVID-19 subsides, we anticipate our markets will resume pre-pandemic strength. 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 resume growing our Texas franchise.

As we continue operating the bank during this pandemic, we remain keenly focused on the safety of our team members and our customers. Again, I want to thank all of the Southside team members for their outstanding contributions and continued dedication to Southside and our customers.

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 were very pleased to report net income of $27.1 million for the third quarter, an increase of $5.5 million or 25.6% and on a linked-quarter basis, and an increase of $7.3 million or 36.8% compared to the same period in 2019. For the quarter ended September 30, 2020, our diluted earnings per share were $0.82, an increase of $0.17 or 26.2% on a linked-quarter basis, and an increase of $0.24 or 41.4% compared to the same period in 2019.

Linked quarter, our loan portfolio decreased $62.6 million or 1.6%. The decrease occurred primarily in our 1-4 residential and commercial real estate loan portfolios, partially offset by an increase in construction loans.

For the 9-month period ended September 30, we reported an increase in loans of $221.8 million or 6.2%, inclusive of approximately $302.8 million of PPP loans, net of deferred fees. Excluding PPP loans, total loans have decreased $81 million or 2.3% year-to-date. Although our pipeline is beginning to increase, we do not anticipate loan growth during the fourth quarter.

Our credit quality remained strong with a slight decrease in nonperforming assets as a percentage of total assets to 0.23% at September 30 compared to 0.24% at June 30, with the decrease in nonperforming assets of $778,000 or 4.4%, down to $16.8 million at the end of September. Our allowance for loan loss decreased $4.8 million or 8% to $55.1 million at September 30th, largely driven by a partial reversal of provision of $4.4 million for the 3 months ended September 30, 2020. The partial reversal of provision was a result of an improvement in the economic forecast and a decrease in our commercial real estate loan portfolio. At September 30, 2020, we reported our allowance as a percentage of total loans at 1.45%, and when excluding PPP loans, 1.58%. As of October 20, our COVID-19 deferrals have decreased to $76.5 million, a decrease of approximately 76.5%, since we reported $326 million on our second quarter earnings call. The largest categories of remaining deferrals include: hotels at $41.5 million; mortgages at $22.7 million; a self-storage CRE property at $7 million; retail CRE, $2.1 million; and food services and restaurants at $1.6 million. At September 30, our loans with oil and gas industry exposure were $116.4 million or 3.1% of total loans. As of October 20, there were no COVID-19 modifications with oil and gas industry exposure.

Our securities portfolio decreased $51.3 million or 1.8% for the quarter ended September 30 compared to June 30. We recognized approximately $78,000 in net security gains on the sale of AFS securities during the quarter. At September 30, 2020, we had a net unrealized gain in the securities portfolio of $139.8 million, and the duration of the portfolio was 4.6 years, an increase from 4.4 years at the end of 2019.

Our mix of loans and securities remained consistent on a linked-quarter basis with 56% loans, excluding PPP loans, and 44% securities. Our net interest margin remained consistent at 3.02 on a linked-quarter basis, and net interest spread increased to 2.84 as a result of lower deposit and funding cost.

For the 3 months ended September 30, net interest income decreased by $685,000, driven primarily by decreases in interest income on mortgage-related securities and loans, partially offset by decreases in interest expense on deposits and FHLB borrowings due to continued lower-cost funding and, to a lesser extent, a decrease in average interest-bearing liabilities for the quarter. We recorded $602,000 in purchased loan accretion this quarter, an increase of $251,000 or 71.2% from the prior quarter. Additionally, we recorded approximately $1.27 million in net fees related to the PPP program included in interest income this quarter. Not including the potential for accelerated PPP fee income related to loan forgiveness, we expect to recognize an additional $1.3 million for the remainder of 2020.

For the 3 months ended September 30, noninterest income, excluding net gain on sale of AFS securities increased $1.5 million or 16.1% for the linked quarter due to the increase in deposit services, gain on sale of loans and other noninterest income. Other noninterest income increased due to an increase in swap fee income, an increase in the fair value of written loan commitments and a decrease in the fair value write-down on mortgage servicing rights. Our noninterest expense increased $1.8 million or 5.9% for the linked quarter due to an increase in salary and employee benefits, FDIC insurance and other noninterest expense. The decrease in salaries and employee benefits occur primarily as a result of an increase in retirement expense and payroll tax expense. Other noninterest expense increased due to losses recorded on the disposition of assets associated with the branch closure and rightsizing.

For the fourth quarter of 2020, we are estimating noninterest expense of approximately $31 million. Our efficiency ratio increased to 50.07% compared to 48.29% on a linked-quarter basis, primarily due to the increase in noninterest expense.

Income tax expense increased $1 million or 34.7% compared to the 3 months ended June 30, driven by the increase in pretax income. Our effective tax rate increased to 12.3% for the third quarter from 11.5% in the previous quarter. At this time, we estimate an effective tax rate of 12% for the remainder of the year.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) First question comes from the line of Michael Young from Truist Securities.

Michael Masters Young ***Truist Securities, Inc., Research Division - VP and Analyst***

I wanted to ask about just the construction pipeline. How large of a pipeline do you have remaining at this point? Do you think that might grow? Or do you think that will continue to fund up and kind of shrink from here? And then have you seen any impacts in terms of construction time lines since the pandemics maybe alleviated a bit?

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

Some of the lending opportunities we have that are extremely good are going to be in the construction space. So I'm not sure that we're going to see a decrease in construction. So the last part of your question was about -- Michael?

Michael Masters Young ***Truist Securities, Inc., Research Division - VP and Analyst***

Sorry. So the last part was just kind of what you're seeing in the market in terms of construction time lines and appetite to continue projects?

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

What we're seeing in the market is an increase in building costs, lumber prices. Framing package on homes has doubled in the last I think 6 months. Construction seems to be going extremely well right now, especially in the single-family home space, the multifamily space and in -- mainly, the warehouse-type space on the construction side. So -- and we're really not seeing weather delays or anything like that. It's more labor shortages and material costs moving up.

Michael Masters Young ***Truist Securities, Inc., Research Division - VP and Analyst***

Got you. And then separately, sort of another topic, but just on the tax rate, if we do have a change in political leadership here and there's a move towards higher tax rate, moving it up to 28%-or-so. What -- do you have an expectation of what that would do to your effective tax rate? Or anything we should be thinking about as we kind of roll that into our models at some point potentially?

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

Well, if the overall tax rate goes up 7%, ours will probably go up 5%, somewhere in that range, mainly because of the amount of tax-free income we have, but not only in the loan portfolio, but also over in the securities portfolio. So it's not going to go up the full impact, but obviously, it would go up some.

Operator

Your next question comes from the line of Will Jones from KBW.

Will Jones ***KBW - Analyst***

So just one quick question, and kind of one more headline items is this quarter was the big provision reversal. It looks like it's mostly prompted by some loan paydowns and maybe a little bit better economic outlook. With the ACL currently sitting at pretty healthy levels, how are you guys viewing for provisioning? And are you guys kind of getting comfortable with the level that the ACL is sitting at?

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

Well, the elephant in the room every quarter is what is the CECL model going to say. And the CECL model is dependent on the economic forecast. This quarter, the -- we follow the Moody's economic forecast, and this quarter, they put it out a little early in September and put out some notes towards the end of September, but they didn't change their model, because they had anticipated a stimulus package being passed by Congress, which obviously hasn't been passed. So we did change our weightings this quarter, and we basically threw out that there were 3 forecasts that we weighted: baseline, one that's better than baseline, and one that's significantly worse than baseline. So we basically threw out the better -- the one that was better than baseline, took 10%, put it to baseline and took 20%, because it was weighted 30%, and put it to the worst. And so basically, it was weighted 50% baseline, 50%, the worst economic forecast. It's all going to depend on where the economic forecast comes in. Based on our credit metrics to date and the trends we're seeing, I feel extremely good about our reserve that we have in place.

Will Jones ***KBW - Analyst***

Great. No, that's great color. Maybe just moving on, thinking about the NIM. It's been held fairly stable in the past few quarters, right around that 3% range. And this is kind of where you guys have been guiding all along this year. As we move into 2021, do you think that 3% range feels more of a permanent bottom? Or do you think there's more opportunity on the funding side? Or maybe potentially some future loan compression, just some thoughts around the future NIM?

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

If we take out the -- any accelerated accretion on the PPP loans due to payoffs and look at the NIM that way, then I think going forward, the NIM is going to be -- for the fourth quarter, it's going to be relatively stable. It may move 1 basis point or 2, maybe 3 at the most. But in the future quarters in 2021, if we can achieve some loan growth, and that quality loan growth is there, then I think the margin can stay relatively stable. If we can't, and the securities market remains like it is, I will tell you, there's a little bit of additional lifting to do on the funding side in terms of reducing costs there. But over the next 2 quarters, we will have probably done everything on the funding side that there is to do absent a few minor moves, a basis point here or there. So it's really going to be dependent on what type of loan growth we have or if we can hold loans stable. But right now, we're encouraged by the gradual increase in the loan pipeline, and that's what we're kind of studying right now. But I know that's a long answer, but it's really going to be dependent on the asset mix moving forward.

Will Jones ***KBW - Analyst***

Yes. No, no, that totally makes sense. And any new loans that you guys are making? Where are those coming on the books at?

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

It depends whether they're fixed or floating, but a lot of them are coming on in the 3 to 3.75 type range, depending on what type of loan it is. There's a few that come on in the 4s, but most of them are coming on pretty close to where prime sits. And some of them, a little over that, some of them just a little under that, but they definitely are coming in, on average, in that probably 3.25 to 3.50, somewhere in that range.

Will Jones ***KBW - Analyst***

I got you. I got you. Yes. So it kind of feels like the loan yields are stabilizing a bit then. Maybe just last one for me, shifting gears. Just to add on to deferrals. Great improvement since the last disclosure you guys gave. Are the majority of remaining deferrals on their second deferral? Or just what's kind of the content of those remaining deferrals in terms of second versus first?

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

The -- Julie mentioned the hotels are right around $41.5 million, and they're either on their second or third deferral. The rest of them, I'll have to go and check because I don't know because $22.3 million is 1-4 family. I don't know if some of those are on a second deferral or not. They're telling me in the room, maybe a handful at most. But the rest of them are -- as far as I know, on their first deferral. And we were looking at it this morning and what's already happened in the last 2 days, and what we know is going to happen. And probably over the next 30 to 45 days, we're going to see this deferral number drop another $12 million to $15 million.

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

This is Lee Gibson. Southside had an outstanding third quarter, highlighted by continued sound asset quality, a 76% reduction in modified loans, a stable net interest margin and a 41.4% increase in earnings per share. Thank you for joining us today. We look forward to reporting fourth quarter results in January. This concludes this morning's earnings call.

Operator

Ladies and gentlemen, this concludes today's conference. Thank you for participation, and have a wonderful day. You may now disconnect.