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Q4 2020 Southside Bancshares Inc Earnings Call

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### CORPORATE PARTICIPANTS

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

### CONFERENCE CALL PARTICIPANTS

**Brett D. Rabatin** *Hovde Group, LLC, Research Division - Head of Research*  
**Graham Conrad Dick** *Piper Sandler & Co., Research Division - Research Analyst*  
**Michael Masters Young** *Truist Securities, Inc., Research Division - VP and Analyst*  
**Wood Neblett Lay** *Keefe, Bruyette, & Woods, Inc., Research Division - Associate*

### PRESENTATION

#### Operator

Good morning, ladies and gentlemen. Welcome to the Southside Bancshares, Inc. Fourth quarter and year-end 2020 earnings call. (Operator Instructions) As a reminder, this conference call is being recorded. I would now like to turn the conference over to your host, Ms. Lindsey Bailes, Vice President, Investor Relations. Please go ahead.

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

Thank you, Tiffany. Good morning, everyone, and welcome to Southside Bancshares' Fourth Quarter and Year-end 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.

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

Good morning, and welcome to Southside Bancshares' fourth quarter and year-end earnings call for 2020. This morning, we reported record annual and fourth quarter net income and earnings per share. Closing the year on a strong note, the fourth quarter results were largely driven by an increase in net interest income and a partial reversal of provision for credit losses. Additionally, during the quarter, we expensed approximately \$1 million related to 3 branch closings.

In March, we will close 2 in-store branches in East Texas that are in close proximity to other Southside branches and 1 leased branch in North Texas.

During the fourth quarter, our net interest margin increased 18 basis points of which 14 basis points were attributable to additional accretion income on loans forgiven by the SBA.

Overall, during 2020, our net interest margin increased 1 basis point to 3.07%, while our net interest spread increased 15 basis points. Increasing our NIM during 2020, given the relatively flat and historically low interest rate environment was a big contributor to the success we enjoyed during 2020. The decision to purchase \$500 million of high-quality municipal bonds at extremely attractive yields during the short-term bond market liquidity crisis in March, combined with funding decisions were big contributors to maintaining the NIM.

For the year ended December 31, 2020, net income increased 10.2% to a record \$82.2 million compared to \$74.6 million in 2019. The increase was due to an increase in net interest income and noninterest income that was partially offset by a \$15 million increase in the provision for credit losses, largely due to the implementation during the same time when heightened economic uncertainties related to COVID-19 surface. At year-end, our asset quality metrics improved slightly when compared to 2019, as nonperforming assets to total

assets decreased from 0.26% to 0.25%.

COVID-19 modified loans have decreased to \$35 million as of Monday, of this total, \$32 million, representing 2 loans on 3 hotels are expected to resume payments within the next 2 weeks, which will further reduce modified loans to \$3 million. We continue to diligently focus on asset quality through ongoing monitoring of the loan portfolio and the most at risk categories. We just completed the latest deep dive into our loan portfolio this week.

In addition to our normal procedures, we are reviewing more detailed reports by industry within the loan portfolio and as needed on an individual loan basis. Overall, we are encouraged and optimistic by what we've learned and observed as a result of this heightened scrutiny. Our long-established consistent credit underwriting standards were stress tested well by the pandemic and reaffirmed our belief that they are sound.

Our loan pipeline has increased during 2021, a trend we anticipate will continue throughout the year, given the outlook for the high-growth markets we serve. After carefully considering potential loan growth for 2021, we are currently budgeting for 7% loan growth, net of any PPP loans forgiven are originated.

During the fourth quarter, we successfully issued a \$100 million sub debt offering. This low-cost capital provides further optionality to grow through acquisitions or organically. We believe during the next few years, bank consolidation in Texas will accelerate. As a result, utilizing the strength of our balance sheet, liquidity and capital position, we believe we are well positioned to actively pursue attractive bank acquisitions, while at the same time, organically growing and expanding our Texas franchise in the coming years.

The Texas markets we serve continue to experience growth and increased economic activity due to the in-migration from other states and corporate relocations. Tyler, where we are headquartered, will soon be home to a new medical school that is projected to significantly enhance economic activity, much of which is slated to occur within a block from our main campus. After what seemed like a very difficult and challenging start to the year, 2020, in my opinion, ultimately turned out to be the best year in the 60-year history of Southside.

During 2020, we all became better bankers and embraced technology at a new level. During 2021, we will invest in additional revenue producers, many of which have been identified and we will make continued investments in technology to enhance the customer experience and produce additional efficiencies.

In closing, a few weeks ago, we were honored to be recognized by Bank Director Magazine as one of the top 10 banking powerhouses in America, as measured over the last 20 years. Further confirming our commitment to our long-term business model and growth strategy.

I want to thank all of our team members for their significant contributions in making this recognition and our record results for 2020 a reality. I will now turn the call over to Julie.

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

Thank you, Lee. Good morning, everyone, and welcome to our call this morning. We ended the year strong with record fourth quarter net income of \$29.6 million, an increase of \$2.5 million or 9.2% on a linked-quarter basis, as well as record annual net income of \$82.2 million for 2020, an increase of \$7.6 million or 10.2% compared to 2019.

For the year ended December 31, 2020, our diluted earnings per share increased \$0.27 or 12.3% to \$2.47 per share. For the quarter ended December 31, 2020, our diluted earnings per share increased \$0.07 or 8.5% to \$0.89 per share compared to \$0.82 per share on a linked-quarter basis.

Linked quarter, our loan portfolio decreased \$132.2 million or 3.5% to \$3.66 billion, driven largely by a decrease of \$88 million of PPP loans. For the year ended 2020, we reported an increase in loans of \$89.6 million or 2.5% inclusive of approximately \$214.8 million of PPP loans, net of deferred fees.

Excluding PPP loans, our total loans decreased \$125.3 million or 3.5% in 2020. Although our pipeline is beginning to increase, we

believe loan growth may be challenged during the first quarter. Our credit quality metrics remained strong with nonperforming assets as a percentage of total assets of 0.25% at year-end compared to 0.26% at December 31, 2019.

On a linked-quarter basis, total nonperforming assets increased 3.9% or \$658,000.

Linked quarter, our allowance for loan loss decreased \$6.1 million or 11.1% to \$49 million at year-end due to a partial reversal of provision of \$5.9 million in the fourth quarter, largely the result of an improvement in the economic forecast and, to a lesser extent, the decrease in the loan portfolio at year-end.

At December 31, 2020, we reported our allowance as a percentage of total loans at 1.34% and when excluding the PPP loans, 1.42%. As of January 25, our COVID-19 deferrals have decreased to \$35 million, a decrease of approximately \$291 million or 89% since we reported \$326 million on our second quarter earnings call. The largest category of remaining deferrals are hotels at \$32.1 million, followed by mortgages at \$2.9 million.

At December 31, our loans with oil and gas industry exposure were \$104.5 million or 2.86% of total loans. There are no COVID-19 modifications with oil and gas industry exposure.

Our securities portfolio decreased \$52.3 million or 1.9% for the quarter ended December 31, compared to September 30. We recognized approximately \$24,000 in net security losses on the sale of AFS securities during the quarter. At year-end, we had a net unrealized gain in the securities portfolio of \$156 million, and the duration of the portfolio was 4.7 years, an increase from 4.4 years at the end of 2019.

Our mix of loans and securities at year-end shifted slightly to 58% and 42% compared to 59% and 41% at 2019, primarily due to municipal bond purchases in the first quarter. The mix remained consistent on a linked-quarter basis.

We are also pleased to mention that in November, we issued \$100 million of 3.875% fixed to floating rate subordinated notes due in 2030. This debt initially bears interest at a fixed rate of 3.875% through November 14, 2025, and thereafter adjusts quarterly at a floating rate equal to 3-month SOFR plus 366 basis points. We believe the issuance of the subordinated notes strengthens our capital position as well as provides funding for general corporate purposes in loan and franchise growth opportunities.

Since the end of September, we have purchased 175,118 shares of our stock at an average price of \$30.97. Approximately 930,000 authorized shares remain under our stock repurchase plan.

Our net interest margin increased to 3.20% an increase of 18 basis points from 3.02% on a linked-quarter basis. Approximately 14 basis points of this increase was due to increased accretion recorded of \$2.2 million related to PPP loans, forgiven during the quarter, and our net interest spread increased to 3.02% for the fourth quarter, an increase from 2.84% linked quarter.

On an annual basis, the net interest margin increased slightly to 3.07% from 3.06% at December 31, 2019. A result of lower deposit and funding costs, offsetting decreases in our average yield on earning assets.

For the 3 months ended December 31, net interest income increased \$2.1 million or 4.6%, driven primarily by the increase in accretion during the quarter.

We recorded \$453,000 in purchased loan accretion this quarter, a decrease of \$150,000 or 25% from the prior quarter. Additionally, we recorded approximately \$3.5 million in net fees related to the PPP program included in interest income this quarter. As of December 31, 2020, we had net deferred fees of approximately \$4.3 million remaining, and we are estimating approximately 75% will be recorded to income by the end of June 2021.

For the 3 months ended December 31, noninterest income, excluding net gains/losses on sale of AFS Securities decreased \$139,000 or 1.3% for the linked quarter. For the year ended December 31, noninterest expense increased \$4 million or 3.4% and for the linked quarter decreased \$301,000 or 1%.

For the first quarter of 2021, we are estimating noninterest expense of approximately \$31 million.

Our fully taxable equivalent efficiency ratio decreased to 47.36% compared to 50.07% on a linked-quarter basis. And for the year ended December 31, 2020, we reported 49.36% compared to 52.36% for the comparable period in 2019. The decrease in a fully taxable equivalent efficiency ratio for both periods was primarily due to the increase in net interest income for both periods.

Income tax expense increased \$482,000 or 12.7% compared to the 3 months ended September 30, driven by the increase in pretax income. Our effective tax rate increased slightly to 12.6% for the fourth quarter from 12.3% in the previous quarter.

For the year ended December 31, 2020, our effective tax rate was 12.1%. At this time, we are estimating an effective tax rate of 11% for the first quarter. Thank you for joining us today. This concludes our comments, and we will open the line for questions.

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## QUESTIONS AND ANSWERS

### Operator

(Operator Instructions) Your first question comes from the line of Brett Rabatin with Hovde Group.

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### **Brett D. Rabatin Hovde Group, LLC, Research Division - Head of Research**

Wanted to first ask, just -- I appreciate all the color around the core versus the stated margin. Just kind of given that you guys have \$1 billion of CDs still to reprice or the CDs of \$1 billion have a 91 basis point cost, it would seem like their core margin could continue to progress a little higher. Could you talk about maybe your thoughts on the core margin from here? And then with PPP, I appreciate the color on the fees there, how active you think you might be with this next round of that program?

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

On the CDs, we do anticipate that we'll be able to reprice those down. Some of those in the quarter were brokered CDs, which were down linked-quarter basis about \$200 million. So yes, we do have some additional room there. On the PPP loans, we are taking applications right now, we expect to be active. We initiated \$315 million in the first round back in April and May of 2020, different restrictions this time and less money available, so we're estimating somewhere in the \$50 million range that we'll originate. But we have a lot of activity at this point in time, but it's just difficult to pinpoint a number. And so we're estimating about \$50 million.

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### **Brett D. Rabatin Hovde Group, LLC, Research Division - Head of Research**

Okay. That's helpful. And then the guidance around the expense base going forward, \$31 million in the first quarter. You're closing some branches. Is 1Q, is that \$31 million, would that be inclusive of any nonrecurring expenses? And just how do we think about the trajectory? You've obviously managed expenses well the past year and 2 years, really. Do you have any tech investments you need to make? Just thinking about maybe the full year versus the first quarter as you guys are doing your plans for the year?

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

We took, as Lee mentioned, about \$1 million in losses and rent related and nonrecurring items in the fourth quarter. So we don't expect, in the first quarter, any nonrecurring items associated with those branch closures. Obviously, we will see some decline in rent compared to -- for those branches compared to Q1 of '20, but we do not expect any large expenses related to those closures. We took those once we made the announcement that we were doing it, we booked it in the 2020 year because that's when we announced it.

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

We do anticipate that there'll be some personnel cost savings there. But we also are looking at bringing on some additional revenue producers. So I believe that will offset there. But long term, I think that's going to be a real benefit for us as they'll be producing additional revenue well above what any revenue those branches may have produced and the 2 branches in East Texas, we expect to retain virtually -- I'm not going to say all, but at least 80% of the deposits because of the close proximity to other branches. And obviously, we'll retain all of the loans from the 3 branches.

**Brett D. Rabatin *Hovde Group, LLC, Research Division - Head of Research***

Okay. That's helpful. And then if I can sneak in 1 last one. I'm just curious on the buyback and capital, as you've got a little higher levels now, and it's -- it sounds like you're a little more optimistic on M&A happening. I'm just curious on what you're hearing in terms of conversations? And then on the buyback, if you can intend to continue to be or intend to be active with the repurchase plan?

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

Sure. We do expect to purchase additional shares in the coming months. We'll be evaluating levels that we'll be purchasing at. On the acquisition front, we're hearing from a number of parties that there's going to be increased interest by sellers. I think the new administration and potential additional regulation, the opportunity to adopt CECL in a couple of years and a few things like that, combined with some of the aging boards and ownership groups among the large number of private banks in the state of Texas are all going to act to basically produce more acquisition opportunities.

**Operator**

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

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

Wanted to just kind of follow-up on the loan growth outlook, 7% organic, ex kind of the PPP impact. So but kind of a soft first quarter. So should we expect it to be fairly back-end loaded in the year, maybe more related to construction kind of resuming and funding up? Or is this more related to kind of the new hires?

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

Right. I think it's kind of all 3, and then a little uncertainty about some loans that we have in the pipeline as to whether they'll close in the first quarter or the second quarter. But yes, I think for the most part, I would anticipate most of the loan growth would occur second through fourth quarter of this year. As Julie mentioned, first quarter, it may be a little challenged. Certainly, we're going to be seeing a lot of additional PPP forgiveness during the first and second quarter. But overall, I think you're correct in assuming second through fourth quarters where we're going to see the majority of the increase.

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

And maybe really quickly, just on loan pricing. Could you talk about kind of the dynamics you're seeing? Is there stability there? Or is it actually better maybe than 2020? Any kind of commentary given kind of the rise in the long end of the curve?

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

Okay. For the high-quality loans that most banks go after competition is pretty fierce. You can give on credit quality, you can give on structure or you can give on pricing. We're not, we're not big on giving on credit quality at all. Structure is something we think is pretty important. We'll give on that a little bit sometimes. So pricing is where it comes in. And pricing is like all the credit markets is pretty tight right now. So we could probably get higher pricing if we went after a different level of credit, but that's not what we historically have done.

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

Okay. And last one for me. Just on the reserve, you've still got over like 6x coverage of nonperformers, which is very high. But should we expect that level to still trend down with positive macro assumptions and kind of some of these hotel loans returning to normal or any other impacts or factors we should think about there?

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

Assuming the vaccine gets out to a large number of people and a large number of people take it, and we get what they call herd immunity going. I think the markets we're in are continuing to grow, and they'll do nothing but probably grow faster. And the economic activity will be stronger in those markets. So it's all dependent on when we kind of see COVID in the rearview mirror. But the outlook looks good at this point in time.

**Operator**

Okay. Our next question comes from the line of

Graham Dick with Piper Sandler.

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**Graham Conrad Dick Piper Sandler & Co., Research Division - Research Analyst**

Just a few quick ones here for me. I guess I'll start on the securities portfolio. Can you talk a little around the mortgage-backed securities book and what kind of drove those yields higher this quarter relative to what we saw in 3Q?

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

Well, as Julie mentioned, we did sell some securities in the fourth quarter. We went through and analyzed some of the premium mortgage-backed securities that have continued to prepay and look like they're not going to probably stop anytime in the near future. Those were obviously at the lowest yields. And so we did sell-out those securities that we didn't think there was really any significant hope of them recovering back to yields we'd be happy with. So I think that partially drove it. It certainly wasn't a slowdown in prepayments. The prepayments continued to come in at a fairly fast rate. And we have -- we did have some prepayment penalties on some of our CMBS that helped. And then we're also getting down to the point where we have a lot of, what I'd call, locked out CMOs that probably won't pay regardless of what the prepays are for the next year to 18 months. And then most of the CMBS are -- either they can't prepay or they have yield maintenance on them. So that's kind of where we are at this point.

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**Graham Conrad Dick Piper Sandler & Co., Research Division - Research Analyst**

Okay. Great. That's awesome color. And then I guess kind of going back to loan growth, what are you guys seeing from borrowers and in your economies that's giving you this the confidence behind the 7% growth for '21? I mean, you've seen a lot of pent-up demand? Or is this just kind of like you talked about on relocations to Texas and the general positive trends surrounding the reopening in your economies?

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

Yes. And when you look at the DFW area and especially the Austin area and even to some extent, the Houston area, and you just look at the major corporate relocations that are taking place and have been announced even in the last few months. They're just bursting at seams. And there's -- the growth that's occurring, there's an end user for it. And with that, the more, more people that moved into those areas, the more Amazon facilities and all the other types of warehouses are required to be able to continue commerce in the way that we're experiencing commerce being done today. So it's just kind of a self-perpetuating engine. And fortunately, Texas is benefiting, and we happen to be in the markets that are benefiting most in Texas.

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**Graham Conrad Dick Piper Sandler & Co., Research Division - Research Analyst**

Okay. Great. And then just 1 last housekeeping item for me here. Do you all happen to have the average PPP balance this quarter?

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

And you're talking about -- yes, for the fourth quarter.

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**Graham Conrad Dick Piper Sandler & Co., Research Division - Research Analyst**

Average loan balances in PPP for the fourth quarter?

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

Yes. The average was around \$272 million.

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**Operator**

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

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

Just wanted to go back to the core NIM. And given the loan growth outlook, do you think as we progress through 2021, we could see the core NIM remains stable or even possibly expanded slightly?

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

I think for the first couple of quarters, I expect to see it stay kind of in the general range where it is. Given the types of loans we're looking at, I'm not sure that the NIMs going to have any significant growth in the 2021. And most of the heavy lifting in the -- on the funding side has been done, but there still is some to do there. So overall, I think we're looking at a NIM that's fairly stable for most of 2021.

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

Okay. That's helpful. And then last for me on the M&A side. I was just curious if there's any geographies within Texas that would be most attractive to acquiring for you all?

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

Basically, where we look for attractive acquisitions is along Interstate 35 to the East. We'll go -- we look west of 35, which if you know Texas, 35 goes down through Fort Worth down through Austin, and into San Antonio, we'll look west, maybe 30, 40 miles. But after you get pass that, it's a long way to the centers of population in West Texas. So that's kind of our geography, but that covers over 80% of the population in the state of Texas.

**Operator**

At this time, I'm currently showing no further questions in the queue. I would now like to turn the conference back over to Mr. Lee Gibson, President and CEO.

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

Well, thank you for joining us today. Given the outlook for our markets, our strong balance sheet, capital position and core earnings, We are very encouraged about 2021 and look forward to reporting results to you throughout the year. And we look forward to the next earnings call in April of this year. Thank you for attending.

**Operator**

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

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