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Q2 2021 Southside Bancshares Inc Earnings Call

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PRESENTATION

Operator

Good day, and thank you for standing by. Welcome to the Southside Bancshares, Inc. Second Quarter 2021 Earnings Call. (Operator Instructions)

Please be advised that today's conference is being recorded. (Operator Instructions)

I would now like to hand the conference over to your speaker today, Ms. Lindsey Bailes, Vice President of Investor Relations. Please go ahead.

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

Thank you, Roche. Good morning, everyone, and welcome to Southside Bancshares' Second Quarter 2021 Earnings Call. A transcript of today's call will be posted on southside.com under Investor Relations.

During today's call and in other disclosures and presentations, I will remind you that any forward-looking statements are subject to 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' Second Quarter Earnings Call for 2021. This morning, I am pleased to report we had another solid quarter with net income of $21.3 million, earnings per share of $0.65 and an annualized ROA of 1.2% and an annualized return on average tangible common equity of 13.13%. Our quarterly results included continued linked quarter deposit and loan growth, net of PPP loans, and continued strong asset quality metrics. The second quarter results included a provision for credit losses of $1.7 million due to a decline in the downside component of the economic forecast and its effects on macroeconomic factors used in the CECL model.

Our strong asset quality metrics included nonaccruing loans to total loans of 0.14% and nonperforming assets to total assets of 0.21%. Our linked quarter loan growth net of PPP loans of $14.5 million was partially offset by earlier-than-anticipated loan payoffs due to recently completed construction projects selling prior to stabilization at very low cap rates. A year ago, we were seeing construction projects typically sold post stabilization.

Annualized loan growth as of June 30, 2021, was 4%. We continue to believe 7% loan growth for 2021, net of PPP loans is achievable as our loan pipeline remains very healthy, a trend we anticipate will continue throughout the year, given the outlook for the high-growth markets we serve. The $656,000 decrease in our net interest income linked quarter was due entirely to the decrease in PPP loan accretion during the quarter.

Linked quarter, our net interest margin and spread decreased 14 basis points primarily due to an 18 basis point decrease in the yield on earning assets. The average yield on loans decreased 16 basis points, half of which was due to the decrease in the combined PPP and purchase loan accretion.

The average yield on securities decreased 18 basis points linked quarter, largely due to a 42 basis point decrease in the yield on mortgage-backed securities, primarily a result of higher prepays, and a 23 basis point decrease in the yield on taxable securities primarily due to an increase in the average balance of a treasury position during the second quarter.

The mortgage-backed securities position continues to decrease as a percentage of the overall securities portfolio. In addition, during July, we have sold approximately $57 million of our lower-yielding mortgage-backed securities. On September 30, we anticipate the redemption of our 5.5% coupon $100 million sub debt issue pending regulatory approval, which will have a positive impact on both net interest income and the net interest margin beginning in the fourth quarter.

For the 6 months ended June 30, 2021, our net interest margin has increased 11 basis points when compared to the prior year. During the second quarter, we continued to see a nice increase in non-maturity deposits, which represents our lowest cost interest-bearing liabilities. Over the past 15 months, we have experienced significant growth in non-maturity deposits, which has allowed us to strategically lower our higher cost funding sources, CDs and FHLB borrowings.

Economic conditions in our market areas remain strong, bolstered by company relocations, our expansions combined with population growth. As the Texas economy continues to benefit from individuals and companies migrating from other states. The DFW and Austin markets that we serve continue to be among the highest growth markets in the country.

I look forward to answering your questions following Julie's presentation, and 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 today. We reported net income of $21.3 million, a linked quarter decrease of $12.8 million or 37.5% due primarily to an increase in provision expense of $11.8 million and a decrease in net security gains of $2 million. Net income decreased $237,000 or 1.1% compared to the same period in 2020. For the quarter ended June 30, 2021, our diluted earnings per share were $0.65, unchanged when compared to the same period in 2020 and a decrease of $0.39 or 37.5% on a linked quarter basis.

Linked quarter, net of the decrease in PPP loans of $88.8 million, our loan portfolio increased $14.5 million to $3.64 billion. Our commercial real estate loans increased $82.3 million, partially offset by a decrease in construction loans of $77.5 million. Construction loans decreased due to several large unexpected early payoffs in the second quarter and commercial loans, excluding the PPP forgiveness, increased approximately $21 million during the second quarter.

As of June 30, our PPP loans, included in the commercial loan category, totaled $132.1 million down from $220.9 million at March 31, 2021. The average balance of our PPP loans for the 3 months ended June 30, 2021, was approximately $200.6 million.

Our asset quality remains strong as nonperforming assets decreased slightly by $98,000 down to 0.21% of total assets compared to 0.22% at March 31, 2021.

Linked quarter, our allowance for loan loss increased approximately $1.5 million or 3.5% to $42.9 million at June 30, due to recording a provision for credit losses on loans of $1.5 million in the second quarter of 2021, an increase of $8.9 million compared to the reversal of provision in the first quarter. The increase in the provision for the second quarter was primarily due to a decline in the S3 Downside Scenario in the Moody's economic forecast at June 30, 2021, and its effect on macroeconomic factors used in the CECL model.

On June 30, our allowance for loan losses as a percentage of total loans was 1.18%. And when excluding PPP loans, 1.22%. Our allowance for off-balance sheet credit exposures at June 30 increased slightly to $3.8 million when compared to March 31, 2021, due entirely to provision expense of $157,000, again compared to a reversal of provision of $2.8 million in the previous quarter.

Combined with the provision expense for credit losses on loans, the provision for credit losses totaled $1.7 million for the 3 months ended June 30, 2021. Our COVID-19-related deferrals have decreased to 1 remaining mortgage loan with an approximate balance of $158,000.

As of June 30, our loans with oil and gas industry exposure were $94.3 million or 2.7% of total loans.

Our securities portfolio increased $215.8 million or 8.2% on a linked quarter basis. We recognized $15,000 in net security gains on the sale of AFS securities during the quarter, a decrease of $2 million from the net gains reported last quarter. As of June 30, 2021, we had a net unrealized gain in the securities portfolio of $136.4 million, and the duration in the portfolio increased slightly to 5.4 years from 5.3 years at the end of the first quarter. Our mix of loans and securities at June 30 shifted to 56% loans and 44% securities, from 58% and 42%, respectively, at March 31 due to the purchases in the securities portfolio.

Our net interest margin and spread were 3.06% and 2.89%, respectively, with a linked quarter decrease in both of 14 basis points, a result of the decrease in yield on interest-earning assets. Consistent with last quarter, approximately 10 basis points of the net interest margin related to interest and fees earned on the PPP loans.

For the 3 months ended June 30, net interest income decreased $656,000 or 1.4%. We recorded approximately $1.7 million in net fees related to the PPP loans included in interest income this quarter compared to $2.6 million linked quarter. As of June 30, 2021, we had net deferred fees of approximately $5.3 million remaining to be recognized as a yield adjustment over the terms of the loans. Additionally, we recorded $649,000 in purchased loan accretion this quarter, an increase of $234,000 from the prior period.

For the 3 months ended June 30, 2021, noninterest income, excluding net gains on the sale of AFS securities, decreased $702,000 or 6% for the linked quarter, which was primarily driven by a decrease in other noninterest income, partially offset by an increase in deposit services income.

Our other noninterest income decreased primarily due to a decrease in swap fee income and a decrease in the fair value of mortgage servicing rights. An increase in debit card income was the primary driver of the increase in deposit services income.

Additionally, we have experienced consistent increases in our trust fees and brokerage services income over each of the 5 linked quarters since June 30, 2020, resulting in increases of 51% in brokerage services income and 14% in Trust fees for the 6 months ended June 30, 2021, when compared to the same period in 2020.

Linked quarter noninterest expense decreased $535,000 or 1.7% to $30.7 million. For the third quarter of 2021, we expect noninterest expense to be approximately $31 million. Our fully taxable equivalent efficiency ratio decreased to 50.31% compared to 50.44% linked quarter. The decrease in the fully taxable equivalent efficiency ratio was due to the decrease in noninterest expense for the quarter.

Income tax expense decreased $1.9 million or 39.2% compared to the 3 months ended March 31, 2021, a result of the decrease in pretax income. Our effective tax rate decreased slightly to 11.9% for the second quarter from 12.2% last quarter due to an increase in tax-exempt income as a percentage of pretax income.

Additionally, we recorded $115,000 of discrete tax benefit in connection with equity award transactions during the second quarter. At this time, we are estimating an annualized effective tax rate of 12.5%.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Your first question coming of Brad Milsaps from Piper Sandler.

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

Lee, I was going to maybe start with the bond portfolio. I was kind of writing quickly. It looks like the average bond portfolio finished -- was around $2.6 billion during the quarter. You were closer to $2.9 billion at period end.

I think you mentioned you sold some stuff. But just kind of curious what categories you did buy into. It sounds like you're continuing to let MBS run off. Did you go -- do you buy more tax exempt? Or is that in the kind of the taxable book? And then kind of what does that mean for your margin going forward?

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

Right. Primarily what we bought were municipals, some taxable, a lot of tax-free municipals. We bought a few sub-debt deals, bank sub-debt deals. But primarily, it was in the municipal arena. We're just not finding any value in the mortgage arena at this point in time.

In terms of the margin going forward, I think the -- on the taxable side, the treasury position weighed on that yield, but we're not increasing that treasury position at this point in time. So I don't see that being an issue. As for the other taxable purchases. They've typically been in the 2.50% to 2.70% range. On the tax-free side, it really just depends what maturity you're buying and what the call is. But for the really high-quality stuff, obviously, whatever we put on is going to be a slight reduction in the rate there.

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

Okay. Great. And it sounds like you were more optimistic on loan growth picking back up in the back half. Is that -- sort of did you believe that maybe the NIM can maybe stabilize here above 3%? Or do you think there's more significant compression coming?

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

I don't know that we'll see a 14 basis point decrease in the NIM going forward, especially in the third quarter. But I do see some slight NIM compression. We just had a number of factors that caused it to be lower. We're anticipating that we'll begin to see some of the round 2 of PPP loans, began to be forgiven in the next 6 months to 9 months for sure. So we'll be bringing that income in. And then, of course, pending regulatory approval. If we -- when we call the sub-debt deal, that's going to take a lot of pressure off the NIM, and it will go the other direction.

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

Great. And just one housekeeping question. Julie, do you have now the average number of PPP loans in the quarter?

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

You want the average number or the average balance?

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

I'm sorry, the balance. I apologize. The balance.

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

Okay. Well, that's what I thought you meant. It's -- yes, it's $200.6 million.

Operator

Your next question with line of Brett Rabatin with Hovde Group.

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

It's interesting pronunciation, Hovde Group. I was -- wanted to ask the Securities question in a different way maybe. Lee, how much do you guys have in cash flow coming that you have to reinvest, maybe in the next few quarters? And what would be the average rate? I guess I'm just trying to get to what you have to replace relative to the current portfolio going forward.

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

Yes. The cash flow that comes in is almost exclusively related to the mortgage-backed securities portfolio. And it's probably averaging somewhere around $30 million a month at this point in time with the sale of some of those mortgage-backed securities that might decrease a little bit. But I would anticipate that we're looking at close to $90 million for this third quarter in redemptions there.

And the -- that has an average yield of 2.2% and what's prepaying is typically the lower rate stuff. So for the most part, we should be able to put on securities that are close, but it may cause a little bit of additional pressure in the overall yield of the securities portfolio.

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

Okay. That's good color. And then just on the payouts you had in the construction portfolio, it sounds like those were unexpected. It was essentially projects where -- but even before the letter of occupation was filed, they got refinanced away from you, or what maybe drove the decline that you weren't expecting in construction?

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

Yes. We were expecting these to sell. But typically, what we've seen is that the project, say, it's a multifamily, it will reach stabilization, which means it may be 90%, 95% occupied. What we were starting to see in the second quarter was they were able to sell these projects prior to stabilization. So they weren't leased up to stabilization. And so they were prepaying anywhere from 3 to 9 months faster than we originally anticipated that they would pay off.

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

And then a last question for me. I've had some contacts in the state tell me that the talks are picking up. And I know you've been thinking about doing M&A I was just curious to get your tea leaf read on M&A for you, and if you were seeing some opportunities and you're hearing or having conversations with folks these days.

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

We are hearing more opportunities out there and having additional conversations and some of the opportunities that are out there are ones that we may not be interested in. But yes, we are definitely seeing an uptick in and opportunities to have conversations surrounding M&A.

Operator

(Operator Instructions)

Your next question on line are Will Jones with KBW.

William Bradford Jones ***Keefe, Bruyette, & Woods, Inc., Research Division - Research Analyst***

So I just wanted to pivot back to loans and loan growth for just -- I know this is unfortunate that you guys had the pay downs burden growth this quarter, especially coming off the strong momentum in 1Q. But it does sound like you guys are still optimistic in the back half of the year.

What are you seeing in your markets today? And where are you kind of anticipating most of that growth come from? I know you guys are in the process of building out your Houston presence, and you've been and some lenders in the Dallas market. So just curious on some commentary around loan growth.

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

We're starting to see -- not starting, we've been seeing a number of opportunities in our current pipeline, there are a number of full funders that we're looking at, at this point in time, which gives us some encouragement about that 7% loan growth.

And then some of our construction projects that we put on last year, those are starting to fund up. And so we're just anticipating that these early payoffs, we may see a few more early payoffs, but those were ones we were really anticipating in the back half of this year, if not early next year.

So with what we're seeing in our pipeline, the types of loans we're seeing and the fact that a number of them are full thunders gives us confidence that barring unexpected payoffs at a large, large volume, we anticipate being able to get to that 7% or real close to it.

William Bradford Jones ***Keefe, Bruyette, & Woods, Inc., Research Division - Research Analyst***

Got you. That's great to hear. And then just on the hiring front, are you guys still active in seeking new lenders? Are you guys still active in building out in different markets or maybe hoping do some lending count within certain portfolio segments. Just curious on the commentary around your hiring efforts and what you guys are seeing out there.

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

We are definitely interested in hiring additional revenue producers, especially in our higher growth markets, and we're actively looking for some. We did bring on 3 in the first quarter that has worked out extremely well. And we're just being very selective on what we do. But yes, we are continuing to look for additional revenue producers in those market areas.

William Bradford Jones ***Keefe, Bruyette, & Woods, Inc., Research Division - Research Analyst***

Great. Just for my reference, what would you consider are your highest growth markets?

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

The Dallas-Fort Worth area, the Austin market and Houston is -- while it may not be as high growth as the other 2, it's still a growing market. And for us, we're just scratching the surface there. So there seems to be a lot of opportunity there for us even with maybe a little slower growth than we're seeing in some of the other markets.

William Bradford Jones ***Keefe, Bruyette, & Woods, Inc., Research Division - Research Analyst***

Awesome. That's great. And just lastly for me, I know that just looking at it, it looks like in the period shares, roughly flat quarter-over-quarter. But I know you guys were active on the buyback last quarter. Did you guys buy back any shares this quarter? And how is your appetite for the buyback as you go into this upcoming quarter? I know same stocks were kind of pulled back a little bit. Is it possible to see you guys engage pretty heavily?

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

In terms of the future, yes, we're definitely looking to repurchase shares moving forward, especially at these prices. And in terms of what we purchased in during the quarter, I'm going to let Julie answer that.

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

Yes. We purchased right at 91,000 shares in the first quarter. It was very early on in April at an average price of $38.49. And like Lee said we do plan to be pay back in there.

Operator

Next question with Michael Young with Truist Securities.

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

Wanted to ask just about interest rate sensitivity. You guys have historically been a little bit liability sensitive. But just wanted to kind of get your thoughts or any proactive measures that you may be taking to maybe be a little more neutral if we think we're moving towards a higher rate environment or extending duration or shrinking duration as the case may be.

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

Yes. Great question. I think one of the things we've been able to do over the last 15 months is utilize this large growth in nonmaturity deposits. And while we may see some runoff in it, it appears that the vast majority of it is going to remain fairly sticky. Those tend to be much longer-duration liabilities than the liabilities that we let run off, which were the CDs and the FHLB borrowings. So we feel like our overall liabilities have lengthened pretty nicely in duration on the -- as a result of the growth in the nonmaturity deposits.

So that, combined with -- we have a lot of floating rate loans. On the loan side we're -- as we mentioned, we're getting a lot of cash flow on the mortgage side. At this point, I feel like we're pretty close to neutral because of that growth in the nonmaturity deposits.

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

Okay. That's helpful. And just maybe a bigger-picture question on sort of the expense infrastructure for the bank. You guys have done a good job of kind of pruning expenses to keep the efficiency ratio at an attractive level. But just curious, now kind of looking back on the pandemic and the impacts and having a -- test run it, maybe branches being closed for a small period of time, and sales activity through that period. Are you more confident in continuing to rationalize the branch network or pivoting the branch network to higher-growth metros? Just any kind of thoughts there would be helpful.

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

Yes. We have -- we did in the last 12 months, I think we've closed 6 branches. I know in the last 9 months, we've closed 6 branches. I'm trying to remember what we closed in the third quarter of last year, if any. And we have opened a branch in -- well, 2 branches. One was an LPO, and it's now a full-service branch.

And then we've opened a branch in Houston, and one in the DFW area. So yes, we are looking at more branches in the higher-growth markets, but still providing sufficient number of branches in our other markets because they produce a lot of low-cost deposits. And so it's important that we make sure that those areas are covered sufficiently with branches.

Operator

I will now turn the call back over to Mr. Gibson.

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

All right. Thank you for joining us today. We appreciate the opportunity to answer your questions and your interest in Southside Bancshares. In closing, given the positive economic conditions in our markets, our strong balance sheet, capital position, asset quality and core earnings. We are very encouraged and look forward to reporting results to you during our next earnings call in October. This concludes the call.

Operator

This concludes today's conference call. Thank you for participating. You may now disconnect. Goodbye.