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## Q4 2021 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

**Brady Matthew Gailey** *Keefe, Bruyette, & Woods, Inc., Research Division - MD*
**Graham Conrad Dick** *Piper Sandler & Co., Research Division - Research Analyst*
**Matthew Covington Olney** *Stephens Inc., Research Division - MD*
**Michael Masters Young** *Truist Securities, Inc., Research Division - VP & Analyst*

## PRESENTATION

**Operator**

Thank you for standing by, and welcome to the Southside Bancshares, Inc. Fourth Quarter and Year-end 2021 Earnings Call. (Operator Instructions) As a reminder, today's program is being recorded. And now I'd like to introduce your host for today's program, Lindsey Bailes, Vice President, Investor Relations. Please go ahead.

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

Thank you, Jonathan. Good morning, everyone, and welcome to Southside Bancshares Fourth Quarter and Year-End 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, and 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, everyone, and welcome to Southside Bancshares Fourth Quarter and Year-End Earnings Call for 2021. This morning, we reported exceptional results for the year and fourth quarter. I want to start by recognizing and thanking the entire Southside team for their extraordinary contributions and efforts during 2021, without which these results would not have been possible.

Highlights for the quarter included earnings per share of $0.88, an ROATCE of 16.8%, annualized linked quarter deposit growth of 29.1%, annualized linked quarter loan growth net of PPP of 3.8%, an increase in the net interest margin to 3.23% and continued strong asset quality with nonperforming assets decreasing to 0.16% of total assets.

Highlights for the full year included record net income of $113.4 million; record earnings per share of $3.47; an ROATCE of 17%; a 16% increase in deposits, a 5% increase in loans, net of PPP; an increase in the net interest margin of 9 basis points; and further improvement in our strong asset quality.

The fourth quarter results included a reversal of provision for credit losses of $3.4 million. Linked quarter, our net interest margin increased 7 basis points. The average yield on securities increased 8 basis points. And the rate on our interest-bearing liabilities decreased 13 basis points, 11 basis points of which resulted from the decrease in sub debt expense. The average yield on loans decreased 12 basis points, largely due to the decrease in PPP loan accretion.

We were extremely pleased with our annualized linked quarter loan growth, net of PPP, of 3.8%, given the previously discussed anticipated large payoffs that occurred during the fourth quarter. As we begin 2022, our loan pipeline is extremely strong. What is especially encouraging is that the pipeline in each of our regions is very strong. Given the excellent outlook for the high-growth markets we serve as well as the growth occurring in our other markets, we anticipate solid loan demand will continue well into 2022. We are projecting 2022 loan growth, net of PPP loans, of 9%.

During the fourth quarter, we continued to experience an increase in our average nonmaturity deposits, which represent our lowest cost interest-bearing liabilities. Over the past 24 months, nonmaturity deposits have increased significantly, which has allowed us to strategically transform the funding base by significantly reducing dependence on higher cost and shorter duration CDs and unswapped FHLB and other wholesale borrowings. Currently, our swapped borrowings are $575 million, down $30 million since December 31.

The economic conditions in our markets remain strong, bolstered by continued company relocations and existing company expansions combined with population growth resulting from continued migration 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 remarks, 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 ended 2021 with another strong quarter and record financial results for the year with annual net income of $113.4 million and diluted earnings per common share of $3.47, a 40.5% increase from $2.47 for 2020.

We reported fourth quarter net income of $28.7 million, a linked quarter decrease of $619,000 or 2.1% due to a lower reversal of provision for credit losses and a decrease in gain on sale of AFS securities, partially offset by a decrease in interest expense.

For the quarter ended December 31, 2021, our diluted earnings per common share were $0.88, a decrease of $0.02 or 2.2% on a linked-quarter basis. Linked quarter net of the decrease in PPP loans of $36.5 million, our loan portfolio increased $34 million to $3.61 billion. Our construction loans increased $25.8 million. Commercial loans, excluding the PPP forgiveness, increased $11.7 million. And we also experienced an increase in municipal loans of $15.8 million on a linked quarter basis.

We had increased payoffs in commercial real estate, including several large loans between $24 million and $30 million. The weighted average rate of new loans funded during the fourth quarter was approximately 3.4%.

As of December 31, our PPP loans included in the commercial loan category totaled $31 million, down from $67.5 million at September 30, 2021. The average balance of PPP loans was approximately $53.6 million for the fourth quarter and $142.7 million for 2021. Currently, our remaining PPP loans are approximately $25 million.

Our asset quality remains strong. Nonperforming assets decreased throughout 2021 with a total decrease of $5.9 million or 33.6% for 2021, 0.16% of total assets compared to 0.25% at December 31, 2020. On a linked-quarter basis, nonperforming assets decreased $815,000 or 6.6%. Linked quarter, our allowance for loan loss decreased $2.7 million or 7.2% to $35.3 million at December 31 due to recording a reversal of provision for credit losses on loans of $2.7 million in the fourth quarter of 2021.

The reversal of provision for the fourth quarter was primarily due to an improved forecast for commercial real estate as well as the impact of loan payoffs on the allowance. As of December 31, our allowance for loan losses as a percentage of total loans was 0.97% and 0.98% when excluding PPP loans. Our allowance for off-balance sheet credit exposures at December 31 decreased to $2.4 million when compared to $3.1 million at September 30, 2021, due to a reversal of provision of $706,000 in the fourth quarter. This, combined with the reversal of provision for credit losses on loans, the total reversal of provision for credit losses was $3.4 million for the 3 months ended December 31, 2021.

As of December 31, our loans with oil and gas industry exposure was $69.7 million or 1.9% of total loans. Our securities portfolio increased $9.5 million or 0.3% on a linked quarter basis. We recognized $463,000 in net security gains on the sale of AFS securities during the quarter, a decrease from the net gains of $1.4 million reported last quarter. At year-end, we had a net unrealized gain in the securities portfolio of $111.7 million, and the duration of the portfolio was 5.9 years, up from 5.8 years linked quarter and 4.7 years at the end of 2020.

Our mix of loans and securities at December 31 was 56% and 44%, respectively, remaining consistent on a linked quarter basis with a shift from 58% loans and 42% securities for the prior year-end.

Our deposits increased $390.7 million or 7.3% compared to September 30, 2021. This increase consisted of an increase in public fund deposits of $126.6 million or 14.7%. Public fund deposits normally increase in the fourth quarter each year. Additionally, brokered deposits increased $181.3 million or 159.8%. In December, in order to obtain lower cost funding, we utilized $265 million in brokered deposits for funding our cash flow hedge swaps and reduced FHLB advances.

During the first quarter of '22, we plan to utilize brokered deposits in place of FHLB advances on the remaining $310 million of cash flow hedge swaps. We expect this to reduce the overall funding cost on the swaps by approximately 10 basis points.

Our net interest margin increased 7 basis points on a linked quarter basis to 3.23%. And the net interest spread increased 9 basis points to 3.09%. The reduction of our subordinated notes on September 30 impacted the average rate paid on our interest-bearing liabilities by approximately 11 basis points for an impact of 9 basis points on the NIM. Approximately 8 basis points of the net interest margin related to fees earned on PPP loans compared to 18 basis points last quarter.

For the 3 months ended December 31, net interest income increased $1.2 million or 2.5% when compared to the linked quarter. We recorded approximately $1.4 million in net fees related to the PPP loans included in interest income this quarter compared to $3.1 million last quarter. As of December 31, 2021, we had net deferred fees of approximately $935,000 remaining to be recognized as a yield adjustment over the terms of the loans. Additionally, we recorded $364,000 in purchased loan accretion this quarter, an increase of $168,000 from the prior quarter.

For the 3 months ended December 31, 2021, noninterest income, excluding net gains on the sale of AFS securities increased $160,000 or 1.4% for the linked quarter. For the fourth quarter, noninterest expense was $31.3 million. Excluding the loss on the redemption in the third quarter, noninterest expense increased $689,000 or 2.2% on a linked quarter basis. For 2022, we expect quarterly noninterest expense to be approximately $32.5 million.

We are pleased to report our fully taxable equivalent efficiency ratio for the 3 and 12 months ended December 31 was 47.61% and 49.03%, respectively. Income tax expense decreased $165,000 or 3.3% compared to the 3 months ended September 30, 2021. Our effective tax rate decreased slightly to 14.4% for the fourth quarter. At this time, we are estimating an annual effective tax rate of 12% for 2022.

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

## QUESTIONS AND ANSWERS

**Operator**

(Operator Instructions) Our first question comes from the line of Graham Dick from Piper Sandler.

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

Just wanted to start on the bond portfolio. Do you guys have any plans to grow it from here? I know you all talked about the addition of those brokered deposits. But it looks like there might have been some seasonal funds in there as well. Overall deposit growth is pretty strong. Just wondering if you guys are planning to grow it anymore from here?

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

No. I think for the year, we're budgeting just an ever so slight increase in the bond portfolio, $30 million or $40 million, somewhere in that range. But no, we're really not. And those growth in brokered deposits were due to us changing the funding of our swap hedge funding from home loan bank to the brokered deposits so that we could save approximately 10 basis points.

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

Right. That sounded like a pretty good trade for you guys. And then I guess one last thing on the bond portfolio. I was just wondering if there's anything nonrecurring driving the improvement in the MBS yields this quarter?

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

I think the increase had to do with less amortization expense on the mortgage-backed securities. We continue to have some prepayment where there's yield maintenance on some of those mortgage securities. And I would anticipate, with rates being up a little bit on the long end, that we may see some further slowing of prepayment speeds that could possibly move the mortgage yield up a little bit.

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

Okay. That's kind of what I thought. And then just moving, I guess, more to asset sensitivity and looking at a higher rate environment. So wondering if you guys could provide just a little color on how you all are positioned heading into this, maybe like broadly, your NII shock scenarios or what percent of loans repriced immediately and then even like what you guys might be expecting on the deposit paid upfront, would all -- all of that would be very helpful.

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

Okay. I think over the last really since the pandemic began, deposits in all banks started growing. We basically utilized that deposit growth in nonmaturity deposits to become significantly less dependent on the CDs and to become significantly less dependent on unswapped wholesale funding, which right now we just don't have a lot of.

So as the short-term interest rates increase, we don't feel like we're going to have to raise our funding costs anywhere near what those increases are. In fact, first increase on some of the nonmaturity deposits, there may not be any increase at all, but it'll be a very small percentage increase of the going forward, even throughout the year if it goes up the 4 rate increases that they're anticipating this year.

On the loan side, I think just a little less than 50%, and Julie probably has the number, is in floating rate of that. Probably 60% to 70% reprices immediately, but most of it reprices within 6 months to a year. Some of it's based off a 3-month LIBOR, and some of it's 1 month, but a lot of it is overnight and immediate.

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

I appreciate that. Congrats on a pretty solid quarter.

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

Thank you.

**Operator**

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

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

Just wanted to touch on the loan growth outlook. You mentioned, I think, 9%. I assume that's kind of ex PPP, so just the core loan growth. And I was just curious what areas you're seeing the most strength in, if it's kind of the historical construction bucket, and what the new yields are on loans that you might be putting on. Are they a good bit higher at this point than kind of the back book of what's rolling off?

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

We are seeing a fair amount of construction loans, and those are typically -- not typically, they're almost always floating. And they're either tied to prime or they're tied to 1-month LIBOR or SOFR at this point. So as rates move up, those construction loans will move up. But what's really encouraging is we're seeing a lot of full funders, and it's primarily on the commercial real estate side that we're seeing that. And then we're seeing some nice increases in municipal loans that we anticipate throughout the year. Does that kind of answer your question, Michael?

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

Yes. I guess I'm trying to get at, basically, are the new loans you're putting on, are they sort of at higher rates and higher yields and what's running off and that it should be sort of accretive to loan yields? Or is it more in line or still kind of slightly dilutive?

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

I'd say the full funders that if we're fixing the full funders, they're at slightly higher yields than what's rolling off. And on the floating rate, they're probably at similar yields to what we have today. But they're going to -- in March, I think everybody is anticipating at least 25 basis point increase. And you'll see that across the board reflected in SOFR, LIBOR and prime if that occurs.

So those floating rate loans, the spreads on those, let's say, we've got one at prime at 3.25 the real spread is going to increase over what our cost of funds is pretty much, I wouldn't say the full 25 basis points, but it ought to -- it will be in the 20 somewhere, 20 -- 22, 23 basis points, that spread will increase.

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

Right. Okay. And then on the capital side, Lee, just sort of curious, you guys are going to have stronger loan growth. So wanted to just get your updated thoughts on capital returns, if share buyback is even still in the equation given where the stock is and then what the outlook is for M&A?

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

Okay. In terms of stock buybacks, we do not have one at this point in time currently in place. But that's something that we're looking at and would anticipate that sometime during the first half of this year, you'll probably see something on that. In terms of, let's say, it was -- you mentioned capital.

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

M&A, yes.

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

M&A, we're actually having some more meaningful conversations with some potential partners that would be something we'd be interested in acquiring. And I don't look for anything to happen immediately, but I think -- I'm hopeful that sometime maybe during the first half or first 3 quarters of 2022, it may be possible that we're able to announce something. But there's nothing sitting on the table exactly today, but just good conversations.

**Operator**

Our next question comes from the line of Brady Gailey from KBW.

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

So when I look at your fee income, a lot of it is driven by service charges on deposits. Can you just talk about, now that industry is seeing some pressure on NSF fees and overdraft, maybe just, one, tell us how much NSF and overdraft within 2021? And then how you guys are thinking about that going forward?

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

Julie is grabbing the number for 2021. What I can tell you is that we're cognizant of that. And our budget for 2022, we basically have lowered it by 10% for the last 9 months of the year. Is that correct?

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

Yes, that's correct.

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

Yes. And the only reason we're doing that is because if we look to make a change today on something, it would take a while for that to filter through. And really some of our lower months of overdraft income occurs in the first quarter because of tax refunds and things of that nature. So we are cognizant of that, and I think Julie has that number for 2021.

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

Yes, Brady, the overdraft and return check charges together were about $9.2 million. The overdraft just by itself was $8.4 million. And that was some decline from 2020 as well, not significant, but some decline, mainly due to the abundance of deposits in probably in all institutions right now.

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

And then moving to the expense base, the guidance of $32.5 million, is that more kind of the run rate in the first quarter and you're going to see some growth beyond that? Or is that more kind of an average run rate for the full year?

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

It's probably closer to an average for the full year based on budgeting.

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

And we've factored it in some additional loan officer hires that likely you'll see hopefully in the second and third quarter, possibly fourth quarter.

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

It might run a little lower in Q1.

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

Run a little lower in Q1. I think you were guessing somewhere closer to $32 million, yes, in the first quarter. But on average, we think it's budgeting $32.5 million for the year per quarter.

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

Okay. And then, Lee, it sounds like you're a little more active on M&A now than you have been in the last couple of years. So just remind us what geographies do you like and kind of what's the sweet spot from a size point of view for a bank target for Southside?

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

Geography, basically, we'd like to stay and, at this point in time, we plan on staying along Interstate 35 to the east. We might go 50, 60 miles west of Interstate 35, but probably not much past that. And that encompasses about 85% of the population in the state and probably at least that percentage of the economy in the state.

So in terms of size, ideal size would be somewhere between $1 billion and $2 billion. We started getting too much above $2 billion and we're touching on $10 billion. And so we'd like to -- if we do an acquisition, we'd like to stay under that unless we were to look at a really, really large acquisition that would take us at least $1 billion or $2 billion over $10 billion. But the sweet spot for us really probably $1 billion to $2 billion.

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

All right. And then just on that topic, Durbin, I know it sounds like you guys are going to stay under $10 billion for a while here, but if you do cost, remind us what the Durbin impact could be.

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

Our last estimate was around $8 million. It would probably need to be refreshed, but that was, I think, last quarter or so.

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

And Julie, that $8 million, is that $8 million on today's balance sheet or a $10 billion balance sheet?

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

No, it is today's balance sheet.

**Operator**

Our next question comes from the line of Matt Olney from Stephens.

**Matthew Covington Olney** ***Stephens Inc., Research Division - MD***

I want to ask about the loan growth guidance that you guys provided of 9% for the full year ex PPP. It implies a nice pickup versus what we've seen over the last few quarters. Any more color on that improvement? And I think you mentioned pay downs were heavier in the back half of 2021. So are you assuming a more moderate level of pay downs in 2022?

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

We certainly are not expecting pay downs like that in the first half of the year. And then we had a lot of -- there was some uncertainty about tax laws and things of that nature that probably drove a few of the payoffs that -- via some sales that occurred in the fourth quarter. But no, we're not anticipating the volume. But the main thing is our pipeline, typically December and January are pretty slow months. And it's been fast and furious, and we have not seen a start to the year like this in quite some time.

So it's just very encouraging, and it's not just 1 or 2 regions. It's in all of our regions. So we just feel good. The economy is doing extremely well, and growth is occurring, and it's real growth. It's new jobs, people moving in, companies moving in. It's just -- it's amazing what's going on.

So we're not talking about -- we're talking about apartments that down in Austin and the DFW area that -- we heard this week that there's bidding wars for apartments in Austin, kind of like you see bidding wars for houses. So it's housing related. It's company relocation related and a lot of warehouse related type stuff. So it's just really positive right now, and we're beginning to see a real impact as a result of that on our pipeline.

**Matthew Covington Olney** ***Stephens Inc., Research Division - MD***

That's helpful, Lee. And you also mentioned earlier optimism around hiring additional new producers for the year. Is loan production from those producers you expect later on this year, is that also embedded in that 9%? Or could that be potential upside even from the current guidance?

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

I think that could be potential upside from the current guidance. We're visiting actively with different lenders and feel good that over the -- especially the first 3 quarters that we're going to land a few. And it always takes about a month for somebody to kind of get their feet on the ground and notify everybody that they've moved. But we expect -- we're hoping to get some additional lift out of loan officers that we hire. But we're not including that in our 9% because that's not something we have in place today.

**Operator**

This does conclude the question-and-answer session of today's program. I'd like to hand the program back to Lee Gibson for any further remarks.

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

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 pipeline, balance sheet, capital position, core earnings and asset quality, we're excited about the prospects for 2022 and look forward to reporting first quarter results to you during our next earnings call in April. This concludes the call. Thank you.

**Operator**

Thank you, ladies and gentlemen, for your participation in today's conference. This does conclude the program. You may now disconnect. Good day.