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Q2 2022 Southside Bancshares Inc Earnings Call

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PRESENTATION

Operator

Good day, and thank you for standing by, and welcome to the Southside Bancshares, Inc. Second Quarter 2022 Earnings Conference Call. (Operator Instructions) Please be advised that today's conference is being recorded. I would now like to hand the conference over to your speaker today, Lindsey Bailes, Vice President of Investor Relations. Please go ahead.

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

Thank you, Justin. Good morning, everyone, and welcome to Southside Bancshares Second Quarter 2022 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.

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

Good morning, everyone, and welcome to Southside Bancshares' Second Quarter Earnings Call for 2022. This morning, we reported strong financial results for the second quarter. Highlights for the quarter included earnings per share of $0.79, a return on average tangible common equity of 18.62%, annualized linked quarter loan growth of 18.3%, net of PPP, a linked quarter 8 basis point increase in the net interest margin, an efficiency ratio of 47.74% and continued strong asset quality metrics.

The linked quarter increase in our net interest margin reflected a 17 basis point increase in the average yield on loans, a 9 basis point increase in the average yield on securities partially offset by an 8 basis point increase in the average rate on our interest-bearing liabilities. We're extremely pleased with our continued strong loan growth during the second quarter of 2022. Our loan pipeline remains strong, and we are encouraged about the loan growth prospects for the second half of '22. However, I do want to point out that approximately $60 million of the second quarter loan growth may be short term and pay off prior to year-end. Given the solid outlook for the high-growth markets we serve as well as the growth occurring in our other markets, we're increasing our anticipated full year 2022 loan growth estimate net of PPP from 9% to the mid-teens.

During the quarter, as interest rates increased, we sold lower coupon mortgage-backed securities and purchased primarily higher coupon mortgage-backed securities. In addition, we purchased municipal securities, half of which had 5% coupons. We hedged approximately 72% of the municipal securities purchased during the quarter to the call date to reduce the overall duration of these securities. We have also hedged additional AFS municipal securities. Currently, approximately 30% of the par amount of our AFS municipal securities are hedged to the call date.

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 performing growth markets in the country. Rising mortgage rates and higher costs have taken some of the steam out of the highly robust single-family market, moving this market closer to the very solid pre-pandemic levels, and there continues to be a housing shortage in several Texas markets.

We continue to successfully execute our business model and what we consider to be the best state in which to operate in the country. We recently hired 2 additional seasoned lenders, one in Austin and one in Houston that should enhance overall loan growth. I want to recognize and thank the entire Southside team for their continued contributions and efforts, without which these results would not have been possible.

I look forward to answering your questions following Julie's remarks, 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're pleased to report second quarter net income of $25.4 million, an increase of $409,000 on a linked-quarter basis; and diluted earnings per common share of $0.79 for the second quarter, the $0.02 increase linked quarter. Linked quarter, net of a $10.9 million decrease in PPP loans, our loan portfolio increased $173 million to $3.96 billion driven primarily by strong growth within our real estate loan portfolio.

Our CRE loans increased $112.2 million. Construction loans increased $30.3 million, and we also experienced an increase in commercial loans of $38.7 million net of PPP on a linked-quarter basis.

The weighted average rate of new loans funded during the second quarter was approximately 4.3%. As of June 30, our PPP loans included in the commercial loan category totaled $3 million, down from $13.9 million last quarter. The average balance of PPP loans was approximately $9.4 million for the second quarter.

We continue to experience strong asset quality metrics with nonperforming assets of $11.8 million or 0.16% of total assets at June 30, consistent with the first quarter. For the 3 months ended June 30, our allowance for loan loss decreased slightly due to the reversal of provision for credit losses on loans of $112,000 recorded in the second quarter, partially offset by net recoveries of $37,000. As of June 30, our allowance for loan losses as a percentage of total loans was 0.89%. Our allowance for off-balance sheet credit exposures decreased to $1.9 million on a linked quarter basis due to a reversal of provision of $521,000 compared to provision expense of $28,000 in the prior quarter. As of June 30, our loans with oil and gas industry exposure were $154.5 million or 3.9% of total loans.

Our securities portfolio increased $276.7 million or 10.9% on a linked-quarter basis. The increase was driven by purchases in the securities portfolio that more than offset the sales of securities, principal payments and the increase in unrealized losses in the portfolio. The purchases consisted of approximately $320 million in mortgage-backed securities, $195 million in municipal bonds and $54 million combined of U.S. treasuries and corporate bonds.

During the second quarter, we transferred additional available for sale securities with fair values of $612.7 million to held to maturity. We recognized additional net losses of $2.2 million on the sale of AFS securities during the quarter. At quarter end, we had a net unrealized loss in the securities portfolio of $288.3 million compared to $103.7 million at the end of the first quarter.

As of June 30, the duration of the entire securities portfolio was 9.3 years, an increase from 8.1 years at March 31. The duration of the AFS portfolio at June 30 was 7.4 years. Our mix of loans and securities at June 30 shifted closer to 58% and 42%, respectively, from 60% and 40% on a linked-quarter basis due to the purchases in the securities portfolio more than offsetting the growth in the loan portfolio. Our deposits increased $178 million or 2.9% on a linked-quarter basis, which includes an increase in our noninterest-bearing deposits of $105.4 million or 6.5%.

In the first quarter, our Board approved a new stock repurchase plan with an authorization to purchase up to 1 million shares. During the second quarter, we purchased 223,901 shares at an average price of $39.49. Since quarter end and through July 22, we repurchased 8,613 shares at an average price of $35.93 per share.

Our net interest margin increased on a linked-quarter basis to 3.30% from 3.22% and net interest spread increased for the same period to 3.14% from 3.09%. The increase in net interest margin was primarily driven by the increase in the average yield on loans of 17 basis points and 9 basis points on the securities portfolio. Together, this resulted in a $2.1 million or 4.4% increase in net interest income for the 3 months ended June 30 when compared to the linked quarter.

We recorded approximately $268,000 in net fees related to PPP loans included in interest income this quarter compared to $569,000 last quarter. As of June 30, 2022, we had net deferred fees of $99,000 remaining to be recognized as a yield adjustment over the remaining terms of these loans. Additionally, we recorded $372,000 in purchased loan accretion this quarter.

For the 3 months ended June 30, 2022, noninterest income, excluding net loss on the sale of AFS securities, decreased $994,000 or 8.1% for the linked quarter. The decrease was driven by a nonrecurring net gain recorded on other investments of $837,000 in the prior quarter and decreases in deposit services income, mortgage servicing fee income and swap fee income, partially offset by an increase in brokerage services income.

For the second quarter, noninterest expense was $32.1 million, an increase of $911,000 or 2.9% on a linked-quarter basis due primarily to increases in salaries and employee benefits, professional fees and software expense. For the remainder of '22, we expect quarterly noninterest expense to be approximately $32.5 million.

Our fully taxable equivalent efficiency ratio decreased to 47.74% from 48.15% for the previous quarter. Income tax expense increased to $3.3 million compared to $3.1 million for the 3 months ended March 31. Our effective tax rate increased to 11.5% from 11.2% for the second quarter. At this time, we estimate an annual effective tax rate of 11.5% 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) And our next question comes from Brad Gailey.

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

It's Brady. So Southside has enjoyed a nice, healthy level of service charges for a while. I just wondered, can you update us on where you all are at as far as any changes to overdraft or NSF? And do you think that, that revenue kind of bigger picture is at risk over the next couple of years? Or do you think that we should think of it more as stable?

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

We made some adjustments earlier in the year. We're probably going to make a few more adjustments effective, I think, September 1. Yes. Right now, it's tough to tell, Brady. It just depends on what the regulatory actions are out there. But I can see that on the overdraft side that it's -- we're going to slowly see that reduce over time, but I'm not expecting it to go away by any means, but I can see it reducing a little bit over the next couple of years. We anticipated approximately 10% this year. Actually, we're a little above what we budgeted so far, and so we're going to take additional action and expect some of that revenue to come down but not substantially between now and year-end.

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

Sure. And the change we -- that Lee mentioned that we did make already was effective April 1, so that explains some of the impact that you see in that line quarter-to-quarter. It was an April 1 effective date change.

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

All right. And then if you look at the average balance sheet, bonds -- your bond portfolio has been stable to -- it was down a little bit this quarter. But how should we think about the size of the bond portfolio for the rest of the year and into next year?

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

My thought would be that assuming that loan growth continues [the bond portfolio is probably as high as you're going to see it.] (added by company after the call)

We may gradually begin to bleed some of [the portfolio] (added by company after the call) off through the mortgage-backed securities prepayment and let it become less a part of the organization. But that's dependent on the loan growth, which right now looks very good. And if that continues, like I say, we'll -- the bond portfolio is probably as high as you're going to see it.

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

Okay. And then finally for me just on your reserve. The reserve has been coming down the last year. So now at roughly 90 basis points, do you think that's, at least in terms of a percentage, do you think that's kind of hit a floor here at around 90 basis points? Do we think of that as stable? Or do you think there's more of a down...

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

I would think it's pretty stable. One of the things that brings that down some is a little over 10% of our loans are in municipal loans. And those loans have -- for the most part have alarm tax pledges, and the reserves on those are very, very small since we've not ever experienced any losses on those. So I am thinking that the reserves about from a percentage standpoint, it's where it really needs to be and should be fairly stable moving forward, absent any changes in economic conditions. And if the economic forecast worsens, then you'll see that ratio move up.

Operator

And our next question comes from Brett Rabatin from Hovde Group.

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

Wanted to first ask, you guys kind of bucked the trend a little bit with deposits this quarter being up and just wanted to kind of get a sense of the deposit flows in the quarter. Was that new account openings? Was that new or existing customers? And kind of how you think about your balances from here and then the deposit beta and how that affects the margin?

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

Yes. Some of it was new account openings. Some of it was existing customers. A portion of the interest-bearing was a little bit of a seasonal increase that will likely go away in the third quarter. But as Julie mentioned, I think it was around $105 million of that deposit increase was in noninterest-bearing. And that's new accounts, existing customers.

In terms of the deposit beta moving forward, since we're likely next week going to be into the well above 200 into that next 100 basis point tier, that third one, we're thinking the deposit beta is going to be somewhere in the 30% range. And it just really is difficult to say exactly where it's going to be, but -- and that's on all deposits. So -- because we do have approximately $575 million of those deposits are hedged at this point, and so we really don't anticipate any movement in those. And then, of course, we've got the noninterest-bearing deposits.

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

Okay. That's helpful. And then I wanted just to talk about the loan growth. And obviously, really strong loan growth in 2Q. Was any of that, Lee, you think kind of loans that were on a rate sheet that might have been a little older? Or was that all production that has certainly high rates on it? Can you talk maybe about the loan rates that you got on the production in 2Q?

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

Some of it was loans that we had set for closing in the first quarter that basically ended up closing in the second quarter. But for the most part, they were new loan closings for the second quarter. And then, of course, we have some now that are set to close in the third quarter.

In terms of the rates, that's the combined rate that they went on, and approximately half of those are probably floating rate loans, and so those floating rate loans are moving up. And we anticipate that, that average rate is going to move up here in the third quarter pretty nicely, especially with what's likely going to happen next week.

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

Okay. And then maybe just last one back on the margin. Would it be fair to assume that the margin continues to tweak up here but maybe at a slightly lower pace than the second quarter?

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

Yes. If the loan growth is -- continues at the pace we've seen, then I would think it would tweak up a little bit, but it's certainly not going to be at the pace we saw in the second quarter simply because I think the deposit beta is going to be higher than what we saw in the first and second quarters.

Operator

And our next question comes from Brad Milsaps from Piper Sandler.

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

You guys have done a good job addressing most everything. I did want to maybe follow back up on the bond portfolio, just kind of maybe the timing of some of the purchases. It looked like the average was a good bit below period end. So I'm assuming a lot of those moves kind of came late in the quarter, particularly maybe around some of the MBS. Is it safe to say that the MBS category should be up on average quite a bit from the 2Q level? I'm just curious if you guys can kind of talk about some of the timing of the moves, and then maybe also to kind of what that would mean for kind of the rates on those 3 individual buckets that you guys have, taxable, tax exempt, and MBS as we think about the third quarter.

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

Okay. Yes, the -- a lot of the MBS was purchased in June. And basically, we purchased, for the most part, mortgage pools that were 4.5s and 5s. And 5s had very little premium on them, meaning 1%, maybe 1.5% premium. And the 4.5s were purchased pretty close to par, maybe just slightly above par. But yes, I would think the -- definitely, the average balance for the MBS will be up in the third quarter.

And in terms of -- oh, okay. So the yields on the municipal side, we purchased a lot of 5s, and we also purchased some 4s and 4.5 coupons. Most of those were purchased -- some were purchased in May when rates got really high, but a lot of them were purchased in June when basically the spreads widened considerably on the municipal securities. But we did -- we took into consideration and we pretty much shortened the final maturity on a lot of the securities we purchased, and that's why when we hedged them to the call that we've taken a lot of the duration risk out of those securities. So the -- basically, as overnight SOFR rises, the cost of our hedge goes down. And based on what happens next week, the cost of the hedge should be very low starting in August. And I don't know if that helps you or gives you any color on that.

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

Yes, that does help. But I would think based on kind of the timing and such, you should see another nice lift kind of across the 3 buckets in terms of the yield that you're going to report in the third quarter. Back to kind of Brett's question, it would seem like that...

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

Yes, yes. No, that -- you are correct. You are correct. I think the securities portfolio as a whole will see a nice lift in overall yield.

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

So it should be larger on average and it should be higher yielding on average, correct?

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

That is correct.

Operator

And our next question comes from Matt Olney from Stephens Inc.

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

Wanted to circle back on the loan growth. I think you gave some good color by loan type. Any more color you can give as far as the 2Q loan growth by market? And then also would love to hear about the loan pipeline as it stands today as compared to 3 months ago.

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

Okay. A lot of the loan -- well, the loan growth occurred, I guess, primarily in 4 of the markets. It was in Austin, in East Texas, in Southeast Texas and then in Houston. The DFW market is where we saw some payoffs occur, and so that was pretty much flat there. So those are the 4 markets that we saw.

In terms of the pipeline, it's still strong. It may not be as strong as it was when we had the last earnings call, but it's still well above what we would have anticipated at the beginning of the year.

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

Okay. That's helpful. And then I guess you kind of gave us an outlook for deposit betas, but I guess just taking a step back, I would love to hear how you'd characterize the overall level of competition on both sides of the balance sheet, on both deposits and loans. Here we are in July, I would love to maybe appreciate kind of how you think it compares to what your expectations would have been a few months ago.

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

The competition on deposits is fierce, which I would have anticipated with the rates up and customers having opportunities for return in other areas. The competition for loans remains extremely competitive, but I think the thing that surprised us is the amount of really quality loans that are available in the marketplace. And so while the competition there is fierce, the amount and the total volume of those is much larger than we would have anticipated the latter part of last year.

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

And just to follow up on that last point. I know the bank has done a lot of commercial loan hirings over the last year or 2 that's producing a portion of that growth. So how much of the opportunities that you mentioned are maybe from some of the new hires versus just a really robust market?

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

Quite a bit. I would -- I don't know that I can quantify in numbers, but my guess would be that at least 1/3 of the overall loan growth has come from the new hires on the last 18 months. So it's -- they've been very successful, and they've been great new hires, and we're looking forward to the 2 new hires we've just added and what the potential there is.

Operator

And I am showing no further questions. I would now like to turn the call back over to Lee Gibson for closing 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 continued positive economic conditions in our markets, our strong loan pipeline, balance sheet, core earnings and asset quality, we are excited about the prospects for the second half of 2022 and look forward to reporting third quarter results to you during our next earnings call in October. This concludes the call. Thank you again for joining.

Operator

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