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Q3 2022 Southside Bancshares Inc Earnings Call

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CORPORATE PARTICIPANTS

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Bradley Jason Milsaps *Piper Sandler & Co., Research Division - MD & Senior Research Analyst*
Brady Matthew Gailey *Keefe, Bruyette, & Woods, Inc., Research Division - MD*

PRESENTATION

Operator

Good day, and thank you for standing by. Welcome to Southside Bancshares Inc. Third Quarter 2022 Earnings Conference Call. At this time, all participants are in a listen-only mode. After the speaker's presentation, there will be a question-and-answer session. (Operator Instructions) I would now like to hand the conference over to your speaker for today, Suni Davis, Chief Risk Officer. You may begin.

Suni Davis *Southside Bancshares, Inc. - Chief Risk Officer*

Thank you, Towanda. Good morning, everyone, and welcome to Southside Bancshares Third 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 statements are subject to risk 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 Third Quarter Earnings Call for 2022. This morning, we reported excellent financial results for the quarter. Highlights for the quarter included earnings per share of \$0.84, a return on average tangible common equity of 19.94%, annualized linked quarter loan growth of 10.1% net of PPP, a linked quarter increase of 6 basis points in our net interest margin, an efficiency ratio of 47.42%, and continued solid asset quality metrics. The linked quarter increase in our net interest margin reflected a 48 basis point increase in the average yield on loans, a 10 basis point increase in the average yield on securities, partially offset by a 40 basis point increase in the average rate on our interest-bearing liabilities.

I want to thank the entire Southside team for their continued contributions and efforts, which made these results possible. We're extremely pleased with our continued strong loan growth during the third quarter of 2022. During our second-quarter earnings call in July, we discussed the possibility that \$60 million of our second-quarter loan growth could be short-term and pay off prior to year-end. That potential payoff occurred during the third quarter. There was actually only \$35 million, with a longer-term refinance of the remaining \$25 million. Our loan pipeline remains solid, and we're encouraged by the loan growth prospects for the fourth quarter and beginning of 2023. In addition, we are seeing advances in our construction portfolio increasing as loans that closed several quarters ago are now beginning to fund.

Given the outlook for the markets we serve, we continue to estimate loan growth for 2022, net of PPP loans in the mid-teens. During the quarter, as interest rates increased, we hedged additional available-for-sale municipal securities for the call date to reduce the overall fair value volatility. Currently, approximately 2/3 of the par amount of our AFS municipal securities are hedged to the call date. The economic conditions in our markets remain solid, bolstered by continued company relocations and existing company expansions combined with population growth, a result of continued migration from other states. Rising mortgage rates and high costs have continued to take some of the steam out of the highly robust single-family market, moving this market closer to pre-pandemic course.

However, housing shortages continue to exist in several Texas markets. We continue to successfully execute on our business model and what we consider to be the best state in the country in which to operate. 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 are pleased to report third-quarter net income of \$27 million, an increase of \$1.5 million on a linked-quarter basis, and diluted earnings per common share of \$0.84, a \$0.05 increase linked quarter. Our loan portfolio increased \$103.1 million to \$4.06 billion linked quarter, net of the \$2.7 million decrease in PPP loans. The increase was driven primarily by strong growth within our real estate loan portfolio. Our CRE loans increased \$67.2 million, construction loans increased \$33.9 million, and we also experienced an increase in commercial loans with \$7.2 million net of PPP on a linked-quarter basis.

The weighted average rate of new loans spent during the quarter was approximately 5.2%. As of September 30, our PPP loans included in the commercial loan category totaled \$306,000, down from \$3 million last quarter. The average balance of PPP loans was approximately \$2.5 million for the third quarter. We continue to experience strong asset quality metrics with nonperforming assets of \$11.7 million or 0.16% of total assets at September 30, consistent with last quarter. For the 3 months ended September 30, our allowance for loan loss increased due to the provision for credit losses on loans of \$1.3 million recorded in the third quarter, partially offset by net charge-offs of \$237,000. As of September 30, our allowance for loan losses as a percentage of total loans was 0.90%. Our allowance for off-balance sheet credit exposures increased to \$2.1 million on a linked-quarter basis due to a provision of \$200,000 compared to a reversal of provision expense of \$521,000 in the last quarter. As of September 30, our loans with oil and gas industry exposure were \$117.5 million or 2.9% of total loans.

Our securities portfolio decreased \$241.3 million or 8.6% on a linked-quarter basis. The decrease was driven by sales of securities, principal payments and the increase in unrealized losses in the portfolio. During the third quarter, we transferred additional available-for-sale securities with fair values of \$70.2 million to hold to maturity. And subsequent to September 30, we transferred additional AFS securities to HTM with fair values of \$175.8 million. We recognized additional net losses of \$99,000 on the sale of AFS securities during the quarter. At quarter end, we had a net unrealized loss in the AFS securities portfolio of \$168.3 million compared to \$83 million last quarter, an increase of \$85.3 million. As Lee mentioned in his remarks, during the third quarter, we hedged additional AFS municipal securities. And as of September 30, the unrealized gain on the hedged securities was approximately \$24 million, partially offsetting the additional unrealized losses in the AFS securities portfolio.

As of September 30, the duration of the entire securities portfolio was 10.8 years, an increase from 9.3 years at June 30. The duration of the AFS portfolio at September 30 was 9.6 years. Our mix of loans and securities at September 30 was 61% and 39%, respectively, compared to 58% and 42% on a linked-quarter basis due to growth in the loan portfolio, a decrease in the securities portfolio, combined with the decrease in the sum of total loans and securities. Our deposits decreased \$67.3 million or 1.1% on a linked-quarter basis. The linked-quarter decrease in deposits consisted of a decrease in interest-bearing deposits of \$91.7 million, partially offset by an increase in noninterest-bearing deposits of \$24.4 million. Our tax equivalent net interest margin increased on a linked-quarter basis to 3.36% from 3.30%, while the tax equivalent net interest spread decreased for the same period to 3.08% from 3.14%.

The increase in net interest margin was primarily driven by the increase in the average yield on loans of 48 basis points and 10 basis points on the securities portfolio. Together, this resulted in a \$4.4 million or 8.7% increase in net interest income for the 3 months ended September 30 when compared to the linked quarter. We recorded approximately \$89,000 in net fees related to PPP loans this quarter compared to \$268,000 last quarter. We also recorded \$141,000 in purchased loan accretion this quarter. For the 3 months ended September 30, 2022, noninterest income, excluding net loss on the sale of AFS securities, decreased \$906,000 or 8% for the linked quarter. The decrease was driven primarily by decreases in deposit services income and brokerage services income. For the third quarter, noninterest expense was \$33.5 million, an increase of \$1.4 million or 4.2% on a linked-quarter basis due primarily to increases in salaries and employee benefits and professional fees. For the remainder of 2022, we expect the quarterly noninterest expenses to be approximately \$32.5 million.

Our fully taxable equivalent efficiency ratio decreased to 47.42% from 47.74% for the previous quarter. Income tax expense increased to \$3.9 million compared to \$3.3 million for the 3 months ended June 30. Our effective tax rate increased to 12.6% for the third quarter from 11.5% last quarter. At this time, we estimate an annual effective tax rate of 11.8% 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

Thank you. (Operator Instructions) Please stand by while we combine the Q&A roster. Our first question comes from the line of Brad Milsaps with Piper Sandler.

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

Lee, I may have overestimated maybe the size of the bond portfolio for the quarter. Can you kind of help me understand maybe where the averages are headed? I think they were closer to \$2.9 billion for the quarter versus the period end was a little over \$2.5 billion. I know one's presented at fair value, and the other is presented at cost. So I just wanted to make sure you had a lot of movement in the quarter. So can you help me kind of get a feel for directionally kind of which way the average bond portfolio is headed over the next several quarters in your mind?

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

I think, Brad, we indicated we weren't going to increase the securities portfolio. So I would say that the average should stay somewhere close to that. It may vary \$50 million one way or another. But there's some good opportunities to reinvest a roll-off at this point in time. So I anticipate doing some of that. But I don't really look for a major change as long as we continue to have the loan growth that we're having. And Brad, when we talk about the average, I'm looking at the average balance. The balance is back on Page 14 of the earnings release for the 3 months of September 30, which is right at \$29 million -- not \$29 million, \$2.9 billion. Let me get the numbers right. I'm sorry.

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

So the difference, I mean, you ended the quarter with just under \$2.6 billion. So some of that is obviously the loss, but it feels like the average should come down some, too, because you feel like you sold some bonds as well. But just want to make sure we're on the same page.

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

And we did sell some bonds, but it was only maybe \$15 million, \$20 million in bonds, I think. Julie is looking at me.

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

And it looked like your loan beta was kind of a mid-30s for the quarter. It did sound like you're putting on new loans around 520, if I heard it correctly, which seemed maybe a little low, maybe relative to where rates are, but I just wanted to ask, do you expect loan yield to continue to kind of move up at a similar pace as you saw in the third quarter? Or does that kind of 520 new loan yield put maybe a little bit of a governor on that? It could have been something just with the mix this quarter, but just kind of curious how you're thinking about the loan betas.

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

Right. I think we're looking at something similar for the fourth quarter. And that average loan yield at the time they went on may be skewed a little bit because, for those that flow either overnight or every 30 days, those put on in July didn't take into consideration some of the later Fed increases. So probably, if we look at the real average rate, and we took the real floating rates, it may be a little bit higher, if that makes sense.

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

Yes. So yes, obviously, yes, kind of skewed by the mix, yes, I totally understand. Okay, great. I'll hop back in the queue.

Operator

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

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

So 10% linked quarter annualized loan growth this quarter, if I put you at around 10% next quarter, that will hit the mid-teens guidance for this year. So how are we thinking about next year? I know the outlook is uncertain as far as what the economy is going to do, but is it right to think about maybe a step down in loan growth, something in the high single-digit level? Or how are you thinking about loan growth in the next year?

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

We'll have a better feel for that. I'd be surprised if it's what it was this year. So I think either high single digits or maybe low double digits is probably where we'll land, but that's something really that as this quarter progresses a little further, we'll have a better idea on, looking at the pipeline that's out there and then getting a better feel for how these construction loans are going to fund.

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

And then the guidance for expenses for 4Q of \$32.5 million, that's about \$1 million step down from 3Q. Is that mostly in the compensation line? And any color you can provide on that?

Julie N. Shamburger Southside Bancshares, Inc. - CFO

Yes. On salaries, of course, was the largest increase in employee benefits. And around 2/3 of that increase of \$1.039 million was in health expenses. I mean, obviously, health expense can do anything. We are self-insured. We are under last year's year-to-date on health claims, and we're also under budget. I mean -- but more importantly, we're under last year's year-to-date. So Brady, that could happen again, but that's not what's budgeted. So that's part of the reason for me keeping it really where I had it for the third quarter. And then we had some increase there in professional fees. And at least I think professional fees were up about \$265,000, and at least \$100,000 of that related specifically to a project that we worked on with legal. And so that will not occur again. So that is the budget for \$32.5 million. So that was my reason for that. I was tempted to increase it, but I don't really have a basis for doing so at the moment.

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

Yes. The project was something we decided not to move forward on. It wasn't a lawsuit or anything like that.

Operator

I'm shown no further questions in the queue. 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, we're excited about the prospects for the fourth quarter and look forward to reporting those results to you during our next earnings call in January. This concludes the call. Thank you.

Operator

Ladies and gentlemen, this concludes today's conference call. Thank you for your participation. You may now disconnect.

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