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Q4 2022 Southside Bancshares Inc Earnings Call

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CORPORATE PARTICIPANTS

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

CONFERENCE CALL PARTICIPANTS

Bradley Jason Milsaps *Piper Sandler & Co., Research Division - MD & Senior Research Analyst*
William Bradford Jones *Keefe, Bruyette, & Woods, Inc., Research Division - Research Analyst*

PRESENTATION

Operator

Good day, and thank you for standing by, and welcome to Southside Bancshares Inc. Fourth Quarter and Year-End 2022 Earnings 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 Investor Relations. Please go ahead.

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

Thank you, Justin. Good morning, everyone, and welcome to Southside Bancshares' Fourth Quarter and Year-end 2022 Earnings Call. A transcript of today's call will be posted on southside.com under Investor Relations.

During today's call and other disclosures and presentations, I will remind you that any forward-looking statements are subject to risks and uncertainties. Factors that could materially change our current forward-looking assumptions are described in our earnings release and our Form 10-K.

Joining me today are Lee Gibson, President and CEO; and Julie Shamburger, CFO. First, Lee will share his comments on the quarter, 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' Fourth Quarter and Year-end Earnings Call for 2022.

This morning, we reported excellent fourth quarter and annual results for 2022. Highlights for the quarter included earnings per share of $0.87, a return on average assets of 1.47%, a return on average tangible common equity of 21.35%, annualized linked quarter loan growth of 8.2%, a linked quarter 4 basis point increase in our net interest margin, an efficiency ratio of 46.38%, and continued strong asset quality metrics.

During 2022 loans, net of PPP loans, increased 14.8% or $533.5 million. The net interest margin increased 16 basis points and the efficiency ratio decreased to 47.39%. 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 solid loan growth during the fourth quarter of 2022.

Our loan pipeline, while not currently as strong as it was this time last year, remains solid and we are encouraged by the loan growth prospects for 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 are budgeting for 9% loan growth during 2023.

As previously mentioned, approximately $743 million of our available-for-sale municipal securities are hedged to the call date, with fair value swaps designed to reduce the overall fair value volatility of these securities. During the fourth quarter, this $743 million of fair value swaps began producing net interest income as the overnight SOFR rate we received increased above the average fixed rate we pay. This was largely responsible for the linked quarter 31 basis point increase in the average yield on our tax-exempt municipal securities.

In the month of December, we recorded approximately $645,000 of net interest income related to these swaps. During January 2023, we expect the net interest income associated with these swaps will increase to reflect the full effect of the mid-December increase in overnight SOFR, resulting from the increase in the federal funds rate. Should the Federal Reserve further increase the Fed funds rate, we would anticipate a further increase in net interest income from these fair value swaps.

Conversely, should the Federal Reserve at some point decrease the federal funds rate, net interest income associated with these fair value swaps would decline, at which time we would likely unwind some or all of these fair value swaps.

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. The combination of increased mortgage rates and high building costs has resulted in reduced housing starts and decreased margins, moving this market closer to pre-pandemic levels. We look forward to successfully executing on our business model in 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 a solid fourth quarter to end a strong year with 2022 net income of $105 million and diluted earnings per common share of $3.26. For the fourth quarter, we reported net income of $27.7 million, an increase of $717,000 on linked-quarter basis, and diluted earnings per common share of $0.87, a $0.03 increase linked quarter.

For 2022, we reported record organic loan growth of $533.5 million, excluding PPP loans, a 14.8% increase from 2021. This was driven by our real estate portfolio with increases of $389.5 million in CRE, $111.8 million in construction and $12.4 million in 1-4 family residential. Additionally, we had a $24 million increase in commercial loans, excluding PPP.

Our loan portfolio increased $84.2 million to $4.15 billion linked quarter. The increase was driven primarily by strong growth within our commercial real estate loan portfolio with an increase of $85.8 million on a linked-quarter basis. The weighted average rate of new loans funded during the quarter was approximately 6.4%.

We continue to experience strong asset quality metrics with nonperforming assets of $10.9 million or 0.14% of total assets at December 31, a decrease of $855,000 linked quarter. As of December 31, our allowance for loan losses as a percentage of total loans was 0.88% compared to 0.90% at September 30. Our allowance for off-balance sheet credit exposures increased to $3.7 million on a linked-quarter basis due to a provision of $1.6 million compared to $200,000 in the last quarter. As of December 31, our loans with oil and gas industry exposure were $111.3 million or 2.7% of total loans.

Our securities portfolio increased $50 million or 1.9% on a linked-quarter basis. The increase was driven by a decrease in unrealized losses in the portfolio and to a lesser extent, purchases of securities. During the fourth quarter, we transferred additional available for shelf securities with fair values of $175.8 million to held to maturity.

At December 31, we had a net unrealized loss in the AFS securities portfolio of $88.9 million compared to $168.3 million last quarter, a decrease of $79.5 million. As of December 31, the unrealized gain on the hedged securities was approximately $21.6 million, partially offsetting the additional unrealized losses in the AFS securities portfolio. As of December 31, the duration in the entire securities portfolio was 10.7 years and the duration of the AFS portfolio was 9.3 years.

Our mix of loans and securities remained consistent on a linked-quarter basis at 61% and 39%, respectively. Our deposits increased $16.9 million or 0.3% on a linked-quarter basis. The linked quarter increase in deposits was due primarily to an increase in our public fund deposits, partially offset by a decrease in broker deposits.

During the fourth quarter, we increased our stock repurchase plan authorization by 1 million shares. We purchased 608,976 shares during the fourth quarter at an average price per share of $35.03. Since year-end and through January 24 2023, and we have purchased 141,053 shares at an average price of $35.73.

Our tax equivalent net interest margin increased on a linked-quarter basis to 3.40% from 3.36%, driven by the increase in the average yield on loans of 54 basis points and 21 basis points on the securities portfolio, partially offset by an increase in the average yield on interest-bearing liabilities of 56 basis points.

The tax equivalent net interest spread decreased for the same period to 2.95% from 3.08%. For the 3 months ended December 31, net interest income increased $1.3 million or 2.4% compared to the linked quarter. We also recorded $55,000 in purchased loan accretion this quarter.

For the 3 months ended December 31, 2022, noninterest income, excluding net loss on the sale of AFS securities, increased $398,000 or 3.8% for the linked quarter. The increase was driven primarily by increases in deposit services income, trust income and swap fee income included in other noninterest income.

For the same 3-month period, noninterest expense was $33.6 million, a slight increase from the prior quarter. For 2023, we have budgeted approximately $35.5 million in noninterest expense each quarter. The increase in the budgeted expense is primarily due to increases in salary expense, software expense and the nonservice component of our frozen retirement and restoration plan expense.

Our fully taxable equivalent efficiency ratio at December 31 decreased to 46.38% from 47.42% as of September 30, driven by the increase in net interest income. Income tax expense increased to $4.3 million compared to $3.9 million for the 3 months ended September 30. Our effective tax rate increased to 13.4% for the fourth quarter from 12.6% in the previous quarter. At this time, we estimate an annual effective tax rate of 12.8% for 2023.

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 first question comes from Will Jones from KBW.

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

So Lee, I just wanted to unpack this swap contract you guys have that's coming on and going to start benefiting you guys. So you're receiving variable but paying fixed. What is the fixed rate that you guys are paying? Or I guess the better question is, what is like the net pickup in yield that you received from this favorable swap contract?

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

When you say the favorable yield increase it would -- okay, I'm not sure I understand that part of the question, but -- basically, we have probably somewhere between 20 and 30 of these swaps. Sorry, we have 84. We started putting these on, I think, back in April, of 2022 and the last one we put on was in early October. So each one of them have fixed rates that we're paying that are different. Obviously, the last ones we put on had the highest fixed rate. And at this point in time, I think almost all of them we're in a positive position on. And that's the reason, basically, November was the first time we saw it turn positive, where we actually had net interest income and then it jumped to that $645,000 in December. And there was a 50 basis point increase in SOFR which corresponded with the increase in Fed funds but that was mid-December. So we anticipate the rest of that increase in that net interest income will occur in January. And then should the Fed increase 25 basis points or whatever the amount is in February, then we'll continue to see increases.

So at this point, roughly that amount of our tax-free municipal securities are almost acting like a floating rate security at this point in time. And for the quarter, it had a 31 basis point increase are reflective of 31 basis point increase in our yield on our taxable municipal -- excuse me, tax-free municipal securities. So does that answer...

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

Yes. No, that was very helpful. Yes. Very helpful, thank you for walking through that. And I'd imagine just with the majority of those being in a positive position that you would have a relatively sizable gain if you were to sell the swaps?

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

We do have an overall gain in the swaps right now. It was $21 million at year-end. And it changes based on the -- what happens with the longer-term rates because these are swapped to the call date of the municipal securities. And I can give you the -- they handed me the average fixed rate of our coupon that we are paying is 3.21%.

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

Okay. Great. That's perfect. Yes, that's what I was looking for really. Great. That's very helpful. Okay. So then as we think about just the story of the margin as we move into 2023, you still saw a little bit of expansion this quarter. I mean the deposit costs are ticking up a little bit. Do you feel like you still have leverage on the asset pricing side, maybe to combat some of this accelerated or continuing deposit pressure. So maybe we see the margin flatten out and just hold the line for the remainder of the year? Probably there isn't expansion left. Do you feel like this quarter was a peak? Just any commentary around the margin would be great.

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

Sure. On loans, we do -- we have a fair amount of floating rate loans, I think, 46%, something like that of our loans float. The new fixed rate loans that we are putting on, for the most part, I'd say in the 6% is somewhere probably closer to 6.5. And then with the -- this almost $0.75 billion in tax exempt investment securities that float, that's going to help offset some of that, but we are seeing pressure on the deposit side, all the funding side.

And so we feel like the beta there is probably going to be somewhere between 30% and 35% going forward. Margin, I think we stay where we are, plus or minus 5 to 6 basis points, somewhere in that range. And simply because if the future Fed funds increases are in -- not in 75 basis point increments, then I think there isn't going to be as much pressure moving forward to up those rates as significantly as when it was when it was 75 basis points. But I do think that we're going to continue to see a lot of pressure. Pricing for deposits is extremely competitive. I'm sure that don't come as any surprise. And so we're -- there's no exception here at Southside to that.

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

You're definitely not alone there. Just to clarify, that 30% to 35% deposit beta, is that interest-bearing deposits or total deposits?

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

That would be -- I'm thinking it's interest-bearing deposits is what we're looking at, at this point in time.

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

Awesome. Great. And then last one, if I could just sneak one last one in here. Just what's the messaging on the buyback going forward? I mean it's been notable for you guys this past quarter. What's your further appetite here?

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

At this point, we'll see how we work through the current allocation. And if the price is at such a point that we think it's appropriate for us to expand the buyback, we will at that time.

Operator

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

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

We're just curious, like some other banks, it looked like the period end balance of Federal Home Loan Bank advances were up maybe double or so over the average. Just are those mostly overnight and -- overnight advances. And would that be something you might likely lean into to the extent deposit funding doesn't come through? Just kind of trying to think about how you want to fund your 9% loan growth target? Does -- do you plan to stay levered and keep the bond book where it is? Or hopefully, you can grow the deposits to do both, but just any color there would be helpful.

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

Sure. Last year, in 2022, we were able to get some favorable pricing in the broker deposits, money market environment, and we replaced for our cash flow swaps, and we replaced a lot of the Home Loan Bank. In fact, I think at one point, we had all of it replaced with the Home Loan Bank. Now that has flipped. And so at this point in time, the more favorable funding is at the Home Loan Bank. So what you're seeing there is mostly a flip from broker deposits to cover those cash flow swaps into the Home Loan Bank advances.

At this point in time, we did have $30 million that rolled off in the first quarter of cash flow swaps, and I'm looking at our funding person to make sure. Okay. 25 -- excuse me, $25 million. So we're down to about $350 million in those cash flow swaps. So when you take a look -- excuse me, $550 million in those cash flow swaps. So when you look at our broker deposits and when you look at our Home Loan Bank advances. I think it's important to note that $550 million of that is basically fixed pricing on that. But we do have some overnight funding at Home Loan Bank at this point in time simply because it's one of the cheaper places to go to get additional wholesale funding. Is that clear?

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

Yes, yes. Well, I have those numbers in the queue. Like you're paying like 113 basis points on those on those -- on the $575 million. Is that correct?

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

That was correct at year-end.

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

Or 9/30 -- at September 30. Yes.

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

Yes. And so the one that rolled off, I think, was at 140 something -- somewhere in that range. We'll find it and let you know.

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

Okay. Great. And then just on your loan growth, I mean, 9%, maybe that was a touch higher than maybe I expected given kind of what's going on in the market. But it sounds like you've got a number of construction projects that you planned -- that you plan on funding up. Anything else in there is kind of a big driver in any new lenders? Just trying to kind of get a better sense of what's kind of driving your loan growth target.

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

We do have some new lenders and some of the lenders that came on in '21, even '20 and '21 are really hitting their own. In Houston, approximately $300 million of our loan growth this year was in Houston. And as you know, we opened an LPO down there in early 2020. And they weren't able to do much with the pandemic, but they really come into their own in 2022. And then one of the other lenders or 2 of the other lenders that we hired had relationships in Houston as well. So we're anticipating that that's going to continue at this point in time.

We're not expecting that 14.8% loan growth. But at this point in time, we feel like 9% is achievable. And if that changes, we will update that on future quarterly calls.

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

Got it. And then just a follow-up on my first question, we kind of got bogged down there in the swap talk. But the 9% loan growth target, do you think you can fund that with deposits or aside on what's going on with swapping back and forth between brokered and FHLB, but do you anticipate bringing the bond book down? Or just kind of just some way to think about the size of the balance sheet and kind of how you plan to fund it?

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

We could bring the bond portfolio down some. There's probably, depending on what happens to long-term rates, limit on what we'd be willing to do there, but we could probably fairly easily fund 1/4 of that loan growth by reducing the bond portfolio. We are anticipating some deposit growth. It's not going to be cheap if it's interest-bearing deposits, but we are looking at some other opportunities to be able to fund. But if -- whatever the balance is that we don't have, we would look to the broker market or to the Home Loan Bank, advances market, whichever was the better course for us to take for that additional funding.

Operator

(Operator Instructions) And our next question comes from Brett Rabatin from Hovde Group.

Unidentified Analyst

This is Brian for Brett. Could you just provide a little color on the remaining maturity profile of the securities book there? What do you have maturing in the short term?

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

Yes, maturing in the short term. I know we have monthly amounts that come off the mortgage portfolio. They're not huge. I think we've got about $11 million or $12 million MBS pool that matures in March, and it's at a fairly low rate. Other than that, and then we have probably about $18 million to $20 million in municipals that while they're not going to mature, they will come up on their call dates and that have 4% or higher coupons. And if they don't mature, we're going to see a nice pickup in yield on that. In terms of what's coming off on the MBS portfolio, it's probably about $2 million to $3 million a month, somewhere in that range.

Unidentified Analyst

Great. That's really helpful. And then one more, if I could. Just wanted to get your thoughts on CRE. Are you planning on doing any sort of credit review on that book? And then also wanted to get your thoughts on office space as well.

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

Okay. In terms of credit reviews on CRE, really what we do, probably every 6 months or so, and we just did one in the fall. So we'll have one coming up probably here in the spring, early spring. We go through and we take a look at all the credits above a certain dollar amount, and I believe that dollar amounts $5 million. So we get an update from the office on just about everything and take a look at what the -- their average rents are, the vacancy rates, things of that nature, just see if there have been any changes and then any changes in the financial condition of the borrower. So that's something we do at least twice a year, and it's not just limited to CRE, but it's all of our credits.

In terms of office, we're extremely careful on office. I'm not saying we don't make office loans, but we look at the quality of the tenants that are in there. We look at how long they are tied up for when those leases come due. And those typically require a fair amount of equity going in, and we look for really solid debt service coverage ratio. So office is not probably at the top of our list right now, but it's -- there are some good office loans out there to make. You just have to be very selective and make sure that the borrower is somebody that has a lot of familiarity and experience in that area and that the tenant role is such that you feel like for the life of the loan, you're in pretty good shape. So those we look at extra hard.

Operator

And I am showing no further questions. I would now like to turn the call back over to Lee Gibson, President and CEO, for closing remarks.

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

All right. Thank you very much to everyone for joining us today. We appreciate the opportunity to answer your questions along with your interest in Southside Bancshares. In closing, we're excited about our prospects for 2023 and look forward to reporting first quarter results to you during our next earnings call in April.

This concludes the call. Thank you again.

Operator

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