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SBSI - Q1 2018 Southside Bancshares Inc Earnings Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Southside Bancshares Inc. First Quarter 2018 Earnings Call. (Operator Instructions) Also, as a reminder, this conference call is being recorded.

I would now like to turn the call over to your host, Suni Davis, Senior Vice President and Chief Risk Officer. Please go ahead.

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

Thank you, Delim. Good morning, everyone, and thank you for joining Southside Bancshares First Quarter 2018 Earnings Call. The purpose of this call is to discuss the company's results for the quarter as well as our outlook for upcoming quarters. 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 made are subject to risks and uncertainties. Factors that could materially change our current forward-looking assumptions are described in our earnings release and in our Form 10-K.

Joining me today to review Southside Bancshares First Quarter 2018 Results are Lee Gibson, President and CEO; and Julie Shamburger, Senior EVP and CFO.

Our agenda today is as follows: First, you'll hear Julie discuss an overview of financial results for the quarter, including loan activity, asset quality and update on our securities portfolio and noninterest expense items for the quarter. Then, Lee will share his comments on the quarter, including the core conversion completed over the weekend to integrate Diboll State Bancshares Inc. as a result of the November 30, 2017, merger.

I will now turn the call over to Julie.

Julie N. Shamburger - *Southside Bancshares, Inc. - Senior EVP & CFO*

Thank you, Suni. Good morning, everyone, and welcome to Southside Bancshares First Quarter 2018 Earnings Call. We reported first quarter net income of $16.3 million compared to first quarter 2017 net income of $15 million, an 8.4% increase. Our diluted earnings per share for the first quarter ended March 31, 2018, were $0.46 per share, a decrease of $0.05 or 9.8% compared to $0.51 per share for the same period last year.

During the first quarter, we experienced only a slight increase in total loans of $15.3 million on a linked-quarter basis due to higher-than-anticipated payoffs. When compared to March 31, 2017, total loans increased by $770.7 million or 30.4%. Approximately $621.3 million of the annual growth was a result of loans acquired in the acquisition of Diboll State Bancshares last quarter.

At March 31, 2017, our loans with oil and gas industry exposure remain minimal at 1.66% of our total loan portfolio. We recorded loan loss provision expense during the first quarter of $3.7 million, an increase of $2.5 million compared to provision expense recorded in the fourth quarter. As reported earlier today in our earnings release, the higher first quarter provision expense was a result of 2 commercial real estate loan relationships that were placed on nonaccrual status.

Nonperforming assets increased to $42.4 million or 0.67% of total assets during the quarter ended March 31, 2018, an increase of $32 million compared to $10.5 million or 0.16% of total assets at December 31, 2017, and $14.1 million or 0.25% at March 31, 2017.

Next, for a brief update on our securities portfolio. On a linked-quarter basis, the size of the securities portfolio decreased $220.1 million during the first quarter, primarily due to the sales of lower-yielding CMOs and lower-yielding short-duration agency debentures. The duration of the securities portfolio at March 31, 2018, increased to 5.3 years from 4.8 years at December 31, 2017, due primarily to the sale of the agency debentures.

At March 31, 2018, we had a net unrealized loss in the securities portfolio of $48.6 million. Primarily as a result of the decrease in the securities portfolio this quarter and the loans acquired last quarter, the mix of our loans and securities increased to a 60/40 mix compared to a 57/43 mix at year-end, and a 52/48 percent mix at March 31, 2017, moving closer to our long-range goal of 70/30.

During the first quarter, our net interest margin increased 7 basis points to 3.19% and our net interest spread increased 4 basis points to 2.95% on a linked-quarter basis. The increase in both the net interest margin and spread were primarily a result of the full quarter of purchase loan accretion from the Diboll portfolio, which positively impacted the average yield on our earning assets.

We recorded $1.2 million of loan accretion this quarter, higher than we expect on a recurring basis due to the early payoff of 3 purchase impaired loans, resulting in approximately $329,000 of accretion.

January 1, we adopted the accounting standard related to revenue recognition. In connection with the adoption of this guidance, we netted debit card expense of $796,000 previously included in ATM and debit card expense with deposit services income. And we also netted brokerage service expense of $151,000 previously included in other noninterest expense with brokerage services income. Due to the guidance under the modified retrospective method, prior periods have not been adjusted and are not comparable.

During the 3 months ended March 31, 2018, our noninterest expense increased $1.7 million or 5.8% on a linked-quarter basis, primarily due to a full quarter of operational expenses associated with our acquisition late in the fourth quarter of 2017 and several other expense items recorded in the first quarter.

These additional expenses include acquisition expense of $832,000 in connection with our acquisition last quarter consisting of $652,000 of change in control, payment accruals and severance payments; and the remaining $180,000 included additional professional fees. We also paid one-time $1,000 bonuses to certain employees in response to the benefits received from the Tax Cuts and Jobs Act totaling $744,000, $249,000 of cost related to the close of a grocery store branch within very close proximity of the branch acquired in the Diboll acquisition, and $827,000 of losses on the sale of securities in the first quarter.

Our amortization expense increased due to the additional intangible assets recorded last quarter in connection with the acquisition and a full quarter of amortization compared to only 1 month recorded in the fourth quarter related to the additional intangible assets.

On a linked-quarter basis, our efficiency ratio increased for the 3 months ended March 31, 2018, up 1.86% to 51.28% for the first quarter of 2018 from 49.42% for the quarter ended December 31, 2017, and decreased from 51.60% for the quarter ended March 31, 2017. We expect to see additional efficiencies in future quarters as we complete the integration in Diboll.

The effective tax rate for the first quarter of 2018 was 11.4%. We recorded a discrete tax credit of $88,000 associated with equity awards that decreased the rate by 48 basis points. At this point, we expect an effective tax rate for 2018 of approximately 12%.

Thank you very much, and I will now turn the call over to Lee.

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

Thank you, Julie. Overall, we experienced a good first quarter. Our net interest margin increased 7 basis points and our efficiency ratio decreased compared to the first quarter of 2017, despite the significant reduction in the corporate tax rate that negatively impacted both.

As Julie reported, provision expense and nonperforming loans increased during the first quarter. This was driven by 2 commercial real estate loan relationships, one of which was an acquired loan relationship in our 2014 acquisition. We are not wavering on our underwriting standards, and we believe our asset quality remains solid.

This last weekend, we completed the core conversion related to the Diboll State Bancshares acquisition. We are pleased at how smooth and seamless the integration has gone. With the integration now virtually complete, we expect to realize additional synergies and cost savings. Diboll's outstanding acquired deposit franchise was a significant factor in the linked-quarter improvement in net interest margin and spread.

The decrease in the securities portfolio during the first quarter, mostly to sale of lower-yielding securities, provides additional balance sheet flexibility in this higher interest rate environment. This additional flexibility and the resulting increase in loans as a percentage of earning assets to 60%, combined with the Diboll-acquired core deposit franchise, should enhance our future NIM prospects as the anticipated Fed interest rate increases occur.

We will continue to focus on cost containment and process improvement in an effort to further improve our efficiency ratio. At this point, we believe the 2 areas that will yield the greatest future efficiencies are further process automation and continued rightsizing of our branches.

Economic conditions in the Texas markets we serve remain healthy. The Austin and DFW markets, fueled primarily by ongoing job growth and company relocations, continued to perform exceptionally well. We are excited about our prospects for 2018 given the completed integration of the newly-acquired balance sheet, benefits associated with reduced corporate tax rates, the dynamic markets we serve, our solid balance sheet, strong capital position and outstanding team members.

At this time, we will conclude the prepared remarks and open the lines for your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Brett Rabatin of Piper Jaffray.

Brett D. Rabatin - *Piper Jaffray Companies, Research Division - Senior Research Analyst*

Wanted to, I guess, first ask on the one credit that was memory care related. Is the weakness there a function of Medicaid? Or can you give us any color on kind of what happened with that credit?

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

They basically -- the 2 facilities just have not leased up as anticipated. They are continuing to lease up, but they're not at the stage where they thought they'd be at this point in time. So we felt it appropriate to go ahead and place them on nonaccrual and put some reserve against them. But they are continuing to show some improvement on a quarterly basis, and that's why we said we'd reevaluate that on a quarterly basis.

Brett D. Rabatin - *Piper Jaffray Companies, Research Division - Senior Research Analyst*

Okay. And then I'm just curious, you obviously had higher payoffs than you expected this quarter and that kind of affected the loan growth. Can you talk maybe a little more, Lee, about the pipeline? And just -- you've been a faster growth bank here the past year, is that still on track? What might you give for guidance for loan growth kind of on an updated basis?

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

Our pipeline looks healthy. The issue is we continue to see some payoffs that are going to be coming down the road in the next several quarters. Some of the construction projects have completed and some of those are going on the market. So the pipeline is healthy, but we do anticipate some further drag as a result of payoffs.

Brett D. Rabatin - *Piper Jaffray Companies, Research Division - Senior Research Analyst*

Okay. So if I'm thinking about growth for the year, is mid-single digit appropriate or is that going to be tough given the level of payoffs you're expecting?

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

I'd like to think that the mid-single digit is still achievable. Instead of 7, it may be closer to 5. But we do have a healthy pipeline. We do have some construction loans that are going to continue -- starting to fund up right now. So there are a lot of positive things that are happening and it really just depends, Brett, on the level of payoffs that we see during the year.

Operator

Our next question comes from Brad Milsaps of Sandler O'Neill.

Bradley Jason Milsaps - *Sandler O'Neill + Partners, L.P., Research Division - MD of Equity Research*

Julie, just maybe on the expenses. I know it sounds like there are a lot of moving parts this quarter between the reclass and some of the fees and expenses. Can you kind of just -- you mentioned the additional synergies, maybe in dollars, can you talk about where you think expenses will sort of run over the near term?

Julie N. Shamburger - *Southside Bancshares, Inc. - Senior EVP & CFO*

Well, if we look at the reclasses that we had, we had estimated around 32 for the run rate. And if you take all the noise out, we would come out about 30. And with the reclass, the expenses that we reclassed that to deposit services income that I mentioned, we would have been around $30,789,000. And that include the onetime bonuses that was around $744,000 and a branch closure, so right there is $1 million. We're thinking -- we talked a little bit about that yesterday, 30 to 31, probably. And we would expect it to go down further as the year progresses, probably more in the third quarter even. We'll have some expense related this next -- in the second quarter probably to conversion, additional travel and dissolve the expenses that come along with that function. So we're thinking somewhere in the 30.8 range to 31 probably.

Bradley Jason Milsaps - *Sandler O'Neill + Partners, L.P., Research Division - MD of Equity Research*

Okay. That's helpful. And I was writing quickly during your kind of discussion of all the movement in the balance sheet with the bond portfolio. Can you give us some -- maybe a little additional color, and I apologize if I missed this, kind of what drove the big change between the available for sale and the held at maturity? It looks like you kind of swap one for the other. Just kind of walk us through kind of what you're thinking there and kind of the relative size of that bond portfolio? It sounds like you want to continue to bring that down, but always try to get all the moving part straight with that.

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

Right. There was a new accounting pronouncement that allowed us to transfer some things -- transfer anything out of HTM that we wanted to AFS. And we felt like with the changing interest rate environment, it made sense for us to move some of -- a lot of those items out of HTM to AFS so that we can restructure the securities portfolio as we deem appropriate in this higher interest rate environment right now. So that's what drove that. And basically, we transferred 700 -- about $740 million in securities out of HTM to -- and they were all callable securities, out of HTM to AFS.

Bradley Jason Milsaps - *Sandler O'Neill + Partners, L.P., Research Division - MD of Equity Research*

Got it. Would you anticipate you would have more kind of wholesale restructuring going on over the next couple of quarters? Or is it just kind of a more wait and see and you have the flexibility to get the right environment arises?

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

Yes. I think it's more of a wait and see in case -- depending on the interest rate environment. We're actually glad to see interest rates move up. And that's one of the reasons we sold a lot of securities, and about half of that was in the first month of this first quarter. So we do feel like we have a lot of additional flexibility and we're going to continue to look at potential restructuring going forward.

Operator

(Operator Instructions) Our next question comes from reading Brady Gailey of KBW.

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

So it sounds like one of the CRE loans was probably in Fort Worth from the OmniAmerican deal, but what was the geography of the other CRE loan?

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

The geography of the other CRE loan is in Little Rock.

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

Okay. So that's obviously outside of your home markets. So is that -- how did you get the Little Rock exposure?

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

It's actually a participation. And what ended up happening was -- and I guess it was in January or February, I can't remember which month it was, Toys 'R' Us announced that they were going to be closing all of their locations in the United States, and it had Toys 'R' Us combined with the Babies "R" Us. And basically, they busted the debt service coverage covenant ratio. And so we felt it appropriate to put it on nonaccrual status.

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

So it's a participation, so that was a shared national credit loan?

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

That is correct.

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

Okay. And where -- what's the balance of your total shared national credit portfolio?

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

Yes. Just one second, I'm -- Brady, we're going to have to get you that number. It's not that significant. There's not a lot of it.

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

Okay. Okay. All right, and then...

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

And that particular loan is $13 million.

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

Okay. All right. And then so, accretively, yield was $1.2 million this quarter. And I know you had the $330,000 roughly, that was kind of unexpected. So you backed that out, that's around $900,000. Is that, absent any sort of onetime payoffs that might push that number up, do you think $900,000 is around a good run rate for yield accretion for the next few quarters?

Julie N. Shamburger - *Southside Bancshares, Inc. - Senior EVP & CFO*

I do. I was looking at the Omni accretion, and it's gone down but it's pretty flat the last 3 quarters. It went -- it only went down around $9,000 this quarter from the fourth quarter, so I expect it to trickle down a little bit more. But overall, I do think between $8,000 and $9,000. There will be the payoffs and there's just no way to predict those at this point. Well, at any point, actually. But I do think that's reasonable.

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

Okay. All right then, so if you adjust the $1.2 million out of the reported margin, that takes your kind of core margin down to around 3.11%. So how do you think your core margin trends for the next few quarters? Is there -- do you think the bond book will continue to go down and that remix will continue to happen and the core margin could see some additional lift from this level?

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

I do. I think there is potential for some additional lift, especially given the fact that the fed is planning on raising interest rates at least 2 more times this year.

Operator

Our next question comes from Brian Zabora of Hovde Group.

Brian James Zabora - *Hovde Group, LLC, Research Division - Director*

Just a question on fee income. How much of the reclassification that could be impacted -- that you did impacted the fee income this quarter?

Julie N. Shamburger - *Southside Bancshares, Inc. - Senior EVP & CFO*

Well, the total was around, let's see, $800,000 -- $950,000. $796,000 was related to debit card and $151,000 was related to brokerage services. So our deposit service still increased if you look at the year-over-year, and that's the result of having the acquisition largely. And then the brokerage services, even with the net -- you will notice a decrease because of the netting. But if you add back the $151,000 essentially to that, you all see an increase because the prior periods do not have it netted out. And that should be fairly -- I would expect that to be fairly consistent. This was our first full quarter with Diboll activity in it. We just had 1 month of activity in the fourth quarter, so probably we'll be able to have a better feel for what that run rate on the debit card expense will be after another quarter.

Brian James Zabora - *Hovde Group, LLC, Research Division - Director*

Understood. And then just maybe on those payoffs that you had this quarter. Maybe just kind of percentage-wise, can you give us a sense of what's the magnitude of the increase that you saw this quarter versus last or maybe year-over-year?

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

The magnitude of the payoffs?

Brian James Zabora - *Hovde Group, LLC, Research Division - Director*

In the loan book, you said it was a bit higher this quarter.

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

Gosh, I'd have to go back to fourth quarter and see what payoffs were then. But I do think we did experience higher payoffs this quarter than we did in the fourth quarter and certainly, higher than what we had in the third quarter last year. But I'd have to go back and check the exact dollar amounts.

Brian James Zabora - *Hovde Group, LLC, Research Division - Director*

But do you think that -- do you still have kind of payoff activity kind of going forward? Or do think it slows a bit or still kind of hard to determine at this point?

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

It really is hard to determine. Most of the 2 markets that we've lent a lot of money into, the Austin and the DFW markets, continue to be very, very healthy and there's a lot of continued sales of different properties that take place. And as I tell the loan officers we agonize over are they going to pay off, and then we get upset when they do pay off. So it's just part of a healthy economy, I think, that we are experiencing payoffs.

Operator

I show no further questions in the queue at this time. I like to turn the call back to Lee Gibson, President and CEO, for closing remarks. Please go ahead, sir.

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

Thank you. We believe Southside is well positioned for the future, and look forward to reporting the results for the remainder of 2018. Thank you for being on the call today, and we look forward to hosting our next earnings call in July.

Operator

Thank you, ladies and gentlemen, for attending today's conference. This concludes the program. You may all disconnect. Good day.