

THOMSON REUTERS STREETEVENTS

# EDITED TRANSCRIPT

SBSI - Q3 2017 Southside Bancshares Inc Earnings Call

EVENT DATE/TIME: OCTOBER 27, 2017 / 2:00PM GMT



OCTOBER 27, 2017 / 2:00PM, SBSI - Q3 2017 Southside Bancshares Inc Earnings Call

## CORPORATE PARTICIPANTS

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

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

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

## CONFERENCE CALL PARTICIPANTS

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

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

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

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

**Nicholas Allan Alter** *SunTrust Robinson Humphrey, Inc., Research Division - Associate*

## PRESENTATION

### Operator

Good day, ladies and gentlemen, and welcome to the Southside Bancshares Inc. 2017 Earnings Conference Call. (Operator Instructions) As a reminder, this conference call is being recorded. I would now like to introduce your host for today's conference Senior Vice President and Chief Risk Officer, Suni Davis. You may begin.

### **Suni Davis** - *Southside Bancshares, Inc. - Chief Risk Officer and Chief Risk Officer of Southside Bank*

Thank you, Daniel. Good morning, everyone, and thank you for joining Southside Bancshares' third quarter 2017 earnings call. The purpose for this call is to discuss the company's results for the quarter and 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 risk and uncertainty. 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 third quarter 2017 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 third quarter, including loan activity, asset quality and an update on our securities portfolio. Then, Lee will share his comments on the quarter, including an update on the merger with Diboll State Bancshares Inc. I will now turn the call over to Julie.

### **Julie N. Shamburger** - *Southside Bancshares, Inc. - CFO, Principal Accounting Officer & Senior EVP*

Thank you, Suni. Good morning, everyone. Welcome to Southside Bancshares' 2017 Third Quarter Earnings Call. We had a strong third quarter with net income of \$14.5 million compared to third quarter 2016 net income of \$12.9 million, a 12.8% increase. For the 9 months ended September 30, 2017, we reported net income of \$44 million, an increase of \$6.2 million or 16.4% compared to \$37.8 million for the same period in 2016. Our diluted earnings per share for the third quarter ended September 30, 2017, were \$0.49 per share, an increase of \$0.01 or 2.1% compared to \$0.48 per share for the same period in 2016. For the 9 months ended September 30, 2017, diluted earnings per share increased \$0.10 or 7.2% to \$1.49 as compared to \$1.39 for the same period in 2016.

For a second consecutive quarter, we are pleased to report an increase in total loans of \$72.6 million or 2.8%. And on a linked-quarter basis, our average loans for the quarter increased \$100.5 million or 3.9%. For the 9 months ended September 30, 2017, total loans increased \$126.2 million or 4.9% when compared to December 31, 2016.



## OCTOBER 27, 2017 / 2:00PM, SBSI - Q3 2017 Southside Bancshares Inc Earnings Call

The growth occurred in the commercial real estate, construction and municipal loan portfolios. The indirect portfolio continued to roll off during the third quarter, decreasing \$5.1 million, with the remaining balance of approximately \$16.4 million at the end of September. Year-to-date, this portfolio has decreased approximately \$20 million. At September 30, 2017, our loans with oil and gas industry exposure remained minimal at 1.1% of our total loan portfolio. We recorded loan-loss provision expense during the third quarter of \$960,000, a decrease of \$386,000 from the second quarter.

During the 9 months ended September 30, 2017, the allowance for loan losses increased \$2 million or 10.9% to \$19.9 million or 0.74% of total loans when compared to 0.7% at December 31, 2016.

We are pleased to report a further decrease in our nonperforming assets during the 9 months ended September 30, 2017, bringing the decrease for the 9 months ended to \$6.0 million or 39.6% down to \$9.1 million or 0.17% of total assets compared to \$15.1 million or 0.27% of total assets at December 31, 2016. This decrease was primarily due to the payoff of several nonaccrual commercial loans last quarter.

Now for an update on our securities portfolio. On a linked-quarter basis, the size of the securities portfolio decreased \$121.4 million during the third quarter and year-to-date the portfolio decreased by \$215.2 million. As mentioned in the earnings release earlier today, during the third quarter, we sold selected, mostly longer duration securities. The duration of the securities portfolio at September 30, 2017, was approximately 5 years, a slight decrease from 5.1 years at both June 30 and December 31, 2016. At September 30, 2017, we had a smaller net unrealized gain in the securities portfolio of \$1 million. As loan growth has occurred during these last 2 quarters, we have gradually reduced the securities portfolio as a percentage of earning assets and we are seeing a small shift in the mix of our loans and securities from 51% loans and 49% securities at December 31, 2016 to 55% loans and 45% securities at the end of the third quarter, moving modestly toward our longer range goal of a 70-30 combination. We expect to continue with the barbell approach for future security purchases using U.S. agency CMOs for the short end and treasury notes, agency and commercial mortgage-backed securities for the longer end. During the third quarter, our net interest margin decreased 5 basis points to 3.02% and our net interest spread decreased 7 basis to 2.82% on a linked quarter basis. The decrease in both the net interest margin and yield were direct result of higher funding costs during the third quarter, partially offset by an increase in the average yield on our average earning assets. While our average yield on average earning assets increased slightly, the purchase accretion on the loans decreased \$245,000 during the quarter, a 3 basis point impact on the average loan yield. Also, the interest-earning deposits kept at fed created some drag on the margin.

Our noninterest income, excluding net securities gains, decreased in the third quarter \$587,000 or 6.3%. We reported approximately \$600,000 of swap fee income in both March and June that did not occur again in the third quarter.

During the 3 months ended September 30, 2017, our noninterest expense decreased further compared to both the first and second quarters of '17 and the fourth quarter of '16.

We are pleased to report that our noninterest expenses has decreased consecutively over the last 4 linked quarters, and we continue to see improvements in our efficiency ratio down to 49.99% for the third quarter of '17.

We expect our core noninterest expense to remain consistent with the levels experienced in 2017, although we do expect to see additional merger expense during the fourth quarter of '17.

Thank you. And I will now turn the call over to Lee.

---

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

Thank you, Julie. We enjoyed another excellent quarter of financial results, as we continue to successfully execute our business plan during the third quarter. As Julie discussed, our earning assets mix continue to shift towards loans, as we experienced excellent loan growth during the third quarter, bringing our overall loan growth for the year to approximately 5%. A linked-quarter decrease in the securities portfolio of \$121 million mostly through the sales of longer duration securities during August and September when long-term interest rates were decreasing, provided more than enough funding for this third quarter loan growth. During the fourth quarter with longer-term interest rates up over 40 basis points from the lows in September, we have begun to replace a portion of the third quarter decrease in securities. While deposits decreased during the



## OCTOBER 27, 2017 / 2:00PM, SBSI - Q3 2017 Southside Bancshares Inc Earnings Call

quarter, I am pleased to report our core deposits, our non-maturity deposits increased \$30 million. We are not wavering on our credit underwriting standards and our asset quality ratios remained strong as reflected by our nonperforming assets to total asset ratio of 0.17%.

Cost containment and process improvement efforts continue to bear fruit as our efficiency ratio during the third quarter declined to 49.99%, and our efficiency ratio for the first 9 months of 2017 declined to 50.62%, very close to the stated target of 50% for all of 2017. We still anticipate closing our pending acquisition of Diboll State Bancshares during the fourth quarter. We remain extremely excited about this strategic acquisition, given the expanded contiguous markets we will serve in East Texas, Diboll's tremendous low cost core deposit franchise and the addition of their outstanding talent. Merger teams from both banks have been meeting on a regular basis and are now ready for closing. These meetings will continue after the closing to ensure a smooth integration and to plan for the subsequent computer conversion in April.

Economic conditions remained healthy in all 3 of the markets we serve: East Texas, DFW and Austin. Austin and DFW, fueled primarily by job growth and continued company relocations, continue to perform exceptionally well.

Our future looks bright, given the pending addition of Diboll State Bancshares, the dynamic growth markets we serve, our strong balance sheet, capital position, credit quality and foremost our 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) And our first question comes from Brett Rabatin, Piper Jaffray.

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

Wanted just to ask, Lee or Julie, can you talk about the funding cost from here and just what you're expecting from a deposit beta perspective? And you, obviously, had nice growth in DDA on an average basis in the quarter. Is that something you expect to continue. And maybe just overall the path of your funding costs from here, what you're expecting post [eval] .

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

We are placing a lot emphasis on core deposit growth and all the different non-maturity deposit categories, DDA especially with commercial deposits, and we have teams out there actively working on that. And with respect to funding cost moving forward, we anticipate on the deposit side then the beta being less than the actual fed funds increase that's anticipated in December. And then, our Home Loan Bank advances and things of that nature with the exception of the \$240 million that are swapped should -- the short-term ones should move up with the -- with that increase in Fed funds.

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

Okay. And then, just thinking about loan growth, which was nice in 3Q. I mean, going forward are you looking for more commercial real estate municipal loans. What's the outlook overall? Will construction help that portfolio more next year? And maybe just any thoughts on what you're seeing competitively? And how that's impacting your origination rates versus the current portfolio yield?

## OCTOBER 27, 2017 / 2:00PM, SBSI - Q3 2017 Southside Bancshares Inc Earnings Call

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

Okay. I think there is the several things. One the Indirect Auto portfolio is down to just \$16 million. We've had \$20 million in roll off in that this year. We anticipate a little bit of additional roll off in the fourth quarter and that portfolio will probably be down to close to half of what the roll off should be for this year. So next year, we won't have that headwind. We have made some changes in our residential mortgage lending area. And in 2018, instead of seeing decreases, we're hopeful that we'll actually see modest -- very slight increases in that. So that should reduce that headwind. With respect to the commercial real estate, we continue to look for quality loan opportunities out there. Fortunately, the markets we're in provide a lot of opportunities to look at. So we continue to look at those. And on the construction side, we have a lot of things in construction that are beginning to fund, are currently funding. And then, we anticipate additional fundings in 2018, as the equity goes in on a lot of the projects that we have not funded yet in our construction portfolio. So the outlook for 2018 is probably very similar to the type of loan growth we've seen in 2017, given that we should have less headwinds in the Indirect Auto portfolio and hopefully in the residential mortgage.

**Operator**

And our next question comes from Brady Gailey with KBW.

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

So the tax rate was 21% this quarter. I think that's a little kind of higher than the guidance around 18.5%. I was just wondering, on a forward basis -- by the way you still think the tax rate should be in the mid-18% range? Or closer to 3Q levels?

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

I don't think it's going to be 3Q levels, but I do think it's probably going -- I mean, third quarter -- second quarter was 18.8% and overall I think we were at 18.9% for the year. So I do think it's going to be closer to that 19%. It may get up to 20%. It's hard to tell the tax exempt income is smaller percentage of the total, because -- with our growth in income, a lot of that growth has occurred in taxable income. So we're watching that closely, but I'm thinking it's going to be probably closer in the 19% now -- 19% to 20%.

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

And we do. Brady, we also in the securities portfolio, we've been holding off trying to purchase municipals because they tend to be longer duration, but with interest rates up over 40 basis points from their lows in September, we do look to add some additional muni securities in the portfolio in the fourth quarter.

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

All right. That's helpful. And then, you all talked about the mix shift, basically you're going from 50-50 loans to bonds, now you are 55-45 loans to bonds. It sounds like you sold bonds when the time was right in the third quarter, and now you're going to buy them when the time is right. So should that ratio kind of take a step back in the near term before longer-term headed to that 70-30 split?

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

I don't know that it's going to take a step back. With the acquisition, we should see some improvement actually in loan side. And if we continue to have loan growth at the levels we've had, I don't anticipate us replacing anywhere near all the securities we sold.



## OCTOBER 27, 2017 / 2:00PM, SBSI - Q3 2017 Southside Bancshares Inc Earnings Call

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

All right. And then lastly, for me the loan yield was down around 2 basis points on a linked-quarter basis. I think you had some benefit in 2Q, which maybe, makes that off a little -- little off. But would you expect the loan yield to kind of continue to move higher from here?

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

Yes, with the anticipated increase in Fed funds in December, we should -- with a lot of our loan portfolio floating, we should see that -- that yield move higher.

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

Maybe on adjusted basis, once you back out the noise in 2Q, how much was the loan yield up on a linked-quarter basis?

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

If I take out the lend accretion or better -- when I account for the decrease in the loan accretion from last quarter, the yield on the loans would have been 4.57% as opposed to 4.54%. So it was about 3 basis points on the loans themselves and about 2 on the yield and margin -- or on the spread and margin, excuse me.

**Operator**

And our next question comes from Brad Milsaps, Sandler O'Neill.

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

Guys, you have done a nice job with expenses for some time now. I know it's going to get a little muddled, sounds like this quarter with Diboll closing. But just kind of curious, kind of how you're thinking about the expense run rate. You've talked a lot about some low hanging fruits still able to kind of grab and improve there. So just kind of curious how you're thinking about the expense run rate going forward?

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

Once we have completely integrated the Diboll merger, I would anticipate that we'll be back in that high 40 range. There will be some slight bump up initially. But once we are able to complete the computer conversion and probably get to the back half of 2018, we're anticipating being able to keep the efficiency ratio in -- hopefully in the high 40s.

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

So in terms of stand-alone Southside, do you think you can improve upon kind of where you are in the third quarter? Or is this kind of \$25-ish million dollars -- \$24.5 million kind of where -- where would you think it's going to run?

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

I would think for the fourth quarter it's going to be pretty close to that \$25 million number. It might improve a little bit, but it's a little early to know exactly, but I don't think it's going to change substantially from that third quarter number.



## OCTOBER 27, 2017 / 2:00PM, SBSI - Q3 2017 Southside Bancshares Inc Earnings Call

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

Okay. And Lee, just a follow up on the bond portfolio. It sounds like even though the long ends up a bit, it wouldn't be your intention at least -- it sounds like you bought some bonds but putting back the entire \$120 million or more is not a really in the cards?

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

That is correct. And what we have purchased back actually has a shorter duration and much higher yield than what we sold in August and September.

**Operator**

And our next question comes from Michael Young with SunTrust.

**Nicholas Allan Alter** - *SunTrust Robinson Humphrey, Inc., Research Division - Associate*

This is actually Nick on for Michael. Real quick question with Diboll closing this quarter, can you provide any updated thoughts on M&A at play going forward into 2018 with pricing expectations still pretty high?

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

We'll -- in 2018, we'll begin to look again and make a determination if there is something out there that strategically fits. And then, we'll just have to look at the pricing and relative to our currency and make a decision if that's in the best interest of our shareholders.

**Nicholas Allan Alter** - *SunTrust Robinson Humphrey, Inc., Research Division - Associate*

Okay, great. One more if I could. Was there any impacts from Harvey on either your portfolio or Diboll's loan portfolio or credit quality?

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

No. That Monday after Harvey hit, we came in and had all of our loan officers reach out during that week to the various credits we had down in that area, and I'm glad to say that, that really other than a few leaky roofs and things of that nature, there wasn't rising water, but a few leaky roofs. We came through it virtually unscathed. And 2 of our larger loans actually saw occupancy rates move up as a result of them not having any damage and people needing places to go.

**Operator**

And our next question comes from Brian Zabora with Hovde Group.

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

Just a question -- another question on the securities book. You mentioned that you're buying a little bit lower duration securities this quarter. Is that a trend that we see? I know you mentioned barbell but could the barbell be shifted a little bit towards the shorter side? Or if you consider you're going to keep that duration maybe around 5 years?



## OCTOBER 27, 2017 / 2:00PM, SBSI - Q3 2017 Southside Bancshares Inc Earnings Call

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

I would think the duration, it's unless we made major purchases, that duration is going to be hard to move off that 5 year. It may move down to a 4.9 or something. But it's going to stay roughly in that 5-year range. The only thing that's going to change that duration is through time as we move forward, we should see the duration just naturally move down as we move closer to the maturities.

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

Okay. And then, just a question on the transaction as you're getting closer to close. Just your thoughts -- you mentioned, the improvement in the efficiency ratio. But you talked about, I think, 32-ish percent cost saves when you announced the deal. Do you still feel comfortable with that or any changes regarding that?

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

I think we feel comfortable with that. We're not going to be able to affect those completely in 2018 because the computer conversion is set for August, so but -- excuse me, for April, not August. But we do anticipate that we'll hit that 32% when we're fully integrated in '19.

**Operator**

And I'm not showing any further questions at this time. I would now to turn the call back over to President and CEO, Lee Gibson, for any further remarks.

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

All right. Thank you. The anticipated closing of the Diboll acquisition, our continued strong loan growth during the third quarter, cost containment success, near pristine asset quality, markets ripe with quality loan growth potential and our success in replacing securities with higher-yielding loans provide the foundation for an excellent close to 2017 and our prospects for 2018. Thank you for being on the call today, and we look forward to hosting our next earnings call in January.

**Operator**

Ladies and gentlemen, thank you for participating in today's conference. This does conclude today's program, and you may all disconnect. Everyone, have a wonderful day.

### DISCLAIMER

Thomson Reuters reserves the right to make changes to documents, content, or other information on this web site without obligation to notify any person of such changes.

In the conference calls upon which Event Transcripts are based, companies may make projections or other forward-looking statements regarding a variety of items. Such forward-looking statements are based upon current expectations and involve risks and uncertainties. Actual results may differ materially from those stated in any forward-looking statement based on a number of important factors and risks, which are more specifically identified in the companies' most recent SEC filings. Although the companies may indicate and believe that the assumptions underlying the forward-looking statements are reasonable, any of the assumptions could prove inaccurate or incorrect and, therefore, there can be no assurance that the results contemplated in the forward-looking statements will be realized.

THE INFORMATION CONTAINED IN EVENT TRANSCRIPTS IS A TEXTUAL REPRESENTATION OF THE APPLICABLE COMPANY'S CONFERENCE CALL AND WHILE EFFORTS ARE MADE TO PROVIDE AN ACCURATE TRANSCRIPTION, THERE MAY BE MATERIAL ERRORS, OMISSIONS, OR INACCURACIES IN THE REPORTING OF THE SUBSTANCE OF THE CONFERENCE CALLS. IN NO WAY DOES THOMSON REUTERS OR THE APPLICABLE COMPANY ASSUME ANY RESPONSIBILITY FOR ANY INVESTMENT OR OTHER DECISIONS MADE BASED UPON THE INFORMATION PROVIDED ON THIS WEB SITE OR IN ANY EVENT TRANSCRIPT. USERS ARE ADVISED TO REVIEW THE APPLICABLE COMPANY'S CONFERENCE CALL ITSELF AND THE APPLICABLE COMPANY'S SEC FILINGS BEFORE MAKING ANY INVESTMENT OR OTHER DECISIONS.

©2017, Thomson Reuters. All Rights Reserved.