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Q3 2021 Southside Bancshares Inc Earnings Call

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to the Southside Bancshares, Inc. Third Quarter 2021 Earnings Conference Call. (Operator Instructions) Also, please be advised that today's conference is being recorded. (Operator Instructions) I would now like to hand the conference over to your speaker today, Ms. Lindsey Bailes. Thank you. Please go ahead.

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

Thank you, Jeff. Good morning, everyone, and welcome to Southside Bancshares' Third Quarter 2021 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 presentation, 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, 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, and welcome to Southside Bancshares' Third Quarter Earnings Call for 2021. This morning, we reported outstanding quarterly results. I want to thank the entire Southside team for their tremendous contributions and efforts without which these results would not have been possible.

Highlights for the quarter included earnings per share of $0.90, an ROA of 1.61%, annualized linked quarter loan growth, net of PPP, of 7.9%, annualized linked quarter deposit growth of 13.5%, an increase in the net interest margin to 3.16% and continued strong asset quality with nonperforming assets decreasing to 0.17% of total assets.

The third quarter results also included a reversal of provision for credit losses of $5.1 million. Linked quarter, our net interest margin increased 10 basis points, and our net interest spread increased 11 basis points, primarily due to a 10 basis point increase in the yield on earning assets. The average yield on loans increased 15 basis points, largely due to the increase in PPP loan accretion. The average yield on securities increased 5 basis points, and our cost of funds decreased 1 basis point.

On September 30, 2021, we redeemed our 5.5% coupon $1 million subordinated notes, which will further positively impact the net interest margin in the fourth quarter. During the quarter, we expensed $1.1 million in connection with this redemption. Annualized loan growth as of September 30, 2021 was 5.3%. Our loan pipeline in all of our markets is strong. We anticipate this will continue well into 2022, given the strong outlook for the high-growth markets we serve.

Fourth quarter payoffs are anticipated to generate headwinds as the anticipation of potential tax law changes has accelerated sales of customer projects. We now believe loan growth for 2021 net of PPP loans will be closer to 5%. We are currently budgeting for and projecting 2022 loan growth, net of PPP loans of 9%.

During the third quarter, we continued to experience an increase in our average nonmaturity deposits, which represent our lowest cost

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interest-bearing liabilities. Over the past 18 months, nonmaturity deposits have increased significantly which has allowed us to strategically transform our funding base by lowering our dependence on higher cost and shorter duration CDs and unswapped FHLB borrowings. We had swapped FHLB borrowings at September 30 of $605 million.

The economic conditions in our markets remain strong, bolstered by continued company relocations and existing company expansions combined with population growth. The DFW and Austin markets that we serve continue to be among the highest growth markets in the country. 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 reported net income of $29.3 million, a linked quarter increase of $8 million or 37.5% due primarily to the reversal of provision of $5.1 million and a net gain on sale of AFS securities of $1.4 million. Net income increased $2.2 million or 8.2% compared to the same period in 2020. For the quarter ended September 30, 2021, our diluted earnings per share were $0.90, an increase of $0.08 or 9.8% compared to the same period in 2020 and an increase of $0.25 or 38.5% on a linked-quarter basis.

Linked quarter, net of the decrease in PPP loans of $64.6 million, our loan portfolio increased $69.9 million to $3.65 billion. Our commercial real estate loans increased $174.2 million, partially offset by a decrease in construction loans of $106.1 million. The decrease in the construction loans is primarily the result of payoffs and completed projects converting to permanent financing. Commercial loans, excluding the PPP forgiveness, increased approximately $10.8 million during the third quarter. We also experienced an increase in municipal loans of $9.9 million on a linked-quarter basis. The average weight of new loans added during the third quarter was 3.6%.

As of September 30, our PPP loans included in the commercial loan category totaled $67.5 million, down from $132.1 million at June 30, 2021. The average balance of our PPP loans for the 3 months ended September 30, 2021, was approximately $103.9 million. Our asset quality remains strong. Nonperforming assets decreased by $2.8 million or 18.6%, down to 0.17% of total assets compared to 0.21% at June 30, 2021.

Linked quarter, our allowance for loan loss decreased $4.9 million or 11.4% to $38 million at September 30 due to recording a reversal of provision for credit losses on loans of $4.4 million in the third quarter of 2021, a decrease of $5.9 million compared to the second quarter provision. The decrease in the provision for the third quarter was primarily due to an improvement in the Moody's economic forecast at September 30, 2021.

As of September 30, our allowance for loan losses as a percentage of total loans was 1.04% and 1.06% when excluding PPP loans. Our allowance for off-balance sheet credit exposures at September 30 decreased to $3.1 million when compared to $3.8 million at June 30, 2021, due to a reversal of provision of $683,000 compared to provision expense of $157,000 in the previous quarter. Combined with the reversal of provision for credit losses on loans, the reversal of provision for credit losses totaled $5.1 million for the 3 months ended September 30, 2021.

As of September 30, our loans with oil and gas industry exposure decreased to $70.7 million or 1.9% of total loans compared with $94.3 million at the prior quarter end, driven by paydowns on several oil and gas loans during the quarter. We currently have no remaining COVID-19-related deferrals.

Our securities portfolio decreased $15.3 million or 0.5% on a linked quarter basis. We recognized $1.4 million in net security gains on the sale of AFS securities during the quarter, an increase from the net gains of $15,000 reported last quarter. As of September 30, 2021, we had a net unrealized gain in the securities portfolio of $106.7 million, and the duration of the portfolio increased to 5.8 years from 5.4 years at the end of the second quarter.

Our mix of loans and securities at September 30 remained consistent on a linked-quarter basis at 56% loans and 44% securities.

During the quarter ended September 30, we repurchased the remaining authorized shares under our stock repurchase plan, a total of 420,204 shares purchased at an average price of $36.74.

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Our net interest margin increased 10 basis points on a linked-quarter basis to 3.16% and net interest spread increased by 11 basis points, a result of the increase in yield on interest-earning assets and fees on PPP loans forgiven. Approximately 18 basis points of the net interest margin related to fees earned on the PPP loans.

For the 3 months ended September 30, net interest income increased $2.6 million or 5.6% when compared to the linked quarter. We recorded approximately $3.1 million in net fees related to the PPP loans included in interest income this quarter compared to $1.7 million at June 30. As of September 30, 2021, we had net deferred fees of approximately $2.3 million remaining to be recognized as a yield adjustment over the terms of the loans.

Additionally, we recorded $196,000 in purchased loan accretion this quarter, a decrease of $453,000 from the prior quarter. For the 3 months ended September 30, 2021, noninterest income, excluding net gains on the sale of AFS Securities, increased $470,000 or 4.3% for the linked quarter, which was primarily driven by an increase in deposit services income and other noninterest income. An increase in overdraft charges was the driver of the increase in deposit services income. And other noninterest income increased primarily due to an increase in mortgage servicing fee income.

On September 30, we redeemed our 5.5% subordinated notes, resulting in a $1.1 million loss on redemption reported in noninterest expense. Excluding the loss on the redemption, noninterest expense remained consistent on a linked-quarter basis. For the fourth quarter of 2021, we expect noninterest expense to be approximately $31 million.

Our foreign taxable equivalent efficiency ratio decreased to 47.92% compared to 50.31% in the previous quarter. The decrease in the fully taxable equivalent efficiency ratio was due to the increase in net interest income for the quarter.

Income tax expense increased $2.1 million or 72.4% compared to the 3 months ended June 30, 2021, driven by the increase in pretax income. Our effective tax rate increased to 14.5% for the third quarter, up from 11.9% last quarter, primarily due to a decrease in tax-exempt income as a percentage of pretax income. At this time, we are estimating an increase in our annualized effective tax rate to 13.2%.

Thank you for joining us today. This concludes our comments, and we will open the line for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question comes from the line of Brady Gailey from KBW.

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

Yes, it's Brady. So I want to start with loan growth. I mean 9% ex PPP loan growth next year is a fairly healthy level. Maybe just a comment. Relative to this year, do you expect it to be more production that's driving that higher rate? Or is it a lesser amount of payoffs? And then just within your geographies, where are you seeing the best growth?

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

I think it's going to be a combination of both of those, but more additional production next year. Some of the people we hired this year, we only had for about 70% of the year that are producing well. And most of the production, the big dollar production, is probably going to come in the metropolitan area is what we're anticipating. The DFW, the Austin and the Houston markets. And that's where we're seeing the largest dollar amount. Now the largest number of loans are being made in East Texas markets. But in terms of the dollars, it's going to be the metropolitan areas.

And as far as the payoffs go, a lot of people are concerned about tax changes this year. And so that generated some additional payoffs in the third quarter, but we're seeing that accelerate even more in the fourth quarter.

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

All right. And then next, on the buyback. If I look at the first 3 quarters of the year, you've repurchased about 3% of the company, so a fairly healthy level. But you don't have anything authorized beyond that. Should we think about the buyback continuing from here? Or does that pause?

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

I think at some point, we'll discuss with the Board an additional authorization to have available if not this quarter, early next quarter. But I would anticipate we're going to have additional authorization so that we have availability.

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

All right. And then last for me. You guys have done a good job of holding expenses flat around this $31 million level. It sounds like it's going to be the same to close out the year next quarter. As you look towards 2022, what sort of expense creep should we expect?

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

We haven't completed the budget for 2022. I know we're going to have some additional technology spend. In all likelihood, there will be some increased compensation spend. Exactly what that's going to amount to, I don't know from a percentage standpoint, Brady, but I would anticipate somewhere in the neighborhood of maybe $1 million, $1.5 million a quarter. I'm looking at Julie to see.

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

No, I think the 2 things that came to my mind were compensation and technology.

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

Yes.

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

Because we're looking at a few things right now. So -- but I think -- I mean I would like to see it around $1 million, $1.5 million at the most.

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

We'll have a better idea of that, obviously, with the January call, unfortunately. But based on what we're seeing now and what we're projecting, that would be my initial stab at it.

Operator

Your next question comes from the line of Michael Young from Truist Securities.

Michael Masters Young ***Truist Securities, Inc., Research Division - VP & Analyst***

Just wanted to ask kind of a follow-up on the loan growth. Obviously, 9% for 2022 is very healthy, very good. It sounds like some larger loans may be kind of driving that. But just generally, I think when we've been surprised at times, it's been related to payoffs or paydowns. Do you have better visibility into payoffs and paydowns into 2022 than you have in prior years or anything like that, that would just kind of help us with the confidence around that 9% number?

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

Our best visibility is for the fourth quarter, but we know when construction projects are slated to be finished, and that's typically not too long after that. Some of those that begin to lease up depending on how fast they lease up. That's when they become the most vulnerable for payoffs. And we know what's coming up, but we also have a good idea of what our pipeline -- how strong it is right now, and we anticipate that's going to continue on into 2022 because things are just continuing to explode in a lot of the markets that we're in and company relocations, company's expanding existing relationships that they have in the state. And then overall, just population growth. There's -- they can't build the houses fast enough, multifamily is needed in a lot of these areas, warehouse space. There's just all sorts of needs as we see the end migration from the other states.

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Michael Masters Young ***Truist Securities, Inc., Research Division - VP & Analyst***

Thanks. That's helpful. And then just on maybe the securities book. With that strong loan growth outlook, do you expect to kind of hold the size of the securities book relative to the loan book? Or do you expect to kind of continue to push some excess liquidity into that? Just any outlook there for kind of balance sheet size as we move through next year?

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

Our plan is not necessarily to expand the securities portfolio. The hope would be that the loan growth would be such that we'd be able to, at a bare minimum, hold it where it is and maybe actually see it decrease a little bit. Some of that's going to depend on continued deposit growth if we continue to see deposits grow at the rate we've seen this year. Then it's possible that the securities book would hold steady and might even be up just a little bit as we deploy some of that excess liquidity.

Michael Masters Young ***Truist Securities, Inc., Research Division - VP & Analyst***

That's helpful. And then maybe just lastly, just on asset sensitivity. Could you just remind us how much of the loan book now is variable versus fixed? And any kind of early thoughts around impact of maybe 0.25 point hike or more?

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

It is -- the loan portfolio is right at 50-50. It varies from 49-51 to 50-50, but it's stayed in that range all year, and that's essentially what we see moving forward. On our fixed rate loans, we typically don't fix them other than on the 1 to 4 family home loans. We typically don't fix in the past 5 years. So even those probably have an average duration of 2.5 to 3 years, somewhere in that range. So with 0.25 point up, I would anticipate we'll get to enjoy most -- almost all of that in the loan book. And then since we've been able to transform the liability side into a significant amount of nonmaturity deposits, I would anticipate that we're not going to see maybe 10% to 20% of that, that 25 basis points migrate up on the deposit side. So it will be very small.

Operator

Your next question comes from the line of Brad Milsaps from Piper Sandler.

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

Lee, you guys have addressed most of my questions. I did want to ask around loan yields. It looks like they are maybe only down 2 or 3 basis points, excluding accretion and the impact of PPP. I think earlier you're talking about new loans coming on kind of 3.50, if memory serves, now sounds like it's closer to 3.60. Is that obviously driven by mix? Or are you just getting better pricing out there, more fees? Just kind of curious if you could help me kind of understand the kind of the key drivers there around kind of new yields on new originations.

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

Yes. In the first quarter, the average was in that lower 3 range. I think in the second quarter, it was closer to 3.50. And then you hit it right on the nose. It's 3.60 for the new loans that went on the books in the third quarter. So it's a combination of some better pricing and folks are concerned about rates moving up, and we're just able to get a little better pricing.

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

Okay. That's great. And then just as you think about your provisioning, reserving, last quarter, you took a provision this quarter, you reversed that out and then some. Do you think you're kind of mostly through that at this point, and you would start provisioning again to support some of the loan growth you've got coming down the pipe all is equal?

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

I think that's a correct statement. We look at the CECL reserve, obviously, every quarter, and kind of saw an upper and a lower band. And we were right at the top of the upper band where the reserve was this time. But there's -- it's -- that has -- that band has narrowed dramatically, and it's down to a fairly small number at this point in time. So absent a mix in the loan portfolio, I would anticipate that further loan growth is going to come at the cost of some additional reserves, which is fine. I mean that's what you ultimately want.

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

Sure. No, that's helpful. And then final question. I know you guys typically pay out a special dividend in the fourth quarter where your payout ratio is typically, at least since I've covered you guys, kind of bed into the mid-50s. You guys are tracking to record earnings this year. I know a part of that is because of reserve release, but even then for you guys are going to get back to that mid-50s payout would imply a special dividend, a pretty large one. Just kind of curious how -- I know it's a Board decision, but should we think about that type of payout or because it is coming from the reserve, maybe you scale back that a little bit. Just kind of curious how to think about that based on your history?

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

We haven't made any decisions, but to think about a payout in the mid-50s is probably a little aggressive. But that's something we're certainly going to be taking up with the Board here early next month. And I guess more to come on that. And I'm sorry, that doesn't provide you a lot, but I don't see it being in the mid-50s this year simply because a lot of it has been that reversal of provision expense.

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

Yes, I know. Makes total sense. I really appreciate the color. Thanks, Lee.

Operator

Your next question comes from the line of Brett Rabatin from Hovde Group.

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

Wanted to -- I guess, first, I missed -- I heard that there was $2.3 million remaining on the PPP fees, Julie, but I didn't catch what was the amount recognized in the third quarter if you just had that handy.

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

Yes. The fees recognized during the third quarter were $3.1 million compared to $1.7 million second quarter.

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

Okay. And then you talked about the margin and the potential for upside when rates go higher. As you think about the remaining opportunities to improve the funding mix versus the loan yields and new originations in the securities book, does the margin creep from here a little bit lower unless you have a mix shift change in the earning asset base? Or can you maybe give a little bit of a stronger outlook on the margin and how you see that playing out until rates move higher?

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

Well, in the fourth quarter, I think the fact that we took $100 million at 5.5% of the funding side is going to have a real positive impact in the fourth quarter. If they do start raising short-term rates, I think it will be positive. And the reason I say that is, if you look at our average home loan bank borrowings, approximately 90% of them are fixed with swaps at this point in time. And then we have reduced CD funding dramatically over the course of the last 1.5 years. And it's mostly in nonmaturity deposits right now. So I would anticipate that if they do start raising the short-term interest rates, that's going to have a positive impact on our overall net interest margin. And even if they don't, I still think it's going to improve in the fourth quarter and then worst case would hold flat next year.

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

Okay. Appreciate the color there, Lee. And then just thinking about the -- if I heard it right, you're expecting 5% core growth for the year, ex PPP. So the fourth quarter, if I got the numbers right here, it means a little bit of stated atrophy relative to 3Q. Is that right? And then just back on the 9% expectations for '22, is a lot of that construction in C&I? And is that pipeline building? Just wanted to get maybe a little more color on the things that are growing in terms of the pipeline.

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

Right. Some of it is construction because there was a period of time in 2020 where we weren't putting on a lot of construction loans for about a 4- to 6-month period simply because people put their projects on hold until they figured out what was going to happen with the pandemic. And then, of course, when you make a construction loan, the equity goes in upfront. And so we're just now seeing in the last

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quarter or so fund up on a lot of those funds that were made in '20. And we're anticipating that the loans we've made in '21 will start funding up in '22. That combined with -- there's a lot of whole thunders that we're taking a look at on the CRE side, some on the commercial side.

And then on municipal lending, we think it's going to be -- continue to be -- have a nice increase. A number of the larger banks are not allowed -- are not going to be able to make municipal loans in the state of Texas, originate them because of their position on guns related to what the state legislature did in their legislative session this time. So there's just a number of factors that come in that we believe are going to bode well for us in terms of loan growth next year.

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

Okay. And then I guess that was a 2-part question, but the first part was just around the fourth quarter and the stated balances declined a little bit linked quarter.

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

I'm sorry. And then what declines?

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

Just with the 5% core guidance, I just want to make sure I have it correct that kind of the...

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

Yes, I mean, basically, we're right at 4% for the year. If we didn't have any more loan growth, I think we were at 4% through 3 quarters. The 5.3% is annualized. So we are anticipating a little bit of loan growth in the fourth quarter but not anything like what we experienced in the third quarter simply because of the headwinds with the payoffs.

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

Okay. I appreciate that. And then just maybe lastly, Lee, I'm curious, it seems like I've had some diverging conversations around M&A and the possibility of doing transactions here in the near term. And I think you've been more optimistic at one point about potential deal making. What's your current view on M&A? And do you expect to be active? And how big of a priority is that for you at this point?

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

We expect to be active. It goes back to banks are sold, they're not bought. And you've got to have willing sellers. And at this point, we're just not seeing a lot of willing sellers that we would have interest in. And then some of them that we've talked to that maybe it's not something that is going to be actionable here in the near future.

Operator

There are no more questions at this time. Turning the call back to Mr. 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 positive economic conditions in our markets, our strong pipeline, capital position, core earnings and asset quality, we look forward to reporting fourth quarter and annual results to you during our next earnings call in January. This concludes the call.

Operator

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

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