South Plains Financial, Inc.

Third Quarter 2022 Earnings Call Transcript

October 21, 2022

CORPORATE PARTICIPANTS

Steve Crockett, *Chief Financial Officer and Treasurer*

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Curtis Griffith, *Chairman and Chief Executive Officer*

CONFERENCE CALL PARTICIPANTS

Brady Gailey, *KBW*

Brad Milsaps, *Piper Sandler*

PRESENTATION

Operator

Good morning, ladies and gentlemen. Welcome to the South Plains Financial Incorporated Third Quarter 2022 Earnings Conference Call.

I would now like to turn the conference over to Mr. Steve Crockett, Chief Financial Officer and Treasurer of South Plains Financial. Please go ahead, sir.

Steve Crockett

Thank you, Operator, and good morning, everyone.

We appreciate your participation in our third quarter 2022 earnings conference call. With me here today are Curtis Griffith, our Chairman and Chief Executive Officer, and Cory Newsom, our President. A replay of this call will be available on our website within two hours of the conclusion of this call until November 4, 2022. Additionally, a slide deck presentation to compliment today's discussion is available on the News and Events section of our website.

Before we begin, let me remind everyone that this call may contain forward-looking statements that are subject to a variety of risk, uncertainties and other factors that could cause actual results to differ materially from those anticipated future results. Please see our Safe Harbor statement in our earnings press release that was issued this morning and on Slide 2 of the slide deck presentation available on our website.

All comments made during today's call are subject to those Safe Harbor statements. Any forward-looking statements presented herein are made only as of today's date and we do not undertake any duty to update such forward-looking statements except as required by law.

Additionally, during today's call, we may discuss certain non-GAAP measures which we believe are useful in evaluating our performance. A reconciliation of these non-GAAP measures to the most comparable GAAP measures can also be found in our earnings release and on Slide 22 of the slide deck presentation.

At this point, I'll turn the call over to Curtis.

Curtis Griffith

Thank you, Steve, and good morning.

On today's call, I will briefly review the highlights of our third quarter 2022 results, which we believe are a clear validation of our ongoing strategy to grow the bank. Cory will discuss our loan growth in more detail as well as review the credit profile of our portfolio, which remains strong. Steve will then conclude with a more detailed review of our Q3 results.

To start, there are five key points that I hope you will take away from today's call. First, we spoke to our business being at an inflection point on last quarter's call and I'm proud to say that our results this quarter validate that view. Second, we delivered 17% annualized loan growth in the third quarter, driven by strength in both our community markets and our major markets of Dallas, Houston and El Paso. Third, this strong loan growth is building the earnings power of the bank and we continue to have liquidity to fund further loan growth. Fourth, the credit quality of our portfolio continues to improve through the third quarter, and we believe we are well positioned for an uncertain economy. Lastly, we continue to believe that our shares have been trading below intrinsic value and remained active with our share repurchase program, having bought back approximately 366,000 shares in the third quarter.

Looking at our results on slide 4 of our earnings presentation, we delivered net income of $15.5 million or $0.86 per diluted common share for the third quarter of 2022. This compares to net income of $15.9 million or $0.88 per diluted common share in the second quarter of 2022 and $15.2 million or $0.82 for diluted common share in the year ago third quarter.

It's important to highlight that our results over the last three quarters have included certain items which are making comparisons difficult, as well as obscuring the improving earnings power of the bank. These items include large recoveries, negative provisions for loan losses and fair value increases in our MSR portfolio.

Looking at this in more detail, our second quarter 2022 results benefited from $0.24 per share of these items net of tax, which we had discussed on last quarter's call. Likewise, our third quarter results benefited from approximately $0.10 per share of these items net of tax. As a result, our third quarter earnings per share increased by approximately 19% from the second quarter of 2022, when normalizing for these items.

We recorded a negative provision for loan loss of $782,000 in the third quarter of 2022, which was triggered by a loan loss recovery in our energy segment of $822,000 combined with paydowns of $19.6 million in our hotel portfolio, over half of which of those paydowns was adversely classified. The improving credit quality of the portfolio largely offset the reserves required for the new organic loan growth experienced during the quarter.

Looking forward, we remain well reserved for an uncertain economic outlook, given that our allowance for loan loss ratio is 34 basis points higher than pre-pandemic levels. Nevertheless, concerns regarding forecasted economic conditions continue to increase due to the rising interest rate environment and persistent high inflation levels in the United States and our markets and provisions for loan losses may be necessary in future periods.

While we expect economic growth to moderate as the Federal Reserve continues to raise their target benchmark interest rate, loan demand remains strong through the third quarter, as we grew our loan portfolio 17% annualized from second quarter of 2022. Our loan growth was driven by gains in both our community markets as well as our major metropolitan markets.

Importantly, the scale that we have achieved in our lending portfolio has more than offset the declines in our mortgage business where our mortgage banking revenues declined to 11% of bank revenues in the third quarter of 2022. This is significant as the core earnings power of the bank is now readily visible and expected to continue to grow through year-end.

Additionally, we continue to have liquidity to fund future loan growth as our loan-to-deposit ratio was 77.7% at September 30, 2022, as compared to 75.3% at the end of the second quarter of 2022. We have historically been comfortable running the bank at a loan-to-deposit ratio in the mid to upper 80% range, which provides significant capacity for future loan growth as we work to redeploy our low-cost deposits into higher yielding commercial loans.

This liquidity represents significant earnings potential as we continue to fund higher yielding loans over time. Overall, I am very proud of our accomplishments as we have grown our lending team, increased share across our markets and delivered results above our expectations. Most notably, we have achieved 10.4% loan growth year-to-date, which is ahead of our mid-to-high single digit loan growth guidance for the full year, 2022.

As we have improved the earnings power of the bank through the year, our share price has not fully reflected this improvement as we believe our shares have been trading below intrinsic value. As a result, we accelerated our share repurchases in the third quarter, having bought back 366,000 shares as compared to 257,000 shares in the second quarter. Year-to-date, we have repurchased approximately 730,000 shares under our stock repurchase program.

Returning a steady stream of capital through our shareholders through our stock repurchases and dividend remains a priority for our management team. Along those lines, our Board of Directors authorized a $0.12 per share dividend as announced earlier this week. This will be our 15th consecutive quarterly dividend to be paid on November 15, 2022, for shareholders of record on October 31, 2022.

To conclude, we remain cautiously optimistic as the Texas economy continues to experience healthy economic growth and low unemployment. While we expect growth to moderate, we are not seeing concerning signs in our portfolio nor in our markets. The credit quality of our loan portfolio is strong, and we continue to underwrite to more conservative assumptions, including not sacrificing credit quality for loan growth.

We believe that we are in an advantageous position and remain excited with the opportunities that lie ahead.

Now, let me turn the call over to Cory.

Cory Newsom

Thank you, Curtis, and good morning, everyone.

As Curtis touched on, loans held for investment increased during the third quarter of 2022 by $109.9 million or 17% annualized compared to the second quarter of 2022, as outlined on slide 5. Our loan demand remained primarily in the commercial real estate market, residential mortgage, and consumer auto. Overall loan demand was strong despite the noted paydowns in our hotel segment, which is not a growth sector for us.

Our loan yield in the third quarter of 2022 was 5.12%, which compares to 5.57% in the second quarter of 2022. That said, it is important to adjust our second quarter loan yield for the $4.4 million of large recoveries and prepayment penalties that we experience. When adjusting for those items, our second quarter 2022 loan yield was 4.88%. As Curtis touched on, the improving trends and our results over the last three quarters have been obscured and we believe it is important to adjust for these benefits in order to properly model the growing earnings power of the bank.

The rise in our loan yields in the third quarter also reflects our concerted effort to proactively price new loans to account for a higher interest rate environment combined with the rise in funding costs, which we have started to see through the third quarter. We are working hard to stay ahead of the market while also maintaining our competitive position, which will remain a focus as the Federal Reserve continues their aggressive interest rate increases and tightening policy.

As we discussed in our second quarter 2022 call, we are a community retail bank in our smaller markets and primarily a commercial bank in our major markets of Dallas, Houston and El Paso. As outlined on slide 6, our strategy is to redeploy our excess liquidity consisting of low-cost deposits from our community-oriented markets into our major metropolitan markets. To accomplish this, we have added experienced commercial lenders who share our culture values and who focus on developing a long-term customer relationships done the right way.

Our expansion and growing scale in our metropolitan markets is a key factor to the accelerating loan growth that we have delivered through the year, combined with this share gain that our community bankers continue to deliver. As outlined on slide 7, we grew loans in our metropolitan markets by $30 million in a third quarter of 2022, representing 14.6% annualized growth as compared to the second quarter of 2022.

Year-to-date, we've grown our loan portfolio by 15.2% to $849 million in our major markets, which is strongly contributed to the bank's 10% total loan growth through the first three quarters of the year. Our growing scale and presence in the metro markets provide us with optimism on our ability to sustain mid-to-high single digit loan growth over time.

Additionally, we have the ability to add space and bankers on our metro markets as growth opportunities present themselves. As Curtis touched on, we have seen loan growth moderate given the rapid rise in rates as borrowers need to put more equity into deals and builders are beginning to offer more incentive to borrowers to keep deals going.

That said, inventory remains constrained, and the Texas economy is still very healthy. If the economy transitions to a higher market interest rate environment, we are proactively underwriting to more normal levels and asking for more money down on new loans as we focus on discipline growth. Likewise, we continue underwriting to lower energy prices in the Permian Basin to ensure we avoid potential problems if an economic downturn occurs.

We are continually stress testing our loan portfolio and remain pleased with the improving credit quality that we have experienced year-to-date. Overall, we want to enter the next downturn in an advantageous position and remain pleased with our asset quality, liquidity and strong capital position.

Skipping ahead to slide 9, our indirect auto loan portfolio increased by $7 million to $289 million in the third quarter of 2022, as compared to the second quarter of 2022. While there was growth in this sector, the level of increase has declined given the rising market interest rate environment. Importantly, we have maintained a disciplined approach to underwriting a 78% of the indirect auto loan portfolio originated with a credit score of 690 or better. This strong credit profile position portfolio for resilience across varying economic cycles.

Turning to our mortgage business on slide 10. Mortgage loan originations decreased 26.6% to $152 million in the third quarter of 2022, as compared to the second quarter of 2022, as a result of rising market interest rates combined with normal seasonality.

As we discussed last quarter, our strategy with mortgage banking business has been delivering. We have been aggressively managing this business for profitability as volumes decline while focusing on growing our commercial lending platform across both community and metro markets.

As Curtis commented, we believe we reached an inflection point in the second quarter of 2022, where our growing loan portfolio would generate improving interest income and return the bank to growth despite the decline in our mortgage banking business that can clearly be seen in our results this quarter. Our mortgage business is now at a level which may no longer have a material impact on our results, positive or negative. We will remain in the business as long as is possible and drive incremental business in the way of cross-sell.

Turning to slide 11. We generated $20.9 million of non-interest income in the third quarter of 2022, compared to $18.8 million in the second quarter of 2022. This increase was primarily the result of $2.1 million in legal settlements and seasonal increase of $3.3 million from insurance activities in our insurance business.

For the third quarter of 2022, non-interest income was 37% of bank revenues as compared to 34% in the second quarter of 2022.

To conclude, our organic growth strategy has been deliberate and focused as we add experienced commercial lenders in our major metro markets where we have the infrastructure in place and can quickly scale.

These markets represent large opportunities for commercial loan growth as well as other services, and we will continue to selectively add to our team to further build our presence in these markets. While loan demand has remained robust, we have experienced a moderation as the Federal Reserve continues to raise third target benchmark interest rate.

We remain cautious but optimistic looking to the fourth quarter of the year as cash balances remain healthy for both our business and consumer customers and we continue to see healthy cash levels go into new deals.

I would like to now turn the call over to Steve.

Steve Crockett

Thank you, Cory.

Starting on slide 13. Net interest income was $35.1 million for the third quarter of 2022, as compared to $37.1 million for the second quarter of 2022. This comparison to the second quarter is skewed by the $4.4 million of large loan recoveries and prepayment penalties that were recognized during the second quarter.

Excluding these one-time benefits, net interest income increased by $2.4 million, primarily as a result of the increase of $122 million in average loans outstanding combined with higher interest income received on securities and other interest earning assets in our portfolio as a result of the rising market interest rate environment.

Looking forward, we continue to believe that we are well positioned for our net interest income to benefit as we grow our loan portfolio and benefit from the anticipated rise in interest rates through the fourth quarter and potentially into the year ahead. Our net interest margin calculated on a tax equivalent basis was 3.7% in the third quarter of 2022, as compared to 4.02% in the second quarter of 2022.

Excluding the $4.4 million of large loan recoveries and prepayment penalties that we recognized in the second quarter, our net interest margin was 3.54%, which is a better comparison to the 3.7% in the third quarter of 2022. The improvement in our net interest margin as compared to the second quarter was driven by our strong organic loan growth combined with the rising market interest rate environment.

Our average cost of deposits was 52 basis points, an increase from 27 basis points in Q2. During the third quarter, we made the decision to proactively raise our deposit interest rates as we started to see increased competition for deposits in our markets. We are being strategic in how we raise interest rates in order to maintain our deposit relationships in a rising interest rate environment. Looking forward, we expect our funding costs to continue to gradually rise as a Federal Reserve continues to raise their target benchmark interest rate.

Turning to slide 14. Total deposits increased $34.7 million in the third quarter to $3.46 billion as compared to the second quarter of 2022. As we continue to benefit from our strong customer relationships, which are driving organic growth.

Additionally, we continue to experience a positive mix shift in our deposit base as non-interest bearing deposits increased to 36.5% of total deposits in the third quarter of 2022, as compared to 34.9% in the second quarter of 2022.

Turning to slide 15. We continue to believe that our loan portfolio remains appropriately reserved as our allowance to total loans was 1.47% at September 30, 2022, as compared to 1.54% at June 30, 2022.

As Curtis touched on, we recorded a negative provision for loan loss of $782,000 in the third quarter compared to no provision for loan losses in the second quarter of 2022. Importantly, we believe we remain well reserved for an uncertain economic outlook given that our allowance for loan loss ratio is 34 basis points higher than pre-pandemic levels.

Overall, we continue to experience improving credit metrics in our loan portfolio with particular improvements in our hotel portfolio as non-performing assets to total assets declined slightly to 19 basis points in the third quarter of 2022, from 20 basis points in the second quarter of 2022, and 33 basis points in the first quarter of 2022.

Nevertheless, concerns regarding forecasted economic conditions continue to worsen due to the rising rate environment in persistent high inflation levels in the United States, and additional provisions for loan losses may be necessary in future periods.

Skipping ahead to slide 17, our non-interest expense was $37.4 million in the third quarter of 2022, as compared to $36.1 million in the second quarter of 2022. The increase was primarily due to an additional $937,000 in insurance commission expense as a result of the higher revenue from insurance activities, partially offset by decline in variable mortgage related expenses in accordance with the reduced demand for mortgage loan originations, which Cory discussed.

Looking to the fourth quarter of 2022, we expect non-interest expense to be slightly better than the third quarter of 2022, as our elevated legal expenses largely behind us given the legal settlements that were reached in the third quarter of 2022. That said, we expect to continue to experience wage pressure to retain personnel given the current inflationary environment, which may be a headwind in the year ahead.

Moving ahead to Slide 19. We remain well capitalized with tangible common equity to tangible assets of 8.00% at the end of the third quarter of 2022, a decline from 8.60% at the end of the second quarter of 2022. The decline was mainly driven by a $26.7 million decrease in the fair value of our available-for-sale securities and related fair value hedges net of tax, partially offset by net income after dividends paid of $13.4 million.

The decline in fair value of our securities was a result of the increase in market interest rates during the period. Tangible book value per share decreased by $0.89 to $18.61 during the third quarter of 2022.

I will now turn the call back to Curtis for concluding remarks.

Curtis Griffith

Thank you, Steve.

To conclude, our third quarter results validate our view that our business has reached an inflection point and the bank is now positioned for additional growth. Our strategy to expand our lending platform and our metro markets is driving improved loan growth as we quickly build scale in Dallas, Houston and El Paso, while our community bankers continue to increase our share in those markets.

Importantly, we have liquidity to put to work in higher yielding loans, which will serve to further improve the earnings power of the bank. As we grow, we will see our returns improve, which we believe will increase the value of South Plains. While the economic outlook remains uncertain, the Texas economy remains healthy and we have maintained our disciplined approach to underwriting.

The credit profile of our loan portfolio has continued to improve and we remain in an advantageous position for whatever the future may hold.

I would like to thank our employees for their hard work and commitment to our customers and communities once again this quarter. None of our success is possible without them. Thank you again for your time today.

Operator, please open the line for any questions.

Operator

Our first question comes from Brady Gailey with KBW. Please proceed with your question.

Brady Gailey

It's good to hear that expenses will be down a little bit third quarter and the fourth quarter, but I heard the comment on wage inflation, which I know everybody is seeing, so how do you all think about the level of expense creep that we could see into 2023?

Steve Crockett

Yes. As far as what we're showing, Q4, we definitely expect to see that lower than where we were in Q3. As we get into 2023, we still think that we'll be flat to slightly better than the run rate there that we were showing in Q3, that we'd be able to offset some of that personnel expense due to inflation with other costs that we've got, and also including the reduced legal that we spoke to.

Brady Gailey

All right. Then, it was great to see the share repurchases. I know year-to-date you've repurchased about 4% of the Company. How do you think about continuing at this pace of buybacks? You still have excess capital, but we are potentially headed into a recession, so how do you think about buybacks into 2023?

Curtis Griffith

Well, our Board is going to have some good discussion on that at our next meeting. We will likely reauthorize repurchase program, but I also would think that given the potential recessionary fears issues out there, and frankly where our stock prices improved as well, that the speed of repurchase might be slowing a little bit. But I think we'll still stay in the market as long as we feel like we have a slightly undervalued stock.

Brady Gailey

All right. Finally for me, I know Lubbock can be a fairly competitive market when it comes to deposit rates. Deposit rates moved up in the quarter, so what should we expect on how much those deposit rates should continue to go up next quarter and into next year?

Cory Newsom

There's no question that we're going to see some increase in rates with everything that's going on. We're not seeing stuff really crazy locally. I mean, there was a little bit of movement early on, but it's not getting out of hand, which is a good thing, which kind of makes you feel good about the market and the competitors that we've got.

We know that some of the stuff is going to increase some. I mean, if you look at the expectations that where we kind of thought it was, it's right in line. And we talked about last quarter, I mean, we're offering some additional products that we've got in other markets that we haven't been active in in the past, and we're seeing some results out of that. So yes, we'll see some increase, but I don't think it's going to get out of hand.

Curtis Griffith

Now, everything we're seeing, we still think we can hold that data, that we've talked about, being 50% or better on it. But there's another thing here locally, I know you're aware of it. Obviously, we talk about more from the loan side, but the recent M&A activity in our markets here that Prosperity has done, we think that may also tend to lessen some deposit pricing pressure out here as well, as those transactions move forward. So, reduction in the number of competitors fighting over the limited pool of deposits is probably a good thing for us.

Operator

Our next question is from Brad Milsaps with Piper Sandler. Please proceed with your question.

Brad Milsaps

You guys addressed a few of my questions already, but just did want to follow up on the deposit beta discussion. Curtis, did I hear you say correctly that you think 50% or less, would that be total deposits or interest-bearing deposits? How do you think about that 50% beta number that you just put out there?

Curtis Griffith

That's on interest bearing.

We do have nice DDA numbers but some of those are somewhat seasonal for various reasons, including public funds and others. So, that's one thing that DDA numbers will move up and down for us. But we're also trying to just add customer relationships and bring good DDA accounts in as we go with that, we still are big believers in what we're doing in treasury management and we're reaching out not only here locally, but also in our metro markets with those.

So, over time, I think you'll see the average of the DDA piece continue to grow, but don't be surprised if you see it bounce up and down a little bit quarter-to-quarter.

Brad Milsaps

On the flip side, it looked like your loan beta on a core basis was somewhere around 25%. It does look like you're putting on a lot of CRE with your new lenders. Just curious, is that the right number to think about as the Fed continues to increase, you'll see that type of lift in your loan yield going forward?

Cory Newsom

Yes, we're all sitting here cautiously wanting to answer that. We're getting good yields on the loans that we're putting on, that's the beauty of it. I mean, from a pipeline standpoint, when we look at that to bring it together, pipeline is still strong, it's moderating some, I mean there's no question, but probably where we're seeing as some of the biggest challenges is on our own underwriting. Making sure that we're comfortable with what we're bringing in here and the way we're stretch testing this stuff, but we're getting good yield on the stuff that we're putting on.

Brad Milsaps

On insurance revenue, I know the third quarter is always a big one for you guys, but you're tracking for growth over 20% year-over-year which is a pretty big number. I know it's a good insurance market and yours is focused on Ag. Anything else that would be driving that? Or, do you think you kind of pull back to some more typical high single digit, 9%, 10% growth rate in 2023? Or, is there something out there that makes this more sustainable?

Steve Crockett

I know some of that just had to do with the timing. There was a little bit of revenue that might have typically come in in the fourth quarter that came in the third quarter that pushed that number up a little bit. I mean, they did have overall better revenues than last year. But I don't know that that's anything that we're projecting to show increases in the upcoming year from what we've seen now.

Cory Newsom

Part of that is we do a really good job of diversification across a number of states. So, a lot of that growth comes back on what the year looks like as far as loss rates and things like that. We don't take any underwriting risk, we never have, we're not going to, but from a profit-sharing position, you look back at how the year turned out.

We got to look back at how the overall year turns out to see if you're going to look at that kind of increase next year. But if you look at the footprint of how we're expanding with the number of agents and stuff, yes, it's good. We're pleased with it.

Curtis Griffith

It's good business, and please remember that virtually all of it, what we report as insurance income is tied to the Federal Crop Insurance program. As Cory was mentioning, we do get some nice profit sharing on that, but that's related to underwriting gains at the companies that we write for.

While 2021, was a very good year for those companies, and therefore we got a nice check coming in this time, 2022 hasn't been good in many areas, not entirely across the country, but they definitely had some underwriting losses. So right now, our own forecast is we'll probably be down at least slightly for the 2023 same period, whenever those profit sharing checks do come in. Not on the overall base revenue side. We continue to grow that.

Brad Milsaps

Right. Final question, kind of more housekeeping. Curtis, you mentioned the kind of $0.10 this quarter of what you might consider non run rate items. Can you tell me what encompasses that? I'm curious, was there any type of MSR right up this quarter? I mean, I saw the $2.1 million of litigation proceeds, but just making sure I didn't miss anything else that should be pulled out either positively or negatively in your mind?

Curtis Griffith

Steve, I believe indicated and he confirmed it, but $400,000 in MSR gains for this quarter. So, not a big number, but there was some in there. So yes, that's in there.

Steve Crockett

Yes. Brad, on the legal settlement, we did net off some of the increased legal expense that we had in the quarter related to that. So, that kind of lowered that number just a little bit in the coming up with the $0.10 number.

Curtis Griffith

We did have a couple of loss recoveries, not on the level that we did in Q2 on loan loss recoveries, but we did have some in Q3 as well.

Brad Milsaps

Got it. Got it. So those, as you mentioned in response to Brady's question, some of those legal expenses are going to come out in the fourth quarter which drives your guidance for lower expenses in the fourth.

Curtis Griffith

Yes, sir.

Cory Newsom

Yes.

Operator

We have reached the end of the question-and-answer session, I'd now like to turn the call back over to Curtis Griffith for closing comments.

Curtis Griffith

Thank you, Operator, and thanks to all of you on the call today for your time.

I am proud of our results again this quarter. We are delivering on our strategy to organically grow the bank, and the disruptions from M&A and our community markets are really adding some great opportunities for our lenders to increase our market share. As we just discussed, probably pick up some deposits as well.

Our lenders in our metro markets are continuing to grow their portfolios, bringing on strong customer relationships to the bank. Our mortgage is still profitable, but now down to the level that won't meaningfully impact results positively or negatively going forward. The earning power of our core business really does continue to grow and we are optimistic about the future.

Our markets do remain healthy, but I think our activity will moderate. As the Federal Reserve continues to raise rates, we'll remain focused on the credit profile of our loan portfolio, which continues to be very strong.

So, thanks again today everybody, for your time and for your interest in South Plains Financial.