South Plains Financial, Inc.

Second Quarter 2019 Earnings Call Transcript

July 25, 2019

CORPORATE PARTICIPANTS

Steven Crockett, *Chief Financial Officer and Treasurer*

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Cory Newsom, *Director and President*

CONFERENCE CALL PARTICIPANTS

Brady Gailey, *KBW*

Brad Milsaps, *Sandler O'Neill*

PRESENTATION

Operator:

Greetings, and welcome to the South Plains Financial Second Quarter 2019 Earnings Conference Call. At this time, all participants are in a listen-only mode. A question and answer session will follow the formal presentation. If anyone should require Operator assistance during the conference, please press star, zero on your telephone keypad. As a reminder, this conference is being recorded.

I would now like to turn the call over to your host, Steven Crockett, Chief Financial Officer. Thank you. You may begin.

Steven Crockett:

Thank you, Operator, and good morning, everyone. We appreciate your participation in our Second Quarter 2019 Earnings Call. With me here today are Curtis Griffith, our Chairman and Chief Executive Officer, and Cory Newsom, our President.

As a reminder, a telephonic replay of this call will be available on the Investors section of our website through 11:59 pm Eastern Time on August 1, 2019.

Additionally, a slide deck outlining our acquisition of West Texas State Bank, which we announced this morning, can also be found on our website.

Before we begin, let me remind everyone that this call may contain certain statements that constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These include remarks about future expectations, beliefs, estimates, plans and prospects. Such statements are subject to a variety of risks, uncertainties, and other factors that could cause actual results to differ materially from those indicated or implied by such statements. Such risks and other factors are set forth in our Prospectus filed with the Securities and Exchange Commission dated May 9, 2019. We urge listeners and readers of our earnings release to review the Risk Factors section of that Prospectus and the Risk Factors section of other documents South Plains files with the SEC from time to time. 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. The presentation of this additional information should not be considered in isolation or as a substitute for results prepared in accordance with U.S. GAAP. A reconciliation of these non-GAAP measures to the most comparable GAAP measures can be found in our earnings release.

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

Curtis Griffith:

Thank you, Steve, and good morning, everyone. Before I get started, I would like to take a moment to thank all of those people who helped us through our initial public offering, which culminated in our first day of trading on the NASDAQ on May 9th. The many months of hard work of our employees and advisers, and the loyal support of our customers and partners, contributed to the success of our offering. Importantly, our public listing provides South Plains with the additional flexibility to take full advantage of the numerous growth opportunities that lie ahead.

This morning, I would like to start by providing a brief overview of South Plains for those investors who were not able to hear our story during the IPO roadshow and discuss our recently-announced merger with West Texas State Bank, or WTSB, a validation of our decision to go public. Cory will discuss the investments that we have made in South Plains which provide the foundation for growth, increased scale and, ultimately, a meaningful improvement to the return profile of the Bank. Steve will conclude with a review of our second quarter financial results and we will then open the call for your questions.

Our Bank has a rich history, having been founded in West Texas more than 75 years ago, as First State Bank of Morton. My family's relationship with the Bank began when my father invested in 1961, and I then joined the Board of Directors in 1972. In 1984, I was elected Chairman, when the Bank was really a small town institution with just $30 million in assets. We saw an opportunity to grow the Bank and executed several mergers and acquisitions through the 1990's, including South Plains Bank and City Bank, which is spelled with a Y and is sometimes confused with that somewhat larger New York-based bank. Today, City Bank is one of the largest banks in West Texas with $2.8 billion in assets, and only the second public bank headquartered west of I-35, which runs from Dallas south through Austin, San Antonio and ends on the Mexican border near Laredo. While a majority of the state's population lives along I-35 and to the east, a majority of the state and its natural resources lie to the west, with about 4 million residents benefiting from those natural resources.

We currently operate 20 bank branches under the City Bank name across six geographic markets, including Lubbock, El Paso, Dallas, Houston, College Station, and Ruidoso, New Mexico. We also operate 13 mortgage production offices across Texas. Our focus over the last two decades has been to increase the franchise value of the Bank through steady balance sheet growth, remaining vigilant on credit, growing our core deposits, creating operational efficiencies, and improving our digital and in-branch customer experiences. Our success can be seen in our strong earnings growth, which has risen at an 11.9% compound annual growth rate from 2014 through 2018.

The key to our success and growth has been our focus on our customers and the communities that we serve. We have a strong brand which is well recognized for the best-in-class service that we provide, the high-quality products that we deliver, and the relationships that we build. This clearly differentiates our bank from the competition and has allowed us to maintain and build our share in our core markets, even when larger competitors have entered through acquisitions. This would not be possible without our employees, who are critical to our success and are engaged in numerous community activities and organizations beyond the Bank. Our consistent corporate message is that the success of our communities will drive the success of the Bank.

This can be seen in our strong core deposit base, which has been built over many years by providing quality products and services to our customers in our market areas. We offer retail deposit services through our existing branch network, as well as digital banking products. Core deposits totaled $2.1 billion, or 90.3% of total deposits, and non-interest-bearing deposits totaled $513.4 million, or 22.5% of total deposits as of June 30, 2019. Our cost of deposits was 108 basis points for of the second quarter.

To grow our franchise, we are focused on leveraging our banking platform as we have expanded into large metropolitan markets, such as Dallas and Houston, where we target customers looking for our relationship-based approach to banking and our sophisticated products and services. Our strategy is to continue gathering low-cost deposits in smaller, non-metropolitan markets and deploy them in larger, more dynamic lending markets, where we have had strong success, as can be seen by our 33% loan growth achieved over the last five years.

In addition, we intend to actively recruit additional lenders and employees from other institutions. We have had success in this area, which we believe is attributable to our employee ownership, longstanding market presence and desirable culture in which our employees can thrive. We will also cross-sell our various banking products, including our deposits and treasury wealth management to our commercial loan customers, which we believe provides a basis for expanding our banking relationships.

Our second priority for growth is strategic M&A, as our core markets of Texas and New Mexico have more than 160 banks with total assets between $250 million and $1 billion. This provides South Plains with a tremendous opportunity to grow our franchise, as well as our geographic reach. We believe that our longstanding presence in West Texas, our culture of emphasizing employees as our most important asset and our financial commitment to helping our communities will give us a significant advantage in making us an acquirer of choice. Proof of this can be seen in this morning's announcement of our acquisition of West Texas State Bank, headquartered in Odessa, Texas, for $76.1 million, all in cash.

As we highlighted in a separate release, WTSB has approximately $425 million in assets, $375 million in deposits and $200 million in loans at June 30, 2019. WTSB operates six bank branches located across five West Texas communities, which we will rebrand to City Bank. The acquisition, which we expect to close by year end, expands our geographic reach into the attractive Permian Basin region of Texas, while offering a significant opportunity for expense savings. We estimate, through taking out duplicative infrastructure and operating expenses, that we can reduce WTSB's non-interest expense by 30%, and expect the acquisition to be more than 20% accretive to South Plains' earnings when all cost savings are realized, with a tangible book value per share earn-back of less than four years.

As Cory will touch on in more detail, we have invested in technology and systems at South Plains, which provides the capacity for the Company to be a much larger bank. As we scale the Bank through both organic loan growth and accretive M&A, we will see our profitability expand.

We look forward to working with the Management Team and all employees at WTSB as we continue to provide the great service that their customers expect. We are committed to maintaining the high-quality staff at WTSB, that their customers know and appreciate, and provide them with even better products and technology to serve those customers. The integration will leverage existing infrastructure for greater efficiencies, capturing synergies, which, in turn, will allow us to harvest cost savings for the combined entity. That said, this blending of like-minded institutions permits minimal changes, capitalizing on the strong and successful team WTSB has in place. This puts us in a unique position in West Texas, as we continue to believe in the future of our Company and the communities in which we serve.

I will now like to turn the call over to Cory.

Cory Newsom:

Thank you, Curtis, and good morning, everyone. We could not be more excited with our announcement this morning of our acquisition of WTSB, which is a clear validation of our decision to not only go public, but also the significant opportunity that we see to consolidate a very fragmented West Texas banking sector.

Key to our strategy, and a third driver to growing the franchise value of the Bank and delivering value to all of our stakeholders, is the significant investment that we have made in our infrastructure, having implemented a rigorous enterprise risk management system, or ERM, in the aftermath of the financial crisis. This system delivers a systematic approach to risk measurement and enhances the effectiveness of risk management across the Bank.

Integrating this system into our culture and strategic decision-making has improved all functional areas of the business. Our asset quality has improved significantly, by enhancing our underwriting process and establishing a specific credit appetite that aligns to the broader enterprise risk management framework. Our operational oversight has been heightened to include monitoring for potential personnel, process and systems issues. We have also implemented monitoring and controls for other functional areas, such as information security and technology, vendor management, liquidity, interest rate risk, compliance and company reputation.

Additionally, we believe that we are now better positioned to execute M&A with less risk and increased cost savings, which gives us confidence in achieving the targets that Curtis has laid out for WTSB. Importantly, we believe we are one of the only community banks in our size range and market area to implement such a comprehensive risk management system.

Our credit culture is a key differentiator of the Bank, as we consistently and aggressively review our portfolio for signs of potential issues and move to remove those loans from our balance sheet before they become a real problem. Our ERM system has only improved our ability to manage credit and will allow us to effectively and profitably scale the Bank. In the current environment of yields compressing with the prospect of the Fed reducing rates, we will not reduce our underwriting standards to grow our portfolio. We will not sacrifice credit quality for loan growth.

Beyond our ERM, we have also invested in a number of systems and processes that we believe are comparable to those of much larger financial institutions. These include our new operations center located in Lubbock, which houses back-office processing for deposit operations, loan operations, mortgage operations, and corporate training. We are also investing in digital and payment technologies to increase efficiencies and streamline processes. These technologies include improved remote deposit capture software for business customers, expanded usage of electronic signatures, online account tools, and technologies that facilitate more efficient item processing.

Our investment in our systems and infrastructure position the Bank for growth and expansion. As we scale the Bank through mergers, like our announcement this morning, as well as continued organic growth, our profitability and efficiency will improve. In fact, we believe these investments will allow us to scale our business without commensurate additional expenses and position the Bank to be in excess of $5 billion in assets, while delivering peer average or better ROA’s and ROE’s.

Looking forward, our priority for capital will be attractive M&As, like WTSB, which will expand our geographic reach, scale our infrastructure and improve our profitability. Along those lines, we acquired an online mortgage platform and staff from an Overland Park, Kansas-based mortgage company at the end of last year. This was part of our strategy to enhance our consumer direct business model for our mortgage operations and to accompany our traditional brick-and-mortar delivery channels. This is a business which we believe will enhance our existing mortgage operations and we like the electronic delivery channel. That said, we believe it is a business which is best operated out of our existing infrastructure in Lubbock and have made the decision to transfer the technology and staff the business with our employees in our headquarters. As a result, we have closed our Kansas location and released our real estate.

Beyond M&A, our second priority for capital is to create value for shareholders though the payment of a quarterly dividend. Last week, we announced our initial quarterly dividend of $0.03 per share. Looking forward, we will continue to maintain a thoughtful and balanced capital allocation strategy designed to maximize value for all stakeholders.

I would now like to turn the call over to Steve to review our second quarter results in more detail.

Steven Crockett:

Thank you, Cory. I will begin by reviewing the highlights of our second quarter of 2019 results, before turning the line back over to Curtis for concluding remarks.

For the second quarter of 2019, we delivered net income of $6.1 million, or $0.37 per diluted share, as compared to $13.0 million, or $0.88 per diluted share, for the same quarter in 2018. On a pro-forma basis, to adjust for our S-Corporation revocation, net income for the comparable year ago quarter was $5.3 million or $0.36 per diluted share.

In the second quarter of 2019, deposits decreased $23.1 million, or 4.0% annualized, to $2.18 billion compared to the linked quarter, and increased $98.2 million, or 4.5%, compared to the year ago quarter. The decline from the linked quarter was primarily a result of the planned reduction of $18.7 million in reciprocal deposits. Non-interest bearing deposits grew 12.7% annualized from the linked quarter and now represent 22.5% of deposits, which contributed to our relatively stable cost of funds of 108 basis points, as compared to the linked quarter.

During the second quarter of 2019, we delivered loan growth of $20.5 million, or 4.3% annualized, as compared to the linked quarter, and ended June 30, 2019 with $1.94 billion of total loans. Loan growth was driven primarily by a $40.4 million increase in seasonal agricultural production loan fundings, when compared to the linked quarter. I would note that our ag loan fundings have been impacted by the challenging weather conditions experienced in the Texas South Plains and Panhandle, which resulted in delayed plantings. Seasonally, we see ag loan fundings build through the second and third quarters and are currently behind our expectations entering this season.

As Cory touched on earlier, we pride ourselves on our strict credit culture and will not sacrifice our underwriting standards to drive loan production.

The yield on average earning assets was 5.08% for the second quarter, an increase of 26 basis points, as compared to the same period in 2018, and was driven by an increase in our loans, as well as the overall upward rise in rates during 2018. The yield on our total loans increased 48 basis points to 5.90%.

Our net interest margin decreased five basis points in the quarter to 3.88%, as compared to the linked quarter result of 3.93%, and a 10-basis-point decrease as compared to the same quarter in 2018.

Net interest income for the second quarter of 2019 was $24.8 million, which compares to $24.5 million in the linked quarter, and a $1.4 million increase compared to $23.4 million in the same quarter of 2018. The increase from the linked quarter was largely the result of having an additional $34 million in average interest-earning assets during the current quarter.

Turning to non-interest income and expense, non-interest income for the second quarter of 2019 was $13.7 million, an increase of $1.6 million compared to the linked quarter and a $735,000 increase compared with the second quarter of 2018. The linked quarter increase was the result of an increase in mortgage banking activities of $1.8 million, primarily due to $22 million more in originations during the second quarter. Overall, our fee income is primarily driven by our mortgage operations, debit card and other bank service charge income, and income from our insurance, trust and investment services business. Our fee income provides shareholders with recurring a diversified earnings stream, as it represented 36% of total revenue for the quarter ended June 30, 2019.

Non-interest expense for the second quarter of 2019 was $29.9 million, versus $30.0 million in the linked quarter and $28.4 million in the second quarter of 2018. The slight decrease in comparison to the linked quarter was due to a reduction in salaries and employee benefits, in our effort to control costs and improve operating efficiencies, offset by higher variable costs for production in our mortgage banking division.

To conclude, our return on assets was 0.89% during second the quarter of 2019. This return compares to 0.71% for the linked quarter and 0.84% for the comparable period in 2018, as adjusted. The increase in return on assets versus the linked quarter was due to primarily to our increased mortgage banking activities and net interest income during the current quarter.

Lastly, we remain well capitalized to support future growth.

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

Curtis Griffith:

Thank you Steve. To conclude, I am very excited with the progress that we have achieved on executing on our strategic plan to grow the franchise value of the Bank, centered on organic growth, strategic acquisitions, and achieving the benefits of scaling our infrastructure which can handle significant asset growth. We are off to a very strong start with this morning’s announcement of our acquisition of WTSB and are excited with the many benefits that exist from expanding our geographic reach into the Permian Basin. I would like to thank all of our employees for their hard work, for they are the key to our success.

With that, I’d like to ask the Operator to open up the line for any questions. Operator?

Operator:

Thank you. At this time, we will be conducting a question and answer session. If you would like to ask a question, please press star, one on your telephone keypad. A confirmation tone will indicate your line is in the question queue. You may press star, two if you would like to remove your question from the queue. For participants using speaker equipment, it may be necessary to pick up your handset before pressing the star key. One moment, please, while we poll for questions.

Our first question is from Brady Gailey from KBW. Please go ahead.

Brady Gailey:

Good morning, guys.

Curtis Griffith:

Good morning, Brady.

Steven Crockett:

Good morning.

Brady Gailey:

Congrats on the deal. That didn't take long. If you look at the capital, I mean, before going public, you had around 8% TCE. With the IPO, that took you up to 10%. Now, with this deal, you're back kind of down in the mid-8% range. So, you've done a good job deploying the capital that you've just raised. Maybe talk about, you know, appetite for additional capital, and then how you think about how low you would be comfortable taking that TCE ratio. I mean, you were at 8% before the IPO. Would you be comfortable taking it back to that level?

Curtis Griffith:

This is Curtis. I think we would be all right pulling down back down in that range. We would like to stay longer term slightly above that. Right now, we're going to be very focused on doing the best job of integration that we can on this acquisition. We're still going to be looking and we'll evaluate opportunities as they come along, but over the next few months we're going to be very focused on getting this one lined up and blended into our system as efficiently and executed as well as we can, then start looking around for the next one. We will have to look at where we are on capital at that time, and kind of what the market's telling us, as well. I think that's going to be key to what we look at doing in terms of whether we want to seek an additional capital raise, perhaps sometime in 2020, or that area, but currently we're just going to be very focused on getting this deal done and executed.

Brady Gailey:

All right, and then, I mean, the target being located in the Permian Basin, I know energy is not a huge part of South Plains, but maybe talk about the energy exposure at this target.

Curtis Griffith:

They do have some, not very much, in terms of direct lending against production. Obviously, they do have a fair amount of oilfield-related service companies that they both have deposits and loans with. We've done a deep dive in analyzing their credits, penetration of just about 80% of the entire loan book. They have done a great job of cleaning up some problems that they faced a few a years ago and we see a lot of good, strong relationships in there. The old business is what it is. It is going to have some cycles at some point. We think we're in a pretty extended good one right now. We're just going to be careful as we move forward with these. We'll apply our underwriting standards to the credits going forward, and we think can have reasonably good protection in what we'll be dealing with. It is just the realization that this entire economy in the Permian is driven by the pricing and production of oil and gas. We understood that getting into it, but we still think it's a great area and very desirable to be in.

Brady Gailey:

All right, and just any—can you quantify either the dollar amount of energy loans at the target, or percentage of loans that they had in energy?

Curtis Griffith:

Steve's pulling up, I think, numbers right here. We can get you pretty close on that. Again, it kind of depends on what you consider to be energy, because you've got a lot of other companies out there that are driven by what goes on in the energy sector. So, that's something that we just have to accept as we go forward with it.

Brady Gailey:

Maybe while he's looking that up, I can ask a mortgage question. Mortgage fees were up nicely this quarter, $6.6 million. I know you had the acquisition late last year, that is being added to it. Maybe just talk about how you see mortgage fee income trending for the back half of this year and into 2020.

Steven Crockett:

Yes, Brady, this is Steve. Mortgage revenue is down in the second quarter from what we had projected. It is up, obviously, over the first quarter. We're a little bit up over where we were a year go. Our original expectations with our acquisition that we did at the end of last year on the mortgage side, we did not project it as good—well, we over-projected our numbers for what we thought we could do building that business back up. All that being said, though, we've done well in our existing markets, we see those continuing to go as planned, but, overall, our revenue numbers for mortgage will be down a little bit from what the projections were. But, to tailor that, you will notice that our non-interest expense, primarily related to the mortgage side, is down, as well, as we have cut those costs to offset that lack of production.

Cory Newsom:

This is Cory. We're also seeing, though, some momentum in that market simply from the improvement in rate, so we are still optimistic, though, that we'll finish out and have a decent year for mortgage.

Curtis Griffith:

Great, let me get back to your question, and here's the way I'm going to answer that, because it's really the way we look at it. Currently, this Bank has about $62 million in C&I loans. In some sense, all of those are energy loans, because that's what the companies are—they're either directly involved in it or indirectly funded by what's going on out there. They've got another, roughly, $90 million in commercial real estate, and based on what we've looked at, I would say about half of that number is also related to the energy economy. All in, though, that's still only about $100 million of what I would consider energy lending in our, roughly, $2 billion portfolio—in fact, it'll be about $2.2 billion with the acquisition of their loans. It's still not a huge needle-mover for us at this point.

Brady Gailey:

All right, great. Thanks for the color, guys.

Operator:

Our next question here is from Brad Milsaps from Sandler O'Neill. Please go ahead.

Brad Milsaps:

Hey, good morning, guys.

Curtis Griffith:

Good morning, Brad.

Steven Crockett:

Good morning.

Cory Newsom:

Good morning.

Brad Milsaps:

Steve, I was going to see if you could maybe spend a little bit of time on the net interest margin. You guys, obviously, are sitting on quite a bit of cash from the IPO. Obviously, you're going to need some of that later this year to complete the purchase of West Texas. I'm curious, maybe other plans for that cash maybe in the interim, and then, you know, kind of what happens to the NIM if, in fact, the Fed starts cutting rates.

Steven Crockett:

Sure. Yes, our liquidity position is up a little bit this quarter. We did, obviously, bring in the funds from the IPO, and as you mentioned, those, based on the announcement today, we do plan on deploying that cash at the end of the year, so that, for sure, will help that out. We are slightly behind where we would like to be on the loan funding side at this point, although that demand has started picking up, so we're looking to see that cash being deployed there, as well, in loan fundings, which will improve the NIM. As far as projections going forward, with the Fed looking to drop rates, we have already started addressing our interest costs on deposits and have been evaluating those in anticipation of the drop in rates. We have been just slightly asset-sensitive, so we would see a small decline in overall NIM with a drop, but as we continue to deploy that cash into loans, that should help us offset that.

Curtis Griffith:

Brad, this is Curtis. One other thing that we're looking forward to with this acquisition, given their extremely low cost deposit franchise, it's going to give us some flexibility on perhaps not handling as much as we've been on some reciprocal deposits, that we won't necessarily need to bring back on our books, and certainly won't be out trying to chase any kind of rate deposits for any reason. We're going to have plenty of liquidity going forward, I think, over the next couple of years.

Brad Milsaps:

Yes, Curtis, I saw (inaudible) they got 55% non-interest-bearing demand. Any big concentrations in there that concern you, or you feel pretty good about the granularity of that and being able to retain what's a very excellent deposit franchise?

Curtis Griffith:

We really think we can. In looking at that, the largest deposit accounts are some local businesses. There's one municipal deposit that is about $5.3 million. They don't have any high concentrations in public funds. The top 10 deposit relationships run about $46 million. All of those seem to be very stable, long relationships, and we believe, by having a great crew here, at WTSB, and keeping them very involved with their customers, we don't see any reason we can't hang onto those.

Brad Milsaps:

Got it. You guys talked a little bit about ag loans being a little slower than you thought at the start of the year. Did that have any impact on your insurance business, as well? Those revenues, obviously, a bit part of your business, too. Just curious if a little slower start on the lending side, does that have an impact on the insurance side of things, as well.

Curtis Griffith:

It really won't ultimately, because the insurance is just based on our fee income we get from placing those crop insurance policies out with the farmers, so whether or not we have some losses—which we've certainly had some crop losses, so our farmers are going to be receiving some insurance checks over the next several weeks, that lost some of their early plantings. We'll still receive our commission income that we do traditionally from the volume that we've got out there.

Brad Milsaps:

Okay, and then maybe just one final one for me. Steve, tangible book value was a little higher than maybe I was estimating. Obviously, I understand the adjustments you made with the ESOP, but were there any other changes in equity that would have driven that higher, you know, above and beyond kind of the IPO proceeds and the earnings you had this quarter?

Steven Crockett:

I believe the only other change in there is the market value on the security portfolio. There was a pretty sizeable change in that, given what the rate environment did during the quarter.

Brad Milsaps:

Okay, it was like $3 million.

Steven Crockett:

Yes, $2 million to $3 million, yes, sir.

Brad Milsaps:

Okay. All right, great. Thank you, guys.

Steven Crockett:

Thank you.

Curtis Griffith:

Thank you.

Operator:

This concludes the question and answer session. I'd like to turn the floor back to Management for any closing comments.

Curtis Griffith:

Well, we appreciate everybody that was on the call today. It's a very exciting time for us at South Plains Financial. We set out on this path several months ago and so far we believe we're right on track with what we set out to execute. We're proud of what the IPO did and are looking forward to getting this first acquisition done and incorporating a great team here with our City Bank family, and moving forward to being one of the great outstanding banks in this region. Thank you again, everybody, for your time, your support and your interest, and we'll be talking to you again soon.

Operator:

This concludes today's teleconference, you may disconnect your lines at this time, and thank you again for your participation.