South Plains Financial, Inc.

Second Quarter 2021 Earnings Call Transcript

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CORPORATE PARTICIPANTS

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CONFERENCE CALL PARTICIPANTS

Brad Milsaps, *Piper Sandler*

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PRESENTATION

Operator

Good afternoon, ladies and gentlemen and welcome to the South Plains Financial, Inc. Second Quarter 2021 Earnings Conference Call.

I would now like to turn the call 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 afternoon everyone. We appreciate your participation in our second quarter 2021 earnings conference call. With me here today are Curtis Griffith, our Chairman and Chief Executive Officer, Cory Newsom, our President; and Brent Bates, City Bank's Chief Credit Officer. As a reminder, a replay of this call will be available within two hours of the conclusion of the call until August 10, 2021. Additionally, a slide deck presentation to complement 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 risks, 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 afternoon, 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 20 of the slide deck presentation.

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

Curtis Griffith

Thank you, Steve, and good afternoon.

On today's call, I will briefly review the highlights of our second quarter 2021 results and our strategy to grow the bank. Cory will discuss our initiatives designed to accelerate organic loan growth in more detail and Steve will conclude with a more granular review of our second quarter 2021 financial results. We will then open the call for your questions.

To start, there are five points that I would like you to take away from today's call, and our second quarter results. First, economic activity continues to accelerate across Texas as the environment has continued to normalize. That said, we are closely monitoring the current environment, given the rise in cases due to the Delta variant and are prepared to quickly make any necessary adjustments to protect our employees and customers.

Second, while we are benefiting from this improved economic activity, we're also focused on expanding our loan portfolio and are in the process of actively hiring bankers across all of our markets, but with a particular focus on our major metropolitan markets of Dallas and Houston. Third, as we put our excess liquidity to work in organic loan growth, we expect to see margins expand, earnings growth accelerate and our returns improve. Fourth, as we increase our loans, we will maintain our conservative underwriting standards as we will never sacrifice credit quality for growth. Lastly, we will continue to pursue a thoughtful capital allocation strategy focused on share buybacks, maintaining and growing our dividend over time and tactical M&A.

Turning to our second quarter 2021 results on Slide 4, we reported net income of $13.7 million or $0.74 per diluted common share, which compares to net income of $5.6 million or $0.31 per diluted common share that we reported in the second quarter of 2020. Pretax pre-provision income for the second quarter of 2021 was $15.1 million, which compares to $19 million in the first quarter of 2021 and $20.1 million in last year's second quarter. We had a negative provision for loan loss in the second quarter of 2021 of $2 million, which compares to a $13.1 million provision expense in the second quarter of 2020.

Our reserve release this quarter reflects the credit improvement that we are experiencing in our portfolio and the general improvement of, and our expectation for continued strengthening in the overall economy. In particular, we are seeing robust activity in corporate expansion in West Texas, which is driving job growth and the housing market, while the rebound in energy prices is leading to an acceleration of drilling activity and improved economic momentum in the Permian Basin.

This can also be seen in our loan portfolio, where we are generally seeing positive credit migrations and an increase in our customers' demand for credit as our loan pipeline is now at a three-year high. These trends provide confidence as we work to maintain loan growth through the second half of the year to offset PPP loan forgiveness. We are hopeful that we can deliver mid-single digit loan growth in 2021 and that an additional portion of our reserve for loan losses can be returned to capital to support loan growth.

While we believe the market backdrop is very healthy, we are also working to expand our loan originations by hiring experienced bankers across all of our markets with a focus on Dallas and Houston, where we are targeting customers looking for our relationship-based approach to banking and our superior products and services. The opportunity to continue to generate low-cost deposits in our smaller, non-metropolitan markets and redeploy our excess liquidity into our larger urban markets is a key component in our strategy for organic growth.

For the second quarter of 2021, our cost of funds was 27 basis points, as compared to 29 basis points in the first quarter of 2021. This provides a competitive advantage as we establish a stronger presence in our metropolitan markets and work to gain market share. We currently have significant excess liquidity to deploy as our loan-to-deposit ratio at the end of the second quarter was 73%. We have made good progress hiring experienced bankers and are well on our way to achieving our goal of growing our lending team by more than 30% over the next two years. Cory will discuss this in more detail in a moment.

As we strive to accelerate our organic loan growth, we will also continue to employ a thoughtful capital allocation strategy to create value for our Shareholders. We continue our share repurchase program and expect to deliver a consistent return of capital through our quarterly dividend.

During the second quarter of 2021, we repurchased approximately 39,000 common shares under our $10 million share repurchase program. Additionally, our Board of Directors authorized a quarterly dividend of $0.09 per share this past week, which is up from the last quarterly dividend of $0.07 per share in April of this year. This will be our tenth consecutive quarterly dividend and will be paid on August 16, 2021 to Shareholders of record on August 2, 2021.

We believe that we have the capital to pursue both our stock repurchase program and strategic M&A opportunities. We have the capacity to acquire a bank that either opens a new market opportunity for us or consolidates our position in an existing market. We expect M&A activity to accelerate in West Texas over the next year. We are focused on finding a bank with a similar culture that is well suited to complement and add significant value to our current structure. We are looking at banks with good deposit franchises in rural markets, where there could be leadership changes over the next few years.

As mentioned previously, we will then redeploy those excess deposits into our metropolitan markets as we continue to expand our organic loan platform. We believe there are more than 20 potential targets in West Texas as we focus in on banks with assets in the $250 million to $1 billion range. Importantly, we will not do a deal just to do a deal. We are price-sensitive and cognizant of market expectations on valuation.

As we grow the bank, we are also focused on improving our operations by further utilizing technology. The investments that we have made over the years in our digital platforms positioned the bank for success through the COVID-19 pandemic. Looking forward, we see further opportunities to enhance our efficiency and are starting two initiatives as part of our technology roadmap. The first is a refocusing of our advertising to digital media. After much thought and analysis, we have decided to become more focused on targeted digital marketing. We believe this medium will yield more qualified leads and ultimately, new business opportunities while being more cost effective.

As we transition our marketing dollars to digital media, we expect to generate a strong internal rate of return on the spend. As part of our long-range IT plan we are also initiating a process to move our data center computing and data storage to the cloud as we believe this will provide increased security, more seamless maintenance and lower costs. We believe this is the right time to pursue this migration and expect a modestly higher run-rate for our quarterly expenses over the near-term as we execute on these two technology initiatives.

To conclude, I'm very pleased with our second quarter results as we continue to focus on growing the value of the bank, and I am very proud of the success that we have achieved. Over the last year, we have grown tangible book value per share by 19.8% to $20.43 and improved our annualized return on average assets by 82 basis points to 1.46%, both as of June 30, 2021. Our local economies are robust and we are making strong progress growing our banking team, which positions South Plains Financial solidly for the future.

Now, let me turn the call over to Cory.

Cory Newsom

Thank you, Curtis, and good afternoon, everyone.

Starting with our loan portfolio on Slide 5, loans held for investment at the end of the second quarter of 2021 were $2.3 billion, which is a $60.8 million or 2.7% increase from the first quarter of 2021. The increase from the first quarter of 2021 was largely driven by organic net loan growth of $120.1 million, partially offset by a net decrease of $59.3 million in PPP loans, primarily as a result of SBA repayments on PPP loans received during the second quarter.

Our loan growth in the second quarter was primarily driven by residential construction, multifamily properties and agricultural production loans. While CAP rates on new projects that we are currently reviewing are often very low, we're requiring more equity in new loans as we maintain our strict underwriting discipline. Despite our more conservative origination practices, we are seeing solid opportunities as we work with builders with whom we have longstanding relationships.

We are a relationship bank and do not seek participations or shared credits. We have a strong team of bankers in place that we have developed longstanding relationships with our customers. Looking forward, we see an opportunity to build on this foundation by adding scale across our markets. As Curtis touched on, our strategy is to grow our presence in our metropolitan markets of Dallas and Houston, where we can take share by continuing to redeploy our low-cost funds into attractive loans. To accomplish this, we have a goal of adding 20 lenders to our 60 lender team over the next two years. We are actively hiring in all of our markets with a focus on Dallas and Houston, where we have commercial loan offices.

It's important to stress that we are not pursuing a branch strategy in those MSAs. We are expanding the amount of lease space we currently have in our metropolitan branches as opposed to opening additional locations. This is an effective way to grow within our metropolitan markets. In addition, we are being careful and prudent in who we hire. We are focused on veteran bankers who have strong relationships, a history of success and most importantly, who fit our culture. Our expectation is that our new hires will ramp quickly and breakeven within the first six months at the bank.

While we expect our salary expense will grow through the second half of this year and into 2022, we expect our organic growth strategy to be accretive as net interest income should grow more quickly than our expense. As part of our strategy, we recently hired a new market leader in Houston, who is an experienced banker with strong relationships. This is a good example of our approach in attracting high-quality talent as well as bringing new relationships to the bank. This is a new position for South Plains and helps demonstrate our desire to have structure to grow safely.

We also appointed a new market leader in Odessa, who is a veteran City Bank lender and will infuse our culture in the market as well as promote further cross-selling of City Bank's products. With economic activity picking back up due to the rise in energy prices, we are seeing opportunities in the Permian Basin with long-standing customer relationships and expect that we will see an uptick in direct energy loans in the second half of this year. While we do not seek to be a large energy lender, we do expect to see a modest increase in our energy exposure from our current levels of 2% to 3% of our loan portfolio.

However, we do not see our energy exposure going above 5% of our loan portfolio but do anticipate the opportunity to selectively add exposure with existing customers who are seasoned borrowers that have been through many economic cycles.

We have gotten off to a strong start in 2021 and have been consistently successful with the implementation of our strategy to increase the depth, breadth and stability of our loan portfolio. Our focus is on delivering sustainable organic growth, and we are cognizant of the outsized revenues that we've achieved over the last year in our mortgage business, given the low rate environment.

For the second quarter of 2021, we delivered $378 million in mortgage loan originations as compared to $435 million of originations in the first quarter of 2021, as can be seen on Slide 7. This led to a $5.1 million decrease in mortgage banking revenues in the second quarter compared to the first quarter of 2021. While volumes have been slowing and gain on sale margins contracting, we believe that our mortgage business will trough at a higher levels of this cycle given our success hiring mortgage bankers over the last year. We believe the expansion has led us to take share in the purchase market, which will begin to offset declining refinance activity and allow us to stabilize the origination and fees at a higher level than our run rate through 2019.

As outlined on Slide 8, our fee income has declined with moderation in our mortgage banking activity. For the second quarter of 2021, we generated $22.3 million of non-interest income compared to $26.5 million in the first quarter of 2021. Looking to the second half of the year, we believe our mortgage fees are normalizing and should lead to a stabilization in our non-interest income. Importantly, we believe we are positioned to mitigate margin compression, given that we have effectively used technology to scale.

Overall, we believe non-interest income continues to be a real differentiator for South Plains as fee income represented 43% of total revenues in the second quarter of 2021 as compared to 45% in the quarter a year ago. To conclude, we are very fortunate to be in attractive markets with robust economic activity and see an opportunity to expand our lending portfolio over the next two years. We believe that we have significant potential earnings power sitting on our balance sheet, given that our loan-to-deposit ratio is currently 73%. We would like to see that rise to the mid to high 80s over the time, having most recently been at 84% prior to our acquisition of West Texas State Bank in 2019.

As we execute our strategy of adding experienced lenders to drive organic loan growth, we plan to redeploy our excess liquidity into higher yielding loans, which we believe will drive margin expansion and accelerate earnings growth. We anticipate mid-single-digit loan growth this year with an acceleration to better loan growth in 2022 as we make progress adding veteran bankers to our team.

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

Steve Crockett

Thank you, Cory.

Starting on Slide 10, net interest income was $29.6 million for the second quarter of 2021 as compared to $29.5 million for the first quarter of 2021 and $30.4 million for the second quarter of 2020. The decrease since the second quarter of 2020 was due to a decline of 9 basis points in loan rates, partially offset by a decrease of 16 basis points in the cost of interest-bearing deposits. During the second quarter of 2021, we recognized $1.9 million in PPP related SBA fee income as an adjustment to interest income, which included accelerated income on PPP loans forgiven by the SBA during the quarter.

At the end of the second quarter, there was $4.6 million in unrecognized deferred PPP related SBA fees, the majority of which are expected to be recognized as PPP loans continue to be forgiven by the SBA over the next several quarters. Our net interest margin decreased to 3.42% in the second quarter of 2021 as compared to 3.52% in the first quarter of 2021.

Our non-PPP loan rates declined two basis points as rate pressure on our loan portfolio moderated. Additionally, our margin declined approximately 12 basis points from the continued growth in average deposits that has added to our excess liquidity. Our average cost of deposits declined 2 basis points to 27 basis points in the second quarter of 2021 as compared to 29 basis points in the first quarter of 2021 and declined from 39 basis points in the second quarter of 2020.

Continuing on Slide 11, deposits held steady in the second quarter of 2021 at $3.16 billion and increased of $2.9 million as compared to the first quarter of 2021. Deposit balances grew through mid-June, but then declined as many of our customers made tax payments, some of which have been extended from April 15. We ended the second quarter of 2021 with total non-interest-bearing deposits of approximately $1 billion or 31.6% of total deposits.

Turning to Slide 12, our non-performing assets to total assets ratio declined 5 basis points to 37 basis points in the second quarter of 2021 as compared to 42 basis points in the first quarter of 2021. As Curtis touched on, the robust Texas economy is providing a tailwind to our customers and is leading to positive credit migrations in several areas of our loan portfolio.

At quarter end, total active loan modifications attributed to the COVID-19 pandemic were $36.6 million or 1.6% of our loan portfolio, which is down from $46.9 million or 2.1% of our loan portfolio at the end of the first quarter of 2021. Approximately 96% of our active modified loans at quarter end are in our hotel portfolio, where we continue to experience improving fundamentals. Overall, we continue to believe that our loan portfolio remains well reserved as our ALLL to total loans was 1.87% at June 30, 2021, which is a decline of 14 basis points from the first quarter of 2021.

Looking forward, we continue to believe that the reserves that we have built to help guardians in an uncertain outlook are appropriate, and we will continue to evaluate our reserve in the coming quarters.

Skipping ahead to Slide 15, our non-interest expense was $36.8 million in the second quarter of 2021 as compared to $37.1 million in the first quarter of 2021. This decrease was primarily due to a decline in personnel, salary and commission expense following our lower mortgage production, partially offset by increases in marketing and business development expenses, bank card expenses and other non-interest expenses. As Curtis touched on, we are investing to optimize our marketing as well as move our IT infrastructure to the Cloud, which will modestly add to our quarterly expense run rate starting in the second half of 2021.

We are also experiencing an increase in personnel expenses as we add bankers across our markets. That said, we expect to deliver a strong return on the marketing spend and our investments to grow our loan portfolio. Our efficiency ratio was 70.5% in the second quarter of 2021 as compared to 65.8% in the first quarter of 2021, and 63.3% in the year ago second quarter. This increase in the efficiency ratio is a direct result of decreased volume and tighter gain on sale margins in our mortgage origination business.

Skipping ahead to Slide 17, we remain well-capitalized with tangible common equity to tangible assets at 9.98% at the end of the second quarter of 2021 compared to 9.39% at the end of the first quarter of 2021 and 8.66% in the second quarter of 2020.

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

Curtis Griffith

Thanks, Steve.

While I am very proud of our accomplishments, I’m even more excited about the future for South Plains. We are attracting experienced bankers who fit our culture and are poised to drive results as they excel in their new positions. Over the next two years, we will dramatically expand our lending team, which we believe will lead to improved loan growth, margins and earnings as our excess liquidity is repositioned into attractive loans. The plans that we have put in place have firmly set us on a path for growth, which will ultimately benefit all of our stakeholders.

I would like to conclude by thanking all of our employees for their hard work, and for those on the call, thank you for your time today. Operator, please open the line for any questions.

Operator

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

Brad Milsaps

Hi, good afternoon, guys.

Curtis Griffith

Hi, Brad. Good afternoon.

Brad Milsaps

It looks like you guys had a nice quarter. Just maybe want to start on the loan yields. Obviously, they stayed relatively flat linked quarter. I think last time that we spoke, you were talking about new loans coming on, maybe in the low-fours. Can you guys talk about anything that might not be recurring in the quarter to help prop those up or are you seeing loans come on at higher rates to where you think those can maybe hang in there as you continue to grow the loan portfolio?

Steve Crockett

Yes. Brad, this is Steve. There really wasn't anything significant extra in the quarter. We are seeing, as we talked about last quarter, some of these newer loans that are coming on at a little bit lower yield, and we probably saw that maybe in June with some of the numbers that are being put on. Yes, I would look for there to be a little bit more compression there on the loan side. As some of the older existing loans that are at the higher rates as those continue to pay down.

Cory Newsom

This is Cory. I think we are still getting some pretty good yields on a lot of the loans in the portfolio. There is some that we are having to get down there on price, but we are not making that as a whole that we are having to do that.

Brad Milsaps

Got it, and then just on loan growth in general, Curtis, I think you said that you hope to hit mid-single digit growth this year. Are you talking about on the entire portfolio or—because you are essentially already passed that point on the HFI book. Curious to make sure what you are referring to there in terms of your loan growth guidance, you said you wanted to replace at least all of the PPP loans that you have remaining, is that correct?

Curtis Griffith

Yes, sir. That's really what we are doing because, as you know, we are continuing to see the drop in the balances on the PPP side. Our goal out there, and it's—we are feeling better about it that we may be able to hit mid-single digit looking across the entire portfolio, even taking into account those PPP loan runoffs. We are getting some opportunities at some slightly larger credits. Some of the folks we brought on board as lenders have good relationships that are bringing in some $20 million to $25 million, even $30 million loan possibilities out there, and we are getting where we can execute on some of those.

I do think that we are going to see some very reasonable loan growth from now and through the balance of the year.

Brad Milsaps

As you think out maybe into 2022, with the folks that you have hired thus far, do you think you are in a position to accelerate above what's been historically this mid-single digit rate that you have guided to?

Curtis Griffith

We think so. It's still a little early to tell. But when we bring some of these folks on, and we have got literally some hiring taking place as we speak today, that it will take a few months for them to get some of their relationships and to get loan opportunities to get them to the table, get them underwritten and get them funded. So 2022, is looking pretty good. Internally, we are talking about getting better than mid-single digit loan growth in 2022. Obviously, that's not a guarantee, but given the folks we are bringing on board and the relationships they have, we think that's doable.

Cory Newsom

This is Cory. One of the things we have talked about is we had our goals from the hiring process. We are extremely involved in that hiring process, making sure that we bring the right ones to come on from a culture perspective. But we are by no means just starting this process. We are very well mature into it. That's how we think we will be able to see some of the results that Curtis is talking about.

Brad Milsaps

Okay, great. I will hop back in queue. Thank you.

Operator

Our next question is from Brady Gailey with KBW. Please proceed with your question.

Brady Gailey

Hi. Thank you. Good afternoon, guys.

Curtis Griffith

Hi Brady.

Brady Gailey

When adding—taking the lender base from 60 to 80, that's a big move. Maybe just talk about, have you hired any of those new incremental 20 lenders yet? Then just talk about, are these all coming from geographies that you are already in or are they new geographies? What lender type are you looking for, C&I, CRE? Just any additional color on the plan there.

Cory Newsom

Brady, this is Cory. When you look at it from the discussion from going from 60 to 80, well, we are well into that. I would say, of the increase hires that we are looking at doing, we're 40%, nearly 50% into that process. We are hiring in markets that we are already in. We are by no means going into a new geography that we know nothing about. We're looking for relationship lenders. I don't know at what point you fell out of the queue a while ago when we were—when Brad had his question. I don't know if you were able to hear, but one of the things that—for us to hire, it's a big process and not that we make it cumbersome, but we make it through.

We've got to make sure these are cultural fits for people that are bringing relationships that are the type of customers that we want to do. CRE, we have no problem with it. C&I is good. We're balanced on construction. But we are definitely looking at a lot of real estate, and we like that. As Curtis mentioned, there are some opportunities out there on the energy side, but it's very measured. As we go through that, we are not—we are not trying to become an energy bank. But we think that we have the talent to do some energy loans that make sense.

We are definitely not just trying to start out and decide we are going to go hire some lenders. This is something that we put a lot of thought into and make sure that the growth that we can do from this point, we know we are going to spend money, but we think the returns that are going to come with it will far outweigh what we are trying to do right now. We are already seeing the results. That's why what we are baking in and exceeding some of the projections that we had.

Curtis Griffith

Kind of like we are seeing all across the country, a lot of people are just changing jobs. I don't know to blame it on COVID or whatever. But of course, we have also seen, as you guys know, some change upheaval and just M&A activity happening in our Texas markets. We are seeing some opportunities for some of those lenders who were pretty happy with the bank they were with, but now it's not the same bank anymore. We are seeing opportunities to work with those people. Again, like Cory has been saying, we didn't just start this yesterday. We are just now really talking about it because we are seeing some of the results.

We are getting those hires in place, and that's what we really feel good about. We do vet them very carefully. Senior Management is always involved in every one of the hires. It's growing the team the way we think we can to have some good sustainability and maintain our conservative culture.

Brady Gailey

All right. That's good color. Then I know revenue will outpace it over time. When you look at the expense impacts, and you are bringing on some new lenders. You also talked about the—a couple of technology things that should put a little upward pressure on expenses. How do you think about what level of expense creep will we have for next year or so?

Steve Crockett

Yes, Brady, this is Steve. We kind of look at it, that it could add up to 2% to 3% to the annual non-interest expense number to that run rate starting in Q3. Now that won't hit immediately in Q3, but that will be over the next several quarters into next year. Obviously, that's going to exclude some of the fluctuations we have got on the mortgage side as their operations, whenever they slow or ramp back up or whatever happens, as that number changes a little bit. But that's kind of how we are looking at it right now.

Cory Newsom

This is Cory. But at the same time, we are spending some money to go out there and help us grow the bank in a good, safe fashion. We are also very conscientious of the expense side of it and other areas and trying to cut back everywhere possible to try to offset this as much as we can.

Curtis Griffith

Specifically, on the marketing area, of course, we are going to be front-loaded with some of the development costs and other things on moving to digital marketing or much heavier digital marketing. But over time, realistically, we should spend fewer marketing dollars as we try to spend less in mass media areas. We just think that's the trend to follow because we definitely can see the effectiveness of it when we can target our customers and prospective customers out there and make a great presentation to them for products they are actually interested in as opposed to just spending money buying space in newspapers and time on TV stations.

Cory Newsom

Keep in mind, we have talked about this on every call we have had. We have talked about our infrastructure that we have built. This is where we get to actually go out there and we have always said, we know we have to add production, but back office is intact. We are able to handle the growth without incrementally having to add additional expense to come on with it.

Brady Gailey

Got it. That's great to hear. Thanks, guys.

Curtis Griffith

Thank you.

Operator

We have reached the end of the question-and-answer session. I will now turn the call over to Management for closing remarks.

Curtis Griffith

This is Curtis Griffith. Again, we thank everybody for participating in the call today and for your involvement with South Plains Financial. We feel very good about our direction for the Company, for the way that we have survived through the pandemic months and the prospects ahead of us as the economy rebounds out there.

As we have been talking about, we are doing some investment in lending talent and technology. We think both of those are going to have really great rates of return for us as we move into the future. We are always open to great M&A opportunities, and we do believe that's going to be a continuing thing here in the State of Texas, especially over the next several months. But we also know that the quickest and surest return on the investment is through some conservative organic growth. That's what we are setting out to do with the team that we are putting in place, and I think you are going to see some great results over the next several months.

Thanks, everybody, for being with us today, and look forward to talking to you next quarter.

Operator

This concludes today's conference. You may disconnect your lines at this time. Thank you for your participation.