South Plains Financial, Inc.

Third Quarter 2019 Earnings Call Transcript

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CORPORATE PARTICIPANTS

Steven Crockett, *Chief Financial Officer and Treasurer*

Curtis Griffith, *Chairman and Chief Executive Officer*

Cory Newsom, *Director and President*

CONFERENCE CALL PARTICIPANTS

Woody Lay, *KBW*

Brad Milsaps, *Sandler O'Neill*

PRESENTATION

Operator:

Greetings, and welcome to the South Plains Financial Third 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 conference over to your host, Steven Crockett, Chief Financial Officer. Thank you, sir. You may begin.

Steven Crockett:

Thank you, Operator, and good morning, everyone. We appreciate your participation in our Third Quarter 2019 Earnings Conference 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 through 11:59 p.m. Eastern Time on October 31, 2019.

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 our 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 Financial files with the SEC from time to time. Listeners and readers of our earnings release are caution not to place undue reliance on forward-looking statements contain in this earnings call or in our earnings release. 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 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. On today's call, I will briefly review the highlights of our third quarter, and then, provide an update on our pending acquisition of West Texas State Bank. Cory will discuss the success that we have achieved improving our profitability and returns as we scale our infrastructure and remain disciplined on expenses. Steven will then conclude with a more detailed review of our Third Quarter Financial Results.

To start, I'm very pleased with our results as they clearly demonstrate the successful execution of our strategy to grow the bank while also improving our returns as we pursue our long-term goal of achieving returns in line within or better than our peers.

For the third quarter, we reported net income of $8.3 million, or $0.45 per diluted common share, as compared to net income of $6.1 million, or $0.37 per diluted common share in the second quarter of 2019. Net interest income increased to $26.6 million for the third quarter of 2019, as compared to $24.8 million for the second quarter.

While overall loan growth has been solved, we've benefitted from our normal cyclical ag funding this quarter combined with improved cost of funds. As a result, our net interest margin has increased 19 basis points from the second quarter to 4.07%.

Our cost of funds improved 10 basis points to 98 basis points compared to the second quarter as we experienced of positive mix-shift to non-interest bearing deposits in the third quarter, as well as a decline in interest rates paid during the quarter.

As Cory will touch on in more detail, our key focus of our strategy is to leverage the significant investments that we have made in our infrastructure while also reducing our expense base in order to deliver peer average or better returns, which we believe will create real value for our shareholders.

Today, our infrastructure can handle significant asset growth which will allow us to further scale the bank without adding incremental people or investments. Additionally, this investment will also allow us to push those strategic M&A, like our pending acquisition of West Texas State Bank, or WTSB, which we detailed on our second quarter earnings call.

As a reminder, WTSB is headquartered in Odessa, Texas and operates six bank branches located across five West Texas communities. It will be rebranded to City Bank upon closing of our acquisition. At quarter end, WTSB had $430 million in assets, $375 million in deposits, and $200 million in loans. All of which are consistent with their second quarter financials.

I am pleased to report that we have received all necessary regulatory approvals and expect to close the acquisition on October 3. Ahead of our expected closing, we've been working closely with the WTSB management team on our integration plan and are very pleased with the mutual spirit of collaboration. We continue to believe that our resulting balance sheet will be a competitive advantage, and open City Bank to new business opportunities. We also anticipate cross-selling opportunities with WTSB customers for our mortgage, wealth management, and trust products. In meeting with their branch employees, we believe there is a real need for mortgage lending in WTSB's more rural markets, and we believe our mortgage banking teams will be able to hit the ground running very quickly post-close.

We also believe that there will be strong demand for our wealth management and trust products in WTSB's markets, and are optimistic that we will be able to generate revenue synergies in addition to the cost synergies that we had previously outlined. In regards to our expectations for cost synergies, we continue to expect that we will reduce WTSB's non-interest expense by 30% by 2021, approximately 75% of which we expect to achieve next year.

We continue to expect 20% earnings accretion over four quarters beginning in 2020 for the tangible book value per share earn back of less than four years.

I'd now like to turn the call over to Cory.

Cory Newsom:

Thank you, Curtis, and good morning, everyone. As Curtis discussed, we are very pleased with our progress of working with our WTSB management team as we prepare to close the acquisition and begin to bring their operations into City Bank.

A key advantage that we have relative to our community bank peers is the significant investments that we've made in our systems and infrastructure which position the bank for growth and expansion. In fact, we believe these investments will allow us to scale our business without commensurate additional expenses and will help the bank deliver peer average or better ROA and ROE.

As we continue to grow the bank, both organically and through accretive acquisition, we will remain discipline on expenses as we continue to optimize our cost structure to further improve our profitability. An example of this can be seen in our third quarter results which benefitted from a redesign of our benefit plan be more in line with our peers, as well as continued operational efficiency gain which has allowed us to reduce our headcount. Taken together, we were able to reduce personnel expense by approximately $650,000 in the third quarter of 2019 which marks the second quarter in a row of personnel cost savings.

Importantly, these actions were focused on improving our efficiency without sacrificing customer satisfaction. Additionally, we have implemented technology solutions to help us handle loan growth more efficiently and without adding incremental costs or people, as Curtis mentioned.

Though we did experience one-time costs associated with our IPO and acquisition of WTSB, we see our core forward run rate expenses in the low $29 million range for the fourth quarter versus $30 million run rate that we've been operating at thus far in 2019.

Our success is also beginning to show itself in our financials as we improved our efficiency ratio by 123 basis points year-over-year for the third quarter. Our return-on-average assets increased by 44 basis points year-over-year to 1.8% annualized, and our return-on-average equity increased by more than 200 basis points year-over-year to 11.1% annualized in the 2019 third quarter. While we're pleased with the results, we recognize that this is a journey and know that we have more to accomplish.

Turning to loan growth, the environment has remained challenging, but we will not sacrifice credit quality for growth. In the third quarter, we grew loans by 5.6% annualized, or by $27 million for the second quarter. This growth was primarily the result of seasonal agricultural production loan net funding of $19 million. Overall, we've experienced an increase in loan pre-payments and payoffs which has been a headwind to loan growth. That said, I'm encouraged by our loan production as we have generated over $500 million in new loans year-to-date. For the full year, we expect loan growth to be broadly flat year-over-year before accelerating into 2020 to more normal levels.

Turning to fee income, which is a priority for our team. We have generated $14.1 million of non-interest income in the 2019 third quarter which compares favorably to the $13.7 million that we generated in the second quarter. The increase was primarily the result of the strength of our mortgage banking business given the sharp decline in interest rate so far this year. Overall, our fee income is primarily driven by our mortgage operation, debit card, and other bank service charge income, and income from our insurance, trusts, and investment service business. Our fee income provides shareholders with a recurring and diversified earnings stream as it represented 35% of total revenue for the third quarter.

Looking forward, we are excited by the opportunities that we see to further expand our fee income through potential cross selling of our products into the more rural communities in which WTSB operate, as well as expanding our crop insurance business. As a reminder, our crop insurance business is a good business for us as it generates healthy fee income without presenting the bank with underwriting risks.

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

Steven Crockett:

Thank you, Cory. This morning, I will briefly review the remainder of our third quarter 2019 results, as Curtis and Cory have touched on many aspects of our results, before turning the line back over to Curtis for concluding remarks.

In the third quarter of 2019, deposits were essentially flat at $2.29 billion as compared to the 2019 second quarter. That said, we experienced a positive mix-shift as non-interest bearing deposits increased by $43 million while interest-bearing deposits decreased by $39 million. We ended the third quarter of 2019 with total non-interest bearing deposits of $556 million or 24.3% of total deposits, compared to $513 million or 22.5% of total deposits at the end of the second quarter 2019. This mix-shift contributed favorably to the 10 basis point decline in our cost of fund.

Though Cory touched on our loan growth in the quarter, I would reiterate that we pride ourselves on our discipline credit culture and will not sacrifice our underwriting standards to drive loan production. As a result of this, our non-performing assets to total assets ratio declined six basis points during the third quarter of 2019, down to 31 basis points at the end of the quarter. I will also note that we recorded $420,000 of provision for loan loss expense in the quarter which reflects our annualized net charge-off rate of eight basis points, coupled with below trend loan growth. As loan growth re-accelerates through next year, I would expect our provision expense to rise to more normal levels.

The yield on average earning assets was 5.16% for the third quarter, an increase of 19 basis points as compared to the same period in 2018. It was driven by an increase in our yield on total loans of 34 basis points to 5.91%.

To conclude, we remain well capitalized to support our growth of tier one capital to average assets of 12.17% at the end of the third quarter of 2019, compared to 10.09% in the third quarter of 2018. Our priority for capital remains focused on strategic M&A designed to increase the franchise value of South Plains like our pending acquisition of WTSB, as well as continued organic growth.

Our second priority is to return capital to shareholders through a consistent dividend. Last week, we announced that our Board of Directors had approved our second consecutive 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 will now turn the call back to Curtis for concluding remarks.

Curtis Griffith:

Thank you, Steve. To conclude, I'm very excited with the progress that we've achieved executing on our strategic plan to grow the franchise value of City Bank, which is focused on organic growth, strategic acquisitions, and achieving the benefits of scaling our infrastructure which can handle significant asset growth.

Our third quarter financial results demonstrate the success that we are achieving as we markedly improve our earning profile at the bank and we have made strong progress working to close our acquisition of WTSB, which will provide both cost and revenue synergies as we look to next year. I would like to thank all of our employees for their hard work for they are the key to our success.

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

Operator:

Thank you. At this time, we will conduct 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 while we poll for our first question.

Our first question comes from the line of Woody Lay with KBW. Please proceed with your question.

Woody Lay:

Morning, guys.

Curtis Griffith:

Morning.

Steven Crockett:

Good morning.

Woody Lay:

The NIM growth was really impressive this quarter. I know that some of that was related to the decrease of deposit costs, and I'm guessing some of it is related to increase in ag loans. Just curious as to ag loan run off with seasonality, do you expect the NIM to give up the gains added this quarter?

Steven Crockett:

Yes. We definitely did see an increase as we normally do in the third quarter in our ag fundings. We do expect the NIM to drop back just a little bit. Ag loans will pay down in the fourth quarter. We did see a few things in the NIM not totally out of the norm from what we see during different quarters. We did have a servicing fee that came in for a couple basis points. We also had a recovery of some non-accrued interest on an ag loan that paid off. We did have five or six basis points increase in the NIM for a couple of those items. But, again, we typically have some different servicing fees and some other of those type fees that come in throughout the quarter.

Curtis Griffith:

This is Curtis, while it is true we will see some paydowns in ag portfolio, we actually get the bulk of those in January, we'll still have fairly significant balances outstanding in the ag portfolio through the fourth quarter.

Woody Lay:

Got it. That's helpful color. Then, looking at the ag portfolio as a whole, it was nice to see MPA's dip down. I'm just curious about the health of the portfolio and if you're seeing anything out in the market that gives you a little bit of worry on the credit front?

Curtis Griffith:

I think we're still in relatively good shape. Clearly, across the country, ag loans are a point that can certainly give some banks problems. We have scrubbed ours thoroughly. We did have a couple of non-performers that were really related to cattle loans, which we have very, very few of. Our row-crop producers have had a challenging weather year, but the early indications are that they'll be able to pay back their loans, it's just not going to be a very profitable year for them. We'll look again as we always do next spring at our underwriting standards and whether we can go with some or everybody again. But currently, we actually feel pretty good about where we stand on our ag loans.

Cory Newsom:

This is Cory, and I want to add just a little bit of color to that. One of the things that we're seeing on the ag side with the different payments and stuff that the farmers are seeing, we're seeing those balances carry over just a little bit longer throughout the year so that we don't have as much paydown. We are getting the benefit of that that we haven't have in the four or five years ago, the last four or five years. It just takes a little bit longer for them to get all their money in throughout the year. But the thing as far as the asset quality, as we measure our internal classifications within the bank, we find ourselves at a 10-year low per classification for the way we measure. We really think asset quality is in really good shape.

Woody Lay:

That's good to hear. Then, last for me, the strong quarter-on-quarter interest bearing deposit risk, I'm just curious if part of this is related to seasonal influx of ag loans, or if this is just a reflection of (inaudible) growing that bucket?

Steven Crockett:

Yes, this is Steve. We do focus on trying to grow that, and we've had success. I will point out though that about half of that increase we had during the quarter was related to one customer, and that it's something that could shift into an interest bearing at some point. That's not why we're—while we're proud to be where we're at, and we always strive to increase, that's not something we'll necessarily be able to sustain that type of growth each quarter.

Curtis Griffith:

This is Curtis again, we have really worked hard on our treasury management team and the products, and getting those working with our commercial lenders, and we are beginning to see pay-offs in that, where we're getting some substantial corporate deposits from some customers that previously we just weren't seeing and quite of few of those are non-interest bearing. That's where we're trying to go.

Corey Newsom:

This is Cory, and I'll just add one last comment about that. From the technology side of it, we recently rolled out our business commercial app and that has been extremely well received from the Treasury (inaudible). It gives the Treasury management a lot of leg room to keep moving forward with that.

Woody Lay:

That's great color. All right, congrats on the great quarter, guys.

Cory Newsom:

Thank you.

Curtis Griffith:

Thanks, Woody.

Operator:

Our next question comes from Brad Milsaps with Sandler O'Neill. Please proceed with your question.

Brad Milsaps:

Hey, good morning, guys.

Curtis Griffith:

Morning, Brad.

Cory Newsom:

Morning, Brad.

Steven Crockett:

Morning.

Brad Milsaps:

Good, I appreciate you taking my question. Just appreciate the additional info on the asset yield side of the margin. Just kind of curious on the deposit side, the funding side, you guys did a great job of lowering costs this quarter. Kind of curious how aggressive you plan to be if the Fed cuts again in October, and again, maybe in December. I'm just kind of curious how much more room you think you have to pull deposits costs down so you can balance the margin going forward?

Cory Newsom:

This is Cory, and I will tell you that we're going to have to look very strong at it. We have some things that we've—from interest bearing, that are sitting about as low as they can go. But there's some other areas that we do think that there's some cuts and some room in the pricing that we have that we can have some reduction. But the other thing we keep looking at is we know we've got, with the merger of West Texas State Bank coming in, it's going to help us with our liquidity. We're going to have the opportunity to be a little bit more aggressive than we might have been in the past when we looked at some of these cuts. They've got very low cost of fund, but they also have running roughly a 50% loan deposit ratio, we know that we're going to have liquidity and we can do a better job of managing the overall costs.

Steven Crockett:

Yes, Brad, this is Steve. One thing I would add to that, and I think in the press release itself we did selectively target a few areas of some of our larger customers just that had excess balances in some of the public funds or some brokered deposits of some accounts that maybe we were not needing as much liquidity at the time, especially with the West Texas coming up. We were able to lower some of those balances. You see some of that that occurred in the third quarter, and there's a little bit more on the brokered side that you'll see coming in the fourth quarter. That's an additional help to the lowering of the costs.

Cory Newsom:

I guess the main thing out of that is most of that movement was by design and not by default.

Brad Milsaps:

Great, that's helpful. Steve, I noticed the bond book was, on a period basis, about a $100 million plus or minus kind of bigger than the average. I know you'll need some cash for the West Texas deal, but how do you see if you grow the bond book larger than where it currently finished at the end of the quarter, or do you think you did kind of most your pre-investing there?

Steven Crockett:

We’ve still got a little bit of investing we're doing right now. We did have quite a bit of liquidity at the end of the second quarter and even early to mid-third quarter. We decided, especially with the West Texas acquisition coming online with the liquidity that is there, that we wanted to go ahead and start investing those funds today. Especially because their portfolio is very short term right now. We wanted to go ahead and get that. But don't look to have that type of increase going forward.

Brad Milsaps:

That's helpful. Then, just maybe a moment on fees. You guys obviously had a nice quarter there. I was maybe a little surprised that mortgage wasn't up a little bit more than it actually was. I know you made a lot of changes with the mortgage company, and I know you guys are really focused on purchase as opposed to re-fi, but kind of curious if you had any additional color there on the mortgage business?

Secondly, typically, in your crop insurance business, you get a good seasonal lift in the back half of the year. Just curious with everything going on with ag, if you still feel good about that as you get in the back half. I noticed the third quarter was down maybe just a touch from the second. Just any additional color on insurance revenue piece in general.

Steven Crockett:

Yes, overall we're seeing positive things on the crop side. From what I understand, we are still on track to be able to be consistent with where we were last year on the tail end revenues as you mentioned. We did have a little bit of that come in last year in the third quarter, but we should capture all of that in the fourth quarter this year.

Cory Newsom:

This is Cory, and I'll give you a little color on the mortgage. Currently, we're up about 22% year-over-year for production. Our quarter three was up 16% over quarter two, and then, in reference to some of the re-fi, for 77% of the volume in 2019 is purchased versus 83% which shows you that there is some re-fi business that we're able to pick up and actually getting some benefit from. I think you're just going to see that a little bit like a snowball continue to grow over the next several quarters.

Curtis Griffith:

I might add a little bit on color on crop insurance. While, as you indicate, there's challenges out there in the ag sector, but for virtually all producers, purchase of Federal crop insurance really isn't a discretionary choice. I know we do it here in most instances. Whoever is financing those farmers will require the purchase of that crop insurance. That's just not a revenue stream that varies very much.

Brad Milsaps:

Got it, thanks, Curtis. I wasn't sure if you got extra bonuses depending on performance of the insurance contract.

Cory Newsom:

There's a little bit of it, since we don't take any underwriting risks, we kind of don’t pick up that upside either.

Curtis Griffith:

That's basically a choice. We could have a format in which we basically shared some upside, but you might share some downside, we chose not to go that way.

Brad Milsaps:

Got it, that's helpful. Just one final question, I was writing quickly, I think where you mentioned you thought expenses would go back into kind of the low $29 million range. I think I picked up there's about $300,000 to $400,000 for the costs related to IPO, as well as the West Texas deal. Is that about the right number there?

Steven Crockett:

Yes.

Brad Milsaps:

Okay. Then the rest of the savings would just come from just you guys continuing to kind of wring out costs in the system as you did this quarter?

Cory Newsom:

Yes, I think that's a fair—I mean, we continue to try to find ways to streamline and improve what we're doing. We'll pick up some benefit. It's going to take a little while to get all the benefits for West Texas State Bank in there, because we're going to have to get those computer conversions and everything done. It just gets some of the professional fees and other non-interest expenses back in line where they should be and benefit from what we've already built as a system as a whole.

Brad Milsaps:

That's great. Really good quarter, guys, thank you.

Steven Crockett:

Thanks.

Curtis Griffith:

Thank you.

Cory Newsom:

Thanks.

Operator:

Thank you. At this time, I would like to turn the call back over to Management for closing comments.

Curtis Griffith:

This is Curtis Griffith. We thank everybody for being on the call, appreciate your interest in South Plains Financial. We're excited to see the trends that we believed we could achieve beginning to start. It's a long road ahead of us, we're very excited to proceed with our first major acquisition, and are excited about what that will bring to the table for us, both in asset footings and in quality of talent that's going to help us really make a good presence down in the Permian Basin, and we'll see where things go from there.

We will continue to be looking over the next 12 months for other acquisition targets. We don't have anything on line at this time. But certainly, we will continue to be in a mode of growth through both great organic growth and solid acquisitions.

Operator:

This does conclude today's teleconference. You may disconnect your lines at this time, and have a great day.