South Plains Financial, Inc.

Fourth Quarter 2019 Earnings Call Transcript

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CORPORATE PARTICIPANTS

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Cory Newsom, *Director and President*

CONFERENCE CALL PARTICIPANTS

Woody Lay, *KBW*

Graham Dick, *Piper Sandler*

PRESENTATION

Operator

Good morning, ladies and gentlemen. Welcome to the South Plains Financial Fourth Quarter 2019 Earnings Conference Call. During today's presentation, all parties will be in listen-only mode. Following the presentation, the conference will be open for questions with instructions to follow at that time.

As a reminder, this conference call is being recorded. I would now like to turn the call over to Mr. Steven Crockett, Chief Financial Officer of South Plains Financial. Please go ahead, sir.

Steven Crockett, *Chief Financial Officer and Treasurer*

Thank you, Operator, and good morning everyone. We appreciate your participation in our Fourth 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 February 7, 2020.

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 statements 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 anticipated future results, performance or achievements expressed in or implied by the forward-looking 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 cautioned not to place undue reliance on forward-looking statements contained 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, *Chairman and Chief Executive Officer*

Thank you, Steve, and good morning.

On today's call, I will briefly review the highlights of our fourth quarter of 2019, and then provide an update on our acquisition of West Texas State Bank, or WTSB, which closed on November 12th of last year. Cory will discuss the progress that we achieved in the fourth quarter improving the return profile of City Bank, as well as an update on the investments that we have made to drive organic growth in 2020 and beyond. Steve will then conclude with a more detailed review of our fourth quarter 2019 financial results.

To start, I continue to be very pleased with our results as we execute on our strategy to grow the Bank and improve our returns as we scale our infrastructure and remain disciplined on expenses. While we have more work to do to attain our long-term goal of delivering returns in line with or better than our peers, I am very proud of the success that our employees achieved this past year and would like to thank them for their hard work.

Turning to our financials. Please note that they include WTSB's results or approximately half of the 2019 fourth quarter, which will skew comparisons to the third quarter. As a reminder, WTSB had $199 million in loans, $386 million in deposits and $51 million in capital upon closing of the acquisition, all of which were consistent with the levels that we reported on our third quarter 2019 earnings call.

For the 2019 fourth quarter, we reported net income of $10.1 million, or $0.55 per diluted common share, as compared to net income of $8.3 million, or $0.45 per diluted common share in the third quarter of 2019. Net interest income increased to $28.6 million for the fourth quarter, as compared to $26.6 million for the third quarter of 2019. The increase was largely attributable to a rise in our average loans of $110 million primarily from the WTSB acquisition and a decrease of 30 basis points in the rate paid on one-time interest-bearing deposits.

Our net interest margin decreased modestly in the fourth quarter to 4.03% from the third quarter's level of 4.07%. Of note, our average cost of funds declined 22 basis points to 76 basis points as compared to 98 basis points in the 2019 third quarter. This improvement was largely driven by the acquisition of WTSB's low-cost deposit.

As you can see, we experienced a strong initial benefit from our acquisition of WTSB and continue to be very pleased with the progress that we have achieved integrating their customers, employees and operations into City Bank. A focus of our team has been on both the customer and employee experience to ensure they continue to receive the support and information that they need to successfully transition to our Bank. As an example, our marketing department has created educational materials for WTSB customers to proactively address questions and concerns as we remain focused on delivering a terrific customer experience, which is a critical part of City Bank's success over the years. 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. Our focus on our customers and the communities that we serve is at the center of what we do everyday, and we are working to deliver that commitment and service to our new customers in the Permian Basin. While we are still early in the integration of WTSB, we are very pleased with the initial results and feedback that we have received.

From a system's perspective, we expect to have our conversion completed by the end of the first quarter of 2020, and believe that we will hit our target of 20% earnings accretion over four quarter's beginning in 2020, with a tangible book value per share earn-back of less than four years.

From a revenue perspective, we also see synergies, which are not included on our earnings accretion outlook. As we discussed on the third quarter 2019 earnings call, we have several cross-sell initiatives underway, given the demand that we anticipate for our mortgage, wealth management and trust products. We believe there is a real need for mortgage lending in WTSB's more rural market and believe there will be a strong demand for our wealth management and trust products in our new Permian Basin customer base.

In addition, we've also gained significant experience over the last six months working to integrate WTSB and we're developing a process which we can perfect and utilize in future acquisitions. M&A will continue to be an important growth driver for our Bank and we see several strong potential acquisition candidates across our core markets, which will enable South Plains to increase the franchise value of the Bank for the benefit of all of our stakeholders. While we still have more to do to fully integrate WTSB, we are now at a point where we can begin looking at additional M&A opportunities. I need to emphasize that the timing of acquisitions is always uncertain and dependent on many factors often outside of our control.

Turning to our market, the outlook for the Texas economy is robust, as unemployment remains low and economic activity remains healthy. In the Permian Basin, we have seen a small slowdown in drilling activity, but we are seeing more pipeline construction, which we expect to spur more development. In our Ag portfolio, 2019 was a very tough year for our producers. We are proud of the support that we continue to provide to our producer customers, which we hope will position us well when the market improves and are optimistic that a resolution of the U.S. trade issues with Mexico, Canada and China will prove a tailwind to our agricultural customers. Looking to 2020, we expect loan growth to reaccelerate given this favorable market backdrop and which Cory will touch on in more detail.

Cory?

Cory Newsom, *Director and President*

Thank you, Curtis, and good morning everyone.

As Curtis discussed, we are very pleased with the integration of WTSB and extremely excited to expand our business into the Permian Basin, given the opportunities that we seek to expand our franchise and grow the Bank. The acquisition of WTSB should allow us to leverage the significant investments in our systems and infrastructure which continue to have ample room for further growth. As we grow organically and through future acquisitions, we expect to be able to scale our business without commensurate additional expenses.

Benefits of this scale and leverage can already be seen in our fourth quarter results where our efficiency ratio improved by almost 400 basis points to 69.7% as compared to 73.6% in the 2019 third quarter. Our return on average assets increased by 14 basis points to 1.32% annualized as compared to 1.18% annualized in the 2019 third quarter, and our return on average equity increased by more than 200 basis points to approximately 13.3% annualized as compared to 11.1% annualized in the 2019 third quarter. While we are pleased with our results, we recognize that this is a journey and we know that we have more to accomplish.

Turning to loan growth. Loans held for investment increased $181 million to $2.14 billion at December 31, 2019 compared to $1.96 billion at September 30 of 2019. This growth was largely the result of $199 million of acquired loans from WTSB offset by $36 million in seasonal agricultural production loan paydown. As we discussed on the third quarter 2019 earnings call, we continue to experience an increase in loan prepayments and payoffs, which have continued to be a headwind to loan growth. Another headwind has been our commitment and discipline in maintaining strict credit standards which is central to our culture at the Bank. We will not sacrifice credit quality for loan growth.

Looking to 2020, we do believe that we are well positioned for our return to loan growth given a strong economic backdrop, combined with investments in bankers (phon) that we have made through the second half of 2019. We've been adding high-quality, experienced lenders at our major Texas market as we continue to see an opportunity to take market share and grow the Bank organically. As our new lenders ramp-up, we expect loan growth to reaccelerate to a low single-digit rate. That said, there is a seasonality to our business and we further expect that our Ag portfolio will continue to experience paydowns through the first quarter before stabilizing in the second quarter and rebuilding.

Turning to fee income, which is a priority for our team, we generated $16.7 million of non-interest income in the 2019 fourth quarter, which compares favorably to $14.1 million that we generated in the 2019 third quarter. The increase was primarily the result of a $1.5 million in annual profit-sharing bonuses related to crop insurance activities that we recognized in the 2019 fourth quarter, combined with continued strength in our mortgage banking services, given the tailwind that we had experienced from the decline in interest rates. 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. Our fee income provides shareholders with a recurring and diversified earnings stream as it represented 37% of total revenue for the fourth quarter.

Looking forward, we are excited by the opportunities that we see to further expand our fee income through the potential cross-selling of our products into the more rural communities in which WTSB has operated, 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 risk.

Last, but certainly not least, I'm very pleased to announce that we have concluded our search for a Chief Credit Officer. We are very excited to have Brent Bates join the Bank as our new Chief Credit Officer on February the 1st. Brent has tremendous experience, having spent the last three years as the Division Credit Officer for Simmons First National Corporation, following their acquisition of Southwest Bancorp, where he served as the EDP and Chief Credit Officer. Throughout Brent's career, he has had significant experience building and managing bank credit teams, executing acquisitions, and managing challenged assets. Brent's skill set and experience will align very well with South Plains' credit culture and we believe that he will be a tremendous asset as we grow the Bank both organically and through strategic M&A.

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

Steven Crockett, *Chief Financial Officer and Treasurer*

Thank you, Cory.

This morning, I will briefly review the remainder of our fourth 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 fourth quarter of 2019, deposits increased $411 million to $2.70 billion as compared to $2.29 billion in the 2019 third quarter. The increase in deposits during the quarter was largely a result of the assumption of $386 million in deposits from the WTSB acquisition. We ended the fourth quarter of 2019 with total non-interest bearing deposits of $791 million or 29.3% of total deposits compared to $556 million or 24.3% of total deposits at the end of the third quarter 2019. $222 two million dollars of our non-interest bearing deposits are attributed to the WTSB acquisition. This shift to a higher percentage of non-interest bearing deposits contributed favorably to the 22 basis point decline in our cost of funds in the fourth quarter of 2019.

Cory touched on our loan growth, but I would like to reiterate that we remain committed to our disciplined credit culture and remain diligent on not sacrificing our underwriting standards to drive loan production. I would also like to reiterate that we have seasonality in our business as we experienced $36 million of Ag loan production pay-downs in the fourth quarter of 2019 and expect further paydowns in the first quarter of 2020, which will be a headwind to our net interest income. Our fee income also benefited from $1.5 million in annual profit-sharing bonuses in 2019, which will not repeat in the first quarter of 2020.

We recorded an $896 thousand provision for loan losses in the fourth quarter of 2019 as compared to $420 thousand in the 2019 third quarter. The rise was primarily attributable to the increase of $460 thousand in net charge-offs for the fourth quarter of 2019. As loan growth picks up through 2020, we expect our provision expense to modestly rise to more normal levels.

The yield on average earning assets was 4.89% for the fourth quarter of 2019, a decrease of 10 basis points as compared to the same quarterly period in 2018, and was driven by the overall decline in interest rates for the fourth quarter of 2019. Additionally, our interest earning assets increased $307 million, with approximately two thirds of this increase attributable to increases in investments and other interest earning assets.

Overall, credit quality remains solid as our non-performing assets to total assets ratio declined 6 basis points to 25 basis points in the fourth quarter of 2019, as compared to the third quarter of 2019.

Given our excess liquidity after the acquisition of WTSB, we made the decision to purchase investment securities as we work to better optimize our balance sheet. In the fourth quarter of 2019, we purchased approximately $300 million of investment securities, primarily consisting of mortgage-backed securities in municipal bonds. Looking forward, we plan to continue to better manage our liquidity to further drive interest income.

As Cory and Curtis have commented, expense discipline is a focus of our Management team. During the fourth quarter of 2019, our non-interest expense was $31.7 million as compared to $30.0 million in the 2019 third quarter. This increase was primarily due to our acquisition of WTSB, which included a $1.1 million increase in personnel expense; new occupancy and other non-interest expenses for the acquired branches; $634 thousand in related fees, such as legal, accounting and consulting fees; and finally, $202 thousand in core deposit intangible amortization expense. As the transition period for WTSB is still very much underway, we also expect to generate further efficiencies without sacrificing customer satisfaction, which will positively impact our expense run rate.

To conclude, we remain well capitalized to support our growth with tier one capital to average assets of 10.74% at the end of the fourth quarter of 2019, compared to 9.63% in the fourth quarter of 2018. Our priorities for capital remain unchanged. With the closing of the WTSB acquisition, we continue to be focused on strategic M&A designed to increase the franchise value of South Plains Financial and the Bank. Organic growth is also a top priority as we invest to drive loan 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 third consecutive quarterly dividend of $0.03 per share. Looking forward, we remain committed to maintaining 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, *Chairman and Chief Executive Officer*

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 fourth quarter 2019 financial results demonstrate the success that we are achieving as we markedly improve the return profile of the bank and we have made strong progress integrating WTSB. I would, once again, 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. We'll now 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.

Thank you. Our first question is coming from the line of Woody Lay with KBW. Please proceed with your question.

Woody Lay, *KBW*

Hey, good morning guys.

Curtis Griffith, *Chairman and Chief Executive Officer*

Good morning, Woody.

Steven Crockett, *Chief Financial Officer and Treasurer*

Good morning.

Woody Lay, *KBW*

Hey. So, I'm just trying to nail down a NIM for first quarter for 2020 seasonality and the rest of the WTSB acquisition from this. Is it fair to sort of assume the NIM could down to be down in the 10 basis point range next quarter?

Steven Crockett, *Chief Financial Officer and Treasurer*

Yes. This is Steve. I would believe that's correct. I mean, as we mentioned, we got our seasonal Ag pay-downs that we really started seeing that toward the end of the fourth quarter and then the very first part of January, so we will be down on our outstanding loan balances just due to that. So, yes, we would expect to see the first quarter NIM drop and then start building back up in the second and third quarter as we fund back those loans.

Woody Lay, *KBW*

Got it. I know last quarter you sort of highlighted that there was 5 to 6 basis points of sort of one-time service charges. Did that sort of normalize in the fourth quarter?

Steven Crockett, *Chief Financial Officer and Treasurer*

There was not anything significant like what we saw last quarter. I mean, there's always a few, smaller things in there but nothing along the lines of what we saw in Q3.

Woody Lay, *KBW*

Got it. In the press release you point to around an $800 thousand increase in fiduciary income linked quarter. I was wondering if you think that its sustainable going forward or that was sort of a one-time

Cory Newsom, *Director and President*

This is Cory. I mean, we feel like that's something that we really move forward with in the near term. We've done major focus on trying to increase the business that we run through our trust and wealth management department. We've actually even brought on some new leadership in that area and we're starting to see some benefits from having done that.

Woody Lay, *KBW*

Okay. Yes, that's great to hear. Last for me, it's great to hear you all are still focused on expense management, and I know during the first half of 2020, it gets a little messy just with WTSB being on for the full quarter and then you have cost-saves running through, just longer term for sort of a core bank, how do you see the expense growth rates going forward?

Steven Crockett, *Chief Financial Officer and Treasurer*

You're exactly right. First quarter and even a little bit into the second quarter as we try to—as we get a full quarter's worth of WTSB numbers in there and then of course we'll still have some conversion expenses and some other acquisition related expenses as that flows through the first quarter. We're projecting net interest expense in the range of $33 million to $34 million for the quarters. That should encompass those additional transactional expenses that we're talking about. But that's our current estimate at this point.

Cory Newsom, *Director and President*

This is Cory. I really think if you were to focus that we have on it, I mean, at worst, I think it's flat. You see some improvement as we move forward because, I mean, short of the growth that we'll have to be able to absorb in bringing on any salaries that's tied strictly to production, we're focused on cutting expenses. It is a company-wide concerted effort to make sure that we do that, and all the while though making sure that we don't do it in any way that would ever cost us in the form of customer service.

Curtis Griffith, *Chairman and Chief Executive Officer*

Well, it was great to see that substantial drop in our efficiency ratio number in Q4. I sure want everybody to hear that in all probability that number will actually go back the other direction in Q1 just because of all the factors that we look at and we had some issues regarding the $1.5 million received in the crop insurance side, that's non-interest income, other factors in there. However, we still feel pretty confident that on a year-over-year basis, you're going to continue to see good improvement in our efficiency ratio by the end of 2020 over what we achieved in 2019.

Woody Lay, *KBW*

Okay, that's great color. Congrats on the nice quarter and thanks for taking my questions.

Curtis Griffith, *Chairman and Chief Executive Officer*

Thank you, Woody.

Operator

Our next question comes from the line of Graham Dick with Piper Sandler. Please proceed with your question.

Graham Dick, *Piper Sandler*

Hey guys. Good morning.

Curtis Griffith, *Chairman and Chief Executive Officer*

Good morning, Graham.

Graham Dick, *Piper Sandler*

So, you know that most of the decline in cost of deposits this quarter was due to the effect of the WTSB acquisition. Can you talk a little bit about what kind of success you all had this quarter in reducing that cost organically kind of like ex the WTSB effect?

Steven Crockett, *Chief Financial Officer and Treasurer*

We definitely did decrease our own organic deposits with rate cuts that were done at the end of the third quarter, so we did see a full quarter's worth of that benefit. And then also, with knowing the liquidity that we were bringing on from the acquisition, we were able to reposition some of our other deposits that allowed us to gain that drop in the cost of funds. So, we did it both organically but then as well as bringing on the WTSB accounts.

Graham Dick, *Piper Sandler*

Okay, great. What kind of additional opportunity do you think you have here, maybe like a 4 or 5 basis point in cost interest-bearing deposits in 1Q20. What kind of lagging effect you're kind of expecting to see?

Steven Crockett, *Chief Financial Officer and Treasurer*

Well, I mean, we definitely expect that to drop just from having WTSB balances on for the full quarter, but there will be other things at work. Obviously, we're not sure what the economic interest rate environment will be, but given the flat environment, we always know we'll have to be fighting pressure from specific accounts and pricing, but we definitely should see that drop just from having those accounts on for the full quarter.

Graham Dick, *Piper Sandler*

Okay, great. Then lastly for me, you guys obviously closed that acquisition this quarter and sound pretty ready to re-enter the M&A market, and given your infrastructure, which is really solid, what do you guys kind of estimate as the biggest in asset bank that you'd be willing to pursue or digest at this point? Are there any particular markets where you'd really like to deepen your presence, maybe more rural or even more into the metro area?

Curtis Griffith, *Chairman and Chief Executive Officer*

We're looking in several locations right now. Some of those would be certainly more rural. We're still primarily focused in the western part of the state. As far as size, we believe we can handle something up to a billion dollars in size that I don't know that there's anything that that works for, but I think we'd be able to handle that. Clearly, that would involve some exchange of stock, most likely to make such a purchase work, but in terms of just pure infrastructure and our ability to integrate a bank, I think we could do anything up to around a billion dollars in size.

Graham Dick, *Piper Sandler*

Okay, great. That's it for me guys. Thanks again and congrats on another great quarter.

Curtis Griffith, *Chairman and Chief Executive Officer*

Great. Thank you, Graham.

Steven Crockett, *Chief Financial Officer and Treasurer*

Thank you.

Curtis Griffith, *Chairman and Chief Executive Officer*

Thank you.

Operator

Thank you. At this time, I'll turn the call back to Mr. Griffith for further remarks.

Curtis Griffith, *Chairman and Chief Executive Officer*

Thank you, Operator. Thanks, everybody, for being on the call today. We're very proud of the quarter that we achieved. Clearly, as we mentioned, on the road show and other discussions with investors, our fourth quarter is generally an excellent quarter. For us, we have a little bit of cyclicality largely due to our agricultural lending activities and we see a substantial drop off in that level of income during the first quarter because of the paydown that we do see and expect to see from our operating loans that we have out to our producers. We are excited to see some resolution out in the area of the trade agreements. Hope that that will move forward and we can again ramp-up some export business and that's certainly going to help our producers financially. But clearly, our Q1 numbers will see the effect of having those reduced loan balances in place and also not having some of the seasonal things that we have happened in Q4 each year.

So, I certainly want to not have any surprises for anyone out there as we look at what we do in Q1 because we would not expect to have quite the level of results that we saw here in Q4, but we think we're still on a solid track moving forward and expect 2020 to be even better than 2019.

So, thank you all for participating and for being part of our growth in South Plains Financial.

Operator

This concludes today's conference. You may disconnect your lines and we thank you for your participation.