South Plains Financial, Inc.

Third Quarter 2020 Earnings Call Transcript

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C O R P O R A T E P A R T I C I P A N T S

Steven Crockett, *Chief Financial Officer and Treasurer*

Curtis Griffith, *Chairman and Chief Executive Officer*

Cory Newsom, *President and Director*

Brent Bates, *Chief Credit Officer of City Bank*

C O N F E R E N C E C A L L P A R T I C I P A N T S

Brady Gailey, *KBW*

Brad Milsaps, *Piper Sandler & Co.*

P R E S E N T A T I O N

Operator

Good afternoon, ladies and gentlemen, and welcome to the South Plains Financial Third Quarter 2020 Earnings Conference Call.

During today's presentation all parties will be in a 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 like now to turn the call over to Mr. Steven Crockett, Chief Financial Officer of South Plains Financial. Please go ahead, sir.

Steven Crockett

Thank you, Operator, and good afternoon, everyone.

We appreciate your participation in our Third Quarter 2020 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 through November 10, 2020. Additionally, a slide deck to complement today's discussion is available on the Investors 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 in future results. Please see our Safe Harbor statement beginning on Page 4 of our earnings press release and on Slide 2 of the presentation. All comments made during today's call are subject to that Safe Harbor statement. 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. 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 afternoon.

On today's call, I will provide a high-level review of our results and an update on our priorities for capital in light of our recent subordinated note issuance. Cory will discuss the stabilization that we have experienced in our loan portfolio, as we have seen a sharp decline in active modifications related to COVID-19 during the third quarter, as well as the success that we have achieved growing our mortgage business and scaling our infrastructure. Steve will conclude with a more detailed review of our third quarter 2020 financial results, and we will then open the call for your questions.

To start, I am very pleased with our performance as the Bank’s operations continue to run smoothly, and our customers have largely weathered the uncertain economic environment to date. Our ability to manage through this crisis is a testament to our team and the significant steps that we have taken over the last six years to improve our systems, as well as instill a conservative credit culture at the Bank, which can be seen in our credit metrics this quarter.

Turning to Slide 4. We reported net income of $16.7 million or $0.92 per diluted common share for the third quarter of 2020, which compares to net income of $8.3 million or $0.45 per diluted common share that we reported in the third quarter of 2019.

Pretax pre-provision income for the third quarter of 2020 was $26.9 million, which compares to $20.1 million in the second quarter of 2020 and $10.7 million in last year's third quarter.

We recorded a $6.1 million provision for loan loss in the third quarter of 2020, which compares to $13.1 million in the second quarter of 2020 and $420,000 provision in the year ago quarter. Our provision expense in the third quarter was largely qualitative as we continue to take a conservative approach to credit.

Our decision to allow our borrowers to modify their loans to interest-only payments early in the pandemic has proven to be a sound one, as this has allowed our customers to build cash and better manage their businesses during the peak of this crisis. Importantly, we have experienced a sharp decline in active modifications related to COVID-19 during the third quarter, with only 5.4% of our portfolio remaining in modification versus 19.9% of the portfolio at June 30, 2020, as detailed on Slide 5. While we are optimistic that our local economies are improving with the pace of business accelerating, we will continue to aggressively manage our portfolio and the credit quality of the Bank.

As I touched on last quarter, the Bank continues to enjoy substantial growth despite the challenges that we have faced as a result of the pandemic. In the third quarter of 2020, we grew book value per share to $19.52 as compared to $18.64 in the second quarter of 2020. I'm very proud of the growth that we have been able to deliver in what has been a challenging environment, and despite recording an outsized provision expense again this quarter.

Turning to capital. We issued $50 million of 4.5% fixed to floating rate subordinated notes at the end of the third quarter that qualifies as Tier 2 capital for regulatory purposes. We were very pleased to be able to issue these notes at an attractive interest rate that will position the Bank to take advantage of dislocations that may arise from the pandemic.

Looking forward, having very strong capital levels will allow us to focus on opportunistic and accretive M&A while providing a steady return to our shareholders through our quarterly dividend. We believe this approach will maximize value for our shareholders.

In regards to M&A, our goal is to find attractive acquisitions like West Texas State Bank, or 'WTSB', which will allow us to expand our geographic reach while also scaling our infrastructure, which has the capacity to handle upwards of $5 billion in asset with minimal incremental expense. We believe this will help us to achieve our longer-term goal of delivering returns in line with or better than our peer group.

Despite the drop in energy prices and slowing economic activity in the Permian, our acquisition of WTSB has been very successful as we have exceeded our cost save goals and are in the process of driving cross-sale opportunities to accelerate revenue growth. To accomplish this, we recently launched an internal application, which encourages employees to focus on cross-selling that has raised awareness and is beginning to deliver results. We also rolled out our community rewards program on October 1st, which encourages members of the community to visit our website to vote for their favorite not-for-profit organizations. We have found this program to drive real customer engagement, and see this as a way to further embed City Bank into the local Permian communities.

In regards to our dividend, I am pleased to report that our Board of Directors approved an increase in our dividend to $0.05 per share on October 22, which represents our sixth consecutive quarterly dividend. Importantly, our capital raise provides the balance sheet strength to provide the flexibility to pursue accretive acquisitions and maintain our dividend while the economic environment remains uncertain.

Turning to our local economies. We started to see a rebound through the summer, which was echoed by the Dallas Fed's most recent report, where they also noted an acceleration across Texas, driven by the statewide decline in new COVID cases from the July peak and the result of improvement in consumer spending. We are watching the pandemic and recent trends closely as cases have once again started to rise. That said, we remain optimistic as the economy in Lubbock is seeing a nice pickup as new projects are breaking ground, lifting local employment and spending, and Texas Tech University remains in session.

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 7. Loans held for investment at the end of the third quarter of 2020 were $2.29 billion, which is a $43 million decrease from the second quarter of 2020 and a $326 million increase from the third quarter of 2019. The decline from the second quarter of 2020 was largely driven by paydowns of $10 million in non-residential consumer loans and $8 million in direct energy loans. We also experienced early payoffs of several large commercial real estate loans during the third quarter of 2020.

As Curtis touched on, our aggressive management of our loan portfolio and the assistance that we provided to our customers early in the crisis has paid dividends. By allowing our borrowers to modify their loans primarily to interest-only for six months, they were able to more effectively manage and run their businesses during a very uncertain time. As the economy has improved, the majority of our customers have returned to pre-modification payment terms. These preliminary results are also a validation of our investment in the ERM system, which has provided a process to quickly detect and address potential problems in our loan portfolio. Our ERM system has greatly improved our ability to manage our loan portfolio through the pandemic.

Turning to Slide 9. The one area of the portfolio which will take more time to resolve is our hospitality exposure, which has $119 million in loans, representing approximately 5.7% of our portfolio, excluding PPP loans. At the end of the third quarter, our hospitality portfolio was approximately 60% of our active loan modifications. These modifications are generally 12-month, interest-only or a combination of a 90-day deferral and 9-month interest-only. Importantly, only 2% of these loans are on nonaccrual, and none are 30 days or more past due at September 30. We are also looking for opportunities to improve the Bank's position and obtain additional collateral as we work with our borrowers through the modification process.

Our direct energy exposure at quarter end was $71 million or 3.4% of our loan portfolio, excluding PPP loans. This is a modest decline from the second quarter's level of $79 million. We continue to feel comfortable with our exposure, as oil prices have stabilized and activity in the Permian has modestly improved from the second quarter's levels. As a reminder, almost half of our direct energy exposure is one service sector loan where we have strong guarantor support outside of the energy industry.

Turning to fee income on Slide 10, we generated $31.7 million of noninterest income in the third quarter of 2020, which compares to the $24.9 million that we generated in the second quarter of 2020 and $14.1 million that we generated in the third quarter of 2019. The increase from the second quarter of 2020 was primarily due to the growth of $3.5 million in mortgage banking revenues given an increase of $31.8 million in mortgage loan originations. We also experienced a $2.3 million increase in income related to our insurance activities. For the third quarter, fee income represented 50% of total revenues as compared to 35% in the quarter a year ago.

A key focus for the Bank has been increasing efficiencies as we grow in order to expand our profitability and improve our return on assets. To accomplish this, we've maintained our expense structure as volumes in our mortgage business have grown, which has contributed to our strong margin gains while insulating the Bank against eventual decline in refinance volumes. This can be seen in our efficiency ratio for the third quarter of 2020, which was 56.9% as compared to 63.3% in the second quarter of 2020 and 73.6% in the third quarter of 2019. I'm very pleased with the continued progress that we have achieved scaling our infrastructure, and see room for further growth and profitability gains. That said, I would expect our efficiency ratio to pull back with the eventual decline in refinance volumes through next year.

We expect the earnings power of the Bank, however, to remain robust as credit continues to normalize and the growth investments that we have made recruiting talented bankers to take market share becomes more evident with an improving economy. In fact, we are already starting to see the benefits of our investments in our mortgage business. While the low interest rate environment has certainly benefited refinance activity, the seasoned mortgage teams that we have brought on over the last year have been instrumental in driving market share gains in the builder and purchase markets. Another good example is in our commercial lending in El Paso, where we brought on a new market leader who has strong relationships in the city and has been instrumental in bringing new business to City Bank. Taken together, this provides optimism for organic growth as we are seeing similar positive trends in many of our local economies as our investments are starting to bear results.

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

Steven Crockett

Thank you, Cory.

Starting on Slide 12. Net interest income was $31.3 million for the third quarter of 2020 as compared to $30.4 million for the second quarter of 2020 and $26.6 million for the third quarter of 2019. The increase since the third quarter of 2019 was primarily attributable to a rise in our average loans of $414 million, from the WTSB acquisition as well as PPP loans that were funded largely in the second quarter, partially offset by a decrease of 63 basis points in non-PPP loan rates due to the sharp decline in the rate environment experienced in the first quarter of 2020. During the third quarter of 2020, we recognized $1.1

million of PPP fees as an adjustment to interest income. There is currently $6.1 million in unrecognized deferred PPP fees.

Our net interest margin increased to 3.82% in the third quarter of 2020 as compared to 3.79% in the second quarter of 2020.

Our average cost of deposits declined 5 basis points to 34 basis points in the third quarter of 2020 as compared to 39 basis points in the second quarter of 2020 and 98 basis points in the third quarter of 2019. This improvement was largely due to the 150 basis point decline in the federal funds rate in March of this year, which allowed us to further lower the rate we pay on deposits. We believe there is some additional room to lower our deposit cost in the future, and we will continue to monitor our rates.

In the third quarter of 2020, deposits were essentially constant at $2.94 billion as compared to $2.95 billion in the second quarter of 2020, as can be seen on Slide 13. We ended the third quarter of 2020 with total noninterest-bearing deposits of $906 million or 30.8% of total deposits, which compares to $941 million or 31.9% of total deposits at the end of the 2020 second quarter and 24.3% in the year ago third quarter.

Turning to Slide 14. Our nonperforming assets to total assets ratio increased 13 basis points to 46 basis points in the third quarter of 2020 as compared to the second quarter of 2020. The increase in the third quarter related to a $5.4 million relationship in the transportation industry that was put on nonaccrual. The loans have performed as agreed, but were placed on nonaccrual status due to stress in the borrower's industry. Subsequent to quarter end, the borrower paid off $2.1 million of this debt in October. As Curtis mentioned, we did add to our allowance for loan losses in the third quarter of 2020 given the uncertainty that continues to exist as a result of COVID-19. That said, our provision recorded for the third quarter was largely qualitative and represents our conservative credit culture. Additionally, our portfolio remains very well reserved as our ALLL to total loans, excluding PPP loans, was 2.22% at September 30, 2020 compared to 1.91% at June 30, 2020.

The yield on average interest-earning assets was 4.21% for the third quarter 2020, a decrease of 95 basis points as compared to the same quarterly period in 2019 and was driven by the overall decline in interest rates over the time period. Additionally, our interest-earning assets increased $691 million, primarily to our acquisition of WTSB and the origination of PPP loans.

Skipping ahead to Slide 16, our noninterest expense was $36.0 million in the third quarter of 2020 as compared to $35.2 million in the second quarter of 2020. This increase was primarily due to an additional $758,000 in commissions and other higher variable expenses related to the strong mortgage activity this quarter, partially offset by a recovery of $303,000 from the previously disclosed settlement of a law suit, as well as other expense reductions.

Skipping ahead to Slide 18. We remain well capitalized with tangible common equity to tangible assets of 9.25% at the end of the third quarter of 2020 compared to 8.66% at the end of the second quarter of 2020 and 10.62% in the third quarter of 2019.

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

Curtis Griffith

Thank you, Steve.

Our third quarter results are a validation of the strategy that we laid out on our IPO road show a little more than a year ago, as we have remained disciplined on expenses and are effectively scaling our infrastructure, which can be seen in our record efficiency ratio of 56.9% this quarter as compared to 81.8% at our IPO.

We have instilled a conservative credit culture, and our ERM system has helped us manage the current cycle. Importantly, we feel well reserved and capitalized to take advantage of future opportunities.

We successfully acquired WTSB and have overachieved on our expense save expectations. Through the integration, we have developed a skill set which will help us to more efficiently and profitably execute our next acquisition.

Lastly, we have attracted talented bankers who have contributed to our organic growth this quarter and who will help position the Bank for future growth as the Texas economy continues to normalize.

We have accomplished much in a short period of time and are excited with the opportunity ahead. None of this, however, would have been possible without the tireless efforts of our employees and their commitment to both the Bank and our customers. I would like to thank them. Cory, Steve, Brent and myself greatly appreciate everything that you do.

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

Operator

Thank you. We will now be conducting a question-and-answer session. If you would like to ask a question please press star, one on your telephone keypad. 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. One moment please while we poll for questions.

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

Brady Gailey

Thanks. Good afternoon.

On the sub-debt raise, I hear you that you're interested in M&A longer term and building out West Texas. But I mean, if you look at where your stock trades, it's a little below 80% of tangible book value, which is pretty compelling. What do you think about share repurchases?

Curtis Griffith

This is Curtis. Let me address that one.

We do see some of our other banks in our markets that are coming back into restarts and share repurchase activity, and frankly, I think when you have a bank that's trading below tangible book, that's a wise use of capital, to go out and do that. We've had some discussions at board level about that, and I think that's something we would certainly consider here in the near term.

Brady Gailey

All right. And then, I mean, you guys have done a great job of building your reserves up. I mean, now a little over 2.2% of non-PPP loans. Would you consider that a high watermark, or do you think that you could see the reserve continue to build from here?

Brent Bates

This is Brent.

I think we feel—I feel really good about where our reserves are right now. We're not seeing—as you can tell, we're not seeing broad deterioration in the sectors. And as we continue on through this pandemic, I think we're just going to have to continue to evaluate it. But right now, I feel really good about where we have reserves.

Brady Gailey

Okay. Then, you guys did a really nice job of holding the net interest margin this quarter, even up a couple of basis points. How do you think about the net interest margin - I'm not sure if you look at spread income dollars, however you want to look at it - but how do you think about that going forward?

Steven Crockett

Yes, Brady, this is Steve.

Yes, we ended up with a good quarter on net interest margin. We did have a few basis points of additional purchase loan income in there. Otherwise, we would have been basically flat. Going forward, I mean, we do—we know we will continue to see pressure on the loan side with repricing some loans and new loans that come on the books and maybe having some lower rates than what we had on the books. But we do—as you noticed our deposit side, we were able to reprice down there, and we believe there's still some room there that we can continue to lower that, but I mean we do expect to see some modest pressure to the NIM this next quarter.

Brady Gailey

Okay. And then finally, for me, if you look at loans ex PPP, they were down a little bit linked quarter this quarter. How are you thinking about loan growth as we enter 2021?

Curtis Griffith

This is Curtis.

One reason that we did see—or didn't have the growth that we would normally experience in Q3, our ag portfolio for various reasons just didn't fund up, and that's really weather-related out here, as well as some of the help that came to our farmers from USDA programs. I think we'll be back to a more normal situation on that in 2021.

We're also reaching out to our commercial side and being pretty aggressive on trying to get some new loans on the books that are seasoned quality real estate loans, in particular, and we're being pretty aggressive on some rates on those that may have a little bit of a push down effect on the NIM but I think it's going to have a positive effect on our bottom line as we try to get our loan-to-deposit ratio more back in line with historical norms for us.

It is a tough environment right now, and there's still so much uncertainty, but we are definitely seeing people look around and looking for ways to potentially refinance some of their existing projects, and we want to be top of mind for a lot of those folks when they're looking for a new home.

Brady Gailey

Curtis, would you think mid-single-digit loan growth would be an appropriate number for the next couple of years for you all, excluding any sort of impact from PPP shrinkage?

Curtis Griffith

Yes, sir. If you do that ex PPP, because obviously, that's a couple of hundred dollars million that we all certainly hope goes away during Q4 and Q1. But taking that out of the equation, we really do think that low to mid single-digit loan growth levels in '21 and '22 would be achievable with the team that we have in place.

Brady Gailey

Okay. Great. Thanks, guys.

Curtis Griffith

Thank you.

Operator

Thank you. Our next question comes from Brad Milsaps with Piper Sandler. Please proceed with your question.

Brad Milsaps

Good afternoon.

A lot of the questions have been asked. But maybe just quickly on expenses, Steve. I know you guys have been working hard to look for ways to continue to get more efficient. I know the mortgage banking can play a little bit of havoc with those numbers. But just kind of curious how to think about sort of your expense line, sort of excluding the impact of what may happen to mortgage.

Steven Crockett

Yes. So obviously, the mortgage does skew that up upwards, but that's a good thing whenever we're generating the revenue that they are. Kind of when you exclude them and even our insurance activities in the third quarter, we actually were able to shrink our noninterest expense about $1 million.

Now some of that had, as we talked about in the release, had that legal settlement that offset some of our expenses. But the point is we are continuing to address noninterest expense and looking to drive that down.

Brad Milsaps

Maybe thinking about it another way, if mortgage originations returned to maybe the first quarter level of this year or even some of the quarters you had in 2019, would you kind of expect total operating expense to sort of drop back to those levels? Or do you think you've got further room to push it down?

Steven Crockett

Of course, if we go back to the first quarter, we still had some of the conversion expenses and before we were able to do the cost saves with the acquisition. But it would probably—it's going to be closer back to—I'd say, the fourth quarter is kind of the level we're trending toward.

Brad Milsaps

Got it.

Curtis Griffith

This is Curtis.

Just going to add the comment, Brad, that we are still going through things, and we've tasked all of our department heads. We're still looking for good places that we can do some cost saves, and we're still finding some. Some of that's in personnel areas, but we've also got some other areas of just operating expenses that we're finding that we can trim back. And I think we're going to continue to see moderate cost saves across the Organization. You can't save your way into prosperity completely, but we are very cognizant of it.

When we're in a time like this, where achieving a lot of organic growth is very difficult, obviously, it's certainly something we can focus on right now. And I think you're going to see some nice results out of us in '21.

Brad Milsaps

Great. And that's helpful. And just maybe one follow-up on fee income. And I apologize if I missed this. I know you've had some acquisitions, and you've changed the way on some of the reporting with insurance. But I was thinking the fourth quarter seems to be your kind of biggest quarter with some of the commission dollars that you get. Obviously, a lot of that revenue came in this quarter. Is that a change going forward? Do you still expect a bigger fourth quarter than you typically get?

Steven Crockett

Yes, definitely. We did have a change from the timing on the recognition of revenue this year, and it was—a lot of that really came in right at the end of the third quarter. We do still expect to see our fourth quarter, which is really kind of based on, I won't get too far down in the weeds on this, but on some profit sharing bonuses that we get based on how the—all the insurance companies do. And it's—we would expect to see that like we did historically come in the fourth quarter. I know there were—some of their ratios were pretty close this year. So we're still waiting to see what that would look like.

We would expect to see a bump in the fourth quarter, but it won't be like what we've seen—like what we would have seen last year because we did have—we would have that additional revenue plus a lot of the rest of the commission that would come in. And as you said, we did get—some of that bump came in the third quarter. Sorry if that's a little confusing.

Brad Milsaps

Yes. So kind of best to look at it kind of an annual number. If you did $7 million in insurance last year, you're going to be plus or minus kind of that number depending upon how some of those factors at the end of the year play out?

Steven Crockett

Yes. Yes, that's a great way to look at it.

Brad Milsaps

Got it. Okay. All right guys I appreciate it. Thank you.

Steven Crockett

Thank you.

Operator

There are no further questions at this time. I would like to turn the floor back over to Management for closing comments.

Curtis Griffith

This is Curtis, and I want to thank everybody that was on the call today, and I appreciate your interest and continued support of South Plains Financial.

We think we're moving forward on the direction that we had set out back when we planned for the IPO. Obviously, the pandemic has disrupted a whole lot of things, including a lot of our near-term plans. We do hope that everyone can move through this and that we do get back to a safe and more normal activity levels during—sometime during 2021. But for right now, we're going to be very cautious. We are definitely requiring mask wearing in all of our locations and trying to keep our people safe and healthy and productive. And I hope everyone else out there can do the same.

We look forward to reporting some great results for you at the fourth quarter. Thanks again.

Operator

This concludes today's conference. You may disconnect your lines at this time. Thank you for your participation, and have a great day.