Civista Bancshares, Inc.
Second Quarter 2021 Earnings Call
Friday, July 23, 2021, 1:00 PM ET

Company Participants:
Dennis Shaffer; Chief Executive Officer and President
Richard J. Dutton; Executive Vice President, Chief Operating Officer
Chuck Parcher; Executive Vice President, Chief Lending Officer
Paul J. Stark; Senior Vice President, Chief Credit Officer

Analyst Participants:
Terry McEvoy; Stephens
Nick Cucharale; Piper Sandler
Tim Switzer; KBW
Russell Gunther; D. A. Davidson

Presentation

Operator: Good afternoon and welcome to Civista Bancshares' Second Quarter Earnings Call. [Operator Instructions] Please note that this event is being recorded.

Now I'd like to turn the conference over to Mr. Dennis Shaffer, President and CEO. Please go ahead.

Dennis Shaffer: Good afternoon. This is Dennis Shaffer, President and CEO of Civista Bancshares. And I would like to thank you for joining us for our second quarter 2021 earnings call. I'm joined today by Rich Dutton, SVP of the company and Chief Operating Officer of the Bank; Chuck Parcher, SVP of the company and Chief Lending Officer of the Bank and other members of our executive team.

Before we begin, I would like to remind you that this conference call contains forward-looking statements with respect to the future performance and financial condition of Civista Bancshares, Inc. that involves risks and uncertainties. Various factors could cause actual results to be materially different from any future results expressed or implied by such forward-looking statements. These factors are discussed in the company's SEC filings, which are available on the company's website.

The company disclaims any obligation to update any forward-looking statements made during the call. Additionally, management may refer to non-GAAP measures which are intended to supplement but not substitute the most directly comparable GAAP measures. The press release available on the website contains the financial and other quantitative information to be discussed today, as well as the reconciliation of the GAAP to non-GAAP measures. We will record this call and make it available on Civista Bancshares' website at www.civb.com.

Again, welcome to Civista Bancshares' second quarter 2021 earnings call. At the conclusion of my remarks, we will take any questions you may have.

Let me start off my remarks by noting several significant accomplishments or transactions that occurred during the second quarter. This morning, we reported net income of $9.2 million, or $0.59 per diluted share for the second quarter of 2021 and net income of $19.9 million, or $1.27 per diluted share for the six months ended June 30, 2021.

Our earnings per share for the quarter increased 45.1% compared to the second quarter of 2020 as well as 43.9% compared to the first six months of 2020. This is a direct result of our continued focus on growing and diversifying our revenue streams and the disciplined approach that we take in managing the company.

On June 9, we successfully launched the new Civista Digital Banking, which provides a better customer experience in both the mobile and online platforms. We will also be rolling out online account opening and improving our in-branch account opening process later this year. We also took steps to restructure our balance sheet and improve our margin as we seem to be in another lower-for-longer interest rate environment.

During the quarter, we paid off some long-term FHLB advances, which will reduce our interest expense by $1 million on an annual basis. We paid a penalty of $3.7 million to do that, but we were able to offset that penalty with gains on the sale of our VISA B shares of $1.8 million.

We also put some additional cash to work in investments. The full effect of these transactions will be seen more in our third quarter margin. However, we did see a nice uptick of 23 basis points in our margin this quarter compared to the linked quarter.

Finally, our board of directors approved a 17% increase in our quarterly dividend on July 9 to $0.14 per share, which represents a dividend payout ratio of 23.7%. We continue to be opportunistic in the execution of our stock repurchase program.

Now let's talk a little bit about our quarterly numbers. Our loan growth for the quarter, excluding PPP loans, was 2.9%, or 11.6% annualized. The two categories that we saw the largest increases in were real estate construction and nonowner occupied commercial real estate. Our loan pipeline continues to be strong.

Our mortgage banking business continues to drive noninterest income generating gains of $2.2 million this quarter nearly keeping pace with the $2.7 million gain that we recorded in the linked quarter.

We continue our focus on managing COVID-19 loan deferrals as well as asset quality as a whole. Our deferrals have continued to improve from 3.6% of total loans at December 31, 2020 to 2.5%

at June 30. Many of these borrowers have seasonal businesses which did not resume operations until late in the spring and continue to deal with the shortage of people returning to work.

We anticipate more of our seasonal borrowers exiting their deferrals in the third and fourth quarters of 2021. Due to our efforts of working with customers and the strength of our borrowers, we have not experienced any defaults attributable to the pandemic, and delinquencies remain at historically low levels.

Net interest income for the quarter was consistent with our first quarter and increased $1.8 million, or 8% year-over-year. Net interest income for the first six months of 2021 increased $3.5 million, or 7.9% compared to 2020. Our net interest margin was 3.53% and 3.41% for the quarter and for the first six months of 2021 respectively. Both measures are lower than the comparable 2020 period but higher than the first quarter of 2021.

As we shared in our first quarter earnings release, the increased liquidity we experienced as a result of the federal government's stimulus programs and the excess cash created by our tax processing program both had a significantly negative impact on our margin. Our second quarter margin has rebounded and we expect that it will continue to improve further due to the balance sheet restructuring I previously mentioned.

We continue to see decreases in our funding costs due to the lower interest rate environment. Funding costs went down by $240,000 compared to the linked quarter and $852,000 when comparing the second quarter of 2021 to the second quarter of 2020 and $1.8 million when comparing the first six months of 2021 to the same period of 2020. We expect to see more decreases as a result of the balance sheet restructuring.

Our yield on earning assets is down for the quarter and for the first six months of 2021 compared to the same period in 2020. The largest reason for the decrease in the comparable quarters is the increase in interest-bearing cash. The average balance of interest-bearing cash increased, which reduces the overall yield due to the low rate that we earned. As part of the balance sheet restructuring, we put some cash to work during the second quarter. The yield is also down for the six-month comparable period as interest rates began to tumble late in the first quarter of 2020.

During the quarter, noninterest income declined $165,000, or 1.8% in comparison to the linked quarter, and increased $2.2 million or 31.7% year-over-year. However, if we back out the effect of the $1.8 million gain on the sale of our VISA B stock, noninterest income would have declined $2 million, or 21.2% in comparison to the linked quarter, and increased $386,000 or 5.6% year-over-year.

The first quarter of the year includes a larger portion of the tax processing fees that we earned, which was the primary reason for the decline in fees from the first quarter to the second quarter.

For the first six months of 2021, noninterest income increased $4.5 million compared to 2020. Removing the gain on VISA B shares, the increase is $2.7 million. Most of this increase is due to the gain on sale of residential mortgage loans.

Mortgage banking continues to be the largest driver of our noninterest income. Second quarter gains on the sale of mortgage loans were $2.2 million, down slightly from our linked quarter of $2.7 million and consistent with the gains we recorded in the prior year for the quarter. For the first six months of 2021, we recorded gains of $5 million compared to $3.1 million in 2020.

We sold $69.2 million of mortgage loans during the second quarter of 2021 and $147.8 million during the first six months of 2021. While both measures are increases compared to 2020, second quarter volume is down $9.4 million from the linked quarter. We reduced our pricing in the second quarter as demand softened, resulting in a decline in the average premium recognized on the sale of loans by 35 basis points from 3.55% to 3.20% over the linked quarter.

Service charge revenue increased $387,000 for the quarter and $175,000 for the first six months of 2021 compared to 2020. You may recall, Civista suspended many of our service charges during the second quarter of 2020 as our customers dealt with the onset of the pandemic. Interchange revenue increased $233,000 for the quarter and $513,000 for the first six months of 2021 as consumers continued their shift to online and cashless retail buying options.

Wealth management revenue increased $284,000 for the quarter and $424,000 for the first six months of 2021. Our fees are asset based, and the pandemic's negative impact on the markets adversely affected last year's wealth management revenue.

Our income tax refund processing program continues to be an important contributor to our noninterest income during our first and second quarters each year. Income from that program during the second quarter was consistent with the prior year at $475,000. We also had a decrease in swap fees as we reduced the loans, we entered into swaps as part of our asset liability management program.

Noninterest expense for both the quarter and the first six months of 2021 included a $3.7 million prepayment penalty on long-term FHLB borrowing. Our reported numbers show a 24% increase for the quarter and a 16.4% increase for the first six months. Removing the effect of the prepayment penalty, the increase is 3.5% for the quarter and 6% for the first six months. Additionally, adjusted noninterest expenses would have decreased 3.3% compared to the linked quarter. While our efficiency ratio for the quarter was 67.5%, our adjusted efficiency ratio would have been 59.5% compared to 58% for the linked quarter and 61.7% year-over-year.

Turning our focus to the balance sheet. Year-to-date, our total loans declined $38.3 million. We had a net reduction of $64.3 million of PPP loans in the first six months of 2021. Excluding PPP loans, our loan portfolio would have grown $26 million or 2.8%. Second quarter growth was $52.6 million, or 11.6% annualized. Demand for nonowner occupied commercial real estate

loans across our footprint continued. Real estate construction loan demand increased as the construction season fully opened up.

We are encouraged by the loans booked during the quarter as well as the strong demand across our footprint and undrawn construction lines totaling $124 million, which are nearing all-time high. We expect that we will grow our loan portfolio at a mid-single digit rate for 2021.

On the funding side, we experienced growth in every category except time deposits with total deposits increasing $213.6 million or 9.8% since the beginning of the year. Non-interest-bearing demand accounts, which made up 35.5% of our total deposits at June 30, grew by $132.9 million compared to December 31, 2020.

While balances related to our income tax processing program made up $50.8 million of the increase, $73.2 million of the growth came from non-interest-bearing business accounts as our business customers deposited PPP loan proceeds. We also experienced a $70.1 million increase in our interest-bearing demand accounts driven by a $47.6 million increase in public fund accounts.

During the pandemic, we automatically downgraded commercial loans that requested concessions beyond the initial 90-day modification period. Our total criticized loan portfolio, which includes all classified and substandard loans, declined from $148.1 million at December 31, 2020 to a $118.1 million at June 30, 2021. The largest segment of criticized loans continues to be hotels, totaling $65.8 million. Many of these borrowers are experiencing increase occupancy in the second quarter of 2021, and we anticipate further reduction in our criticized portfolio as hotel revenues stabilize.

Year-to-date, we have realized $339,000 in net recoveries. While there are still uncertainties associated with the economy, we continue to see improvement in both the economy and our customers' financial positions. As a result, it was not necessary to record a provision expense during the quarter.

The ratio of our allowance for loan losses to loans increased from 1.22% at year end 2020 to 1.30%. Exclusive of the PPP loans, this ratio would have been 1.40%. Our allowance for loan losses to non-performing loans also increased to 443.5% at the end of the quarter from 343.05% at the end of 2020.

We ended the quarter with a tangible common equity ratio of 9.51% compared to 9.98% at December 31, 2020. The extra $86.8 million of liquidity related to our income tax refund processing business at quarter end combined with $153 million in PPP loans had the effect of reducing our TCE ratio by approximately 60 basis points.

We continue to create capital through earnings. Our overall goal is to have adequate capital for growth, both organic and for acquisitions. Two important parts of our capital management

strategy are dividends and share repurchases. As previously stated, we recently announced the increase of our third quarter dividend to $0.14 per share. Additionally during the quarter, we repurchased 323,612 shares of common stock for $7.4 million for an average price of $22.80 per share. Year-to-date, we have repurchased 505,239 shares, or 3.2% of our shares that were outstanding at December 31, 2020. We have approximately $7.4 million remaining of the current repurchase program.

In summary, we are very pleased with another quarter fueled by solid earnings, increased loan growth, net interest margin expansion and improved credit quality. During the first half of 2021, we have seen the economy open up and life returning to normal. We remain optimistic as the year progresses. Our loan pipelines are solid. We expect that nearly all of the remaining PPP Phase 1 loans in many of the Phase 2 loans will be forgiven during the balance of 2021. We are continuing to roll out our new digital banking tools, which will allow us to provide a better customer experience.

Thank you for your attention this afternoon. And now, I'll be happy to address any questions that you may have.

Questions and Answers

Operator: [Operator Instructions] First question comes from Terry McEvoy of Stephens.

Terry McEvoy: Maybe let's start with the margin. I want to make sure I understand the message correctly. Should we think about the second half of this year, the margin increases beyond the balance sheet actions that were last quarter? And if so, can you just run through again what do you think drives that core margin expansion?

Richard Dutton: Terry, this is Rich. That transaction occurred late in May. So we really didn't see that entire impact, obviously, on the quarter numbers or even the six-month numbers. And I would expect through our modeling, if we said 17 basis points of growth in the margin for the -- over a 12-month period or annualized, we're looking at probably 10 more basis points over the year. Does that make sense related to that?

Terry McEvoy: Yes, I got you there.

Richard Dutton: Okay. So beyond that, did you have another question, or did I answer what you were asking me?

Terry McEvoy: Beyond the transaction that occurred in the math you just ran through, was there some -- or were you implying that there's additional margin expansion above and beyond there as you reduce funding costs and those come down lower?

Richard Dutton: Well, certainly there's some room to bring the funding costs down. Don't forget about that stimulus, I think the technical term is snafu, that occurred right at the beginning of the year. So we had 16 basis points of drag on our six-month margin for that. And that will continue to diminish as the year runs out. And also the tax, the excess tax cash, that had another 15 basis points of drag on our six-month margin. And again, that number will continue to decline and as the cash rolls out.

Dennis Shaffer: Terry, if -- I have a little bit more noise. And most because of the tax program, because of the stimulus error that was in there, and then we did the balance sheet transaction. And plus we collect a lot of PPP fees in the second quarter. So there is quite a bit of noise in there.

Terry McEvoy: Thanks for clearing all that up. And then just as a follow up, the outlook for mid-single digit loan growth this year, looks like the nonowner occupied CRE was really the bright spot in the second quarter. Do you think that's going to be the driver of growth in the back half of this year? And maybe talk about just market competition in terms of pricing within that loan category.

Chuck Parcher: Yes. Terry, this is Chuck. That's our bread and butter, that non-owner occupied real estate. We have still really good demand. We've got really good pipelines right now. We've been a little softer on C&I, really more so from a -- from just the amount of cash that companies have from all the government stimulus. We had a few loans pay off just because they had a lot of excess cash. And I was looking at our loan utilization revolving lines in the commercial side. It fell from 36% at 12/31 to about -- a little bit under 32% at 6/30. So, we're hoping maybe we get some drawback on some of those lines.

But all in all -- and then you asked me about competition. I think it's as competitive as ever. I think, most of -- almost all banks are much like us, have a lot of cash on the balance sheet. So every deal seems like it's competitive, but we've done a pretty good job of holding, trying to keep margin where we like it at. Have we lost a few more deals than normal? Probably, yes. But where our pipeline is at right now, we really feel comfortable with that mid-single digit going through the end of the year.

Operator: Our next question comes from Nick Cucharale of Piper Sandler.

Nick Cucharale: In terms of accommodation deferrals, do you have a breakout of those hotels that are leveraged to business travel versus those that are more destination or vacation oriented?

Paul Stark: Yes. This is Paul Stark. Virtually all of the hotels are more leisure travel than business. We don't really finance too many that are focused on business. That's not to say there's not some that are mixed. And for the most part, a lot of those, I think, over half of our deferrals are on hotels. Of that $50 million, just for a little more color, of that $50 million that's outstanding, about $26 million of that have already resumed payments. They're just catching up

on interest. So we are taking a conservative line on that and continuing to call those deferrals. So they're all heading -- I shouldn't say all heading, but most of them are headed in the right direction.

Dennis Shaffer: Yes. And Nick, I would say that Chuck and Paul and their teams have both been out making calls on a lot of those clients and a lot of the stuff we're hearing is pretty positive. We just want to make sure that revenues bounce back for some of those, but we want to see a little bit of sustainability to that. So our approach is be a little bit slower and make sure that revenue is being able to be sustained. And as I mentioned in my comments, I think that we do anticipate hopefully in third and fourth quarters that we see more upgrades to the criticized portfolio and that deferral number to continue to go down.

Nick Cucharale: That's great color. So it's fair to say that occupancy and average daily rate have been trending positively?

Dennis Shaffer: Yeah.

Chuck Parcher: Yeah.

Paul Stark: Yeah.

Nick Cucharale: Okay. And then with respect to swap fees, it slowed down relative to 2020 levels. I know they can be volatile, but are you expecting a pickup in this line item or staying at this level for the time being?

Chuck Parcher: I would tell you, Nick -- this is Chuck. I would tell you it would probably be pretty close to the same level through the back half of the year unless we see some major change in the yield curve. Right now, it makes more sense for us to go a little longer on some in-house mortgages than to take that LIBOR plus 225, 250 rate and put on the balance sheet right now.

Nick Cucharale: Okay. That's fair. And then lastly, the tax rate bumped down a little this quarter. What are you expecting on a go-forward basis?

Dennis Shaffer: I'm not sure. What did it bounce down to? But going forward, I think 13% is probably a good run rate going forward, Nick.

Nick Cucharale: On a GAAP effective tax rate basis?

Dennis Shaffer: Yes.

Operator: And our next question is from Tim Switzer of KBW.

Tim Switzer: This is Tim Switzer on for Mike Perito. You guys have pretty strong capital levels on right now, and there's still a good amount of buyback authorization from the board, around $7.4 million. So I was wondering, do you guys expect to keep a similar buyback pace for the rest of this year assuming the environment continues going well? And then, do you have any plans at all to maybe hold on to a bit more capital in preparation for any M&A opportunities that may come up?

Dennis Shaffer: Well, yes. I think that from the capital level, we've publicly stated, from the TCE standpoint, anyway, we've been trying to manage the company to about a 9% level there, or above that. So I think we're about 9.5% or so. So we've been fairly aggressive, and we think we're undervalued. And because of that, I think we view the stock repurchase program as a good way to deploy some of that capital. So yes, we've probably been a little bit more aggressive than we have. And as long as our earnings stay where we are, we'll probably continue to stay fairly aggressive on that front.

Tim Switzer: Okay. And any plans at how to hold?

Chuck Parcher: I just want to add. Dennis was right. Our TCE is 9.5%. But if you if you'd normalize it for all the PPP in the tax money, we've got it closer to probably 10.1%, I think another 60 basis points higher than that. So like Dennis said, we've got plenty of capital, if you will, to continue to repurchase shares.

Dennis Shaffer: Yes. As far as holding it on for acquisitions, that just depends on the deal, I think, Tim, the size of the deal, the percentage of stock and cash into that deal. So that's a hard question to answer. But we have been on that higher end, one, because our earnings have been so strong, but two, we would like to do a deal, get a deal or two done here. So that's why -- but our capital position, we think, is very strong.

Tim Switzer: Great. Thanks. And then, I had a quick follow-up on -- your adjusted expenses this quarter are pretty solid. You have good efficiency ratio of sub-60% despite some of your tech initiatives. So do you think you can maintain that efficiency ratio near the 60% level going into 2022? And I guess, just what is your expense trajectory going to look like with your -- as you expand your tech capabilities here?

Richard Dutton: Tim, this is Rich. And the short answer is yes. But I think if you're -- as you get familiar with the bank, we were front-end loaded with the tax money. So we got maybe more revenue in the first and second quarters. So the low point of our efficiency ratio for the year is the first and second quarter.

We've always kind of said we're a 60%, 61% efficiency bank. There's nothing new. I mean, we've made all the investments at least that we think we're going to make near-term for, I want to say, digital and whatnot. So I think a 60% or 61% is where you can think of us being.

Chuck Parcher: We want to continue, Tim, to invest into the company from a technology -- just I think our mode is to continue to invest some of these earnings back into the company to keep us at the forefront in terms of technology and stuff. So that's not going to slow. I will say that we really recognize some of -- like the new digital product that we rolled out. A lot of that revenue happens on the back end of that. So we will just start to recognize that in terms of what we do the online account opening piece later this year. That could bring more new accounts, which will bring more service charges. The digital piece should enhance our interchange collections, and it should also expand our footprint. So all of those things, I think, will lead to increased revenues down the road for us.

Tim Switzer: Great. Yeah. And do you have any targets you're willing to share on how quickly you think you could accelerate your account growth at all, or related revenues?

Dennis Shaffer: No. We'll be working pretty hard on that, maybe the back half of this year. But really, most of that effort right now -- I mean, we've got some really conservative efforts, but we'll spend a little bit more time on that at the back half of this year as we head into next year. So maybe I will share some things later and maybe in the fourth quarter on that.

Operator: [Operator Instructions] Next question comes from Russell Gunther, D. A. Davidson.

Russell Gunther: Just a couple of follow-ups here. First on the loan growth. So second quarter ex PPP turned out as strong, if not stronger than you guys were expecting. And so just curious as to your thoughts for the back half of the year. Any potential for upside to that mid-single digit number and just what the loan growth drivers on an organic basis are expected to be?

Chuck Parcher: Yeah. Russell, this is Chuck. I mean, we might have a little upside. One of the things I'm watching pretty close is we've got quite a few construction -- large construction projects that are coming to fruition and coming to an end. So we're staring quite a bit of, what I would call, payoff money in that third and fourth quarters as those projects go to the permanent market. So we're tempering our record-high pipelines right now to some of that payoffs down the road. So I'm still comfortable in that mid-single digit number for the end of the year. But if some of those payoffs get pushed off into next year or a couple of extra projects come in, we could exceed that. But I tell you to be much more comfortable on that mid-single digits.

Russell Gunther: Understood. I appreciate the color there. And then just last one is a follow-up to the margin discussion. So I think you guys mentioned an additional 10 basis points from the balance sheet restructuring, talked about some other positive catalysts like funding cost reduction and putting some of that excess liquidity to work. So could you guys share kind of a glide path as to where you think the margin shakes out over the next couple of quarters?

Chuck Parcher: Well, I mean, I guess the math on the back of my sheet says that normalized, when you -- PPP and whatnot, I guess that's the wildcard, Russell, PPP and how quick that

prepays. So I guess if you take that off the table, I mean, it could be a 3.7, 3.8 kind of number. But it just depends on the PPP.

Operator: This concludes our question-and-answer session. Now I'd like to turn the conference back over to Mr. Dennis Shaffer for closing remarks.

Dennis Shaffer: Thank you. In closing, I just want to thank everyone for listening and thank those that participated in the call. Again, we are very pleased with our second quarter and look forward to talking to you again in a few months to share our third quarter results. So thank you for your time today.

Operator: The conference is now concluded. Thank you for attending today's presentation. You may now disconnect.