Event Name: Civista Bancshares, Inc., 2022 Second Quarter Earnings Call
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Officers and Speakers
Dennis Shaffer; President and Chief Executive Officer
Richard Dutton; Senior Vice President and Chief Operating Officer
Charles Parcher; Senior Vice President and Chief Lending Officer
Paul Stark; Senior Vice President and Chief Credit Officer

Analysts
Terry McEvoy; Stephens
Tim Switzer; Keefe, Bruyette & Woods
Nick Cucharale; Piper Sandler

Presentation

Operator: Before we begin, I would like to remind you that this conference call may contain forward-looking statements with respect to the future performance and financial condition of Civista Bancshares, Inc., that involve 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 also available on the company's website contains the financial and other quantitative information to be discussed today as well as the reconciliation of the GAAP to non-GAAP measures.

This call will be recorded and made available on Civista Bancshares' website at www.civb.com. At the conclusion of Mr. Shaffer's remarks, he and the Civista management team will take any questions you may have.

Now I will turn the call over to Mr. Shaffer.

Dennis Shaffer: Good afternoon. This is Dennis Shaffer, President and CEO of Civista Bancshares, Inc., and I would like to thank you for joining us for our second quarter 2022 earnings call. I am joined today by Rich Dutton, SVP of the company and Chief Operating Officer of the bank, and Chuck Parcher, SVP of the company and Chief Lending Officer of the bank, and other members of our executive team.

This morning, we reported net income of $7.7 million, or $0.53 per diluted share, from the second quarter of 2022, which includes approximately $0.02 per share of expense related to our

Comunibanc transaction, and net income of $16.2 million, or $1.10 per diluted share, from the six months ended June 30, 2022, which includes approximately $0.04 per share of expense related to our Comunibanc transaction. While these deal costs contributed to the decline in earnings for the quarter and year-to-date, the primary reasons for the decline were the normal timing of when we earned our tax program fee income from our first to second quarters, lower mortgage production and restructuring charges taken in the second quarter of 2021.

We were able to sustain the strong loan demand we experienced during the first quarter. Net loans, exclusive of PPP, grew by $57.9 million during the second quarter, or at an annualized growth rate of 11.6%. While demand remained strong in most categories, commercial and industrial, non-owner-occupied commercial real estate and residential construction loans experienced the strongest growth.

On June 27, we opened a new branch office in Gahanna, Ohio, located in the northeast portion of Franklin County, which is part of the Columbus MSA. Earlier this year, Intel announced they would be locating two new semiconductor fabrication plants in the nearby area.

We continue to be on track with our Comunibanc transaction, with the legal close taking place on July 1 and the system conversion scheduled for the weekend of October 22. We are excited to expand our footprint into Northwest Ohio and the Toledo MSA. The process of welcoming our new shareholders, employees and customers into the Civista family is well under way.

We continue to be active in repurchasing common shares. During the quarter, we repurchased 264,860 shares at an average price of $22.86 per share. Our return on average assets was 1% for the quarter, compared to 1.07% for the linked quarter, and our return on average equity was 9.86% for the quarter, compared to 9.89% for the linked quarter. Year-to-date, our return on assets was 1.04% and our return on equity was 9.87%.

As I stated, we are extremely pleased with our loan growth for the quarter. Excluding the impact of PPP loans, our loan portfolio grew at an annualized rate of 11.6%. At the end of the quarter, we only had $3.7 million of the approximate $400 million in PPP loans we originated remaining. Our strategy of originating PPP loans to our customers and those referred to us by known referral sources has resulted in no fraud to date in the PPP loans that we made.

Our net interest income increased $1.3 million, or 5.8%, from the linked quarter, fueled by loan growth and rising interest rates. Our net interest income for the quarter and year-to-date were comparable to the prior years as increases in volume and rate were primarily offset by lower PPP accretion.

Our reported net interest margin was 3.43% for the quarter, compared to 3.38% for the linked quarter. Like many banks, the accretion of PPP fees has had an impact on margins, and we have the added complexity of the excess cash generated by our tax program during the first and second quarters also having a negative effect on our margin. Our reported year-to-date net

interest margin was 3.40%, compared to 3.41% for the prior year; similarly, the net impact of PPP fee accretion and excess cash from our tax program reduced our 2022 year-to-date margin by 7 basis points, while it increased our 2021 year-to-date margin by 9 basis points. Assuming interest rates continue to rise, with our PPP loan process all but concluded, and the liquidity generated by our tax program continuing to subside, we expect our asset-sensitive balance sheet to yield strong margin expansion as we move into the third and fourth quarters.

During the quarter, non-interest income declined $2 million, or 26.3%, in comparison to the linked quarter, and declined $4.9 million year-over-year. The primary driver of the decrease from our linked quarter was the timing of fees from our income tax refund processing program. Consistent with prior years, income from our tax program during the first quarter was $1.9 million, compared to $475,000 in the second quarter.

Gains on the sale of loans declined $363,000 from the first to the second quarter, also contributing to the decline. Interchange fees increased $124,000 over our linked quarter due to increased volume. Year-to-date, non-interest income declined $4.9 million, or 27.1%, in comparison to the prior year. A $1.8-million gain we recognized on the sale of our Visa B shares as part of our balance sheet restructuring in the second quarter of 2021 contributed to the year-to-date decline, but the primary driver was a $3.5-million decline in gains on the sale of mortgage loans.

Second quarter gains on the sale of mortgage loans were $573,000, a decline of 38.8% from our linked quarter and a 74.2% decline from the prior year gain, which was $2.2 million. We sold $35.5 million of mortgage loans during the second quarter of 2022, compared to $38.2 million during the linked quarter. The average premium recognized from the sale of loans declined 84 basis points from 2.45% to 1.61% compared to the linked quarter.

Wealth management revenues were consistent, comparing our second quarter to the linked quarter, and wealth management revenue year-to-date 2022 increased to $2.5 million from $2.3 million in the prior year as gains in new accounts and additions to existing accounts kept pace with declines in the overall market. While we anticipate that market pressures will continue to be a headwind for some time, we view the expansion of these services across our entire footprint as an opportunity to diversify and grow non-interest income.

Non-interest expense for the quarter of $20.4 million was comparable to our linked quarter, as increases in professional fees and other expenses were offset by declines in compensation and data processing. Non-interest expense declined $814,000, or 2% year-over-year, as the prior year balance sheet restructuring costs were somewhat offset by increases in compensation expense, software maintenance expense and non-recurring expenses related to our Comunibanc transaction.

You will recall that during the second quarter of 2021, we incurred a $3.7-million prepayment penalty on our early termination of the FHLB long-term borrowing.

Our compensation expense increased $982,000, or 4.2%, over the prior year, primarily due to annual salary increases, which go into effect each year in April. Professional fees increased $779,000, or 52.7%, primarily related to $428,000 in legal and investment banking fees related to our Comunibanc transaction. We also had a $100,000 increase in fees related to our third-party call center that assists with overflow and after-hour calls -- call activity, largely the result of calls from income tax refund customers.

Total expenses related to the Comunibanc transaction, including professional fees, were $776,000 through June 30. With the system conversion scheduled for October, we anticipate recognizing the remaining deal costs during the balance of 2022.

Our efficiency ratio was 67%, compared to 65.2% for the linked quarter and 66.1% year-to-date. If we had adjusted for one-time deal costs, our efficiency ratio for each of those periods would have been 66.1%, 63.7% and 64.9% respectively.

Turning to the balance sheet. Year-to-date, our total loans have grown by $66.3 million. Backing out the $39.5 million of PPP loans forgiven during the first six months of 2022, our loan portfolio grew organically by $105.8 million, or at an annualized rate of 10.8%. While non-owner-occupied CRE loans led the way, we had good demand in owner-occupied CRE, commercial and industrial, and residential construction loans in every market across our footprint. Along with our strong year-to-date loan production, our undrawn construction lines were at an all-time high of $164.5 million at June 30, giving us confidence that even in the face of anticipated headwinds, we will grow our loan portfolio at a mid-single-digit rate for 2022.

On the funding side, the total deposits increased $38.8 million, or 1.6%, since the beginning of the year. As is typical, balances related to our income tax processing program peaked toward the end of the first quarter and returned to more normal levels throughout the remainder of the year. Non-interest-bearing demand accounts continue to be a focus, making up 34% of our total deposits at June 30, as we continue to attract the operating accounts of our business customers.

While asset quality continues to be good, we continue to monitor our hotels and lodging loans closely. At June 30, hotel and lodging loans made up our largest segment of criticized loans, totaling $48.6 million. Most of these operators have experienced increased occupancy from leisure travel during the last four quarters. Despite the lingering effects of COVID on business travel, we anticipate continued leisure demand going forward will result in a further reduction in our criticized portfolio.

There continue to be uncertainties associated with the economy; however, we continue to see improvement in our customers' financial positions across our footprint. While we did make a $400,000 provision during the quarter, it was attributable to growth in our loan portfolio rather than economic stress. In addition, we have realized $94,000 in net recoveries year-to-date.

The ratio of our allowance for loan losses to loans at June 30 was consistent with year-end 2021 at 1.33% and our allowance for loan losses to nonperforming loans improved to 572.8% at June 30, up from 496.1% at the end of 2021. We continue to be on track to adopt the new CECL allowance methodology beginning in 2023.

The higher interest rate environment and the pressure it has had on our bond market resulted in a $55.1-million decline from December 31, 2021, to June 30 and other comprehensive income related to our investment portfolio. As a result, we ended the quarter with a tangible common equity ratio of 7.38%, compared to 9.25% at December 31, 2021. Despite this decline, our Tier 1 capital ratio grew to 9.87% at June 30, which is well above what is deemed well capitalized for regulatory purposes.

Civista continues to create capital through earnings and our overall goal remains to have adequate capital to support organic growth and potential acquisitions. Two important parts of our capital management strategy continue to be the payment of dividends and share repurchases. We continue to believe our stock is a value. During the quarter, we repurchased 264,860 shares of common stock for $6.1 million for an average price of $22.86 per share. Year-to-date, we have repurchased 448,199 shares, or 3% of our shares that were outstanding at December 31, 2021. We have an authorization of approximately $12.3 million remaining in our current repurchase program.

As I indicated earlier, we closed our transaction with Comunibanc and their subsidiary, The Henry County Bank, on July 1. Our employees continue to meet and work toward successfully integrating our systems later this year, and we look forward to welcoming their shareholders and customers to our Civista family as we grow into Northwestern Ohio and the greater Toledo MSA.

In summary, we are extremely pleased with another quarter of solid earnings, continued loan growth and solid credit quality. Despite the volatile interest rates, economic uncertainties and inflationary pressures we are all facing, we remain optimistic. Businesses and consumers across our footprint continue to have strong balance sheets, our loan pipelines are solid and we are well on our way to a successful integration of The Henry County Bank into the Civista family.

Thank you for your attention this afternoon, and now we will be happy to address any questions that you may have.

Questions & Answers

Operator: [Operator Instructions]

Our first question will come from Terry McEvoy with Stephens.

Terry McEvoy: Maybe to start, could you just talk about deposit pricing competition within your markets? And what are your thoughts on your deposit rates and average deposit yields in the second half of the year? Where do you think those can go?

Dennis Shaffer: Well, I think we've started to see a few specials being offered, but -- in our markets, and of course, deposit pricing obviously hasn't kept up with the loan increases. We've not seen much movement in our rates. As we stated on our last call, I think the first 100 basis point of rate increases, there's probably little movement at all, which there was really no movement in ours, through those first 100 basis points. We'll have to give a little bit back to the clients, but again, when rates were higher back in '16 and '17, our margin was much stronger than our peers during that time. And I think as rates fell, we had less room to improve our margin, so we were maybe 15 basis points or so better than our peers, but when rates were at today's level and above, we were very disciplined in our price and raising our deposit prices, and our margin expansion back during that time was probably 50 basis points better than our peer banks. So we -- I would anticipate that to continue. I'll ask Rich Dutton here if he has any other further color he'd like to give around that.

Richard Dutton: Yes, Terry, I think like Dennis said, we'll attack our significant depositors with specials. And again, because most of our accounts are operating accounts with our businesses, they're maybe a little less deposit-sensitive, rate-sensitive. Like Dennis said too, I mean, we were pretty disciplined. We've not seen a ton of pressure to move rates up in our markets. And I would anticipate that while yes, it will go up, I don't think -- we're not going to be a leader in raising rates in the back end of the year. I don't know if that helps or not, but that's kind of what we're thinking.

Dennis Shaffer: Yes, our loan-to-deposit ratio still is hovering somewhere in that 83%, 84% range. We still have a lot of liquidity on our balance sheet. We were comfortable operating the bank somewhere in the high-90s, so we still feel we've got a lot of liquidity from deposits on our balance sheet.

Terry McEvoy: Thank you both for that. And then maybe sticking with the topic of higher rates, I'm just wondering: Have you stress-tested your commercial real estate portfolio in a rising rate environment? And what are your thoughts there as rates rise, particularly the non-owner-occupied CRE?

Paul Stark: Terry, this is Paul Stark. We have -- we view that frequently. We do it every time we underwrite credits as well. So I think right now, given the relationship aspects of our borrowers, we've also got strong sponsors, so I'm not really too concerned, based on what we've seen so far.

Operator: Our next question will come from Tim Switzer with KBW.

Tim Switzer: I'm on for Mike Perito. You guys just mentioned you have a lot of excess liquidity still on the balance sheet, and working on balancing that with deposit pricing, and I guess maybe

possibly some deposit run-up, depending on how trends go. But just given all that, and rates moving up, what's your guys' strategy with that excess cash? Do you have any plans to possibly deploy it into the securities portfolio anymore? Or I guess, what kind of movement should we expect?

Richard Dutton: I don't think we will, probably at least not over the next quarter, do anything big like that and deploy -- make a deployment of liquidity into our securities portfolio. Our loan demand is pretty strong. I'm sure Chuck's chomping at the bit to talk about what we've got in the pipeline, and that's where we want to deploy it. And I think the other thing, while we've not talked about it, and I'm not going to talk much about it, but we've got the Henry County, the Comunibanc deal, and they're -- they've got some liquidity on their balance sheet, too. And we did maybe -- we might do some things with that going forward, but it won't be significant.

Tim Switzer: Okay. I got you.

Unidentified Speaker: And loans are where we want to deploy that.

Dennis Shaffer: Yes, we'd rather deploy it in loans, and we really want to get -- see what happens over the next couple of months with the rising rates, and we've recently seen articles that you do that some of the consumers are starting to spend down their savings and things like that. We've really not seen it too much on our balance sheet. We know there's been a little movement, but not much yet. So I don't think we want to make that move, and we just want to give it a little bit more time before we do that. But we are picking up some excess liquidity from The Henry County Bank deal, too.

Tim Switzer: Right. And speaking of the strong loan growth, very strong trends in the first half of the year, but still expecting mid-single-digit growth for the full year? What's driving that? Are you guys just being cautious? Are you seeing a slowdown, or is it maybe an expectation of a slowdown, just given economic trends and the Fed tightening?

Charles Parcher: [More or less.] I think we got relatively decent clarity just kind of into the third quarter here. Fourth quarter I don't have much clarity at all of what's going on from that side of it. So we're just being -- that was our guidance from the beginning of the year, mid-single-digit growth. I am hopeful to eclipse that, obviously. We're running a little over 10% now. I think 10% might be a stretch to get through the whole year, but I think we're hoping to eclipse that mid-single-digit.

Dennis Shaffer: Yes. I mean, you know, we have record undrawn construction loans already booked, so those will draw up. There's $164 million there. As Chuck said, near-term, the pipelines look good. But the rising rate environment, I think, will definitely slow loan demand, and if loan demand slows and there's less deals out there, I think those deals also get very competitively [bid], so your fallout ratio on your pipelines are a little greater as well. So -- but we are being a little, I think, cautious as we move forward, because we had really great demand

that first half of the year, so we've tried to be realistic in our views, but we're off to a great start for the first six months and the pipelines are good.

Charles Parcher: And you know, the nice part, too, is -- Tim, this is Chuck again -- that our large payoffs in the first half of the year were nearly $30 million more this year than they were last year at the commensurate, same time. The one thing that I guess would temper a little bit of growth would be we're seeing some crazy pricing being offered at some of our real estate clients, just for -- clients for properties that are stabilized, and a few of them have been [advised just] to sell, based on the price that they're getting right now. If that continues to happen into the future, it might temper our growth a touch, but we're still very optimistic. Like I said, the biggest issue we have right now is just trying to look out into the fourth quarter with all the economic things that have taken place, and what will demand be like in the fourth quarter.

Dennis Shaffer: And we're seeing some credit structure that is not typical out there. We've seen more 30-year amortizations on real estate, and historically, Civista and a lot of commercial banks have not gone that far on their amortizations, so you are seeing a little bit of that, and we're fairly -- we're pretty disciplined in our credit structure, so we want to stay disciplined as we move forward.

Charles Parcher: And as you can tell, on our margin [piece], we've been very disciplined on the margin side as well. We're seeing some of the banks that have tons of excess liquidity put some rates out there that we [indiscernible] manage.

Operator: [Operator Instructions].

Our next question will come from Nick Cucharale with Piper Sandler.

Nick Cucharale: I appreciate the mid-single-digit loan growth guide in the commentary from the previous question, but I was hoping you could discuss your approach to adding credits given the macro uncertainty. Are you being more selective at this point in the cycle? Are there segments where you're showing more caution, or on the flipside, areas of particular opportunity?

Charles Parcher: Yes, I think it's more -- Nick, this is Chuck again. I think it's more us looking at it on a case-by-case basis. Obviously we're not going to go run out and do a lot of hotel loans or restaurant loans, et cetera, [indiscernible] relative to the COVID time period and is just bouncing back. But really, we tend to take it on a case-by-case basis, and probably as most importantly, a sponsor-by-sponsor basis. We [look at the] people that are backing the deals and the strength that they have. So we don't have any [indiscernible] signs up to tell our guys, hey, don't go look at that industry, but we're -- I would tell you we're underwriting as hard as we ever have.

Paul Stark: Well -- and this is Paul. We're being selective also in location, so certain parts of Cleveland are much better than other parts of Cleveland, so that just reiterates what he's saying, on a case-by-case basis.

Charles Parcher: Well, I'm just talking about where the [indiscernible] is. And that was what we're seeing. There's a tremendous amount of growth in the Columbus area as far as a lot of -- we do a lot of development lending down there, and that has continued to be strong, especially with Intel moving in here in the next couple of years.

Nick Cucharale: Right. And then the overall expense basis is going to be impacted by the deal closing, but can you help us think about the core expense run rate in future periods?

Richard Dutton: [Indiscernible]. I think last time we were together we kind of guided you to the $20,500 -- or $20,500,000 in a quarter. We came in a little under that this time, but I still think, looking forward, that's where we're guiding to, ex deal costs.

Operator: This concludes our question-and-answer session. I would now like to turn it over to Mr. Shaffer for any closing remarks.

Dennis Shaffer: Well, I -- just with the closing, I just want to thank everyone for joining, and those that participated in today's call. Again, we're very pleased with our second quarter results. We're pleased with the loan growth that we had and the pipelines that we have in place moving forward, so we look forward to talking to you all again in a few months to share our third quarter results. So thank you very much.

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