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SBCF - Q3 2016 Seacoast Banking Corporation of Florida Earnings Call

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PRESENTATION

Operator

Welcome to the Seacoast third-quarter earnings conference call. My name is Jason and I will be your operator. (Operator Instructions). Please note this conference is being recorded. I will now turn the call over to Dennis Hudson, CEO. Mr. Hudson, you may begin.

Dennis Hudson - *Seacoast Banking Corporation of Florida - Chairman & CEO*

Thank you very much and thanks, everybody, for joining us today for our third-quarter 2016 earnings conference call. Our press release issued yesterday after the market closed and updated investor presentation with supplementary information are posted on the Investors portion of our website at SeacoastBanking.com. You can find that information under Presentations.

Before we begin I will direct your attention as always to the statement contained at the end of our press release regarding forward-looking statements that we may make during the call. We will be discussing issues that constitute forward-looking statements within the meaning of the Securities and Exchange Act and our comments today are intended to be covered within the meaning of that Act.

With me today is Steve Fowle, our Chief Financial Officer, who will discuss our financial and operating results. Also joining us in the room are Chuck Shaffer who heads our Community Banking division; Chuck Cross, our Commercial Banking Executive; David Houdeshell, our Chief Credit Officer; and Jeff Lee, our Chief Marketing and Analytics Officer. We will also be available to answer questions following the conclusion of our prepared remarks.

Seacoast Bank's strong third-quarter results reflect another quarter of successful execution of our balanced growth strategy with record loan production and large contributions from recent acquisitions. We are showing strong organic growth, our M&A strategy we believe is working and our cost cutting is producing returns for shareholders.

During the third quarter we grew revenue, excluding securities gains, 27% year over year and we increased earnings per share 85% year over year and 71% on a linked quarter basis on a GAAP basis. And 56% year over year and 22% linked quarter after some non-GAAP adjustments.

Seacoast's business model transformation is yielding impressive top-line and bottom-line results. The combined impact of shifting banking transactions to our lower cost channels and cutting costs while driving revenue through our balanced growth strategy is clearly reflected in the metrics that we posted this quarter.

On a non-GAAP basis our third-quarter return on assets was 0.95% compared to 0.84% in the second quarter of this year and 0.77% in last year's third quarter. This is a 23% improvement in only four quarters. Our third-quarter return on in tangible common equity was 12.6% compared with 10.6% in the second quarter of this year and 8.2% in last year's third quarter. This represents a 52% improvement year over year.

And finally, our third-quarter of efficiency ratio was 63.1% compared with 64.8% in the second quarter of this year and 68.2% in last year's third quarter. This is a 7% improvement on a year-over-year basis.

What is equally important though is we are achieving these metrics while retaining high-quality and granularity in Seacoast's loan portfolio because we believe it is in our shareholders' best interest to keep our commercial real estate assets at levels well below those of our Florida peers.

The driver of this quarter's results were -- certainly was our outstanding loan production. We produced a record-breaking quarter in many of our loan categories with consumer, residential and small business loans up significantly compared to last year's third quarter. To detail a few numbers, our consumer and small business production was up 67% year over year, our residential was up 55% and our commercial production was up 52%.

Our Accelerate commercial banking team continues to contribute significant results with a significant pipeline in place as we enter Q4 of this year. Our operating cost cuts throughout our network are having the impact that we anticipated. We achieved our cost reduction targets for our recent BMO and Floridian acquisition. And we completed all of our previously announced branch-related expense strategies while growing households and deposits in the important Orlando market.

Because our growing deposits, even as we rationalize our branch network, we expect deposits per branch, which were $66 million at the end of last year, to hit $78 million by the end of this year.

While talking about Orlando, let me remind all of you that we started in 2015 with an important beachhead in Orlando through the acquisition of BankFIRST. In only seven quarters since then our BMO and Floridian acquisitions, we now rank as a top 10 bank in the attractive Orlando market, one of the fastest-growing MSAs in the nation. In 2016 alone we added over 8,500 households and $600 million of deposits in this market through both the acquired work that we do and also the organic growth.

The impact of shifting routine transactions to lower-cost channels continues to be significant. We estimate that our shifting of 900,000 routine transactions to our lower-cost channels, this is on an annual basis, as more of our customers use our mobile apps and our ATM network. By next year's third quarter we expect non-teller transactions will exceed our teller transactions. And this is going to represent a milestone in the execution of the transformational strategy that we rolled out in 2015.

Finally we continue to execute our strategy of developing and deepening relationships with our customers through the use of analytics and digitally enabled marketing programs. Let me give you three important indicators of our continued progress in this area.

Consumer loans and deposit accounts sold to existing households during the quarter grew 77% and 54% respectively versus the third quarter of 2015. Organic household growth was 2.4% annualized. We are growing households despite attrition that we expected from some of our branch closures. Debit card spend reached another high in the third quarter, up 2.07% over the second quarter and up 21.25% over Q3 of last year.

Based on our results for the first three quarters of this year we reaffirm our 2016 adjusted fully diluted EPS target of $1. We will provide guidance for 2017 when we announce our fourth-quarter and full-year results next January, late January.

Let me reiterate, Seacoast's balanced growth strategy is producing results for shareholders. And as we close out -- close in on the final quarter of this year Seacoast is entering 2017 we believe from a position of strength.

We see significant runway for continued organic growth and that growth should create an even stronger run rate than that suggested by next quarter's results. Continued organic growth combined with value creating acquisitions that strengthen our presence in the fast-growing Florida market, our home for more than 90 years, will allow us to create continued value for our shareholders.

With that I would like to turn the call over to Steve who will provide a little more detail on the highlights of the quarter and give us some helpful hints for how we are going to achieve the results we have talked about next quarter. We will then look forward to taking a few questions. So, Steve, I will turn it over to you.

Steve Fowle - *Seacoast Banking Corporation of Florida - EVP & CFO*

Thank you, Denny. And thank you all for joining us this morning. Denny's update on the progress of our transformational strategy -- I would like to focus on some of the highlights of our financial and operational performance.

As noted in our press release, we reported third-quarter earnings of $9.1 million or $0.24 per diluted share compared to $5.3 million or $0.14 per diluted share in the second quarter of this year and $4.4 million or $0.13 per diluted share in the year ago period.

Third-quarter adjusted earnings topped $10.6 million and EPS reached $0.28, up 22% from the second quarter and 56% above one year ago. Our third-quarter GAAP earnings include $2.6 million of adjusting items primarily costs related to the Floridian and BMO Harris acquisitions, including cost to take redundant branches out of service as discussed in our press release.

This wraps up expense reductions from these deals, so Q4 will be the first quarter with full cost savings from these acquisitions. As a quick reminder, these acquisitions are providing immediate earnings accretion and have anticipated IRRs near 20% or better.

This quarter our team recorded record when production overall as well as record quarters in consumer mortgage and small business loan production. Our loan portfolio grew $670 million or 32% compared to the prior year at $153 million or 23% annualized above the second quarter of 2016.

Excluding acquisitions we grew our loan portfolio $330 million or 16% year over year with $27 million of this quarter's growth related to loan purchases. Our loan pipelines were also strong as we exited Q3, suggesting continued strength for the last quarter of the year.

Amid impressive loan performance we continue to manage our loan portfolio within our prudent guide rails designed to maintain granularity and limit commercial real estate exposure. At quarter end our sea area exposure totaled around 200% of capital, well below regulatory suggested levels and well below our Florida peers.

Overall our 10 largest lending relationships represent only 36% of capital and aggregate to only $135 million in outstanding balances, that is less than $14 million per relationship on average.

Franchise growth and record loan production also helped us drive continued significant revenue improvement. Revenues excluding securities gains grew $10.1 million or 27% above prior year levels to $47.2 million. This translates to a $3.6 million or 8% not annualized increase about the second quarter.

Our increased loan production again boosted net interest income which came in 9% above second-quarter levels, again not annualized. Margin improved 6 basis points sequentially to 3.69% due to loan growth and as we deployed excess liquidity held at the time of the BMO Harris acquisition in the second quarter of this year.

Margin in the quarter benefited from low fee accretion from purchased loans and loan prepayments. However, the level of loan fees was very similar to levels we saw in the second quarter of this year and to the year ago period. While the impact from this item is very hard to predict from quarter to quarter, I would expect a lower benefit ongoing, decreasing margin by up to about 5 basis points plus or minus.

Putting loan fees aside while we expect the low rate environment will continue to negatively impact loan pricing, improvement in balance sheet mix derived from our strong loan growth is expected to serve as a good offset and result in a slightly rising net interest margin over the next several quarters.

Moving to non-interest income, service fee income increased 21% above last year and rose 7%, again not annualized, linked quarter. We continue to see steady improvement in transaction-based service fees such as interchange income, deposit income and other fee income reflecting growth in households and successful delivery of new products and services to our current customer base as well as benefit from acquired customers.

Our record mortgage production and strong mortgage banking fees also played its part this quarter. We expect non-interest income will continue to benefit from franchise growth. Additionally, fourth-quarter historically benefits seasonally as the beginning of our winter season kicks in. As a result we would expect to see low- to mid-single-digit growth in Q4.

In the third quarter we recorded $550,000 in provision for loan losses compared to a $662,000 provision in the second quarter and $987,000 in the year ago period. Our allowance to non-acquired loans stands at 1%, nearly steady from last quarter. Level of provisioning reflects continued strong loan growth offset by $1.4 million in recoveries recorded in the quarter.

Expense levels in the third quarter reflect the first full quarter with operating expenses from both Floridian and BMO. As mentioned earlier, this quarter does not reflect the full benefit of cost savings from these acquisitions of [10] additional branch locations were taken out of service during Q3 and as other remaining expense savings were implemented.

Non-interest expense increased $4.3 million from the third quarter of last year to $33.4 million. Adjusted expenses increased $4.7 million from prior year levels. The year-over-year increase reflects ongoing costs related to two bank acquisitions made during last year and investments to support our franchise growth with the most significant increases in salary and benefits cost, occupancy and equipment, data processing and the other expense category as well as intangible amortization -- all areas where you would expect acquisition activities to impact expenses.

Expenses in this quarter also include additional incentives rewarding strong performance. As we indicated in our earnings release and is worth repeating, while adjusted non-interest expenses grew 18% compared to prior year levels, revenues excluding securities gains grew 27% providing 900 basis points of operating leverage.

Looking ahead, the fourth quarter will benefit from full merger savings; in fact, it will be our first quarter reflecting full savings. For this reason we would expect expenses to decrease slightly especially in areas impacted by merger savings such as occupancy and other expense line items. As a result we anticipate our efficiency ratio to show continued downward momentum into the low 60s.

Finally, our tax rate benefited from adoption of ASU 2016-09 governing treatment of equity compensation. This accounting lowered our tax provision by $418,000 this quarter. This accounting pronouncement will add volatility and tax provisioning in future quarters dependent on share vesting, option exercise activity and our stock price.

We believe it is appropriate to use an effective tax rate of about 36% for the fourth quarter of this year. As Denny indicated earlier, in light of the factors I just discussed, we continue to target our $1 per share goal for the year. With that recap I will return the conversation back to Denny.

Dennis Hudson - *Seacoast Banking Corporation of Florida - Chairman & CEO*

Great, thanks, Steve. And we would be happy to take a few questions. Operator?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Bob Ramsey, FBR.

Kyle Peterson - *FBR & Company - Analyst*

This is actually Kyle Peterson in for Bob today. Just wanted to touch on the expenses. I know you guys said that next quarter will be the first quarter with the full run rates saved in from the mergers. And I think you guys said somewhere in the low 60%s for the efficiency ratio. Is that kind of low 60% range is where we should be thinking about efficiency then moving forward from here?

Steve Fowle - *Seacoast Banking Corporation of Florida - EVP & CFO*

Yes, so you are right, low 60%s for the end of this year. You may remember first quarter is always a tougher quarter from a seasonality and days in the year dynamic standpoint. But that efficiency ratio is something that would be appropriate to start from and to work downward from there.

Kyle Peterson - *FBR & Company - Analyst*

Okay, great. And then I guess just touching a little bit on margin. I know there is a couple moving pieces here. I think you guys said kind of on a net basis you would expect a little bit of a lift based on balance sheet mix. Is that a fair way to think that it is I guess flat to maybe a basis point or 2 moving up from here?

Steve Fowle - *Seacoast Banking Corporation of Florida - EVP & CFO*

As I think about margin, the underlying dynamics of our margin should be the balance sheet mix. You are right, is will lift us as we move through the next several quarters. I do want to remind that we did have a lot of loan accretion both from purchased loans and from prepayments in our legacy portfolio. So that should, as it normalizes, yield maybe up to 5 basis points of compression on a normal quarter. So it is difficult to predict but that needs to be factored into the equation as well.

Kyle Peterson - *FBR & Company - Analyst*

Okay, thank you. And then I guess just last one from me and then I will jump out.

Dennis Hudson - *Seacoast Banking Corporation of Florida - Chairman & CEO*

You said we had a large amount of it, it was really a fairly small amount this quarter, but I think the context was over the last several quarters we see that coming down as we look forward. So we are not counting on that additional accretion in some of the conversation we just had.

So we are mindful of that and just to reiterate, Steve suggested that we might see some margin compression on the order of 5 basis points plus or minus. But with what is happening and that balance sheet and our stellar growth in loans and households we expect to overcome that with greater net interest income. In the coming quarter and out over the next few quarters, just to be clear.

Kyle Peterson - *FBR & Company - Analyst*

Okay, great. And I guess just the last one for me, I noticed last month you guys did file and 8-K where you guys kind of restructured some of the changing control agreements that you guys had. I was wondering if you guys might be able to provide any more color as to kind of how that came about or your thoughts on that at all.

Dennis Hudson - *Seacoast Banking Corporation of Florida - Chairman & CEO*

I would just say that we were looking at some of our older agreements and kind of updating them for -- from a governance standpoint to be more best practice and that was the driver for some of that. We also had a handful of -- we had some new team members that were in the organization, joining the organization and we were again just re-looking at our overall structure of those agreements.

Kyle Peterson - *FBR & Company - Analyst*

Okay, great.

Dennis Hudson - *Seacoast Banking Corporation of Florida - Chairman & CEO*

That is all I would say about that. Thanks.

Kyle Peterson - *FBR & Company - Analyst*

Great, thanks, guys.

Operator

Peter Ruiz, Sandler O'Neil.

Peter Ruiz - *Sandler O'Neill & Partners - Analyst*

Quick question here just on -- loan growth has been really strong in the last couple quarters obviously you guys have made a lot of great investments. Just wanting to know is that -- is the 20% growth rate kind of sustainable onto 2017 or could that probably trend lower towards maybe a mid-teen or low-double-digit? Is that more reasonable to think about?

Dennis Hudson - *Seacoast Banking Corporation of Florida - Chairman & CEO*

Yes. We still feel confident that we are going to grow. I think what Steve Fowle mentioned before was that we were at about 16% year over year without -- with excluding acquisitions. And so maybe as guidance we are going to stick to the low- to mid-teen growth rate on our loan portfolio.

Peter Ruiz - *Sandler O'Neill & Partners - Analyst*

Okay, that is great. Also obviously credit quality still looking clean and you guys continue to do a great job there. Does it seem like recoveries could maybe slow as we go into 2017, maybe see more normalized recoveries and maybe leading to a little bit of a higher provision? Or do you think strong recoveries could flow through through the majority of 2017 as well?

David Houdeshell - *Seacoast Banking Corporation of Florida - EVP & Chief Credit Officer*

Yes, this is David. Our provision and our recovery pattern is at some point going to decline on a net recovery basis. We are getting distance from the horrific period back during the cycle. And our opportunities for such large recoveries, especially like we reported this quarter, is just diminishing in opportunity.

So we will continue to [reflect] everything we have lost during this cycle, but our loan growth is beginning to outpace those opportunities, and so we will revert to more normal provision expense in the quarters going forward.

Peter Ruiz - *Sandler O'Neill & Partners - Analyst*

Okay. That is it for me now. Thanks.

Operator

(Operator Instructions). Michael Young, SunTrust.

Michael Young - *SunTrust Robinson Humphrey - Analyst*

Denny, I had a couple big picture questions for you I wanted to hit. And I wanted to start first with Hurricane Matthew. First of all I hope everyone in your organization was safe and not impacted too much by that. But just any implications for the Company as a result of that? Obviously I heard Steve's comments on loan growth in the fourth quarter. But -- so it doesn't really seem to be affecting loan growth, but just outside of that maybe.

Chuck Shaffer - *Seacoast Banking Corporation of Florida - EVP & Community Banking Executive*

Michael, it is Chuck Shaffer. Yes, it came through and stayed off our coast for the most part and we dealt with it, but it really shouldn't impact Q4. And anything we got setback we expect to make up by the end of the quarter.

Dennis Hudson - *Seacoast Banking Corporation of Florida - Chairman & CEO*

So very little impact, it was an interesting exercise for us. We were able to transfer our 24/7 call center operation to our backup center during that storm and continue to provide all of our digital access throughout the storm.

Interestingly we saw a bit of a spike in some of the digital transactions that we would typically see during that period of time. Kind of interesting how that is transforming the business model and how important it is for our customers to be able to maintain digital access throughout events like that.

So we will continue to redouble our efforts to make sure we can continue to operate no matter what is going on in terms of weather events. But very little impact on us and probably lost a few days of production that we are making up, as Chuck said.

Michael Young - *SunTrust Robinson Humphrey - Analyst*

Okay, perfect. And another big picture one, just we have seen a lot of chatter obviously in the industry following up on Wells Fargo and the issues that they had. Just curious with your consumer heavy model and the way you are remodeling the distribution channels, any expected impacts to either incentive structures or anything in that channel and how you are doing business there?

Dennis Hudson - *Seacoast Banking Corporation of Florida - Chairman & CEO*

I think it is pretty well known now that the Wells Fargo issue was really a function of culture and a breakdown in the culture in that organization. And I am pleased to say that our culture is in many ways captured in something we talk about internally with all of our associates is our Four Promises. And our Four Promises encourage our associates essentially to always do the right thing when addressing customer needs.

And promise number one for our customers, it literally is promise number one, is we promise to get you comfortable with the right product and the right team to serve you.

And so, based on that news out of Wells Fargo last month, we actually have reexamined our internal processes and looked pretty carefully at it. And we believe based on what we have seen that we haven't seen any issues that would cause us to have any concern. And we have kind of confirmed actually that everything we are seeing is suggesting that we are acting in our customers' best interest as we serve them going forward.

Michael Young - *SunTrust Robinson Humphrey - Analyst*

Okay, great. And just one last one and I will step back. Just, Denny, wanted to get an update on your capital priorities at this point. I know a dividend has kind of been a focus, but also we have seen a lot of M&A chatter and announcements in Florida. So just with the two acquisitions behind you how are you thinking about M&A and then dividend as well?

Dennis Hudson - *Seacoast Banking Corporation of Florida - Chairman & CEO*

Well I think, as we always say, M&A is not what we lead with. What we lead with is organic growth and growing our franchise and helping our customers with their financial needs. And we are really proud of the organic growth we have created. Having said that we remain open for M&A opportunities that will help us engage deeper with the state of Florida and help us build out an organization here that is able to return great value to shareholders over time.

So when we see those things line up and match up with our strategy and the like we take advantage of that. So we are opportunistic acquirers. Having said that, I think we see a lot of smaller organizations across the country that are struggling to maybe address some of the things we have been addressing over the last three years and terms of model transformation. So we see that as an exciting opportunity as we look forward. So I hope that answers your question.

Michael Young - *SunTrust Robinson Humphrey - Analyst*

Yes. And just on the dividend too, thoughts there?

Dennis Hudson - *Seacoast Banking Corporation of Florida - Chairman & CEO*

Clearly we have been leveraging our capital position mightily over the last -- particularly the last year and over time as we have grown the balance sheet and produced the record level of growth that we had this quarter and that we anticipate going forward. So that becomes a huge priority for us.

As our earnings have improved we are accreting additional capital that we are going to pour back into our growth plans and programs and we will -- I guess we would say stay tuned in terms of other things that we would look at in terms of capital transactions out there.

Suffice it to say, we have explored all of the levers from buybacks to dividends and we will continue to look at that as we go forward. But we remain focused on creating very safe growth for shareholders and much better returns as we go forward. And take advantage of what we see are some of the best opportunities for growth we have ever seen in the state.

Michael Young - *SunTrust Robinson Humphrey - Analyst*

Okay, thanks, everyone. And congrats on the good quarter.

Operator

(Operator Instructions). If we have no further questions I will turn the call back to Mr. Hudson for closing remarks.

Dennis Hudson - *Seacoast Banking Corporation of Florida - Chairman & CEO*

Great, well thank you very much for attending today. We look forward to talking with all of you in January, late January, as we conclude the year and again to lay out our plan for 2017 and beyond. Thanks.

Operator

Thank you, ladies and gentlemen, this concludes today's conference. Thank you for participating, you may now disconnect.
