Sterling Bancorp, Inc.

First Quarter 2019 Earnings Conference Call

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CORPORATE PARTICIPANTS

Gary Judd - *Chairman, Chief Executive Officer*

Tom Lopp - *President, Chief Operating Officer and Chief Financial Officer*

Michael Montemayor - *President of Retail and Commercial Banking, Chief Lending officer*

Allyson Pooley - *Financial Profiles*

PRESENTATION

Operator
Good afternoon, and welcome to the Sterling Bancorp, Inc. First Quarter 2019 Earnings Conference Call. My name is Cole, and I will be your operator today. At this time, all participants are in a listen-only mode. This call is being recorded and will be available for replay through May 13, 2019, starting this afternoon at approximately one-hour after the completion of this call.

I would now like to turn the conference over to Ms. Allyson Pooley, from Financial Profiles. Please go ahead, Ms. Pooley.

Allyson Pooley
Thank you, Cole and good afternoon, everyone, and thank you for joining us to discuss Sterling Bancorp's financial results for the first quarter ended March 31, 2019. Joining us today from Sterling's management team are Gary Judd, Chairman and CEO, President, COO and Chief Financial Officer, Tom Lopp and President of Retail and Commercial Banking and Chief Lending officer, Michael Montemayor. Gary and Tom will discuss the first quarter results and then we'll open up the call to your questions.

Before we begin, I'd like to remind you that this call contains forward-looking statements with respect to the future performance and financial condition of Sterling Bancorp's 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 for the most directly comparable GAAP measures. The press release, also 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.

At this time, I'd like to turn the call over to Gary Judd. Gary?

Gary Judd
Thank you, Allyson, and good afternoon, everyone, and thank you for joining us today. We are pleased with our start to 2019, which reflects our focus on generating strong and consistent earnings. For the first quarter, we've reported net income of $15.7 million, down 2% from the fourth quarter and EPS of $0.30 per diluted share, which is flat as compared to fourth quarter, again producing upper quartile returns on average assets and tangible equity of 1.94% and 18.46%, respectively.

Our earnings were driven by continued increases in loans, albeit at a slower pace, disciplined expense management and low credit costs. During the quarter, we generated total revenue, net of interest expense of $34.1 million, flat from a year-ago, down 7% from the fourth quarter, primarily due to lower non-interest income as we sold fewer loans during the quarter. We should point out that market demand remains strong for the loans we sell, reflecting the outstanding quality and performance of the loans we originate.

As we indicated in our last call, during the latter half of 2018, we began to see a change in the market environment with respect to housing and also impacted by the trade frictions with China, which created uncertainty among a number of our customers. This general sense of caution continued into the first quarter of 2019.

As a result, this caution coupled with the expected seasonal drop in loan demand, our loan production was down again this quarter. Annualized loan growth for the quarter was 4%. Loan growth continues to be driven by our residential real estate portfolio, which was up nearly 7% on an annualized basis.

Our commercial real estate and construction loan portfolios were both down slightly from the fourth quarter. Our new construction loan originations more than doubled from the fourth quarter. A meaningful amount of this production will translate into higher loan balances in the coming quarters as these projects were built and the funds were drawn down.

Total originations for the quarter were $305 million, down from $333 million last quarter with residential mortgages accounting for $258 million and construction loans for the remaining $47 million.

At quarter end, our commercial real estate and construction pipeline remains over $100 million and we again expect a significant portion of that pipeline to close in the current quarter. We are seeing some rebound in residential production as mortgage rates are lower and demand is increasing. However, given the continued level of caution among our customer base, we remain cautious ourselves about the near-term.

Moving to deposits, total deposits were $2.44 billion, essentially flat as compared to the fourth quarter. However, there was some movement within our deposit categories. As expected, we are seeing some migration from lower yielding money market, savings and NOW accounts into higher-yielding time deposits. This shift reflects the market expectations are for the short-term rates to remain range bound.

With respect to our time deposits, we actually experienced a net $74 million pickup in retail deposits, the majority being from new funds to the bank. This retail growth allowed us to let our entire $34 million balance of brokered CDs run off during the quarter. We remain dedicated to deepening our relationships with our customers with an objective of capturing a greater share of their deposit balances.

Currently, 92% of our deposits are core deposits, which speaks to the quality of our deposit base. Our cost of deposits continued to increase with the rise in short-term interest rates during the quarter, which adversely impacted our first quarter net interest margin in line with our guidance.

Additionally, the shift in our deposit mix with more time deposits added to rate pressure. While we began to see the competitive environment on deposit promotions abate last quarter, the market remains highly competitive and is particularly strong in some of our geographies. We continue to mitigate some of the NIM pressure with our mainly variable rate loan portfolio, which continues to reset at higher rates based on increases in the LIBOR and prime rates. But with recent decline in LIBOR, we are not expecting as much of a lift as we have seen in prior quarters.

As you know, another component to managing our balance sheet liquidity is loan sales. During the quarter, we sold $48 million in pools of residential loans, down over 50% from the fourth quarter, as expected. Institutional demand in the secondary market for our loans remains healthy, which allows us to realize attractive premiums on the loans we sell. The sales have also enabled us to keep our loan-to-deposit ratio relatively stable.

Finally, productivity remains very high as our efficiency ratio for the quarter was 38.5%. Focused expense control and strong productivity are always a priority for us. During the first quarter, we increased our presence in the Los Angeles market with an opening of a branch in Koreatown.

With respect to new branches, we continue to be very selective about pursuing the right locations and giving the timing any additional branch openings will be in the latter part of the year. Additionally, we will continue to evaluate market conditions as the year progresses, which will also impact our de novo strategy.

Given the continued caution among our customers, we remain slightly more guarded for 2019. However, we continue to believe our long term prospects remain favorable as we operate in four of the most attractive markets in the U.S. We will continue to adapt to market changes and make the necessary investments to grow our business profitably. We continue to expand our presence in our markets, adding client-facing professionals, including commercial loan officers. Accordingly, we continue to believe these efforts will generate growth in both loans and deposits in the high single to low double-digits for the year.

Let me now turn the call over to Tom to provide additional details on our financial performance for the first quarter. Tom?

Tom Lopp
Thank you, Gary. I'll start with the income statement. For the first quarter, total revenue, net of interest expense, was $34.1 million, a 7% decrease from the fourth quarter, which was primarily driven by a $2.1 million decrease in gain on sales revenue as we sold fewer loans than in the fourth quarter.

Net interest income was down slightly from the fourth quarter at $30.3 million, due to a 4 basis point decrease in net interest margin and a $6 million decline in average earning assets. As expected, our net interest margin was down slightly from the fourth quarter to 3.86%. While our deposit costs were higher in the quarter, we were able to offset much of the pressure on our margin with the increase in our average loan yields. Loan yields improved again in the first quarter, but at a slower pace given the current rate environment.

Our average yield increased by 2 basis points to 5.67%, driven by approximately $180 million of mainly LIBOR-based mortgage loans that re-priced at an average of 175 basis points higher and approximately $233 million of our prime-based loans also benefiting from the late December increase in the prime rate. Additionally, we had one loan that went non-performing mid-quarter, which combined with lower prepayment penalties in the quarter had a negative impact on the yield by about 3 basis points.

Our average reset for our entire loan portfolio remains at approximately 24 months, which continues to provide us with positive exposure to last year's interest rate increases. As of March 31, we have approximately $1.1 billion of LIBOR-based loans that will re-price over the next two years.

As Gary mentioned, LIBOR has declined by approximately 29 basis points since the beginning of the year and the interest rate outlook for the remainder of the year is flat to potentially down.

Therefore, while we will continue to benefit from loans that will reset in subsequent quarters, we won't see as much of a positive impact as we have in previous quarters.

We expect that prior to payoffs, approximately $175 million of LIBOR-based loans will re-price in the second quarter of 2019 at a weighted average rate that is approximately 130 basis points higher. The increase we saw in our average loan yields was more than offset by a 13 basis point increase in our average cost of interest-bearing liabilities.

As Gary mentioned, we have experienced some customers shifting funds into CDs out of our lower yielding deposit products in order to lock-in higher rates. In addition, the higher level of deposit cost is partially being driven by the strategy we implemented in 2018 to issue a higher proportion of 24- and 30-month CDs to extend our deposit maturities, which is an initiative that we have significantly scaled back.

Our total non-interest income was $3.8 million for the quarter, down from $6 million for the fourth quarter due to the decrease in the gain on sale of loans, which we anticipated due to a large amount sold in the fourth quarter.

The amount of loans that we sell in any given quarter will vary depending on a number of factors, including loan production and balance sheet and liquidity management strategies. While, we are still seeing healthy demand in the secondary market, we expect gain on sale revenue will be somewhat similar to down slightly in the second quarter of 2019.

Our non-interest expense for the first quarter totaled $13.1 million, a decrease from $13.7 million for the prior quarter. The decline was primarily due to salary expense, occupancy and equipment costs and other expenses, including travel and loan origination expenses.

The lower salary expense was due to normal seasonal patterns between quarters as year-end service awards are recorded in the fourth quarter. Additionally, our occupancy costs were higher in the fourth quarter due to one-time expenses associated with our new branch leases, which did not recur in the first quarter.

We expect operating expenses to gradually increase going forward, as we start to see the full quarter effect of our recently opened branches and as we continue to hire talent to help us gather core deposits and grow lending. But despite the increase in expenses, we expect to maintain our efficiency ratio within our targeted range of the mid to high-30s.

Moving to the balance sheet, total loans which include loans held for investment and held for sale, were $2.94 billion at the end of the first quarter, an increase of 1% from the previous quarter, driven by $26 million increase in total loans for investment.

As Gary mentioned, we expect that our loan growth for the full-year will be dependent upon the amount of loans that we sell as part of our balance sheet management strategy and our ability to grow our core deposits.

Turning to deposits, total deposits were $2.44 billion at March 31, down slightly from the end of the previous quarter. This was mostly due to a $56 million decrease in non-maturity retail deposits, partially offset by $40 million increase in time deposits. Our retail time deposits increased by $74 million and were partially offset by the runoff of our $34 million balance of brokered CDs.

Moving to asset quality, non-performing assets totaled 44 basis points of total assets at the end of the quarter, up from 32 basis points at the end of the prior quarter. The increase was primarily due to one construction and one residential loan, totaling $2.8 million that were moved to non-accrual status and a $1 million construction loan added to troubled debt restructurings.

The company believes that no impairment exists as there is more than sufficient collateral values supporting these loans. We experienced minimal net charge-offs which were $138,000 for the first quarter and consisted of $176,000 in gross charge-offs on a legacy loan and $38,000 of recoveries.

We have an excellent credit history. In fact, the last residential mortgage charge-off on a non-legacy loan we originated was in January of 2012, and the last commercial charge-off was in December of that year.

With virtually no historical loss rates, our allowances are based upon qualitative factors, which capture the economic and other risks inherent in our portfolio segments. Our provision for loan losses for the quarter was negative $1 million, as we released previously recorded loan loss reserves. As a result, our allowance per loan losses decreased 5 basis points to 70 basis points of total loans at March 31.

Finally, I would like to update you on our share repurchase program, which we initiated last quarter. During the quarter, we repurchased approximately 1.2 million shares of common stock at an average price of $9.52 per share. We have not purchased any additional shares since quarter end. We will continue to opportunistically repurchase shares when we believe they are at a discount to fair value, demonstrating our commitment to enhancing shareholder value.

With that, we will open up the call for your questions. Operator, we're ready for questions.

QUESTION AND ANSWER

Operator
We will now begin the question and answer session. To ask a question, you may press "*" then "1" on your telephone keypad. If you are using a speakerphone, please pickup your handset before pressing the keys. If at any time your question has been addressed and you would like to withdraw your question, please press "*" then "2." At this time, we will pause momentarily to assemble the roster.

And our first question today comes from Aaron Deer with Sandler O'Neill. Please go ahead.

Aaron Deer
Hi. Good afternoon, everybody.

Gary Judd
Good afternoon.

Aaron Deer
I'd like to start with respect to the origination outlook, you gave some guidance terms or expectations for loan and deposit growth on the balance sheet. But in terms of your overall outlook, given the new branch locations that you've opened up or the hiring that you've been doing, just curious what your expectations are for total loan origination for this year?

Michael Montemayor
Aaron, this is Michael Montemayor. Obviously, that's a moving target for us. Our expectations are that they will continue. We've seen nice increases in our pipelines, both on the residential and commercial. We've been able to expand our commercial staff from 7 to 10 over the last quarter or two. And so, we believe that as these people get settled in and we continue to add to our residential staff, we'll continue to see an uptick in our overall volumes. Taking seasonality into account, clearly the first quarter was down, but probably more so than what we would have hoped for, but we're seeing a nice rebound in the second quarter.

Aaron Deer
Okay. And then it sounds like you've dialed back your longer term CDs, which makes sense given the change in rate outlook, but I'm curious, with the CDs that you have been adding, what is the pricing on those, and how does that compare to the FHLB borrowings that run off in the quarter?

Tom Lopp
Yes, that's a good question, Aaron. Since we changed the rates on that long-term CD initiative, the average rate on our CDs that we've initiated since then is 2.48%, which is lower than the overnight FHLB, which is roughly in the 2.80% range. Sometimes we can do a little bit better when we take two-week advances, that type of thing. But these CDs at these lower rates are lower cost than the overnight advance.

Aaron Deer
Okay. And then I'm a little surprised by the commentary regarding share repurchases, I would have thought that at the current stock price that that might still seem to be an attractive use to some of your excess capital. But it sounds like you're probably going to dial that back some at this point, am I reading that correctly?

Tom Lopp
No, not actually. Aaron, basically we got out with the blackout period, so we've been out during that period. But as we said earlier, with where our share price is at, we're still in the market or we will be in the market, yes.

Aaron Deer
I misunderstood it. And then are you going to put a 10b5-1 plan in place or what are your thoughts there?

Michael Montemayor
Talking about it.

Tom Lopp
Yes, we talk about it from time to time, but not at this point. We've not decided to do that at this point.

Aaron Deer
Okay. Very good. I'll step back. Thank you for taking my questions.

Michael Montemayor
Thanks, Aaron.

Operator
And your next question comes from Matthew Clark with Piper Jaffray. Please go ahead with your question.

Matthew Clark
Hi, good afternoon.

Tom Lopp
Good afternoon.

Matthew Clark
Can you give us a sense for where, given the move in LIBOR and curve flattening, where new originations are coming on for the [indiscernible] portfolio and the tenant-in-common, just trying to get a sense for how those two origination rates are trending?

Tom Lopp
Obviously, with the pullback in some of the rates competition and other things we have seen some flattening or downward pressure on offering rates. Having said that, during the first quarter, I believe, new originations were up a couple of basis points from 530 to 532. But I would tell you that there is still some continued pressure on the initial offering in the current rate environment. So we don't see a lot of opportunity to see that expand and there could be some pressure on that new origination volume offering rates in both those programs, though, Matt.

Matthew Clark
Okay, great. And then maybe on the deposit side of things, given the change in…?

Michael Montemayor
Yes, on the deposit side, like we talked earlier we have pulled back from some of our longer term strategy, even when we were doing some longer-term CDs at 3%, that wasn't much more than the overnight FHLB rate, but we did pull back from that given the significant change in rates over the last three to six months. But our current offering, as Tom said, is averaging 2.48%, our new CD offerings, we have a 2.50% CD out there that we're offering, so 15 month is the most attractive one that's drawing the most activity.

Matthew Clark
Okay, great. And then any update just getting into LA and the opportunity on the tenant-in-common business, what you are seeing there early on? We are having the opportunity…?

Michael Montemayor
Yes, we are pretty pleased with that initial activity out of the LA market for tenants-in-common. We're looking at some development work on the commercial side and on the residential side, it has been picking up nicely for us. We've got some staff that are trained down there and we even have some staff from the San Francisco market that are making regular visits down there to do some seminars and training. So we're pretty pleased with the uptick, we think that is going to be a market that could be at least as large as our San Francisco marketplace for TICs eventually, but the pickup has been nice over the last three to six months.

Matthew Clark
Okay, then just the new non-accruals and TDR this quarter, just what the plans are for resolution and potential timing?

Michael Montemayor
Yes, I'll touch on those, Matt. The one residential is loan, it's been in and out of delinquency for the last six twelve months it happened to go to a point where we decided to put our non-accrual, but we have been receiving payments on and off from this gentleman, but we don't really know the cause of why he goes delinquent and brings that current type of thing. And that's about an $800,000 credit.

On the commercial side we do have a $2 million construction loan that's been delayed on its take out financing from our borrower for lots of different reasons. We're expecting a payoff on it although that hasn't happened as of yet, we are still hopeful that he will be able to get his transaction closed and pay us off. So that should come back to us if it does pay off here in the near-term.

And then the third one was the TDR a commercial loan that had suffered some vacancies. The guarantor looked a little bit on the weaker side and we extended the loan that had come up for maturity on an interest-only basis, so we felt that would be classified that as a TDR, given the financial issues he is having with his tenant base and the vacancy. And so, we are hopeful that that will…he's making his payments, but we felt the extension was a TDR.

Matthew Clark
Okay, and then just on the coverage ratios, the reserve to loan ratio has been in the range for quite a while now 70 basis points. But how does that 70 basis points compare to your coverage ratios that you require on new originations in the single-family resi side between the two products. Just trying to get a sense for whether or not that ratio could drift a little bit lower or do you think we are stable here?

Tom Lopp
Yes, on the residential side, it's lower than the 70 basis points average. And as we alluded to, it's mostly Q factor based, it is approximately 55 basis points on the advantage program, for example.

Matthew Clark
Okay, great. Thank you.

Tom Lopp
Thanks, Matt.

Operator
And your next question comes from Anthony Polini with American Capital Partners. Please go ahead with your question.

Anthony Polini
Hey, guys. Nice quarter.

Tom Lopp
Thank you.

Anthony Polini
Is that tax rate still good at around 29%?

Tom Lopp
Yes, I would say 29%...29.5%. What's driving in that is the increase in production in New York. So we are getting more volume there and that's going to increase in a little bit here.

Anthony Polini
As far as, the outlook for core expense, I am tempted to lower my number a little now that we…originally I was maybe looking for three more branches by midyear and it looks like maybe one or two branches towards the back half of the year, as far as, that core expense rate, granted Koreatown might not be in for a full quarter, is something like a run rate of 14 good for next quarter?

Tom Lopp
Well, I think, again, that's probably a reasonable kind of thought. Overall, I think you will see expenses continue to increase as the balance sheet increases, but for the next quarter I think that's a reasonable thought.

Anthony Polini
And for NIM outlook, given the fact that the repricing, is it going to be as beneficial this quarter, but then again we've had a little bit of an abatement on the competitiveness for deposits, something in the 4 to 6 basis point decline, is that reasonable for next quarter?

Tom Lopp
Yes, I think, we're currently projecting pretty close to the decrease that occurred this quarter, so your estimate is right in that ballpark.

Anthony Polini
Okay. And I'll just factor in $1 million reserve release a quarter through next year.

Tom Lopp
No, I wouldn't do that. No that's rare for us, but basically had to do with the seasoning of predominantly our advantage loans in new markets and some of our foreign national production that we do, basically roll down from a higher requirement to a lower requirement and that's the main driver for the recapture.

Anthony Polini
Alright, what I've been doing realizing that the bounces around a little bit on the provision line, I had been putting $1 million a quarter in the provision line and this way I'll kind of hit or miss by a little bit on the upside and the downside, is that still a reasonable way to project?

Tom Lopp
Yes, I would say that, again, it's dependent on growth. So really if you look at the growth and say 70 basis points, something like that, you are going to…70 to 75, you are going to get to where we should be at.

Anthony Polini
Okay, alright. Thanks, guys.

Michael Montemayor
Thanks.

Operator
And once again if you would like to ask a question, please press "*" then "1."

And our next question is a follow-up from Aaron Deer with Sandler O'Neill. Please go ahead.

Aaron Deer
Hey, guys. Just I have one quick follow up on the deposit cost. Do you have the volume of CD maturities in the second and third quarter and what the average rate is on those maturities?

Michael Montemayor
Yes, second quarter is $84 million and maturity averaging 1.54%…

Tom Lopp
And third quarter is $55.5 million at 1.83%.

Aaron Deer
Okay. So that should then gradually converge probably by early next year, assuming that there's no change in rates between now and then?

Tom Lopp
Yes, that’s fair.

Aaron Deer
Yes, okay. Good stuff. Thanks, guys.

Operator
And there are no further questions at this point. I would like to turn the conference back over to Mr. Judd for any closing remarks.

CONCLUSION

Michael Montemayor
I think we lost Gary there.

Gary Judd
I'm sorry, I haven't learned how to press the mute button. But anyway thank you everybody. We appreciate you joining us and we look forward to speaking to you at the end of next quarter. And if you do have questions, don't hesitate to reach out and contact us.

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