Sterling Bancorp

Second Quarter 2018 Earnings Conference Call

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CORPORATE PARTICIPANTS

Gary Judd - *Chairman and Chief Executive Officer*

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

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

Allyson Pooley - *Financial Profiles*

PRESENTATION

Operator
Good afternoon, and welcome to the Sterling Bancorp Second Quarter 2018 Earnings Conference Call. All participants will be in listen-only mode. Should you need assistance, please signal a conference specialist by pressing the "*" key followed by "0." After today's presentation, there will be an opportunity to ask questions. To ask a question, you may press "*" then "1" on your telephone keypad. Please note this event is being recorded.

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

Allyson Pooley
Thank you, Chad, and good afternoon, everyone. Thanks for joining us today to discuss Sterling Bancorp's financial results for the second quarter ended June 30, 2018.

Joining us today from the management team are Gary Judd, Chairman and CEO, Tom Lopp, President, Chief Operating Officer and Chief Financial Officer; and Michael Montemayor, President of Retail and Commercial Banking and Chief Lending Officer who will be participating in the Q&A portion of the call. Gary and Tom will discuss the results, and then we'll open it up for your questions.

Before we begin, I'd like to remind you that this conference call contains forward-looking statements with respect to the future performance and financial condition of Sterling Bancorp that involve risks and uncertainties. Various factors that 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.

Gary Judd
Thank you, Allyson, and good afternoon, everyone, and again, we thank you for joining us today. I'm going to begin with a brief overview of our second quarter, and then Tom will continue the discussion in more detail.

We executed well in the second quarter, and our formula of strong loan production, disciplined expense management and exceptional credit quality continued to generate a high level of performance and profitability. Net income for the quarter was $16.0 million, or $0.30 per diluted share. This represents a year-over-year increase of 72% and 50%, respectively.

The high level of efficiency and productivity that we generate from the business model we have developed continues to result in returns that are near the top of the industry, with an annualized ROA of 2.08% and an ROATCE of 21.3% in the second quarter.

We continued to do a good job reaching our target customers, and demand for our suite of loan products continues to be strong across all of our markets, particularly for our niche residential mortgage loans and our commercial loans.

Total loan production was $434 million, an increase of 6% relative to the first quarter, resulting in annualized loan growth of approximately 8% in the quarter, including both loans held for investment and loans held for sale.

With continued strong loan production, managing our balance sheet liquidity continues to be a top priority. Loan sales during the quarter were a key component of that strategy. This enabled us to keep our loan-to-deposit ratio relatively stable and manage our funding costs, while fully capitalizing on the productivity of our loan origination platform.

When you include the loans we sold in the quarter, our total annualized loan growth would have been above 30%, which is consistent with our recent trends. We will continue to strategically utilize loan sales going forward to balance our loan growth with our core deposit gathering, protect our NIM, and ensure that we continue to meet the borrowing needs of our customers.

Total deposits grew by $49 million during the quarter, driven entirely by growth in time deposits, while we experienced modest declines in DDAs, money market and savings accounts. This shift in mix is primarily due to our strategic focus on our liability management. We are choosing to extend deposit maturities in this rising interest rate environment.

Competition for deposits remains high, particularly in the San Francisco and our LA markets. That being said, we have started the third quarter with healthy deposit inflows across our branch network.

We also believe that our recent branch openings in newer markets will generate stronger deposit growth, particularly in the greater Seattle market. We are a relatively new entrant in this region and we think there is a significant opportunity to increase our market share as we expand our presence in the area.

Consistent with industry trends, we have seen an acceleration in our cost of deposits in the first half of 2018. However, we have been able to largely offset this pressure with increases in our yield on earning assets.

With most of our loans tied to the one-year LIBOR and Prime, we aren’t as impacted as many banks by the flattening of the yield curve, with short-term LIBOR increasing notably this year. During the second quarter, our loan beta and our deposit beta were relatively similar, which helped keep our net interest margin unchanged from the prior quarter.

However, we do see some signs of increasing price competition on the loan side, which we believe could create some headwinds as we move forward. Tom will go into more detail in his discussion of our net interest margin.

In a competitive market for loan and deposit pricing, the importance of operating with a high level of efficiency becomes even more critical. Disciplined expense control and strong productivity continue to be a daily focus at Sterling. Our efficiency ratio for the second quarter was 34.9%, up from the first quarter, but down over 250 basis points from the second quarter of 2017 and within our mid to high 30 percent targeted range.

Looking to the second half of the year, we are optimistic about our opportunities to continue delivering positive results. Housing and commercial real estate continue to be healthy in our markets. Our loan pipelines are strong, as demand for our niche residential mortgage loans remain solid. We are also seeing our commercial loan pipelines at record levels and we expect to see a pick-up in commercial loan production in the second half of the year.

Further, our continued expansion into our newer markets, including the greater Seattle area, as well as in New York and Los Angeles, should be helpful in generating core deposits to support our planned loan growth.

In summary, based on our second quarter performance and the solid trends we're seeing, we believe that 2018 will be another record year of profitable growth. Sterling remains committed to executing on our strategy to expand our franchise through high-touch customer relationships that result in strong loan production and a high percentage of core deposits. Combined with our strong credit culture and highly efficient back-office operations, this should continue to drive exceptional returns for our shareholders.

With that as an overview, let me turn the call over to Tom to provide additional details on our financial performance for the second quarter. Tom…

Tom Lopp
Thank you, Gary. As I walk through the income statement and balance sheet, I'm going to focus just on those items where some additional discussion is warranted.

Overall, we were pleased with our continued balance sheet and earnings growth. As I mentioned on last quarter's call, one of the key performance metrics that we track internally is our total revenue, net of interest expense, as a percentage of average loans. We believe that this measurement provides a more complete picture of all the revenue sources from our loan portfolio and services, including the contribution from loans held for investment and the loans that we sell.

Since we began selling a portion of our residential mortgage loans back in 2015, we have consistently generated net interest income and noninterest income as a percentage of average loans at 5% or better on an annual basis, although there can be some significant variance in this metric from quarter-to-quarter due to timing of loan sales. In the second quarter of 2018, our annualized net interest income and noninterest income represented 5.1% of our average loans, up from 5% in the first quarter.

Now looking at the net interest margin, our NIM for the second quarter of 2018 was 3.96%, flat with the first quarter. It was positively impacted by a 10 basis point increase in the average yield on earning assets, but offset by an 11 basis point increase in the cost of interest bearing liabilities. As Gary mentioned, the environment for deposit gathering remains highly competitive, and so we expect to see continued increases in our deposit costs.

The average yield on our loans increased 12 basis points during the quarter. This was primarily due to the upward re-pricing of our loans tied to the one-year LIBOR or Prime, which make up 86% of our total loans. The number of LIBOR-based loans re-pricing in our portfolio continues to increase each quarter, with an expected monthly re-pricing of approximately $80 million, on average, for the remainder of the year. And given where LIBOR currently stands, we would expect these re-pricings to exceed 150 basis points. So we expect to see a positive impact on our average loan yields in the coming quarters.

That being said, as Gary mentioned, we are seeing increasingly aggressive pricing among some competitors, so we are finding that we need to lower some of our initial rates on residential mortgage loans in order to remain competitive. This will likely reduce the level of increase in our average loan yields going forward. Combined with the impact of higher deposit costs, this will likely lead to some NIM compression in the third quarter.

Our total noninterest income increased 14.6% from the first quarter to $6.3 million. The increase was primarily due to a $1.1 million increase in the gain-on-sale of portfolio loans sold in the secondary market during the quarter. The amount of gain-on-sale income we generate from quarter to quarter will vary based on a number of factors, including our loan production levels, our success in gathering deposits and our short-term liquidity needs.

Our total noninterest expense increased 9.7% from the first quarter to $12.6 million, due primarily to higher salary expense, professional fees and a full quarter impact of branches opened earlier this year. Much of the increase in salary expense was implemented in March, so we saw the full effect of this in the second quarter.

We have also added personnel to drive and support our loan, deposit and revenue growth. We expect that our operating expenses will continue to increase in the coming quarters, as we open the new branches and hire additional loan officers and business development professionals. We will also continue to increase our corporate back-office operations team to support our ongoing growth initiatives. However, even with the increase in expenses, we anticipate maintaining our efficiency ratio within our targeted range of the mid to high 30s.

With respect to deposits, as Gary mentioned, our total deposits were up approximately $49 million in the quarter. We saw an increase in retail deposits of approximately $66 million, which was partially offset by a reduction in our balances of brokered CDs of approximately $17 million. It is worth noting that during the quarter we added $92 million of two year CDs as part of our strategic focus on extending deposit maturities in this rising interest rate environment.

Moving to our asset quality. We continue to experience net recoveries and positive credit metrics in the portfolio. Nonperforming assets declined fairly significantly to $3.6 million, or 12 basis points of total assets, at the end of the quarter from $8.1 million, or 27 basis points of total assets, at the end of the first quarter. The decline was primarily due to the large residential real estate loan that we discussed last quarter being upgraded to performing status. The loan has subsequently been fully repaid.

We do not see any meaningful losses in any of our past due loans. We had recoveries of $52,000 and charge-offs of $4,000 during the quarter. Our provision for loan losses was $1.1 million for the quarter, which was primarily attributable to the growth in our loans held for investment. Our allowance for loan losses was relatively steady at 72 basis points of total loans, down 2 basis points from the end of the prior quarter.

With that, let's open up the call to answer any questions you may have. Operator, we are ready for questions.

QUESTION AND ANSWER

Operator
Thank you. We will now begin the question and answer session. To ask a question, you may press "*" then "1" on you telephone keypad. If you are using a speakerphone, please pick up your handset before pressing the keys, to withdraw your question, please press "*" then "2." At this time, we will pause momentarily to assemble our roster.

The first question will come from Aaron Deer with Sandler O'Neill & Partners. Please go ahead.

Aaron Deer
I guess on…I would like to start with the outlook for loan growth. It sounds like your pretty optimistic on the pipeline and I am sure that kind of what you are seeing in terms of deposit inflows to support that is going to…have some basis on how you retain versus sell that, but maybe you can give us a sense at this point as you look out through the remainder of the year, what you expect for full year origination volumes in terms of dollar amount and then how you expect that might play out in terms of what's held on balance sheet versus sold into the secondary market.

Tom Lopp
Yes, Aaron, this is Tom. I would expect that we'll see similar trends in the loan production in the second half as we saw in the first year. Although, residential is showing some renewed strength and the commercial loan pipeline is at an all-time high and then we should see some stronger production. So I would say slightly higher in the second half of the year. We also see the deposit inflow thus far in this quarter being very strong, which would imply that all things equal, loan sales for the quarter would likely be similar to slightly lower than Q2.

Aaron Deer
Okay. And you're speaking specifically then about the third quarter expectation for loan sales.

Tom Lopp
Yes. Just the third quarter.

Aaron Deer
And then it sounds like you're seeing pricing pressure both on the loan side at least with respect to SFR as well as everyone's reporting on the deposit side. Can you talk a little bit about what…specifically what you're seeing in terms of deposit pricing pressure really just within say the past few weeks relative to what you were saying earlier this year? Do you expect betas to be materially higher or kind of given the fact you guys had already started with the higher…kind of toward the higher end or where the market was, maybe you're not seeing the kind of catch up in pricing that we're seeing amongst some other banks?

Michael Montemayor
Aaron, this is Michael Montemayor. We're seeing some renewed competition in the market for the deposits over the last few weeks or month or two for sure, where some of the increases have come through. The competition has seemed to accelerate it. We certainly were pretty pleased with our ability to maintain our betas on deposits for the second quarter, but we feel that that will…there will some continued pressure on deposits as there's more competition in the deposit side of the balance sheet in the coming quarter.

Tom Lopp
Aaron, this is Tom. I would add that as far as the betas go, I think we should see a pretty steady rate of increase if you will, not what you're seeing with some or the other banks that are seeing a more rapid increase in their betas. So, I would expect similar trends from us.

Aaron Deer
Okay, that's encouraging. And then maybe kind of relatedly I guess with respect to…can you give us what the average rate was on the new SFR production in the quarter and then where that rate is currently pricing?

Michael Montemayor
I have the total for…all loans. Let me look into, if I can find the breakout for addressing the single family, but…

Aaron Deer
And that's fine. I mean the single family…

Michael Montemayor
Okay. Yes absolutely. It was up to 546 bank-wide, which was up 25 basis points from the first quarter. But, as Tom mentioned during the presentation, we have become more competitive, we are…to help accelerate our growth, so we’ve come back a little bit to try and increase production and we’ve begun to see some results in that already just over the last few weeks.

Aaron Deer
Okay and then I guess where then would be your incremental cost of funding those loans?

Tom Lopp
Well, the incremental cost would be on our CD offerings that we put on as well as the money market that, our lead product there. We're getting most of the most money in the 24 month CD as well as the money market, and that's in the two to two and a half range.

Aaron Deer
And then one last question, I'll step back. I’m just curious what the volume of loans were that were sold in the quarter?

Michael Montemayor
Well, we don't disclose exactly how much we sell, you can see from our total production and from what we had on our books at the end of the last quarter for loans held for sale. It would give you good indication, but we don't due to competitive reasons disclose exactly what we've sold.

Aaron Deer
Okay. Has the premium or the gain on those sales been relatively consistent or have you seen change in that?

Michael Montemayor
Yes, Aaron. It's been very consistent. We've been pretty pleased even with the increasing rates, our premiums have held very steady.

Aaron Deer
Okay, terrific. I appreciate you guys taking my question. Have a good afternoon.

Tom Lopp
Thanks, Aaron

Operator
Again, if you have a question, please press "*" then "1." The next question comes from Anthony Polini with American Capital Partners. Please go ahead.

Anthony Polini
Hi, thank you. Hi, guys. Nice quarter.

Tom Lopp
Hi, Anthony. Thank you.

Michael Montemayor
Thank you.

Anthony Polini
I like that profitability. But one question I had to do with the brokered CD rates and it sounds like you did 24 months at around 2.5% would that be the most recent put on?

Tom Lopp
That's retail. We've actually lowered our brokered CD portfolio.

Michael Montemayor
By $17 million.

Tom Lopp
Yes. And we have relatively immaterial brokered CDs on the balance sheet at this time.

Anthony Polini
Okay. And if I heard you right, you have $80 million as far as loans re-pricing a month at 150 basis points higher.

Tom Lopp
Yes, on average for the remainder of the year. That's correct. Yes.

Anthony Polini
Now the competition that you're seeing on the pricing for the resi, which competitors are aggressively pushing that price down?

Michael Montemayor
There's a fair broad array of competitors between East West, HSBC, Café and a number of the other institutions that we see competition. I don't think there is one particular, but most of the mainstay within the markets that we are focused on had been relatively competitive in that space.

Anthony Polini
Were you guys surprised by the renewed competition on the pricing side especially given the fact that the fed seems to be signaling a couple of more hikes?

Tom Lopp
Yes actually given the rising rate, we were surprised as competitive as some of the competition got to garner volume. So we're keeping a close eye on it, but we think we're priced right for the volumes that we're looking for to match our deposit growth.

Anthony Polini
Okay, as far as Seattle, what kind of expectation should we have for the second half of the year?

Michael Montemayor
Well, new markets are always interesting Anthony, we have good ideas of what we think we'll be able to do. We've surveyed competition in both loan side which we've been operating in Seattle for a while now on and also on the deposit side. So it's hard to say exactly, but we're ready, we're hoping to open our first branch there this week and if all the inspections go well, we'll be able to report some results at the end of the quarter. But we have some strong expectations that we will be very competitive on the deposit side there.

Tom Lopp
Yes, Anthony, I would add that with opening the retail presence what we saw in LA when we first did that, was a big difference in hiring success and ultimately production volumes and deposit gathering, really until you open that first retail presence, it can be a little challenging, but as Michael said, we are real close to having that branch open.

Anthony Polini
Okay, that's good. Except for the margin you guys are pretty much in line. I hope that every time you guide down for margin, you stay flat, this will work out real well.

Michael Montemayor
We agree.

Anthony Polini
Thanks guys.

Michael Montemayor
Alright. Thank you.

Operator
Ladies and gentlemen, this concludes our question and answer session. I would like to turn the conference back over to Gary Judd for any closing remarks.

CONCLUSION

Gary Judd
Again thank you for joining us today and we will look forward to speaking with you next quarter. Have a great afternoon and we appreciate your time.

Operator
And thank you sir, the conference has now concluded. Thank you for attending today's presentation. You may now disconnect your lines.