Sterling Bancorp

Third Quarter 2018 Earnings Conference Call

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CORPORATE PARTICIPANTS

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

Michael Montemayer - *President of Retail, Commercial Banking, Chief Lending Officer*

Tony Rossi - *Investor Relations*

PRESENTATION

Operator
Good afternoon, and welcome to the Sterling Bancorp's Third 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 touchtone phone, to withdraw your question, please press "*" then "2." Please note this event is being recorded.

I would now like to turn the conference over to Tony Rossi, Investor Relations for Sterling Bancorp. Please go ahead.

Tony Rossi
Thank you, Andrea, and good afternoon, everyone, thank you for joining us today to discuss Sterling Bancorp's financial results for the third quarter ended September 30, 2018.

Joining us today from the management team are, Tom Lopp, President, Chief Operating Officer and Chief Financial Officer and Michael Montemayer, President of Retail and Commercial Banking and Chief Lending Officer. Tom and Michael will discuss the results and then we will open it up to your questions.

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

The company disclaims any obligation to update any forward-looking statements made during the call. Additionally, management may refer to Non-GAAP measures which are intended to supplement, but not substitute for the most directly comparable GAAP measures. The press release issued today contains the reconciliation of the GAAP to Non- GAAP measures. At this time, I'd like to turn the call over to Tom. Tom…

Tom Lopp
Thank you Tony, and thanks to all of you for joining us today. Gary Judd, our CEO is traveling out of the country and unable to join today's call. I am going to fill in for him, and provide a brief overview of our third quarter, and then I'll turn it over to Michael for more detail on our operational results, before finishing with our financial results.

We delivered another strong quarter, driven by continued loan growth, a stable manager's margin, excellent credit quality and disciplined expense management. We generated an income for the quarter of $15.7 million, a 30% increase from a year earlier, and $0.30 per diluted share, an increase of 11%.

Importantly, our productivity and efficiency continues to generate returns that are among the best in the banking industry. In the third quarter, we recorded an annualized return on average assets of 1.98%, and a return on average tangible common equity of 20.1%.

With that, I'll turn the call over to Michael to provide a discussion on our operational performance. Michael…

Michael Montemayer
Thank you, Tom. From an operational perspective, we continue to have strong loan production, although somewhat off the levels we've generated in recent quarters.

During the third quarter, we originated $419 million in loans, which consisted of $354 million in residential mortgages, $38 million in construction loans, $22 million in commercial real estate loans, and $5 million in commercial and industrial loans. This resulted in an annualized growth in total gross loans of 10% during the quarter.

Loan demand continues to be relatively healthy across our markets although we have experienced a slowdown in demand for mortgages in the San Francisco market, strong home price appreciation in that market and higher interest rates have led to rising affordability concerns. Combined with the lack of inventory, this has resulted in some slowing of demand for new mortgages. On an absolute basis, the demand is still relatively good. It's just not at the level we've seen over the past few years.

Anecdotally, we have also noticed some caution among real estate investors in our target markets amid the ongoing global trade disputes involving the U.S. and China. Having said that, we are optimistic about gaining shares in our three newer markets.

As we indicated on our last call, we have lowered rates a bit on our core mortgage product to be more in line with the market. We did this in July and have kept pricing firm since then. Our analysis indicates that we are priced competitively and aren't losing business due to price. The lower production is really being driven by a slowing demand.

Loan sale activity was lower in the third quarter than previous periods, which is consistent with our strategy to keep more loans on our balance sheet and reduce gain on sale income as a percentage of total revenue, but we will continue to strategically use loan sales to balance our loan growth with our core deposit gathering and manage our liquidity.

We continue to hire bankers, invest in branches, build market share in our newer markets, Los Angeles, New York and now Seattle. We are hiring residential mortgage and commercial bankers across those markets and we closed our first commercial loan in both New York and Seattle during the third quarter.

In New York, we relocated our branch to a ground-floor location, boosting visibility and traffic. In Los Angeles, we opened a new branch earlier this year and we will soon relocate another to a more prominent position. We plan to open another branch in Koreatown area of Los Angeles in the fourth quarter, and in Bellevue, the Seattle metro area, we recently opened our first retail branch location.

We launched our Los Angeles operations about 3.5 years ago. Now, that market accounts for nearly half of total residential loan production and contains our largest branch with approximately 300 million in deposits. We started in New York a little over a year ago and it now contributes nearly 10% of production. And in Bellevue the Seattle market, we are already showing substantial promise. Since opening in August, the Bellevue branch has already brought in over $10 million in deposits.

In each of those markets, there is plenty of room for opportunity for us to continue taking market share. We are utilizing the same formula that's driven our success in San Francisco and Los Angeles. We have a highly responsive and efficient underwriting process for residential mortgages which often enables us to close loans in half the time it takes our competition. This has helped us to build a very strong reputation amongst realtors and grow our referral sources.

As we gain visibility and awareness in the newer markets, we expect to continue to increase our loan production, as well as, our ability to bring in core deposits. In keeping with our prudent approach to investing in our business, we've been able to expand our presence in these newer markets and add our business development team while maintaining a superior overall level of efficiency. Our operating efficiency ratio was 35.8 in the third quarter which continues to be among the best in the industry.

Looking ahead, we expect the competition for loans and deposits will remain high. And activity in the San Francisco housing market, while still healthy is likely to remain somewhat lower when compared to previous and recent years at least in the near term. But the traction we are gaining in newer markets gives us confidence that will continue to generate strong balance sheet growth.

Our pipelines are healthy and our commercial loan production is picking up as we add to our commercial banking team. Therefore, we believe we can generate similar level of loan growth as we did in the third quarter. And longer term, we feel very good about our ability to continue to produce strong results and create value for our shareholders.

With that, I'll turn the call back over to Tom to provide some additional details on our financial performance. Tom.

Tom Lopp
Thank you, Michael. As I walk through the income statement and balance sheet, I am going to focus just on those items where some additional discussion is warranted. Revenue, net of interest expense was $35 million, down 3% from the second quarter. The decline was due to a $2.1 million decrease in non-interest income which was the result of the lower volume of loans held in the quarter.

The decline in non-interest income was partially offset by a $900,000 increase in net interest income, which is the result of loan growth and the repricing of loans already on our books. We are very pleased with the stability we've been able to maintain in our net interest margin. The margin was 3.95% in the quarter, down just 1 basis point from the previous quarter. While our deposit costs continue to increase, we have been able to largely offset the pressure on our margin with the increase in our average loan yields.

We are seeing the benefits of repricing that we expected. During the third quarter, we had approximately $170 million of mainly LIBOR-based mortgage loans that re-priced an average of 150 basis points higher. This resulted in our average loan yields increasing 13 basis points to 5.58% in the quarter. In addition, approximately $240 million of our prime-based loans will benefit from the late September increase.

Most of our mortgage production continues to be one year or three years ARMs, and our average reset for our entire loan portfolio is 23 months which provides us positive exposure to rising interest rates. We continue to expect that prior to payoffs, approximately $80 million of

LIBOR-based loans will reprice on a monthly basis at an average rate that is at least 150 basis points higher.

The increase we saw in our average loan yields mostly offset an 18 basis point increase in the average cost of interest-bearing liabilities. The level of increase we are seeing in our deposit costs is partially driven by the strategy we are implementing to issue 24 and 30 month CDs to extend our deposit maturities. During the third quarter, we issued $24 million in 24 month CDs and $65 million in 30 month CDs. While this results in a higher near-term deposit data, we believe the strategy will ultimately help us to better manage our deposit costs over the longer term.

Looking ahead to the fourth quarter, while we will benefit from loan re-pricings, given the continued aggressive deposit pricing we are seeing in our markets, we would expect to see some compression in our net interest margin.

Our total non-interest income was $4.2 million for the quarter, down from $6.3 million for the second quarter. The decline was the result of a decrease in the gain on sale of loans due to the lower level of residential mortgages sold in the secondary market that Michael discussed. This was strictly due to the amount of loans sold as our loan sale premiums actually increased from the prior quarter.

Our non-interest expense for the third quarter totaled $12.5 million, a slight decrease from $12.6 million for the prior quarter. The decline is primarily attributable to non-recurring accrual adjustments on both salary expense and FDIC assessments. This was partially offset by increases in occupancy and equipment costs and advertising and marketing costs which was largely related to the expansion in our newer markets, as well as, higher professional fees.

We expect operating expenses will move up in the fourth quarter and in early 2019 as we open branches and continue to hire talent to help us gather core deposits and grow lending. But even with the increase in expenses we expect to keep 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 $2.93 billion at the end of the third quarter, an increase of $73 million from the previous quarter.

A $92 million increase in residential mortgage loans held for sale and a $7 million increase in commercial real estate and construction loans contributed to the growth and was partially offset by a $26 million decrease in residential mortgage loans held for investment. We had approximately $114 million in mortgage loans held for sale at the end of the quarter. We are in the process of selling most of these loans as institutional demand remains strong for our loans and this will likely result in a similar to potentially higher gain on loan sales in the fourth quarter.

Turning to deposits; total deposits were $2.41 billion at September 30th, an increase of $72 million from the end of the previous quarter. The increase was primarily attributable to a $24 million increase in non-maturity retail deposits and a $76 million increase in time deposits, partially offset by a $28 million decrease in broker deposits.

Moving to asset quality; non-performing assets totaled 19 basis points of total assets at the end of the quarter, up from 12 basis points at the end of the prior quarter. The increase was primarily due to a $2.8 million construction loan that became a troubled debt restructuring when the maturity was extended. The loan remains on accrual and is current on payments, and we do not anticipate any losses on this credit.

Once again, we had net recoveries for the quarter as we had no charge-offs and $42,000 in recoveries. Our provision for loan losses was $423,000 which was primarily due to an increase in special mention loans. Although there were some downgrades to special mention this quarter, we don't anticipate any losses on these loans. With the lack of charge-offs and the provision we had this quarter, our allowance for loan losses increased 2 basis points to 74 basis points of total loans at September 30th.

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

QUESTION AND ANSWER

Operator
We will now being 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 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.

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

Aaron Deer
Good afternoon, everyone.

Tom Lopp
Hi, Aaron.

Michael Montemayor
Good afternoon, Aaron.

Aaron Deer
Tom, Michael, if…it was very encouraging to see that the strength in the margin this quarter, but you said, I guess, in lieu of that, I would like to maybe explore some of the growth trends in the quarter and the origination volumes. Can you talk about, I guess, what…as you look out to the fourth quarter and some of the dynamics in terms of the pipeline, and it sounds like you are going to…you are planning to sell much of what's currently held for sale? What do you…what kind of loan growth should we expect here as we head into year-end, and how are you feeling about 2019 shaping up given what sounds like a…certainly a continued competitive environment and maybe a little bit less loan demand?

Michael Montemayor
Aaron, this is Michael. I would tell you that we…during the quarter, our pipeline, it has been relatively good, we have seen some pickup during the month of October in terms of closings and applications. So feeling pretty confident that we will be able to, as I said during the call, put up similar or even a little better numbers during the quarter in terms of growth. We are continuing to onboard lenders almost every week, but as you well know, it's a pretty competitive labor market. So identifying and onboarding people is a challenge. But we are working in all markets, especially LA, Seattle and New York. And we were encouraged that even though, overall, it was down slightly, our newer markets, New York and Seattle had some nice

expansion for us. And we will continue to focus on the newer markets and also maintain and watch what we are doing in San Francisco and in LA.

Tom Lopp
Yes, just a little more color, Aaron. This is Tom. As Michael alluded to, the October production thus far in residential is higher than the Q3 average for any month and applications are also ticking up and higher than they were for Q3 average.

Aaron Deer
Okay, that’s encouraging, because I guess, the…because your guidance is suggesting that growth is maybe roughly the same or a little better than what we saw this quarter, that I guess, would be on your total outstanding loans which…if we back out some of a more higher volume of loan sales in the fourth quarter, you know, I am just wondering, if we should expect the held for investment portfolio to show continued growth or if that might shrink a little bit in the fourth quarter?

Michael Montemayor
No, I would expect that to continue to expand. We can't always or don't…are always able to control exactly when we execute on these larger loan sales. And so there were some carryover which we don't necessarily try to do, but it did happen this quarter. So I would see the fourth quarter debt shrinking and held for investment going up significantly.

Aaron Deer
Okay, and then on the TDR, it doesn't sound like you have any concern about the…any losses emerging there. But just out of curiosity, what...can you tell us what the developer has in terms of cash in that project and what the completion value of the project is expected to be?

Michael Montemayor
Yes, the...

Aaron Deer
[indiscernible].

Michael Montemayor
Yes, our principal sponsor on that transaction became very ill and incapacitated earlier this year. So we have been working with some of his minority investors to add, to bring in another contractor to complete it due to his condition. They brought in some additional capital for $350,000. And hence, because the sponsor is ill we felt there was really a TDR when we did the extension and provided for longer term for them to complete the project. We expect that project to sell for $4.5 million, it's a multiunit TAC [ph] project in the City of San Francisco, but due to that issue, that's the kind of crux of it.

Aaron Deer
Okay. That's good color. Thank you. And then just a couple of last questions on the expenses, the FDIC and the comp line both down sequentially, it looks like maybe there is some true-ups going on in there, as I missed part of your comments, I am not sure if you said that explicitly. But just...I would expect that both those line items ticked back up a little bit in the fourth quarter. Is that the right way to be thinking about those line items?

Tom Lopp
Absolutely Aaron, and it was due to true-ups in Q3, but I would expect those to tick up in Q4.

Aaron Deer
Okay, very good. Thank you for taking my questions.

Tom Lopp
Thank you, Aaron.

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

Anthony Polini
Hi, guys.

Tom Lopp
Hi, Anthony.

Anthony Polini
Nice quarter. You got there a little bit differently than I thought, but nice…it's nice to see the growth slowing on the balance sheet, and you are able to moderate expenses to some extent. I am assuming some of the variable expenses also went down that quarter and maintained that margin. How comfortable do you feel in your ability, I guess, going forward to continue to manage the growth process where perhaps slowing down, I mean, it's nice to have some variability in your expense base. Can you remind me again what the investment outlook is, as far as, new branches for 2019?

Tom Lopp
Yes, right now, we have one, as Michael mentioned, scheduled to open in Q4 in Koreatown in LA of 2018. And right now, we are in the heart of our business planning process for 2019 and beyond. And the current number we are looking at is three new branches that likely will begin to be opened near the end of the second quarter and later.

Anthony Polini
Okay. Now...

Tom Lopp
Which is typical with the prior years for the most part for us.

Anthony Polini
Right, is it reasonable to assume that even though we have demand slowing down pretty much a national event that the growth in the new markets will likely offset that demand going forward, the decrease in the rate?

Tom Lopp
Yes, we are optimistic of that, Anthony, especially in the newer markets. You know, in New York, as Michael mentioned that’s about 10% of our residential production. We are really just getting started there, Seattle even more so, just getting started. We are optimistic about gaining market share there and…as well as, in L.A. We think there is room for a lot of growth in L.A. We think that’s a multiple of San Francisco. And as Michael mentioned, the commercial lending is…we really had some good success with some hiring of some very good lenders in all our markets, and we are expanding at a pretty good rate there with the lenders.

Anthony Polini
If we look at the third quarter expense line and we add back some of those unusual declines, what number would we be looking at?

Tom Lopp
Well, you would probably be looking at about $450,000, $500,000 or so higher than what was reported.

Anthony Polini
Okay, and no reason to anticipate any changes in the tax rate going forward?

Tom Lopp
No, that's you know, just depending on the mix between the states that we do business in, is the only real variable there. But our guidance there of 28% to 30%, I think, will hold at least through the end of the year.

Anthony Polini
Does it get any worse in California?

Tom Lopp
California is obviously a higher taxation state, but it also has to do with the apportionment and how that mix with the other states goes. But that is the risk in the tax rate being higher.

Anthony Polini
Okay. That's it from me. Nice jobs, guys. Thank you.

Tom Lopp
Thanks, Anthony.

Michael Montemayor
Thank you.

Operator
This concludes our question and answer session. I would now like to turn the conference back over to management for any closing remarks.

CONCLUSION

Tom Lopp
Thank you, operator. Thanks to all of you for joining us on the call today. We look forward to speaking with you again next quarter. Have a great afternoon.

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