Sterling Bancorp, Inc.

Fourth Quarter 2018 Earnings Conference Call

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CORPORATE PARTICIPANTS

Gary Judd - *Chairman and Chief Executive Officer*,

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

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

Allyson Pooley - *Investor Relations*

PRESENTATION

Operator
Good day, everyone, and welcome to the Sterling Bancorp Fourth 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 and to withdraw your question, please press "*" then "2." And please note that today's event is being recorded.

And I would now like to turn the conference over to Allyson Pooley, Investor Relations for the company. Please go ahead.

Allyson Pooley
Hi and thank you, William. Good afternoon, everyone, and thank you for joining us today to discuss Sterling Bancorp's financial results for the fourth quarter ended December 31, 2018.

Joining us today from Sterling's management team are Chairman and CEO, Gary Judd, President, COO and Chief Financial Officer, Tom Lopp and President of Retail and Commercial Banking and Chief Lending Officer, Michael Montemayor who will participate in the Q&A portion of the call. Gary and Tom will discuss the fourth quarter results and then we will open the call to 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 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.

And with that, I will turn the call over to Gary.

Gary Judd
Thank you, Allyson, and good afternoon, everyone, and as Allyson said, thank you for joining us today. We are very pleased with our financial performance for our first full year as a public company, as we've reported record net income of $63.5 million, which translated into a 46% increase in earnings per share, return on average assets of 2.04% and a return on tangible equity of 20.71%, which again puts us at the upper end of our small cap community bank peers.

For the fourth quarter, net income totaled $16 million, up 2% from the third quarter and EPS was $0.30 per diluted share, consistent with the third quarter and more than double the prior year's fourth quarter, which included a $3.3 million expense as a result of the Federal Tax Law change. Our earnings growth for the quarter and year was driven by continued increases in loans, disciplined expense control and loan credit costs with net recoveries for the sixth straight year.

During the fourth quarter, we generated total revenue net of interest expense of $36.7 million, up 23% year-over-year and up 5% from the third quarter. Total revenue expressed as a percentage of average loans came in around 5% for the quarter and for the year. We believe that this metric provides a meaningful picture of all of the revenue sources for our loan portfolios and services, including the contribution from loans held for investment and the loans that we sell.

During the latter half of 2018, the market environment began to change with respect to the housing market as well as the Chinese economy, particularly as it related to the escalated trade tensions between the U.S. and China. These factors have partially impacted our markets in the fourth quarter and has us being more cautious in the near term.

For the fourth quarter, we generated solid loan growth but saw lower loan production. Total loans held for investment increased by $101 million from the third quarter, which translated into a 14% annualized growth rate. The growth was primarily in our residential real estate portfolio, which was up 19% on an annualized basis and our commercial real estate and constructional portfolios were relatively flat from the third quarter.

On the production side, we originated $332 million in total loans during the fourth quarter consisting of $303 million in residential mortgages, $19 million in construction loans and just over $10 million in commercial real estate and C&I loans.

Total loan production was down from $419 million in the third quarter, reflecting the noticeable slowdown in residential home sales in the quarter, as well as purchases or project delays related to the lengthening of municipal approval timeframes impacting a number of our commercial real estate and construction loans which are primarily used for the renovation of single or multifamily residential properties.

At year end, our commercial real estate and construction pipeline grew to just over $100 million and we expect a significant portion of that pipeline to close in the current quarter. That being said, given the overall headwinds that we are facing in our markets and the general level of caution among our customer base, we expect loan production to remain at lower levels than we experienced in the first half of 2018.

Moving to deposits, our total deposits grew by 9% for the full year at an annualized rate of 7% in the fourth quarter. Our effort to deepen our relationships with our customers continues to produce positive results as we seek to earn a greater share of their deposits. 91% of our deposits are core deposits, which we define as all liquid deposits and all retail CDs $250,000 and under, which speaks to the quality of our deposit base.

Although cost to deposit has continued to increase with the rise in short-term interest rates adversely impacting our net interest margin in the quarter and for the year, we’ve been able to mitigate much of this pressure with higher average loan balances and our mainly variable rate loan portfolios, which continue to reset at higher rates based on increases in the LIBOR and prime rates.

We are pleased to say that the competitive pressure on deposit rates appears to be lessening and should help stabilize NIM going forward. Another component of managing of our balance sheet liquidity is sales. And during the quarter, we sold pools of residential loans for $124 million. Institutional demand in the secondary market has been strong, so we continue to realize attractive premiums for the loans we sell.

The sales also enabled us to keep our loan to deposit ratio relatively stable between quarters. Finally, productivity levels remains very high. We expanded our market, sales force and critical support function with the addition of 34 associates in 2018, yet maintaining strong efficiency ratio of 35.4% for the year and 37.3% in the fourth quarter. Focused expense control and strong productivity are ongoing priority for us.

During the year, we expanded our presence in the greater Seattle and New York markets, both being key elements of our growth strategy. We are close to opening a new branch in the Koreatown area of Los Angeles. While our current plan is to potentially add two to three additional branches in the second half of the year, we will closely evaluate market conditions and our de novo plans as the year progresses.

We continue to hire residential mortgage and commercial bankers in all of our markets, as we see the opportunity to increase share. And we continue to make investments to ensure the long-term growth potential for our business.

Given the continued caution especially in the California market, the uncertainty pertaining to China and the government shutdown, we are slightly more guarded going into 2019. However, our long-term prospects remain quite favorable as we operate in four of the most attractive markets in the United States based on household income, wealth and employment rates.

We will adapt to market changes quickly and we will make the necessary investments to grow the business. We continue to expand our presence in our markets, add client-facing professionals and focus on commercial loan originations. Combined, we believe this will generate growth in both loans and deposits in the high single to low double-digits for the year.

We are excited about the success we are having in attracting new customers to the bank, and believe the investments that we are making in our business, along with our expanding geographic footprint, will position us for continued growth and strong profitability in 2019 and beyond.

Finally, I'd like to mention the share repurchase authorization that we also announced today. Our board of directors has authorized the share repurchase program of up to $50 million of our common stock. While our primary goal is to use our capital to reinvest in the business, from time to time when shares are trading at what we believe to be significant discount to fair value, repurchasing shares demonstrates our commitment to enhancing shareholder value.

Our strong ongoing financial performance coupled with our solid capital levels following possible repurchase, will support our growth opportunities as we look ahead. Importantly, the program reflects our confidence in the long-term prospects for the company and our focus on shareholder value.

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

Tom Lopp
Thank you, Gary. Starting with the income statement, for the fourth quarter, total revenue net interest of expense was $36.7 million, a 5% increase from the third quarter, which was primarily

due to a $1.8 million increase in noninterest income. As Gary mentioned, we sold pools of residential loans resulting in a 52% increase in gain on sales revenue as compared to the third quarter.

Net interest income was down slightly from the third quarter at $30.7 million as a $33 million increase in average earnings assets was offset by a lower net interest margin. We are pleased, however, with the stability we've been able to maintain in our net interest margin. At 3.90%, it was down just five basis points from the previous quarter.

While our deposit cost continues to increase, we've been able to offset much of the pressure on our margin with the increase in our average yield. The competition for deposits remains high in the first half of the quarter and we increased rates again late October, which will put a bit more pressure on NIM in the current quarter. However, we expect deposit pricing to stabilize as competition appears to abating.

Loan yield improvement continued in the fourth quarter as our average yield increased by seven basis points to 5.65%, driven by approximately $220 million of mainly LIBOR-based mortgage loans that re-priced at an average of 163 basis higher and approximately $240 million of our prime base loans also benefiting from the late September increase in the prime rate.

Our average reset for our entire loan portfolio is approximately 24 months, which provides us positive exposure to past and future interest rate increases. As of December 31, we have approximately $1.1 billion of LIBOR-based loans that we will reprice over the next two years. So if the Fed pauses with its rate increases, we will continue to benefit from loans that we will reset in subsequent quarters based on earlier LIBOR increases.

We expect the part of the payoffs, approximately $190 million of LIBOR-based loans, will reprice from the first quarter of 2019 at an average rate that at least 160 basis points higher. The increase we saw in our average loan yields was more than offset by a 16 basis points increase in our average cost of interest-bearing liabilities.

The level of increase we are seeing in our deposit cost is partially driven by the strategy we've implemented in 2018 to issue a higher proportion of 24 and 30 months CDs to extend our deposit maturities. During the last two quarters, we issued $43 million in 24-month CDs and $92 million in 30-month CDs. While this results in higher near-term pressure on deposit rate, we believe the strategy will help us better manage our deposit costs over the longer term.

Our total noninterest income was $6 million for the quarter, up from $4.2 million for the third quarter, due to the increase in gain on sale of loans, as I mentioned. There is strong demand for the type of loans that we originate and the premiums that we were able to achieve in the fourth quarter were particularly attractive, so we sold a larger amount than our recent quarters.

At the end of the quarter, loans held for sale were $1.2 million compared to $113.8 million at the end of prior quarter, suggesting gain on sale revenue will be down significantly in the first quarter of 2019. The amount of loans that we sell in any given quarter will vary as we use these sales to support our balance sheet and liquidity management strategies.

Our non-interest expense for the fourth quarter totaled $13.7 million, an increase from $12.5 million for the prior quarter. The increase was primarily due to salary expense and occupancy and equipment costs required to support new offices and the growth of our operations.

We expect operating expenses to gradually increase due to new branch openings and further additions to our staff, as we continued to hire talent to help us gather core deposits and grow lending. But despite 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 $2.92 billion at the end of the fourth quarter, essentially flat with the previous quarter. As Gary mentioned, the $101 million increase in total loans held for investment was offset by the decline in loans held for sale.

Turning to deposits, total deposits were $2.45 billion at December 31st compared to $2.41 billion at the end of the previous quarter. The increase was primarily attributable to a $99 million increase in time deposits partially offset by a $58 million decrease in non-maturity retail deposits.

Moving to asset quality, non-performing assets totaled 32 basis points of total assets at the end of the quarter up from 19 basis points at the end of the prior quarter. The increase was primarily due to two residential loans totaling $4.1 million that were moved to nonaccrual status. We have received current appraisals on each of these properties showing loan to values that average 59%. So we believe that no impairment exists.

Once again, we had net recoveries for the quarter as we had no charge-offs and $40,000 in recoveries. Our provision for loan losses was $1 million, which was primarily due to the growth in total loans held for investment during the quarter. Our allowance for loan losses increased 1 basis point to 75 basis points of total loans at December 31st.

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

QUESTION AND ANSWER

Operator
Thank you. And we will now begin the question and answer session. To ask a question you may press "*" then "1" on your touchtone phone. If you are using a speakerphone please pick-up your handset before pressing the keys, to withdraw your question please press "*" then "2." And at this time we will pause for a moment to assemble our roster.

And the first questioner today will be Aaron Deer with Sandler O'Neill and Partners. Please go ahead.

Aaron Deer
Hi, good afternoon, everyone.

Gary Judd
Hi, Aaron.

Tom Lopp
Hi, Aaron.

Aaron Deer
I would like to start on the subject of loan production; obviously the demand has been a factor and you walk through some of the environmental dynamics leading to that. But, I am just…I

would like to get your sense of whether in your view as you look out at the market and your customers, whether this is a reset lower or maybe a temporary phenomenon and we get some lifts as we move forward through the year or if we could see a trend continue lower in terms of the production volumes.

Michael Montemayor
Hi, Aaron, this is Michael Montemayor. We perceive it to be somewhat temporary in that there are some headwinds that we have been hearing and experiencing from our staff. We've been able to expand our staff over the previous quarter on the residential side and the commercial side. We believe those expansion will eventually lead to larger market share in our California market, as well as, the newer markets of New York and Seattle. So we have a plan in place to expand our staff to pick-up market share so that current volumes will increase in the coming quarter or two.

Aaron Deer
Okay. And then, related to that, as you just think about what your expected production volumes are for the year and how much like your balance sheet versus sell, maybe I know you don't like to give specifics in terms of your gain on sale premiums, but what would you expect to see in terms of quarterly sale, revenue gain on sale, revenue through the…obviously you said the first quarter is going to be light just given that, you took out a lot of your pipeline here this past quarter. But what are you expecting to sell as the year goes on?

Michael Montemayor
Well, as we've said over the previous number of quarters, Aaron, our gating factor there is deposit growth and we will try to time it. Although, we won't always be able to do it quarter-to-quarter, month-to-month type of things, but we try to look at what our deposit growth is and try and match that so we keep a steady loan to deposit ratio.

Given that, as Tom mentioned and Gary mentioned in their remarks, the first quarter we anticipate will be significantly lower than what we saw in the fourth quarter. I don't know that we can say right now, we don't have anything definitive as we didn't announce anything on the prepared remarks, but I would expect that would be potentially less than half of what we saw in the fourth quarter.

Aaron Deer
Okay. And then on the two non-performers that emerged this quarter non-accruals. Can you share any information in terms of what the causes behind those were, if they were just kind of idiosyncratic or what the nature of those non-performers were?

Michael Montemayor
Yes, I would describe both of them as issues life type events for both of those borrowers where they ran into particular issues that are pertinent to them versus more of a market type of issue. So both of those borrowers are experiencing some difficulties obviously that are specific to them and their financial condition, and I wouldn't describe them as anything systematic or throughout the portfolio.

Aaron Deer
Okay. And then one more on the buyback, obviously the stock is trading well below peer multiples, and I would just be curious know how, as you guys are looking at its potential usage, how aggressive might you look to be and what kind of pricing sensitivity you might have, if any?

Tom Lopp
Yes, Aaron, this is Tom. Yes, we definitely internally have some price sensitivities that we are looking out here, but we definitely want to return value to the shareholders and we think it's severely undervalued as you alluded to. We think we have some room in stock price before we get to that sensitivity, a pretty good ways.

Aaron Deer
Okay, very good.

Gary Judd
Aaron, I would just add working with investment bankers, I think the price sensitivity actually ranges up quite nicely from where we are because the stock is a such discount to peer multiples and discount to what we believe the real value of the stock is based on the earnings performance and the sustainability of that earnings performance. So I think we believe that there is a pretty good range for us to be utilizing the authority the board has given us.

Aaron Deer
Terrific. Thanks for taking my questions guys.

Gary Judd
Thanks, Aaron.

Tom Lopp
Thanks, Aaron.

Operator
And as reminder to everyone, it is "*" then "1" if you would like to ask a question today.

And the next questioner will be Anthony Polini with American Capital Partners. Please go ahead.

Anthony Polini
Hi, guys.

Gary Judd
Hi, Anthony.

Tom Lopp
Hi, Anthony.

Anthony Polini
So I should just…apparently just put $0.30 a quarter for you guys forever, right?

Michael Montemayor
We are consistent I guess, is how you'd say that.

Anthony Polini
Looking at the net interest margin you pretty much did what we were looking for, and now the...why has the environment changed? It looks like the Fed might be done or most people we speak to so far this quarter seems to think there is one more left in June and then they are done. But most banks are noticing deposit pricing pressure at least abating somewhat. And is

that minus 5 basis points still a good indicator of what we can expect quarter-to-quarter or should that the decline in the margin gradually start to slow, as well as, loan origination volume?

Tom Lopp
Yes, we think with the reasons that you cited, Anthony, with the Fed slowing down, pausing deposit, competition abating, as well as, the prime increase that happened in December that we will get the benefit out for the full quarter. We think actually that rate of decrease should definitely slow down. We are starting to think that we have our fair chance to stabilize, give or take even starting as early as Q1, 2019.

Anthony Polini
Okay, good. What do you think the best guess is for the tax rate going forward?

Tom Lopp
Still 28 to 30, in line with prior guidance that we've given, it was a little bit different this quarter due to some movement and the loans held for sale. We had also some changes actually let me back up there, review [ph] the changes in the allocation that we put towards New York that has a higher tax rate. So that made some differences in Q3 to be higher. So Q4 is actually a little bit lower. But we expect 28 to 30 depending on the state contribution.

Anthony Polini
Okay. And can you just give a little color as to how New York and Seattle are playing out?

Tom Lopp
Sure, New York is actually been very favorable on the loan side. They are starting to produce a meaningful percentage of the total. And Seattle is actually been responding very nicely on the deposit side, little bit slower in Seattle to get the loans going. We have a new effort there; we have a new person overseeing Seattle [technical difficulty] hopefully increase the lenders out there. We only have a couple residential lenders there right now. So we have a lot of room for improvement there. And New York on the deposit side, steady progress but not as high as we had hoped at this point.

Anthony Polini
Okay, and did I hear you right that depending on what happens over the next quarter or so, you may actually be slowing a little bit, as far as, adding new branches with that one branch in Koreatown and that's it for now?

Tom Lopp
Yes. So…and we have already got expenses in the income statement for Koreatown, but that is the only one that is going to open here in the near future. We do have three in our business plan for the second half of 2019, but we are going to look at those very closely and see if we move forward with three or two or one and we'll adapt to the market conditions at that time.

Anthony Polini
And are those three in California?

Michael Montemayor
They could be in California, Anthony or Seattle or New York. But I think our main focus for looking right now is trying and find the best location in one of those markets. And I think we are focused on LA and Seattle for the next…and like Tom said we will be cautious and diligent about when and where we open them. And again with the timeframes for negotiating a lease

and signing a lease and building it out and taking occupancy, we don't see that happening before the latter half of this year.

Anthony Polini
Well, congratulations on another quarter, the profitability is just truly outstanding. And don't be afraid to spend some of that money on buying back the cheap stock.

Michael Montemayor
We won't. Thank you, Anthony.

Anthony Polini
Thanks guys.

Operator
And there look to be no further questions at this time. So this will conclude our question and answer session. I would now like to turn the conference back over to Mr. Judd for any closing remarks.

CONCLUSION

Gary Judd
We appreciate everyone joining us today. And pleased again with the results for 2019 and look forward to a very healthy 2019 and thank you.

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