HomeStreet, Inc.

Third Quarter 2017 Earnings Call

Tuesday, October 24, 2017, 1:00 PM Eastern

CORPORATE PARTICIPANTS

Mr. Mark Mason - *Chairman, President & Chief Executive Officer*

Mr. Mark Ruh - *Executive Vice President, Chief Financial Officer*

PRESENTATION

Operator
Good afternoon and welcome to the HomeStreet, Inc. Third Quarter 2017 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 Mark Mason, Chairman and CEO. Please go ahead.

Mark Mason
Hello and thank you for joining us for our third quarter 2017 earnings call. Before we begin, I'd like to remind you that our detailed earnings release was furnished yesterday to the SEC on Form 8-K and is available on our website at ir.HomeStreet.com under the News and Market Data link. In addition, a recording the transcript of this call will be available later today at the same address.

On today's call, we will make some forward-looking statements. Any statement that isn't a description of historical fact is probably forward-looking and is subject to many risks and uncertainties. Our actual performance may fall short of our expectations or we may take actions different from those we currently anticipate. Those factors include conditions affecting the mortgage markets such as changes in interest rates and housing supply that affect the demand for our mortgages and the impact our net interest margin and other aspects of our financial performance; the actions, findings, or requirements of our regulators, which could impact our growth plans; our ability to meet our internal-operated targets and forecasts and implement our business strategy; and general economic conditions that affect our net interest margins, borrower credit performance, loan origination volumes, and the value of mortgage servicing rights.

Other factors that may cause actual results to differ from our expectations or that may cause us to deviate from our current plans are identified in our detailed earnings release in our SEC filings, including our most recent quarterly report on Form 10-Q as well as our various other SEC filings. Additionally, information on any non-GAAP financial measures referenced in today's call, including our reconciliation of those measures to GAAP measures, may be found in our SEC filings in the detailed earnings release available on our website. Please refer to our detailed earnings release for more discussion of our financial condition and results of operations.

Joining me today is our chief financial officer, Mark Ruh. In just a moment, Mark will present our financial results. But, first, I'd like to give you an update on results of our operations and review our progress in executing our business strategy.

We are happy to report solid financial results for the third quarter despite a challenging mortgage market and costs related to the restructuring of our mortgage banking business. We did, however, make significant progress on our strategy of growth and diversification toward our goal of becoming a leading West Coast regional bank.

Before discussing our financial results, I would like to take a moment and express our heartfelt regret to those that have suffered from the effects of the recent California wildfires. The fires have impacted some of our customers, our employees, at four of our single-family lending offices. These four single-family lending offices in Northern California were closed for a short period but are now open again for business. Some of our customers' homes and places of business were destroyed in the fires along with the home of one of our employees. FEMA has declared many of the affected areas as disaster zones, and we are working with our affected customers to assist them in recovering as quickly as possible.

On a more positive note, we are happy to report that our Commercial and Consumer Banking segment achieved $14.0 million of net income for the third quarter, a record for that segment. Loan held for investment grew by 4% during the quarter, contributing to strong growth and net interest margin. And $227.5 million of SBA and commercial real estate loans sold during the quarter contributed to a sizable increase in noninterest income.

The strong results brought our efficiency ratio for the segment down to 65% from 72% in the prior quarter. While total deposits decreased by 1.6% during the quarter due to several large account-holders making seasonal withdrawals to meet cash needs, our de novo branches, specifically those opened since the beginning of 2012, grew deposits by 20% in the quarter. The ratio of nonperforming assets to total assets ended September at just 28 basis points, down from the second quarter's level of 30 basis points, representing our lowest absolute in relative levels of problem assets since 2006.

Our early-warning credit indicators continue to reflect strong fundamentals in all of our markets, which is not a surprise, given we do business in some of the strongest markets in the United States today. Job creation, unemployment, commercially-residential development activity and absorption, vacancies, cap rates, and all other leading indicators of economic activity almost without exception reflect strong, growing economies in our primary markets.

In the quarter, we completed the acquisition of one retail deposit branch and related deposits in El Cajon, California, a fast-growing suburb in Eastern San Diego County. We now have four retail deposit branches in San Diego County. We also opened a stand-alone single-family lending center in North Scottsdale, Arizona, a suburb of the Greater Phoenix market.

During the quarter, HomeStreet placed 80th on *Fortune's* 100 Fastest-Growing Companies for 2017. The *Fortune* list rates publically-traded companies according to a formula that takes into account revenue growth rate, earnings per share growth rate, and three-year annualized total return for the period ending June 30, 2017. Being named on the list of *Fortune's* fastest-growing companies is an honor, and my thanks go to all of our hard-working colleagues that made this achievement possible.

On our last call, we discussed the supply, demand, and balance in many of our major markets adversely affecting our outlook for mortgage originations. The strong West Coast economies and local markets in which we operate are continuing to produce above-average job and population growth which, in turn, is causing a shortage of new and resale housing and, in turn, lower purchase mortgage originations. These conditions, along with lower demand for refinanced mortgages in the current rate environment, have adversely impacted the profitability of our Mortgage Banking segment. As we discussed last quarter, we do not see any near-term catalyst that would result in meaningful improvement in new or resale home inventories.

Accordingly, to improve operational efficiency and overall profitability in third quarter, we took meaningful steps to restructure the capacity, cost structure, and management of our mortgage origination business. The restructuring included a reduction in a force of 60 full-time equivalent employees, substantially all of which was completed in the third quarter, resulting in pre-tax severance cost of $245,000 recorded in the quarter. Including the previously-announced reduction in the force of 41 full-time equivalent employees that occurred in the second quarter and net voluntary attrition since the beginning of the second quarter totaling 32 full-time equivalent employees, the Mortgage Banking segment will have reduced full-time equivalent employees by 133 by the end of the fourth quarter.

We expect annual pre-tax expense savings of approximately $9.4 million as a result of this reduction in personnel. These personnel reductions are primarily concentrated in operations and support functions and represent a 9% decline in total full-time equivalent employees in the Mortgage Banking segment since March 31, 2017, and an 18% decline in operation roles in this segment.

Additionally, we closed two single-family lending offices, consolidated three additional offices into nearby offices, and reduced leased space in three other offices. One additional single-family lending office will be closed during the fourth quarter, and this closure is expected to have a non-material impact on fourth quarter financial performance. The changes to these eight office locations in the third quarter resulted in pre-tax charges of approximately $3.3 million but are an expected result in pre-tax occupancy expense savings going forward of approximately $1.0 million per year.

We also streamlined the single-family lending senior leadership resulting in the elimination of two regional manager positions. From this, we incurred an additional pre-tax severance cost of approximately $300,000, and we expect annual pre-tax expense savings going forward of approximately $1.2 million. We also modified certain compensation plans resulting in expected pre-tax expense savings of approximately $1.7 million per year.

In summary, the third quarter Mortgage Banking segment pre-tax restructuring charges were $3.9 million and were comprised of severance costs of approximately $545,000 and real estate-related charges of approximately $3.3 million or $2.5 in total after tax. After these charges, the Mortgage Banking segment would have recognized that income of $2.4 million. The total expected annual pre-tax expense savings related to the Mortgage Banking segment restructuring including the reduction in force that occurred during the second quarter of 2017 is estimated to be $13.2 million.

Our Mortgage Banking segment remains an important part of HomeStreet's heritage and business going forward. Our retail focus, broad product mix, and competitive pricing continue to attract some of the best retail originators in our markets. And we enforced our position as the top purchase mortgage originator in the Pacific Northwest during the third quarter of this year.

We believe that these restructuring steps will align our cost structure with our current production opportunities and return the profitability of the Mortgage Banking segment to the levels that we expect. While these cost savings estimates are based on lower industry expectations for mortgage loan volume, we also took the opportunity to improve our cost structure such that we do not expect that an increase in volume, even if it were to return to recent highs, would require an increase in expenses to the level we have previously recorded in this segment.

Lastly, we are happy to report that, on September 27, the federal banking regulatory agencies issued a joint notice of proposed rule-making regarding several proposed simplifications of the Basel III capital rules. If adopted as currently drafted, these proposed changes would significantly benefit our mortgage banking business model by reducing the amount of regulatory capital that would be required to be held related to our mortgage servicing assets.

Other proposed changes, if adopted, would require a small increase in capital related to commercial and residential acquisition development and construction lending activity and would off-set a small portion of the benefit we would expect to receive with respect to our mortgage servicing assets under the proposed rules. The final rule is that we have to be published following the comment period. But, if they are adopted without any material changes with the current proposal, we would expect to benefit from a reduction in the regulatory capital requirements beginning in 2018.

And, now, I will turn it over to Mark, who will share the details of our financial results.

Mark Ruh
Thank you, Mark. Good morning, everyone, and thank you, again, for joining us. I'll first talk about our consolidated results, and then provide detail on our two segments.

Regarding our consolidated results, net income for the third quarter was $13.8 million or $0.51 per diluted share compared to $11.2 million or $0.41 per diluted share for the second quarter of '17. The increase in net income from the prior quarter was primarily due to higher net interest income attributable to the growth in loans both held for investment and held for sale and due to higher SBA and commercial real estate net gain on sale revenue, both being partially offset by higher noninterest expense due to restructuring charge in our Mortgage Banking segment.

Total pre-tax restructuring charges in our Mortgage Banking Segment were $3.9 million and acquisition-related costs were $353,000. Including restructuring charges and acquisition-related costs, core net income was $16.6 million or $0.61 per diluted share in the third quarter compared to $11.4 million or $0.42 per diluted share in the second quarter.

The return on average tangible shareholder's equity was 8.5% in the third quarter compared to 7% in the second quarter. Excluding the after-tax impact the restructuring and acquisition-related expenses, the core return on average tangible shareholders' equity was 10.2% in the third quarter compared to 7.2% in the second quarter.

Net interest income increased by $3.9 million to $50.8 million in the third quarter from $46.9 million in the second quarter. Our net interest margin of 3.40% increased 11 basis points from 3.29% in the second quarter. These increases are primarily due to the higher balances of both loans held for investment and loans held for sale. Some was offset by higher rates on deposit and Federal Home Loan Bank borrowing.

Noninterest income increased by $2.8 million to $83.9 million in the third quarter compared to $81.0 million in the second quarter, primarily due to a $5.1 million quarter-to-quarter increase in the net gain on sale from SBA and commercial real estate loans. Some was offset by lower other noninterest income being driven by lower prepayment [indiscernible] income. Noninterest expense was $114.7 million in the third quarter compared to $111.2 million in the second quarter of '17. This increase in noninterest expense is primarily due to the previously mentioned $3.9 million expense related to the Mortgage Banking segment restructuring.

At September 30, the bank's tier 1 leverage ratio was 9.83% while the total risk-based capital ratio was 13.78%. The consolidated company's tier 1 leverage ratio was 9.29% while the total risk-based capital ratio was 11.54%.

I'll now discuss some key points regarding our Commercial and Consumer Banking segment results. Commercial and Consumer Banking segment net income was $14.0 million in the third quarter compared to $9.4 million in the second quarter. Net interest income increased to $45.3 million in the third quarter from $42.4 million in the second quarter primarily due to both higher rates and balances of loans held for investment during the period. Segment noninterest income increased quarter-to-quarter to $12.0 from $8.3 million. This $3.7 million increase was primarily due to higher gains from both SBA and commercial real estate loan origination sale activities partially offset by lower commercial loan prepayment penalty fees during the quarter.

Segment noninterest expense was $37.2 million, an increase of $529,000 from the second quarter of '17. This increase was primarily due to higher incentive costs driven by increased loan production. We recorded a provision for loan losses in the third quarter of $250,000 compared to $500,000 in the second quarter. This decrease in provision expense was primarily due to continued improvement in credit quality and lower expected loss rates combined with $475,000 of net recoveries during the third quarter.

Our net recoveries are $475,000 during the quarter compared to net recoveries of $928,000 in the second quarter. Gross recoveries during the third quarter were $748,000 with gross charge-offs of only $273,000 during the same period.

The portfolio of loans held for investment increased 4.0% to $4.3 billion in the third quarter. Net loan growth was $155.8 million during the third quarter compared to $196.9 million in the second quarter.

Nonperforming assets were $18.8 million at September 30 compared to nonperforming assets of $20.1 million at June 30. This decrease was a result of a decline in both nonaccrual loans and other real estate owned.

Deposit balances for the quarter were $4.7 billion at September 30, a decrease of $77.3 million from June 30 due to several large depositors withdrawing funds during the quarter to meet seasonal cash needs. However, our noninterest-bearing demand deposits, which include mortgage banking servicing accounts, increased by $72.1 million quarter-to-quarter. Note that mortgage banking servicing deposits will fluctuate seasonally due to the timing of mortgage prepayments, insurance, and property taxes.

I'll now share some key points from our Mortgage Banking segment results. The Mortgage Banking segment's net loss in the third quarter after $3.9 million of pre-tax restructuring charges was $123,000 compared to net income of $1.8 million in the second quarter. Excluding the after-tax restructuring charges of $2.5 million in the third quarter and $67,000 in the second quarter, core net income for the Mortgage Banking segment was $2.4 million in the third quarter compared to $1.8 million in the second quarter.

As Mark previously stated, the mortgage banking restructuring charges were comprised of $3.3 million in real estate-related charges and $545,000 in severance costs. Going forward, we do not believe that there will be any material additional charges related to the remaining components of the previously-disclosed restructuring plan.

Gain on single-family mortgage banking origination in sale activities in the third quarter was $64.0 million compared to $64.2 million in the second quarter. Single-family mortgage interest rate lock in forward-sale commitments totaled $1.9 billion in the third quarter, a decrease of $77.8 million from $2.0 billion in the second quarter. Single-family mortgage closed loans totaled $2.0 billion in the third quarter, an increase of $23.6 million from the second quarter. We are continuing to gain efficiencies from the implementation of our new loan origination system and from the migration of our mortgage pipeline from our prior loan origination system.

The volume of interest rate lock and forward-sale commitments was lower than closed loans that were made for sale by 8% this quarter, which negatively affected reported earnings. As a majority of mortgage revenue is recognized at interest rate lock while a majority of origination costs including commissions are recognized upon closing.

The gain on loan origination in sales deposit margin increased to 342 basis points in the third quarter from 331 basis points in the second quarter. The 11-basis-point increase was primarily due to the benefits of competitive secondary market pricing amongst the government-related mortgage agencies.

Mortgage banking noninterest expense of $77.5 million increased $2.5 million from the second quarter. This increase was primarily due to the $3.9 million restructuring charges previously disclosed. Without these restructuring charges, noninterest expense would have decreased.

Closed loans decreased in the third quarter to 4.3 loans per loan officer per month from 4.4 loans per loan officer per month in the second quarter. Single-family mortgage servicing income was $7.4 million in the third quarter, a decrease from $7.9 million in the second quarter. This was primarily due to lower risk management results.

Our third quarter results were comprised of $5.6 million of net servicing income and $1.8 million of risk management income. Our portfolio of single-family loans serviced for others increased to $21.9 billion of unpaid principal balance at September 30 compared to $21.1 billion of unpaid principal balance at June 30. The value of our mortgage servicing assets relative to the balance of loans serviced for other was 112 basis points at quarter end.

I will now turn it back over to Mark Mason to provide some additional insights on HomeStreet's general operating environment and their outlook for the future.

Mark Mason
Thank you, Mark. I'd like to now discuss the national regional economies as they influence our business today.

We remain fortunate to operate in some of the most attractive market areas of the United States today. These markets enjoy lower unemployment and substantially higher rates of population growth, job creation, commercial and real estate construction, and real estate value appreciation than the remainder of the country. The major markets that we focus on are substantially larger than most of the other markets in the United States, which gives us the opportunity to grow meaningfully without the necessity of acquiring a significant market share.

Together, the most distinguishing feature of the Washington, Oregon, Idaho, and California economies continues to be their superior job growth compared to the national economy. According to the most recent case-shown data, Seattle's home prices increased by 13.5% over

the past 12 months. Portland increased by 7.6%, San Francisco by 6.7%, and Los Angeles by 6.1% compared to the 20-city composite increase of 5.8%.

Rental prices have continued the same trend. According to Zillow, annual rents for the year ended August 31 have increased 5.4% in Seattle, 4.3% in Portland, and 4.4% in Los Angeles compared to 1.9% nationally. San Francisco rents have actually decreased by 0.6% since last year but are still some of the highest in the nation.

Ironically, growth in these markets is one of the drivers of our decreased outlook for the home mortgage market and the catalyst for our restructuring. Population growth is outpacing the ability of the Western housing markets to keep up the demand for homes. According to the National Association of Home Builders, total residential building permits increased 8.0% nationally and 12.0% in the West for the year ended August 31.

Permits increased 11.0% in the Seattle area, but this was primarily due to multifamily permits, which increased 18.0%. Single-family permits increased only 2.0%. The Portland market's difference was even more pronounced with multifamily permits increasing by 31.0% but single-family permits decreasing by 12.0% for a total increase of 9.0%.

Nevertheless, we believe these conditions improve the outlook for our consumer and commercial real estate, construction, and commercial lending and deposit operations. The Seattle, Portland, and Orange County office vacancy rates of 9.9%, 10.0%, and 10.6%, respectively, are all well below the national average of 13.6%, suggesting a continued positive outlook for our commercial and real estate lending, both permanent and construction, as well as our general commercial lending.

You may be aware that Amazon has recently announced its intention to open a second headquarters location. They have committed to their existing presence in Seattle, so we do not believe they their initiative will have an adverse impact on our market. In fact, they have recently announced their intention to occupy six floors of the historic Macy's building in downtown Seattle. In total, Amazon is either building or has pre-leased an additional 2.4 million square-feet of office space in Seattle.

Looking forward to the next two quarters in our Mortgage Banking segment, we currently anticipate single-family mortgage loan lock and forward sale commitment volume of $1.7 billion and $1.8 in the fourth quarter of this year and the first quarter of next year, respectively. We anticipate mortgage held for sale closing volumes of $1.8 billion and $1.6 billion during the same periods, respectively. For the full year of 2018, we now anticipate single-family mortgage loan lock and forward sale commitment to total $7.7 billion and loan closing volume to total $7.8 billion. These volumes will also be highly dependent on inventory levels in the housing market in which we do business, local economic conditions affecting employment growth and wages, as well as prevailing interest rates.

Additionally, we now expect our mortgage composite profit margin to decline to a range of between 315 and 325 basis points over the next few quarters. For the full year of 2018, we expect a mortgage composite profit margin to average in the range of 318 to 328 basis points.

In our Commercial and Consumer Banking segment, given the growth that we have achieved since our IPO, we are lowering our expected average quarterly net loan portfolio growth to 2% to 4% per quarter for the year of 2018 and going forward. This is a reflection of our current size and not a reflection of our market opportunity.

Reflecting the continued flattening of the yield curve and asset changes in market rates and loan prepayment speeds, we expect our consolidated net interest margin to decrease from the 3.4% margin in the third quarter to a range of 3.35% to 3.40% for the fourth quarter. As our loan portfolio continues to grow and reprice upwards, we expect the net interest margin to increase to a range of 3.40% to 3.45% starting in the first quarter of next year and remaining within that range throughout 2018.

For the fourth quarter of 2017, our noninterest expenses are expected to decrease given the lower single-family closed loan guidance and absence of the restructuring charges we recognized in the third quarter. For 2018, we expect noninterest expenses to grow on average 1.5% per quarter reflecting the continuing investment in our growth and infrastructure. The growth rate of our total noninterest expenses will vary somewhat quarter-over-quarter driven by seasonality and cyclicality in our single-family closed loan volume and in relation to the timing of further investments in growth.

This concludes our prepared comments. We thank you for your attention today. Mark and I would be happy to answer any questions you have at this time. Operator?

QUESTION AND ANSWER

Operator
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 questions, please press "*" then "2."

Our first question comes from Jeff Rulis with DA Davidson. Please go ahead.

Jeff Rulis
Thanks. Good morning. Mark Mason, maybe just comment on the morale of the company and the employees given the restructuring efforts.

Mark Mason
Well, it's clear any type of restructuring has a significant impact on various areas of the business, particularly on the people impacted, of course. We spent a lot of time before eliminating any position. We spent a fair amount of money and time recruiting these people. They are all high-quality people typically doing a very good job, and so having to exit them is not a positive experience.

It is a reality, though, of the mortgage banking business that, from time to time, the volume of operations personnel may have to decline. And that is sometimes driven by catalysts like rising interest rates, obviously, and lower refinancing volume. Sometimes, it comes as a consequence of advances in technology and efficiency. In this case, part of our opportunity was driven, in fact, by increases in efficiency as a consequence of our new loan origination system.

And so, while it is hard on morale to say goodbye to people who have worked well and done a good job, for those remaining in the business, it is a positive statement regarding our commitment to the business, our commitment to improving the efficiency and profitability of the business which, at the end of the day, secures jobs. And the people in the segment are very

proud of their accomplishments, they're very proud of their growth and, surprisingly, resilient in the face of changes like we're discussing.

So, I would say now that we're on the backend of the personnel changes of the decisions on branches that the folks that are in our business are very focused. And I think the morale is surprisingly good. But, thank you for that question.

Jeff Rulis
Okay thanks, and for either of you, just a more technical question on mapping this through the income statement, I just want to make sure I had the numbers correct. In Q3, the 3.3, is that in the occupancy line, and the 5.45 in salaries?

Mark Ruh
Yeah, that is correct.

Jeff Rulis
Yeah, okay. And then, going forward, if it's 13.2 for the year, I'll call it 3.3. The 3.0 or 3.1 of that would be out of the salaries, and then, the balance out of occupancy.

Mark Ruh
We talked about that. We had it brought up again. Mark mentioned in the script getting a pre-tax occupancy expense [indiscernible] about $1.0 million per year. And, again, that's, of course, right in the occupancy. And then, of course, the savings on salaries from the personnel, again, will be in the salaries-related costs.

Mark Mason
Yeah, the $9.4 million pre-taxed.

Jeff Rulis
All right, that's close enough. I got you. Maybe one last one, M&A going forward. In light of the restructuring effort, does that augment the strategy in what you're looking for, particularly if additional more mortgage-heavy operations were to come available?

Mark Mason
So, we've been very careful, one, not to acquire banks with material mortgage origination activities. We have plenty, and our goal is to reduce reliance on mortgage-related income. So, I would not expect, absent some unusual opportunity, to acquire an institution with any material mortgage operations.

Our strategy with respect to growing the commercial and consumer business remains unchanged. We're committed to growing primarily within our footprint, which means the large West Coast markets; growing the commercial-related lines of business; growing all types of deposits, consumer and commercial. And that strategy remains unchanged.

Jeff Rulis
Okay, thank you.

Operator
Our next question comes from Jessica Levi-Ribner with FBR. Please go ahead.

Jessica Levi-Ribner

Hey, guys. Thanks so much for taking my question. There's just a couple here from me. The first is can you quantify how much capital the capital simplification standards would free up for you? And how does that change the way you're thinking about the business and maybe asset mix?

Mark Ruh
Hi, Jessica. It's Mark Ruh. I'll take the first question. We have definitely done estimates. It's very exciting news, as you can imagine, when you have a mortgage servicing asset size the way that we have. So, we're very, very excited about this.

On our estimates, we, right now, will free up approximately $70.0 [million] to $75.0 million of capital that we hold against the mortgage servicing asset. So, it's a big deal. I'll let Mark take a second after that.

Mark Mason
Obviously, it impacts our capital planning. And, ultimately, it should impact the return on equity of the mortgage segment because less capital will be committed to carrying that business, which already has, in the normal course, a very good ROE. That should go up.

Most importantly, in the short-term, it reduces our need to augment capital for growth. So, what we may have planned in the next year to be necessary to continue growing at the prior growth rates was going to be mitigated by this change if indeed it gets finalized on the basis currently proposed.

Mark Ruh
Yeah, it's effectively, for us, like getting a free capital raise. It's amazing what it has done for us, so yeah, very transformative and very positive for HomeStreet.

Jessica Levi-Ribner
It certainly sounds like it. And could that capital by put towards the commercial bank, and would that increase your guidance of 2% to 4% quarterly asset growth there?

Mark Mason
We may indeed grow more than that. I think that the management team felt it appropriate, at the size we're at, to lower the guidance a little bit. The denominator is getting much larger than when we started this 4% to 6% a quarter growth. And I think it's realistic to reduce expectations a little bit, even though last quarter we grew another 4% and we do have very powerful origination capability. But, tempering that somewhat is our ability to grow deposits as quickly in a market where deposit costs are growing and the need for deposits is likely to tighten with market liquidity or industry liquidity going down.

And so we just thought better to lower expectations a little. It doesn't mean that some quarters we may not exceed that guidance. But, there are other quarters we may not make the guidance. And so that's where we think the guidance should be.

As a matter of capital planning, that's a little bit of an opportunistic question. Last year, we took the opportunity, in a very good market, for most equities but, in particular, bank equities at the end of the year to raise some capital. We'll probably be filing another ATM prospectus in the next quarter or so. Not that we're ready to raise capital, but being ready for another period of opportunistic valuation.

And that could allow us to grow faster because, again, we are not limited by origination capability or infrastructure or markets by any means. We're limited by our ability to fund and provide capital.

Mark Ruh
And, Jessica, just to make sure we answer your question too, the way to think about that capital is, once we free it up from our Mortgage Banking segment, yes, we would. Internally, we look at the way we manage capital between segments. Yes, we would redeploy that over to the Commercial and Consumer Banking segment.

Jessica Levi-Ribner
Okay, great. And then just to piggyback off your remark, in terms of deposits, do you have a deposit growth strategy that you're hunting deposits, or is it just your normal core strategy of growing your deposit base and your outreach there?

Mark Mason
So, our strategy continues to be the same. On the commercial side, it's growth in commercial deposits consistent with the growth in the commercial customer base, and our investment in commercial lenders and growth in loan officers, and so on.

On the consumer side, it involves opening additional de novo branches, purchasing branches as we did this last quarter from other institutions, a limited use of promotional accounts - money market and CD accounts in selected markets - mostly associated with opening branches, and that strategy has served us well to this point. If you look at the average annual organic growth rate in deposits, it's been very close to our loan portfolio growth rate. And so we think that that strategy is going to be sufficient to fund our growth on the pace that we're projecting.

Jessica Levi-Ribner
Okay, great, and one last one from me. It's just what kind of competition you've seen on both the mortgage side, and also, the commercial loan side in terms of larger players coming into the market. Or has competition kind of stayed constant?

Mark Mason
For us, at our size, we compete with essentially everyone. We compete with the smallest community banks because we bank very small businesses. We compete with middle-market banks across the board in all product types. And we compete with the national banks, substantially for consumers, and at the lower end of their commercial banking businesses. We essentially compete with everyone, which means the competition is unchanged. It's significant, it's broad, and we are in the markets of interest. Even for national banks who do not have deposit-taking activities in our markets, they all have lending offices.

So, we compete not only with regionally headquartered-located banks but others nationally. And, as a consequence, in part because of competition, in part because of our fairly conservative credit culture, we compete on price. We seek to compete on price and on credit, and that positions us well to compete with all of those parties because we can price with the national banks on any product and, of course, those prices are substantially superior, generally, to community banks and so the regional banks.

So, we feel like we're well-positioned, structurally, to compete. But, the competition is fierce.

Mark Ruh

Yeah, and with respect to mortgage banking, we continue in the purchase market, generally, to be, in the Pacific Northwest being Idaho, Oregon, and Washington, would be number one. In aggregate, when you look at our aggregated purchase in refi, we generally are number two only behind Wells Fargo. So, we have definitely maintained our position with respect to the competitive landscape in the single-family mortgage side of our business.

Mark Mason
Which means we have to be ultra-competitive in our pricing. But, our structure is set up to do that day in and day out. It's one of the reasons we attract people. Not only do we have the widest menu of available products including all of the important portfolio products, like custom home constructions loans and jumbo nonconforming loans, but we have great pricing and great service. And so we still feel like we're well-positioned to compete.

Jessica Levi-Ribner
Okay, great. I appreciate you taking my questions.

Operator
Our next question is from Jackie Bohlen with KBW. Please go ahead.

Jackie Bohlen
Good morning, everyone. I'm just curious as to what kind of rate environment and potential fed fund increases you're looking at for the 2018 NIM guidance.

Mark Ruh
Well, actually, right now, in the short-term, generally, when we model, we run static is what we do. That's generally what we've done here.

Mark Mason
We know that we are not great at forecasting interest rates. So, when we're forecasting volumes and interest margins, we are forecasting based upon current rates.

Jackie Bohlen
And, on a theoretical basis, assuming that the curve doesn't flatten, if we were to get additional rate increases, they maybe one in December and one or two next year, how would you anticipate the net interest margin, at the commercial bank level, to perform?

Mark Mason
The same or better, typically, if the yield curve doesn't flatten. Our enemy is a flattening yield curve, in part because of our mortgage loans held for sale. If you think about it, these are loans that are yielding mortgage rates net of hedging costs. But, they're being funded with short-term money, like less than 30-day money.

So, every time the Fed increases and mortgage rates don't increase commensurately, you get a squeeze in the net interest margin in that loans held for sale warehouse which, at times, can be $1.0 billion. So, that's meaningful. If the curve rises parallel, mortgage rates will rise commensurate with short-term rates and will maintain or perhaps even grow, if this curve steepens, that portion of the net interest margin.

A wildcard is deposit costs. To date, deposit cost increases or the beta most banks have been experiencing has been relatively low. Our beta has been very low. So, that continues to be a question that will be answered in the future somewhat. We don't really know.

So, typically, as long as the curve rises in a parallel fashion or better, our margin should be the same or better.

Mark Ruh
And, Jackie, I just wanted to follow up a little bit. I want to make sure. I may have misunderstood your question.

Again, right now, in our current forecasting, we're using the September 30 yield curve, and that's really what our estimated [indiscernible.] But, we are not forecasting rate increases. As Mark said, we're not very good predictors of when that's going to happen. So, we assume that basically the yield curve now is the yield curve that we're going to be using going forward. That's how we think about things.

Jackie Bohlen
Okay, that's very helpful. Thank you. I too am not a great rate forecaster, so I can identify.

Mark Mason, just to follow-up on some of your M&A comments, I understood that you're not interested in looking at acquisition targets that have a mortgage banking platform. Does that thought process carry over to a bank that might have a large mortgage platform that's not for sale where they portfolio those loans?

Mark Mason
Let me answer clearly. We would not exclude a bank that had a meaningful or material mortgage portfolio program. We have one, and that portfolio is one of the most consistent earners at the bank. It typically earns between 14% and 18% ROE quarter-to-quarter. It has very low losses and is a good contributor to the bottom line.

If there were an opportunity with a similar portfolio, that would not necessarily be a negative. Though, in fairness, we are looking for commercial assets and liabilities and institutions that are concentrated in those assets and liabilities.

Jackie Bohlen
Okay, so your comments were more geared towards somebody who is originating mortgages purely for sale, not for portfolio.

Mark Mason
Correct, because that's the business, as we well know, that produces cyclicality and seasonality and the type of volatility that we're trying to dilute with diversification.

Mark Ruh
And we can certainly grow that on our own, organically. Should we choose to, we would not need to pay for that in the market in a transaction.

Jackie Bohlen
Okay, fair enough. And then, just lastly, obviously, a really strong sales volume in this area in the SBA space in the quarter. Was that originally generated as held for sale, or did any of that come out of the held for investment portfolio And I apologize if I missed any of that in your prepared remarks.

Mark Mason

The SBA loans, because they're essentially split, they get originated into a held for investment classification, and then the insured portion is split and sold, and so it never starts in a held for sale position. The commercial real estate loans are designated for sale post-origination based upon the different interests or characteristics that buyers might be interested in at the time. So, those also have come out of the held for investment portfolio.

The Fannie Mae DUS loans, the multifamily loans we originate and sell to Fannie Mae, those are held for sale loans.

Jackie Bohlen
So, it wasn't necessarily the small-balance CRE group that drove all of the CRE sales that took place in the quarter. There were some that came out of the portfolio.

Mark Mason
Well, the small-balance CRE group originates to the portfolio, and then, periodically, we sell some of the loans.

Mark Ruh
Everything goes into held for investment, and then, opportunistically, when we have the right transaction, we'd move it from held for investment over to held for sale. And then it exits out. And for, again, DUS portfolio, it's generally is held by the bank and held for sale, and then we would turn the bank to a DUS affiliate and get securitized to Fannie.

Does that help out?

Jackie Bohlen
It does. And so would you just categorize the strength this quarter as opportunistic in terms of what sales you were able to accomplish, and perhaps we won't see the same level of strength in the future? Or is this the new ongoing run rate?

Mark Mason
I wish it was the ongoing run rate. But, in fairness, it's a little seasonal. If you look at prior years, the third and fourth quarters have historically been the most significant for SBA lending and loan sales and Fannie Mae DUS lending and loan sales, which I think it going to remain true.

With respect to the small-balance CRE business, let me try to say it's seasonal. It's lumpy. The market volume rises and falls in these non-agency small-balance CRE loans based upon the appetite of the market, which means other banks, and insurance companies, and credit unions. And it really works in inverse to those banks' origination activities. And, if they find that they are not meeting their growth targets and origination targets, they will look to the market to supplement by buying loans. And starting in the second quarter, and continuing through the third quarter, and today, there has been increased interest.

So, I don't know if you'd call it seasonal, or cyclical, or periodic, but it's lumpy. So, in total, I would say that the activity in the third quarters would be higher than an average quarter, and you shouldn't forecast necessarily based upon this level.

As we grow, the average level quarter-to-quarter will also grow. But, I think this quarter was a little bit outsized. Hopefully, that makes sense.

Jackie Bohlen
It does, very much. Thank you, both, for taking my questions.

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

Our next question comes from Tim O'Brien with Sandler O'Neill. Please go ahead.

Tim O'Brien
Good morning, guys. The first question I have for you, just to piggyback on what Jackie was talking about with regards to loan sales and commercial and consumer, you guys sold $227 million in loans to the secondary market this quarter. So, was any of that SBA?

Mark Mason
Yes, it was.

Tim O'Brien
How much of it was SBA? And that would be in the other bucket, obviously not multifamily DUS?

Mark Ruh
Yeah, that would be in the other bucket. That is correct.

Tim O'Brien
And then you alluded to the $67.0 million of that other bucket, of the $125.0 million, was from the single-family portfolio this quarter in the footnote, right?

Mark Ruh
So, you're looking at footnote five, correct, Tim?

Tim O'Brien
Yeah. So, $67 million was single-family, page 23.

Mark Mason
Yeah, that was second quarter.

Tim O'Brien
Let's start with this. So, the $125.493 million of other loans sold in the third quarter, that $125.0 million number...

Mark Ruh
So, this footnote five, if you read the full note, it's the fourth quarter of 2016.

Tim O'Brien
Oh, yeah.

Mark Mason
Yeah, just read that full sentence.

Tim O'Brien

Yeah. Can you give the breakdown of the parts that contribute to that $125.0 million in total sales? How much was single-family, how much was other, multi, and how much was SBA, just something along those lines, just a sense of it? Even if you can't nail it directly, what was the biggest piece maybe?

Mark Mason
First, there was no single-family loans in the number. It's all either SBA or small-balance commercial real estate. I'm sorry. I don't have the numbers in front of me.

Mark Ruh
I'd say the SBA is around $30-ish. I'd have to look it up, but that's an approximate. I'm doing this from memory. I just don't have the schedule in front of me.

Tim O'Brien
That's okay. The other question I have for you is, just looking at this, is it fair to say that that portfolio of other loans held for sale was depleted a little bit as far as the work through this particular channel looking at the fourth quarter?

You also talk about lumpiness or seasonality in this segment. Extending through, typically, being the second half of the year, how does the fourth quarter look, again, to reiterate what Jackie asked, in light of how much in loan sales you had this quarter, and what kind of production you had, and what's left in the tank?

Mark Mason
I understand your question, Tim. First, with respect to small-balance commercial real estate loans, we are originating substantially more than we have sold. So, there's no shortage of inventory. Those numbers depend, really, on buyer interest. And, from quarter to quarter, it's a little harder to gauge.

It's pretty strong right now, and the fourth quarter could have another $30.0 [million] to $50.0 million of those type of sales in the quarter. At this juncture, I'm not comfortable predicting, with any reasonable amount of accuracy, what that number might be. And we will have SBA loan sales in the quarter as well.

I do not believe next quarter will be as high as this quarter. It will not be as low as the second quarter. If you look at the second quarter back, it was about $25.0 million. But, I don't think it is going to approach the third quarter levels. I know that's a big range, so I apologize.

Tim O'Brien
No, that's okay. Hey, you take your best shot. As far as pricing and what you guys booked on gains this quarter, that was considerably stronger than the second quarter numbers. So, obviously, that's a reflection of, again, appetite demand. People were willing to pay up in the September quarter.

That momentum rolls into the fourth quarter, at least at the start, as well. So, demand is there, and pricing appetite, willingness to pay up. Did that persist into October as well?

Mark Mason
Well, the appetite does. The pricing on SBA loan sales continues to be spectacular. The last sale that we completed, the range of premiums was 10% to 14%. Now, we don't get to keep all

of that because anything over 10% gets split 50/50 with the SBA, which is probably fair. So, SBA loan sales gain's pricing remains very good.

Small-balance commercial real estate, I think those gains will be a little softer, as rates have risen, and that has a direct impact on the premiums you get from loans originated pre-rise-in-rates. So, those gains will probably be 50 basis points lower. If they were averaging, let's say, 250 basis points in the third quarter, it may be 1.75% to 2.0% or a little over 2.0, something like that, in the fourth quarter.

So, we'll have to see how that goes. Appetite may fix that, or not.

Tim O'Brien
And then last question just clearing up the $7.7-$7.8 billion rate lock in closed loan volume numbers for next year, that was for next year or 12 months, the next four quarters including 4Q? Was that 2018?

Mark Mason
That's 2018, yes. And that's only origination in sale of mortgages held for sale, not on the origination.

Tim O'Brien
Okay, thanks a lot.

CONCLUSION

Operator
This concludes our question and answer session. I'd like to turn the conference back over to the Mark Mason for any closing remarks.

Mark Mason
Thank you all, again, for your patience. Thank you for the great questions. By the analysts that cover the company, we appreciate the coverage. We look forward to talking to you all next quarter. Thank you.

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