HomeStreet Inc.

Third Quarter 2018 Earnings

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CORPORATE PARTICIPANTS

Mark Mason – *Chief Executive Officer*

Mark Ruh – *Chief Financial Officer*

PRESENTATION

Operator
Good day and welcome to the HomeStreet 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 star (*) key followed by zero (0). After today's presentation, there will be an opportunity to ask questions. To ask a question, you may press star (*) then one (1) on your touchtone phone. To withdraw your question, please press star (*) then two (2). Please note this event is being recorded.

I would now like to turn the conference over to Mark Mason, CEO. Please go ahead, sir.

Mark Mason
Hello and thank you for joining us for our third quarter 2018 earnings call. Before we begin, I would 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 Events link. In addition, a recording and a transcript will be available at the same address following the call.

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 than 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 that impact our net interest margin and other aspects of our financial performance, the actions, findings or requirements of our regulators; 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 and in our SEC filings, including our most recent Quarterly Report on Form 10-Q as well as our various other SEC filings.

Additional information on any non-GAAP financial measures referenced in today's call, including a reconciliation of those measures to GAAP measures, may be found in our SEC filings and 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 a moment, Mark will present our financial results, but first I would like to give an update on our results of operations and review our progress in executing our business strategy.

During the third quarter of this year, we made significant progress on our long-term strategy to build a better HomeStreet. Our cost savings initiatives in 2018 and 2017 have materially reduced our noninterest expenses due to lower head count and fewer office locations. These actions, while important to improving our long-term results, negatively impacted our third quarter results. In addition to some additional restructuring charges, the wind down of closed lending offices adversely affected our results of operations during the third quarter by creating a larger imbalance of closed loan volume relative to interest rate lock volume.

Our commercial and consumer banking segment achieved record net income for the quarter, driven by growth, loan growth of 3%. We were particularly pleased with 2% growth in commercial and industrial lending. During the quarter, we originated $71.9 million of new commitments and $54.5 million in new commercial and industrial loan balances. The year over year growth in commercial and industrial loan balances was a strong 27%, reflecting the substantial investments we have made in this line of business. Overall loan growth drove an increase in our net interest income during the quarter despite a decline in our net interest margin. The flat yield curve and increasing competition for deposits is putting pressure on our net interest margin. After several quarters of interest rate increases by the Federal Reserve, we are seeing upward pressure on deposit rates, which resulted in our cost of funds increasing at a faster rate than our yield on assets in the quarter. Additionally, we experienced seasonal outflows of deposits by some of our larger commercial clients, which we replaced with higher costing wholesale deposits. Notwithstanding the seasonal and industry-wide competitive pressure, our de novo branches, those open five years or less, grew deposit balances by 4.5% during the quarter.

Asset quality remained strong during the quarter with our nonperforming asset ratio indeed 15 basis points of total assets. Our early morning credit indicators continue to reflect strong fundamentals in all of our markets, which is not surprising given we do business in some of the strongest markets in the United States today. Job creation, unemployment, commercial and residential development activity and absorption, vacancies, cap rates, and all other leading indicators of economic activity reflect strong economies in our primary markets. Given the persistent shortage of new and resale housing and increased interest rates reducing demand for both purchase and refinance mortgages, along with a decrease in composite profit margins, we took steps in the second quarter to streamline our mortgage banking operations by closing, consolidating, or reducing space in 21 single-family lending offices. These steps also included a substantial reduction in headcount. These actions were completed this quarter and as a result, we realized an expected decrease in interest rate lock commitments compared to the second quarter of this year. However, we did not realize a corresponding decrease in single family closed loan volume during the quarter, as we closed the pipeline originated by the production personnel no longer with us. This resulted in approximately $947,000 of additional pretax net costs to close this pipeline of loans.

The mortgage banking industry remains at a low point in its cycle. We will continue to analyze and make efficiency, process, and strategic improvements to position our mortgage banking business to be a positive contributor in the near term and competitive in the long term. During this low point in the mortgage industry cycle, we believe smaller, less efficient, and less well-capitalized companies will exit the industry thereby reducing capacity and improving profitability. Over the long term as volumes and margins increase cyclically, we believe that our mortgage banking business will be well positioned to generate strong returns on equity, given our almost 100-year history in the mortgage business and our strong market share in some of the best markets in the United States.

It is important to remember that our mortgage banking business also produces and services mortgages and home equity lines of credit for our balance sheet, comprising 28% and 11% respectively of our loans held for investment. These loans are a meaningful source of our balance sheet diversification for our commercial and consumer banking segment. As we execute on our strategy of converting a troubled thrift into a full service regional community banking franchise, we will continue to consider new and alternative business strategies to improve efficiency and profitability in an effort to maximize shareholder value over the long run.

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 will first talk about our consolidated results and then provide detail on our two operating segments. Regarding our operating results, net income for the third quarter of '18 was $11.8 million or $0.44 per diluted share compared to $7.1 million or $0.26 per diluted share from the second quarter. Included in income for the third quarter of '18 was a total of $418,000 of restructuring and acquisition-related expenses net of tax. Excluding the impact of these charges, core net income for the third quarter was $12.3 million or $0.45 per diluted share compared to core net income of $12.5 million or $0.46 per diluted share for the second quarter. The decrease in core net income from the prior quarter was primarily due to lower non-interest income largely from lower net gain on loan origination and sale activities in our mortgage banking segment. This was primarily due to the impact of fewer loan origination personnel as a result of our second quarter of '18 restructuring, as Mark previously discussed.

Net interest income increased by $641,000 to $51.6 million in the third quarter from $51 million in the second. This increase in net interest income is primarily due to the higher balances of loans held for investments. Our third quarter net interest margin of 3.20% decreased from the second quarter's net interest margin of 3.25%. While our retail deposit betas have remained relatively low, our wholesale deposit and borrowing costs have continued to increase as the Federal Reserve continues to increase short-term interest rates. During the quarter, this increase in funding cost was partially offset by higher yields on our interest-earning assets.

Non-interest expense excluding impact of restructuring-related expenses decreased to $94.1 million in the third quarter of '18 from $104.7 million in the second quarter. This decrease in non-interest expense was primarily from lower commissioning costs on lower closed single-family mortgage loan volume. As a result of our 2017 and 2018 cost savings initiatives, total core non-interest expense declined by $29.5 million or 9% for the nine months ended September 30, 2018, compared to the nine months ended September 30, 2017.

The primary driver for this reduction was lower bonus and commission expense due to lower mortgage loan volume. However, we also achieved a $9.5 million or 7.9% net decrease in base salaries due to the overall reduction in our headcount from 2,552 full-time equivalents at December 31st of '16 to 2,053 full-time equivalents at September 30th of '18. Additionally, general and administrative and occupancy expenses decreased $6.1 million and $1.2 million or 12% and 4.5% respectively during the same period, due in part to reducing our total office count from 139 to 123 during the same period. These expense reductions were partially offset by increases in information services expense as we continue to invest in upgrading our technology platform to support our growth. Our effective tax rate was 17.9% for the third quarter and different from our estimated federal and state combined statutory rate of 23.5% primarily due to the impact of higher tax-exempt interest income and adjustments to prior periods during the quarter.

I'll now discuss some key points from our commercial and consumer banking segment results. Commercial and consumer banking segment core net income was $16.6 million in the third quarter, increasing 39% over core net income of $11.9 million in the second quarter. Net interest income increased $116,000 in the second quarter of '18 to $47.9 million due to the growth in our loans held for investment and despite the 5 basis-point decrease in our net interest margin. Our portfolio of loans held for investment increased by $142.2 million or 3% to $5.1 billion in the third quarter. Growth occurred throughout the portfolio in all of our major business lines. Segment non-interest income increased quarter-to-quarter to $10.7 million from $8.4 million. This increase was primarily due to higher net gain from our sales of multifamily DUS loans and small balance commercial real estate loans during the quarter. Segment core non-interest expense was $37.8 million, a decrease of $1.5 million from the second quarter of '18. This decrease was primarily due to lower salaries and related costs from loan originations and fewer full-time equivalent employees in the corporate support functions.

Non-performing assets remained relatively unchanged at $10.4 million or 15 basis points of assets at September 30th, compared to 14 basis points of assets at June 30th. We recorded a $750,000 provision for credit losses in the third quarter compared to $1 million in the second quarter. This decrease in provision expense was primarily due to $122,000 of net recoveries during the third quarter compared to net charge-offs of $464,000 during the second quarter. Deposit balances were $5.2 billion at September 30th, an increase of $34.8 million from June 30th driven primarily by an increase in broker deposit accounts as these wholesale deposits to replace seasonal draw-downs of large commercial customers. During the quarter, we completed the consolidation of our Richland and Selah retail branches in Eastern Washington into nearby branches in Kennewick and Yakima respectively, reducing our total retail branch count from 62 to 60 by the end of the third quarter. Deposits in our de novo branches, or those opened within the past five years, increased approximately 5% during the quarter.

I will now share some key points from mortgage banking segment results. Mortgage banking segment's core net loss in the third quarter was $4.3 million compared to core net income of $630,000 in the second quarter. Compared to last year, correction, compared to last quarter, we had lower interest rate lock commitment and a lower composite margin that resulted in a decrease in core earnings from gain on loan origination and sale activities offset somewhat by increased mortgage banking servicing income. Competitive pressure on single-family mortgage pricing intensified during the third quarter, resulting in a reduction of our composite profit margin.
Our gain on mortgage loan origination and sales composite margin was 311 basis points, a 15 basis-point reduction from the second quarter.

The decrease in interest rate lock commitments during the quarter was due to generally lower industry originations and the restructuring that included closing or consolidating 21 single-family lending offices, which was previously announced in the second quarter. While the majority of the loan officers affected by our reduction were no longer employed during the third quarter of '18, we still incurred the cost of closing their previously locked loan pipeline, including paying commissions to those loan officers. This had the impact of significantly increasing closed loan volume relative to interest rate lock commitments. As previously mentioned, the net pre-tax impact of closing those loans originated by loan officers no longer with the Company was $947,000, primarily in commission and fulfillment costs. When single-family interest rate locks are less than closings in a given quarter, earnings are negatively impacted as the majority of mortgage revenue is recognized at interest rate lock, while the majority of origination costs, including commissions, are recognized upon closing.

To illustrate the impact of this imbalance, if rate lock volume had been equal to closed loan volume at our reported composite margin, the estimated net income for the segment would have been $1.1 million. If closed loan volume had been the same rate lock volume during the quarter, the estimated net loss for the segment would have been $2.4 million. Single-family mortgage servicing income was $6.9 million in the third quarter, an increase from $6.1 million in the second quarter. This increase was primarily due to higher risk management results partially offset by lower servicing income. The higher risk management results were primarily driven by gains from a more stable interest rate environment and decreased negative convexity costs. The decline in servicing income is related to a lower average balance of loans serviced for others due to the sale of $4.9 billion in unpaid principal balance of mortgage servicing rights in the second quarter of this year.

Mortgage banking segment core non-interest expense of $56.3 million decreased $8.1 million from the second quarter of '18 primarily due to the decrease in commissions paid as a result of lower closed mortgage loan volume, but also from lower base salaries due to lower headcount and lower G&A and occupancy expenses from operating fewer single-family lending office locations. Our portfolio of single-family loans serviced for others increased to $19.8 billion of unpaid principal balances at September 30th compared to $19.1 billion at June 30th. The value of our mortgage servicing rights relative to the balance of loans serviced for others was 133 basis points at quarter end, an increase of 4 basis points compared to the prior quarter end.

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

Mark Mason
Thank you, Mark. 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 $1.1 billion and $1.3 billion in the fourth quarter of this year and first quarter of next year respectively. We anticipate mortgage loan held-for-sale closing volumes of $1.2 billion and $1.1 billion for the same periods. For the full year of 2019, we anticipate single-family mortgage loan lock and forward sale commitments to total $5.7 billion and loan closing volume to total $5.8 billion. These volumes will be highly dependent on inventory levels in the housing markets in which we do business, local economic conditions affecting employment growth, wages, as well as prevailing interest rates. Reflecting the competitive pressures on gain-on-sale margins, we expect our mortgage composite profit margin to remain in the range of between 310 [basis points] and 320 basis points during the next two quarters as well as for the full year of 2019.

In our commercial and consumer banking segment, we expect our quarterly loan portfolio growth to average between 2% and 4% for the fourth quarter of this year and through 2019. Reflecting the yield curve as of the end of the third quarter and asset changes in market rates of loan prepayment speeds, we expect our consolidated net interest margin to remain in the range of 310 [basis points] to 320 basis points over the next two quarters and remaining within that range throughout 2019. During the fourth quarter, we expect our total core non-interest expense to decrease between 3% and 5% given seasonally lower closed single-family mortgage loan expectations and the ongoing impact of our streamlining. Following that decrease, we expect non-interest expenses to increase as seasonal lending volume increases during the middle of 2019.

For the full year of 2019, we expect total core non-interest expenses to decline by approximately 1% compared to 2018, reflecting the cost saving initiatives we have implemented during 2017 and 2018, which were primarily concentrated on mortgage banking segment. These savings will be somewhat offset by increased non-interest expenses in our commercial and consumer banking segment as we continue to invest in our growth. Total core non-interest expenses will vary somewhat quarter-over-quarter, driven by seasonality and cyclicality in both our single-family and commercial real estate closed mortgage loan volume.

The FDIC's fall 2018 regulatory agenda, released last week, signaled that the final rule addressing the change to the capital treatment of mortgage servicing rights will be released this month. As a reminder, in September of 2017, the regulators proposed a rule easing the capital burden for smaller banks by raising the cap on the amount of net MSRs allowable in Tier 1 capital from 10% to 25% and increasing the risk weighting exposure for the amount of MSR above the threshold from 100% to 250%. The pro forma impact on us, if the rule were applied to our preliminary third quarter 2018 capital ratios, would be to increase our consolidated Tier 1 ratio from 9.12% to approximately 10.1% and our total risk-based ratio from 12.6% to approximately 12.5%.

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

QUESTIONS AND ANSWERS

Operator
We will now begin the question-and-answer session. To ask a question, you may press star (*) then one (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 star (*) then two (2).

Our first question will come from Jeff Rulis of D.A. Davidson.

Jeff Rulis
Good morning.

Mark Mason
Good morning, Jeff.

Jeff Rulis
Mark Mason, a question on your assumptions on the non-interest expense, what are the underlying assumptions on headcount in 2019?

Mark Mason
The headcount will increase slightly, not in the mortgage banking area. That headcount is expected to be flat currently, but in the commercial and consumer banking area, we will be opening some additional branches and hiring some additional commercial lenders and those activities will result in some slight increase in headcount in the commercial and consumer bank.

Jeff Rulis
All right. Then just what were you looking at, well, first question, restructuring costs, are those now complete, at least for this round that you've announced?

Mark Mason
Yes.

Jeff Rulis
Okay. Then is there something in your fiscal calendar or a planning or budgeting period where additional restructuring would be analyzed if needed, or is that more of an ongoing process?

Mark Mason
We do not have any planned restructuring currently. We continue to analyze opportunities to improve efficiency in all aspects of our business, whether it be technology improvements, workflow improvements, real estate occupancy, and capacity improvements, and we expect to have some improvements in many of those areas next year. We also look at strategy and are there ways to improve our strategy, which would improve our results, not only over the long term but the short term. No, I would never really say we're finished, and particularly given the challenging part of mortgage cycle it's important that we continuously look to ways to improve those results.

Jeff Rulis
Okay. Maybe one quick one for Mark Ruh. Just on the tax rate, any thoughts on, that's been bumping around in '18, but what you expect for Q4 and then into '19?

Mark Ruh
I expect for Q4 similar to what we have for Q3 based upon basically changes in our provisioning expenses. For 2019, I think I discussed in the last call, it's approximately 21% and I believe that that's going to be accurate or a good estimate for 2019, again 21% for 2019.

Jeff Rulis
Okay, thank you.

Operator
The next question will come from Tim O'Brien of Sandler O'Neill.

Tim O'Brien
Good morning. Just one question on efficiency in the mortgage banking segment, obviously that ratio is pretty elevated. Do you anticipate any improvement in that looking out into 2019? Is it possible that could come down below 100%, or is it just reflective of the nature and challenges of the market right now and it's going to take some market changes to improve that?

Mark Mason
We currently expect the mortgage banking segment to be profitable next year. We made a lot of changes in the past several quarters and this year in the cost structure. Absent another meaningful decline in industry loan volume or a meaningful decline in our composite profit margin being the biggest factors, we expect this segment to be profitable. We don't expect it to return to the higher levels of profitability that we have experienced in more recent years though. Given the lower composite margin and lower volume, we expect that profitability to be not nearly as significant, but we do expect it to be profitable.

Tim O'Brien
Good. That's good to hear. That's the product of all the work that you guys have gone through. Just shifting gears quickly to deposit betas, the margin guidance that you gave for next year, does that include any assumptions of rate increases in the forward yield curve, reflective in the forward yield curve?

Mark Mason
It does not. We're not sure what the yield curve is going to look like and so making assumptions solely based upon Federal Reserve increases without a commensurate assumption on the yield curve is like throwing dice. When we forecast, we're forecasting static changes or micro changes and so obviously depending upon which direction the yield curve changes, it could have a positive or negative impact on the margin.

Tim O'Brien
All right. Those are my questions. Thanks, guys.

Mark Mason
Thanks, Tim.

Operator
Next we have a question from Jackie Bohlen of KBW.

Jackie Bohlen
Sorry, I was muted. Good afternoon, everyone.

Mark Mason
Hi, Jackie.

Jackie Bohlen
Hi. Just a couple of questions on deposits, digging into some of the more micro trends there. Are you seeing any variance in terms of repricing betas? I know you mentioned that they've been holding the line from the retail segment, but just across geographies?

Mark Mason
We're not really seeing different experience. Our geographies are generally larger metropolitan areas along the West Coast, very competitive deposit markets accordingly. I don't know that we're seeing differences in geographic regions, and then that includes the Hawaiian Islands, which is a strong savings region. It's just become more competitive, so our betas moved up a little this year. Fortunately, it's still below our loan beta and so we're able to, at least on the retail side, maintain our spread. Where we've been hurt is wholesale borrowings.

Jackie Bohlen
No, understood. What about deposits from commercial customers?

Mark Mason
Yes. That's hard to generalize, when you think of all the different businesses. As we noted in the third quarter, some of our larger commercial clients, and think about title companies and the like, drew down their deposits with declining real estate activity. Some of our other commercial clients had true seasonality in their cash flow patterns, and so we had a headwind there in the quarter. I think that basically we see strong cash flow at our commercial customers, some of which they leave with us and some of which they invest, but they are not borrowing as actively as we might have hoped.

Jackie Bohlen
Okay. Then just one last one on, obviously, credit remains very, very clean. Are there any categories or any areas that you look at that perhaps you're starting to watch a little bit more closely as rates have risen?

Mark Mason
Yes. We are being substantially more careful about commercial construction. Who we lend to, what types of projects, where they're located. In particular, multi-family construction, new lending has slowed, at least for our part, materially over the last couple of quarters as we've sought to restrict that business to very, very strong sponsors who are end-users, not merchant builders, who have strong portfolio cash flow and liquidity should costs over-run or timelines to build construction and absorption lease-up extend, and both of those are true. We've seen many projects this year have construction cost overruns and more elongated absorption periods. Fortunately, our underwriting and customer selection has been very strong, and those concerns which we knit into our underwriting have supported those additional timelines and costs and so we are being even more selective though not out of the market.

Jackie Bohlen
Okay. Thank you. That's great color. I'll step back.

Operator
The next question will come from Tim Coffey of FIG Partners.

Tim Coffey
Great. Thank you. Good morning, Mark.

Mark Mason
Good morning, Tim.

Tim Coffey
Can you maybe provide a little bit more color on the seasonal outflows and deposits you saw this quarter, and maybe provide a little more detail on what made those seasonal?

Mark Mason
Sure. As I just mentioned in my answer to Jackie, part that was real estate related. We do have several significant regional title companies who, consistent with lower mortgage volume, lower home sales volume, they have lower transactional volume. Those temporary funds, right, closing real estate transactions have declined and pretty significantly, in the tens of millions of dollars each. We have other large commercial customers who have seasonal cash flow, and that unfortunately happens every year, it's a little more acute this year.

Tim Coffey
Okay, all right. If we look at your loan-to-deposit ratio using just loans held for investment, that's up near 100%. Is that a level you're comfortable with given the current rate environment or do you see that coming down?

Mark Mason
We've been running about 90% on that calculation for a long time. And I think our prior discussion about the deposits has had an impact this quarter. We've had to supplement retail deposit growth or lack thereof this quarter with wholesale deposits, despite an increase in the loan portfolio of 3%, and that's what's really driving that. We expect that to normalize back to around 90%.

Tim Coffey
Okay, okay. Ten I don't know if it was in the text of the prepared remarks, but you discussed the expectation of an eventual shake-out in the mortgage lending business, in the industry that you compete in and the markets that you compete in, rather. Are you seeing any signs of that starting to happen or are your competitors still competing on, by cutting fees?

Mark Mason
To this point it's anecdotal. We hear of a lot of anecdotal stories of individual loan officers leaving the industry. Of course, some of that are our own loan officers who are not performing that we are reducing headcount with. Also smaller mortgage brokers and mortgage bankers. We think this quarter you will see more substantial reductions in capacity in that regard and through next quarter. This is the low part of the season, and many who have been able to hang on through the summer and the fall will not be able to do so, and we expect to see more movement here over the next six months.

Tim Coffey
Okay. Then with, I think you're at – as Mark mentioned, now 60 retail branches. Is that the right number for you or could you see that number going down?

Mark Mason
Retail deposit branches?

Tim Coffey
Yeah, I am sorry, yes, retail deposit branches.

Mark Mason
We see that number increasing over time. As we've consolidated a couple of smaller branches in Eastern Washington that we had acquired or transitioned branches over the last couple of years, we have other branches that are de novo branches that both have been opened in the last several years that are on their expected growth path. While they may not yet house the level of deposits that we would like to see in a mature branch, they are still on their expected slope of growth. This has been our strategy for the last six years and we expect to continue that. Supplementing that is higher C&I-related deposit growth. We think that our strategy has been a good one. It has resulted in an average deposit growth of 20% a year over the last six years. Some of that has been through M&A transactions, but the preponderance of it has been organic growth, and it's resulted in lower deposit betas than the industry and consistent growth and we think we're on the right track.

Tim Coffey
Okay, great. Well, thank you. Those were my questions.

Mark Mason
Thanks, Tim.

Operator
The next question comes from Brian Rohman of Boston Partners.

Brian Rohman
Well, I would have had a question, but they've have already been asked so I won't ask any. I'll say it was a good, serviceable quarter. Moving in the right direction, guys.

Mark Mason
Thank you, Brian.

Operator
Again, if you would like to ask a question, please press star (*) then one (1) at this time.

This will conclude our question-and-answer session. I would like to turn the conference back over to Mark Mason for any closing remarks.

CONCLUSION

Mark Mason
Thank you all for your patience and attention and attendance today on our third quarter call. We look forward to speaking with you again next January.

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