HomeStreet, Inc.

Fourth Quarter 2021 Earnings Conference Call

Tuesday, January 25, 2022, 1:00 PM Eastern

CORPORATE PARTICIPANTS

Mark Mason - *Chairman, President, Chief Executive Officer*

John Michel - *Chief Financial Officer*

PRESENTATION

Operator
Good day, and welcome to the HomeStreet Fourth Quarter 2021 Earnings Call. All participants will be in a listen-only mode. Should you need assistance, please signal a conference specialist by pressing "*", then "0" on your telephone keypad. 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, 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, Chief Executive Officer and President. Please go ahead.

Mark Mason
Hello and thank you for joining us for our 2021 fourth quarter and full year earnings call. Before we begin, I'd like to remind you that our detailed earnings release and an accompanying investor presentation were filed with the SEC on Form 8-K yesterday, and are available on our website at ir.homestreet.com under the news and events link. In addition, a recording and a transcript of this call will be available at the same address following our call.

Please note that during our call today, we will make certain predictive statements that reflect our current views and expectations about the company's performance and financial results. These are likely forward-looking statements that are made subject to the Safe Harbor statements included in yesterday's earnings release, our investor deck and the risk factors disclosed in our other public filings. Additionally, reconciliations to non-GAAP measures referred to on our call today can be found in our earnings release and investor deck available on our website.

Joining me today is our Chief Financial Officer, John Michel. John will briefly discuss our financial results, and then I'd like to give an update on our results of operations and our outlook going forward. John...

John Michel
Thank you, Mark. Good morning, everyone, and thank you for joining us. In the fourth quarter of 2021, our net income was $29 million or $1.43 per share as compared to net income of $27 million or $1.31 per share in the third quarter of 2021. For the full year 2021, our net income was $115 million, or $5.46 per share, a record for the company.

For the fourth quarter of 2021, our annualized return on average tangible equity was 17%, our annualized return on average assets was 1.59% and our efficiency ratio was 62.2%. For the full year 2021, our return on average tangible equity was 16.8%, our return on average assets was 1.58%, and our efficiency ratio was 61.9%.

Our net interest income in the fourth quarter was slightly lower than the third quarter, due to a $2.1 million decrease in interest income derived from the PPP loans, which was substantially offset by higher levels of non-PPP loans. PPP loans caused our net interest margin to be higher by 3 basis points in the quarter. Excluding the impact of PPP loans, our net interest margin in the fourth quarter of 2021 was consistent with our net interest margin in the third quarter of

2021. As of December 31, 2021 outstanding PPP loans were only $38 million with deferred fees of $1 million.

As a result of the continued favorable performance of our loan portfolio, and the improving outlook of the impact of COVID 19 on our loan portfolio, we recorded a $6 million recovery of our allowance for credit losses in the fourth quarter of 2021.

As we continue to have more clarity of the minimal impact COVID is having on our loan portfolio, and with projected improvements in our economies, changes in the composition of our loan portfolio to higher credit quality assets and borrowing negative developments affecting our loan portfolio, we expect to recover additional amounts of our allowance for credit losses in future periods.

Our ratio of non-performing assets to total assets improved to 18 basis points; our ratio of ACL to total loans with 88 basis points. The $4.3 million increase in non-interest income in the fourth quarter of 2021 as compared to the third quarter was primarily due to a $2.6 million increase in net gain on loan origination and sales activities, due to a 2.73% gain realized on the sale of $244 million of permanent multifamily loans in the fourth quarter, which was partially offset by a lower volume of single family mortgage rate locks, and an increase in other non-interest income, which was due primarily to a $0.6 million gain on sale of REO in the fourth quarter.

The $2.0 million increase in non-interest expenses in the fourth quarter of 2021 as compared to the third quarter was primarily due to higher general administrative and other costs, partially offset by lower compensation and benefit costs. The lower level of compensation and benefit costs reflect a $1 million reversal of previously accrued medical benefits related to the positive experience in our self-insured medical program.

Legal costs, which are included in general and administrative and other costs were $2.5 million higher in the fourth quarter of 2021 as compared to the third quarter, due to the cost incurred on certain legal matters. During the fourth quarter of 2021, we repurchased 2% of our outstanding common stock at an average price of $51.17 per share, and declared and paid a dividend of $0.25 per share. Since the beginning of 2021, we have repurchased 9% of our outstanding common stock. This is in addition to the 12% and 9% repurchased in 2019 and 2020, respectively.

I will now turn the call over to Mark. Mark...

Mark Mason

Thank you, John. HomeStreet, which celebrated its 100-year anniversary in 2021, for the first time achieved earnings in excess of $100 million. I love the symmetry. A record $115 million of net income in 2021 reflected the success of our diversified business model, the benefits of our conservative credit culture and our continued focus on operating efficiency.

Our portfolio of loan origination levels remained strong with $795 million of originations in the fourth quarter and a record $3.3 billion for the full year. Excluding the impact of PPP loans, and despite high levels of prepayments, our total loans grew 11% during 2021. In the fourth

quarter, our single-family mortgage loan volume decreased from third quarter levels as we returned to normal seasonal levels of activity.

Historically, fourth quarter single-family lock volume is lower than loan closing volume, which reduces our mortgage banking net income as the majority of our revenue is recognized upon interest rate lock, the majority of loan origination expenses are recognized at closing. This was particularly true in the fourth quarter. Looking forward to the first quarter of this year, we anticipate the lower normal seasonal volume of interest rate locks, but a balanced or higher volume of locks versus closings.

The credit quality of our loan portfolio continued its strong performance in the fourth quarter. And as John mentioned, greater clarity on the impact of COVID on our portfolio allowed us to recover $6 million of our ACL in the quarter. As we head into the New Year, we believe HomeStreet has the ability to provide more consistent and less volatile earnings.

Our mortgage banking revenues, which created significant volatility in the past, were only 12% of our total revenues during the fourth quarter and are expected to normalize at a smaller share of total company revenue going forward. We are focused on growing our loan portfolio between 10% and 15% in the coming years as a result of growth in our loan originations, lower prepayments and reduced portfolio loan sales.

Accordingly, our net interest income is expected to be a larger and more consistent component of our revenues. While we expect growth in our portfolio coming from all our business units, our commercial real estate loan originations, primarily multifamily, are expected to be the primary driver of our growth.

Our efficiency ratio in the fourth quarter was consistent with the prior quarter at 62.2%. While the decline in mortgage banking profitability and reduced sales of permanent multifamily loans is likely to result in upward pressure on our efficiency ratio through midyear this year, we anticipate that as a result of loan portfolio growth and related increases in net interest income and our ability to leverage our existing operating infrastructure, we believe we will improve our efficiency ratio to levels consistent with the last two years in the second half of this year. And next year, we believe we can reduce our efficiency ratio to below 60%, and trending to the mid- to high 50% range going forward.

Based upon our continuing strong financial results and positive outlook, we repurchased $19 million of our common stock during the quarter, and paid a $0.25 per share dividend. We anticipate continuing to efficiently retain capital for growth while returning excess capital to shareholders. With the completion of our $100 million subordinated notes offering this month, we accessed inexpensive capital to continue our stock repurchase program and support our future growth.

In that regard and subject to our board of directors' review and approval, and the non-objection of our regulators, we plan on repurchasing $75 million of our outstanding shares in the coming quarters. Additionally, given our consistently strong performance, the board of directors anticipates discussing an increase in our dividend in the first quarter this year. Of course, future declarations of the current or higher levels of dividends are subject to our financial

condition and outlook at the time, as well as corporate governance, legal and regulatory requirements.

To reiterate my comments from prior quarters, the investments we have made and the improvements in our efficiency and profitability have enabled us the opportunity to grow revenue without commensurate additions to personnel or other operating expenses. We previously told you that excluding recoveries of our allowance for credit losses and nonrecurring items such as PPP loans, and subject to any unforeseen adverse changes in the economy or our business, we believe we have the opportunity to continue to grow year-over-year earnings per share. We expect this to hold true as we consider our earnings per share prospects for 2022.

We are planning on reduced sales of permanent multifamily loans, which combined with lower expected prepayments should support our guidance for growth in our held to investment portfolio this year, positioning the company for a meaningful increase in recurring earnings per share in 2023 versus 2022. Accordingly, we expect earnings in the first quarter of this year to be lower than the fourth quarter of last year due to the absence of a permanent multifamily loan sale.

Additionally, compensation expenses in the first quarter of each year are higher than the prior quarter due to merit increases, employer taxes and the 401k match. Given these expectations, we anticipate earnings in the first quarter to be the lowest of any quarter this year.

So while quarter-to-quarter earnings this year may show some volatility depending upon the levels of sales of permanent multi-family loans, if any, as well as the seasonality of our mortgage banking revenues, as we move into the second half of 2022, we believe that our decision to increase loan retention in the early part of this year will set a strong foundation for meaningful earnings growth after this year.

As a result of our 2019 mortgage banking restructuring, and our initiative to improve operating efficiency and profitability, we have brought the company to a place where we can expect to achieve lower earnings volatility, higher profitability, and stronger earnings growth all of which have and we believe will continue to compare favorably to our regional banking peers going forward.

We have made substantial progress and our shareholders have benefited. Our total shareholder return for one year, three years and five years, was 58%, 156% and 72% versus the KRX, which was 37%, 55% and 30% respectfully and I am very happy about the job we've been doing for our shareholders.

Despite our recent stock price performance, I believe our relative valuation remains well below a level consistent with the current quality and profitability of our bank in relation to our peers. Before concluding, I want to recognize the recent bank Director Magazine 2022 Ranking Banking Report, which ranked our board of directors as one of the top 10 bank boards of all banks nationwide. As the Chairman of the Board, I'm particularly proud of that honor. Bank Director also recognized HomeStreet as one of the top 10 small regional banks nationally.

And with that, this concludes our prepared comments today. We appreciate your attention. John and I would be happy to answer any questions you have at this time.

QUESTION AND ANSWER

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

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

Jeff Rulis
Thanks. Just had a couple questions on the guidance slide, just to dig into the margin assumptions a little bit and Mark, I appreciate the commentary on expectations, but just margin you mentioned some stability or stable outlook, two to three quarters out. Does that include any sort of rates or feds assumption within that?

Mark Mason
No, it doesn't. We are...we're lousy prognosticators or forecasters of fed time inter-fed movements. So obviously that could have an impact, generally a positive impact near term, right, given the adjustable-rate loans we have and given the historical lag in re-pricing deposits.

Jeff Rulis
Okay. And then just following up on the non-interest income line, you mentioned decreasing, and I get that Q1 may be lower than Q4, pretty decent volatility in the game from origination. So could you characterize that any further about as you have stepped down in Q1, the expectation for non-interest income, for the balance or how it relates to at least in magnitude full year or within the range of quarterly in '21?

Mark Mason
We will see...we'll see a decline. We have some offsetting or mitigations expected. We're expecting our loan servicing income as an example to perform better this year because of lower prepayments and in turn lower decay of our MSRs. But our single family related gain on sale will be, we expect a little lower in part because of lower volume. If you look at first quarter over first quarter, first quarter of 2021 was still a pretty strong quarter both in volume and in gain on sale. Additionally, we are not anticipating a sale of commercial real estate loans or multifamily loans, portfolio loans in the first quarter. Those two differences should make for a meaningful difference or decline in gain on sale first...say first quarter over first quarter. And in the first quarter of 2021, I believe our gain on sale line was over of $30 million, right. And it came down to as low as $17 million in the third quarter because there was no portfolio quality multifamily loan sale in third quarter, but third quarter still had higher levels of single family volume. So if you look at the third quarter level of say a little over $17 million, third quarter of '21, we expect the first quarter of '22 to be lower than that.

John Michel
Yeah. I think that Jeff, just the biggest difference between the fourth quarter and the first quarter is going to be the multifamily and perm sale that we did in the fourth quarter.

Otherwise, the single family levels in the first quarter from a revenue perspective are probably going to be somewhat consistent with the fourth quarter.

Jeff Rulis
Okay. Very helpful.

John Michel
Because of seasonality.

Jeff Rulis
Right, yes. Okay. That helps frame that up. I appreciate, I'll step back.

Operator
The next question comes from Woody Lay with KBW. Please go ahead.

Woody Lay
Hey, thanks for taking my question, guys. I wanted to start off looking at expenses, so your guidance calls for them to be slightly increasing over the coming quarters, but I'm just trying to figure out the base of expenses for that guidance. Is that sort of off the reported number of roughly $54 million or is that, looking at the core number, I know you had some outsized litigation expense; you stripped that from $51.5 million, really just looking for some guidance on next quarter's expenses.

John Michel
Yeah. I was going to say there's two items in the fourth quarter looking at that perspective that will impact going forward. One is we had the $1 million recovery on our insurance and the compensation and benefits. And two, we had some additional legal costs in the fourth quarter that we do not expect to be recurring. Those were the two biggest items that are not being carried forward or are non-recurring from that perspective. And I think Mark also mentioned the fact that our compensation expenses in the first quarter compared to the fourth quarter are always higher for the reasons he's stated. So I think the guidance that we provided and Mark has provided in the past is kind of a run rate of around $54 million plus on a quarterly basis and obviously fluctuates up and down based on a little bit of seasonality.

Mark Mason
So you have some things go in both directions, right? The absence of non-recurring expenses like a legal accrual but the absence of a credit on health benefits. So I would take that slightly phrase to heart, if you just look at the overall number quarter-over-quarter.

Woody Lay
Yes. Okay. That's helpful. And then in the expense guidance you sort of talked about expenses incurred to support loan portfolio growth. Is that signaling you'll look to be active on the hiring front or is that really just higher expenses for retaining current employees?

Mark Mason
We don't think we're going to have materially higher expenses to generate the additional loan volume. We are not anticipating a significant level of hiring, though we do have a fair number of open positions, that we've had open for some time. So, we expect our FTE count to go up,

probably in the 20 to 30 FTE range which would kind of get us back to where we were earlier in the year, last year, but not really over that. And, we'll be lucky to hire those folks frankly, in this market.

Woody Lay
Yes. That makes sense. And then the last for me, is another great quarter on the loan growth front. Could you just give some color on loan prepayment levels in this fourth quarter and sort of, I know you said a couple times that you expect prepayment levels to drop down in 2022. Are you seeing any signs of that so far?

John Michel
Boy, the fourth quarter prepayment rate was pretty consistent with third quarter, but a lot better than the second quarter. And, yet the one thing we know about prepayments and prepayment speeds is, you can only prepay a loan once, right. And there is a burn out factor that begins occurring. And we're starting to...we're starting to see that in some loan types.

Mark Mason
Yes, I think the single family definitely recognize a significant decrease in prepayment on a single family. On the multifamily, we're seeing a trend, slightly going down and we expect that to continue going into next year to be more stable and consistent with what historically multifamily has, which is a pretty base level of prepayments. It's not a wide range when you're looking at multifamily portfolios based on our experience.

John Michel
No. Obviously, the Fed it may have a lot to do with that, both on the short end and the long end with quantitative easing. So, it kind of remains to be seen about the total impact.

Woody Lay
Great. Alright. Thanks, guys.

Mark Mason
Thanks, Woody.

Operator
The next question comes from Steve Moss with B Riley Securities. Please go ahead.

Steve Moss
Alright. Good morning, guys. Maybe just tying out loan sales a little further. Is it just that you guys do not expect...just to be clear, you guys don't expect to do a loan sale in the first quarter? Will that carry on throughout the year or just how we think about commercial real estate loan sales for 2023 relative to the...what was the $773 million number for full year '21?

Mark Mason
Well, it's something that we're just going to watch in terms of our ability to meet our growth targets, first of all, in our portfolio. Remember, we always have Fannie Mae DUS loan sales, and we're hoping for a stronger year this year with respect to those sales. We're not...we have decided not to do a multifamily sale in the first quarter. We could have one in the second quarter based upon our success. I would say that our preference is to retain loans today. In

that regard, we are expecting our commercial real estate concentrations to go up somewhat as we retain more multifamily loans. So it remains to be seen. If we are successful in originating the amount of loans we hope to. And we haven't really missed our target for several years, even though the target keeps going up. If we're successful, we will probably have a loan sale. It could be second quarter, it could be later. To the extent that we have higher prepayments or less originations that loan sale may be deferred or eliminated this year.

John Michel
Yes. I think, Steve, one of the important things to remember, and we kind of mentioned it last quarter, is while we're providing guidance of 10% to 15% in the first year, especially 2022, we're going to be looking at being much closer to the higher end of that range, and that's kind of our goal and that's why Mark's answer is kind of dependent on conditions.

Steve Moss
Okay. That's helpful. And then just maybe in terms of loan pricing these days. I know there's PPP noise and stuff, but just kind of curious as to where...what you're seeing for loan pricing, and just thinking about loan yield share going forward

Mark Mason
Well, it's still a competitive mark. You still have single family mortgages in the, say 3.4% to 3.5% range. Multifamily is about 3.25%, C&I continues to be very competitive in the low three's today.

Steve Moss
Okay, that's helpful. And then in terms of just thinking about funding costs and asset sensitivity, I heard the...I don't want to guess on Fed rate hikes and stuff. But just kind of curious as to what you're thinking for deposit rates in a Fed hike or with a Fed hike or two if you think you'll see any movement, if at all?

Mark Mason
That's a great question. I mean historically, our deposit beta has been in the 40%, 45% range. But that history was also dominated by many years of like 20% annual growth, where we had to utilize promotional money market and CD deposits to fund that growth in part, and our decision to stop [ph] growing for a couple of years allowed us to run off the most interest rate sensitive depositors and reorient our core depositors toward lower deposit rates relative to our peers. And we are going to try to hold that strategy going forward. So our beta may be different. We hope lower. We're going to be as interested as you are to see how it works out.

John Michel
I think one thing's too different than in the past, Steve, is our level of wholesale borrowing is almost nominal in terms of that. And that tends to re-price quicker than deposits do. So when we're looking at this, especially this next coming year, we don't see a lot of pressure on our rates from that perspective because of the low level of wholesale borrowing we have. And then there's a lot of liquidity in the market still. So we don't see a lot of pressure on rates even if Fed raised rates a couple of times.

Steve Moss
Right. And then maybe just in terms of liquidity on your balance sheet. Do we think about keeping the investment securities portfolio more or less stable here or would you look to do maybe a little bit of a remix toward loans here as we go forward?

Mark Mason
We try to stay pretty loaned up. If you look at our history, particularly in relation to our peers recently, our loan-to-deposit ratio has remained fairly consistent and fairly high between 90% and 100%. We seek to keep our liquidity at about 15% of assets. We have some liquidity or securities needs that have to do with collateral. We have a fairly large hedging program that requires collateral. So part of that liquidity in the securities portfolio are as pledged as collateral. But we don't intend to grow our securities portfolio beyond its need. We intend to stay loaned up.

Steve Moss
Alright. I appreciate that. Thank you very much, guys.

Mark Mason
Thanks, Steve.

Operator
The next question comes from Matthew Clark with Piper Sandler. Please go ahead.

Matthew Clark
Hey, good morning, guys.

Mark Mason
Good morning, Matt.

Matthew Clark
I wanted to hone in on the commercial, the C&I and CRE loans sold in terms of this year relative to last. I think you did a $773 million in '21. How should we think about that level of sales this year relative to last?

Mark Mason
That's a great question, and it's really similar to prior questions about sales and timing and probability. As we think internally, we have considered reducing that number meaningfully if we have loan sale. And so, we've been thinking about numbers that maybe half of that number this year, but it's not assured that we will have a loan sale. So for your purposes, I know that's not real clear guidance. But if we have a loan sale, we're expecting it to be probably a one-time event as opposed to a multi-quarter event, probably in the second half of the year, again, wanting to see if we're going to outperform, and the sizing being meaningfully less, maybe half.

Matthew Clark
Okay. Thank you. And then on the reserve coverage ratio, I know most of your growth is coming from multifamily, you've got a 24 basis point reserve on multifamily given the quality of that asset class. But it would also suggest that your reserves could come down a decent amount from here. And it sounds like you're looking for negative provisioning to persist in the

near term. I guess, how should...I guess, where would you expect that coverage ratio to bottom, I guess, what's your comfort level? And what's the ratio that you wouldn't want to go below? I know that's a simplified question...a simple question, but with a lot more complex assumptions, but...?

John Michel
Yes. I think from our perspective, we can probably address it more from the perspective of the provisioning. I think in the first half of this year, we still anticipate having recoveries, as we mentioned. We think it will then stabilize, and then as we look into '23 and '24, probably having normal provisioning for the growth in the portfolio. That's probably the way I would rephrase that. We don't have a set number we're going down to, but I can tell you that we still have excess reserves from our COVID provisioning. And I can also tell you because of the shift in the structure of our portfolio to the lower credit, I mean, the lower credit risk multifamily portfolio that we are freeing up reserves that way. It's a new world still with the CECL analysis. And going through the process, and we're still learning from that, as I'm sure everybody else is. But that's kind of where we're looking at in the near term and the longer term.

Matthew Clark
Okay. And then just the housekeeping item. Do you happen to have the PPP loan balance at the end of the year? And how much you...?

John Michel
Yes, I did mention that in my comments. It was about $38 million, I think, was the number that we have left of balances and only less than $1 million in terms of the fees left. So I apologize.

Matthew Clark
Got it.

John Michel
Okay, $38 million and $1 million. So we don't expect any significant impact from the PPP loan amortization because we think that will be spread out over six to nine months.

Matthew Clark
Okay. Thank you.

Operator
This concludes 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 joining us today. We look forward to speaking with you again next quarter.

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