

STERLING FINANCIAL CORP /WA/

Form 10-Q

August 14, 2003

**UNITED STATES SECURITIES AND EXCHANGE
COMMISSION**

Washington, D.C. 20549

FORM 10-Q

(Mark One)

**QUARTERLY REPORT PURSUANT TO SECTION 13 or 15(d) OF
THE SECURITIES EXCHANGE ACT OF 1934
FOR THE QUARTERLY PERIOD ENDED June 30, 2003**

OR

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF
THE SECURITIES EXCHANGE ACT OF 1934
FOR THE TRANSITION PERIOD FROM TO .**

Commission File Number.....0-20800

STERLING FINANCIAL CORPORATION

(Exact name of registrant as specified in its charter)

Washington

(State or other jurisdiction of
incorporation or organization)

91-1572822

(I.R.S. Employer
Identification No.)

111 North Wall Street, Spokane, Washington 99201

(Address of principal executive offices) (Zip Code)

(509) 458-2711

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Sections 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes No

Indicate the number of shares outstanding of each of the issuer's classes of common stock as of the latest practicable date:

| Class | Outstanding as of July 31, 2003 |
|---------------------------------|---------------------------------|
| Common Stock (\$1.00 par value) | 14,781,418 |

STERLING FINANCIAL CORPORATION

FORM 10-Q
For the Quarter Ended June 30, 2003

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PART I - Financial Information
Item 1 - Financial Statements
STERLING FINANCIAL CORPORATION
Consolidated Balance Sheets
(Unaudited)

| | June 30, 2003 | December 31, 2002 |
|--|---------------------|----------------------|
| (Dollars in thousands) | | |
| ASSETS: | | |
| Cash and cash equivalents: | | |
| Interest bearing | \$ 10,100 | \$ 2,525 |
| Non-interest bearing and vault | 74,540 | 74,540 |
| Restricted | 8,965 | 1,526 |
| Investments and asset-backed securities (ABS): | | |
| Available for sale | 1,073,869 | 826,692 |
| Held to maturity | 2,834 | 3,476 |
| Loans receivable, net | 2,668,990 | 2,390,263 |
| Loans held for sale | 50,625 | 22,549 |
| Accrued interest receivable | 16,205 | 14,625 |
| Real estate owned, net | 3,982 | 3,953 |
| Office properties and equipment, net | 51,921 | 47,745 |
| Bank-owned life insurance (BOLI) | 71,189 | 59,399 |
| Goodwill | 45,075 | 43,977 |
| Other intangible assets | 3,038 | 0 |
| Mortgage servicing rights, net | 2,078 | 1,680 |
| Prepaid expenses and other assets, net | 11,176 | 13,114 |
| Total assets | \$ 4,094,587 | \$ 3,506,064 |
| LIABILITIES: | | |
| Deposits | \$ 2,393,707 | \$ 2,014,096 |
| Advances from Federal Home Loan Bank of Seattle (FHLB Seattle) | 995,119 | 874,515 |
| Securities sold subject to repurchase agreements and funds purchased | 276,958 | 249,769 |
| Other borrowings | 139,782 | 127,682 |
| Cashiers checks issued and payable | 13,418 | 13,371 |
| Borrowers reserves for taxes and insurance | 1,825 | 1,401 |
| Accrued interest payable | 7,158 | 6,344 |
| Accrued expenses and other liabilities | 20,277 | 15,230 |
| Total liabilities | 3,848,244 | 3,302,408 |
| Commitments and Contingencies | | |
| SHAREHOLDERS EQUITY: | | |
| Preferred stock, \$1 par value; 10,000,000 shares authorized; no shares issued and outstanding | 0 | 0 |
| | 14,781 | 11,959 |

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Common stock, \$1 par value; 40,000,000 shares authorized; 14,781,418 and 11,958,948 shares issued and outstanding

| | | |
|--|---------------------|---------------------|
| Additional paid-in capital | 180,825 | 125,177 |
| Accumulated other comprehensive income (loss): | | |
| Unrealized gains (losses) on investments and ABS available-for-sale, net of deferred income taxes of \$(509) and \$1,852 | (945) | 3,439 |
| Retained earnings | 51,682 | 63,081 |
| Total shareholders' equity | 246,343 | 203,656 |
| Total liabilities and shareholders' equity | \$ 4,094,587 | \$ 3,506,064 |

STERLING FINANCIAL CORPORATION
Consolidated Statements of Income
(Unaudited)

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|--------------------------------|-----------|------------------------------|-----------|
| | 2003 | 2002 | 2003 | 2002 |
| (Dollars in thousands, except per share data) | | | | |
| Interest income: | | | | |
| Loans | \$ 42,376 | \$ 38,885 | \$ 82,715 | \$ 78,080 |
| ABS | 9,214 | 7,786 | 19,186 | 15,587 |
| Investments and cash equivalents | 1,061 | 1,030 | 2,235 | 2,200 |
| Total interest income | 52,651 | 47,701 | 104,136 | 95,867 |
| Interest expense: | | | | |
| Deposits | 9,493 | 11,590 | 18,513 | 22,850 |
| Short-term borrowings | 2,695 | 1,546 | 5,466 | 3,275 |
| Long-term borrowings | 10,423 | 11,197 | 21,546 | 22,985 |
| Total interest expense | 22,611 | 24,333 | 45,525 | 49,110 |
| Net interest income | 30,040 | 23,368 | 58,611 | 46,757 |
| Provision for losses on loans | (2,550) | (2,227) | (4,800) | (4,313) |
| Net interest income after provision for losses on loans | 27,490 | 21,141 | 53,811 | 42,444 |
| Other income: | | | | |
| Fees and service charges | 4,909 | 4,089 | 9,208 | 7,929 |
| Mortgage banking operations | 2,496 | 1,050 | 4,713 | 2,356 |
| Loan servicing fees (costs) | (153) | 320 | (69) | 594 |
| Net gains on sales of securities | 1,677 | 311 | 3,037 | 397 |
| Real estate owned operations | (180) | (2) | (209) | (194) |
| Charge related to early repayment of debt | 0 | 0 | (1,464) | 0 |
| BOLI | 968 | 881 | 1,790 | 1,702 |
| Other noninterest income (expense) | (28) | 96 | (208) | (210) |
| Total other income | 9,689 | 6,745 | 16,798 | 12,574 |
| Operating expenses | 22,604 | 19,752 | 44,015 | 39,419 |
| Income before income taxes | 14,575 | 8,134 | 26,594 | 15,599 |
| Income tax provision | (5,058) | (2,398) | (9,294) | (4,282) |
| Net income | \$ 9,517 | \$ 5,736 | \$ 17,300 | \$ 11,317 |
| Earnings per share - basic | \$ 0.64 | \$ 0.44 | \$ 1.21 | \$ 0.88 |

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| | | | | | | | | |
|---|----|------------|----|------------|----|------------|----|------------|
| Earnings per share - diluted | \$ | 0.63 | \$ | 0.43 | \$ | 1.18 | \$ | 0.85 |
| Weighted average shares outstanding - basic | | 14,771,708 | | 13,031,704 | | 14,244,227 | | 12,903,754 |
| Weighted average shares outstanding - diluted | | 15,147,572 | | 13,465,641 | | 14,602,015 | | 13,392,933 |

The accompanying notes are an integral part of the consolidated financial statements.

STERLING FINANCIAL CORPORATION
Consolidated Statements of Cash Flows
(Unaudited)

| | Six Months Ended June 30, | |
|--|------------------------------|-----------------|
| | 2003 | 2002 |
| | (Dollars in thousands) | |
| Cash flows from operating activities: | | |
| Net income | \$ 17,300 | \$ 11,317 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Provisions for losses on loans and real estate owned | 4,945 | 4,491 |
| Stock dividends on FHLB Seattle stock | (2,928) | (1,190) |
| Net gain on sales of loans, investments and ABS | (6,387) | (2,892) |
| Other losses | 113 | 610 |
| Change in cash surrender value of BOLI | (1,790) | (1,705) |
| Depreciation and amortization | 5,806 | 4,615 |
| Change in: | | |
| Accrued interest receivable | (1,309) | 488 |
| Prepaid expenses and other assets | 6,578 | (3,684) |
| Cashiers checks issued and payable | (1,888) | (4,581) |
| Accrued interest payable | 323 | 1,690 |
| Accrued expenses and other liabilities | 777 | (6,110) |
| Proceeds from sales of loans | 209,735 | 134,360 |
| Real estate loans originated for sale | (206,385) | (131,865) |
| Net cash provided by operating activities | 24,890 | 5,544 |
| Cash flows from investing activities: | | |
| Change in restricted cash | (7,439) | 438 |
| Loans funded | (1,074,374) | (726,815) |
| Loan principal received | 828,734 | 654,368 |
| Purchase of investments | (11,853) | (32,039) |
| Proceeds from maturities of investments | 1,531 | 29,929 |
| Proceeds from sales of available-for-sale investments | 10,681 | 1,400 |
| Cash and cash equivalents acquired as part of acquisitions | 143,631 | 0 |
| Purchase of BOLI | (10,000) | (25,000) |
| Purchase of ABS | (991,720) | (251,906) |
| Principal payments on ABS | 166,722 | 92,759 |
| Proceeds from sales of ABS | 581,160 | 202,131 |
| Purchase of office properties and equipment | (2,150) | (406) |
| Improvements and other changes to real estate owned | 123 | (830) |
| Proceeds from sales and liquidation of real estate owned | 1,875 | 3,950 |
| Net cash used in investing activities | (363,079) | (52,021) |

The accompanying notes are an integral part of the consolidated financial statements.

STERLING FINANCIAL CORPORATION
Consolidated Statements of Cash Flows (continued)
(Unaudited)

| | Six Months Ended June 30, | |
|--|------------------------------|------------|
| | 2003 | 2002 |
| (Dollars in thousands) | | |
| Cash flows from financing activities: | | |
| Net change in checking, passbook and money market deposits | \$ 54,404 | \$ 106,974 |
| Proceeds from issuance of certificates of deposit | 785,335 | 565,173 |
| Payments for maturing certificates of deposit | (661,334) | (567,831) |
| Interest credited to deposits | 16,983 | 21,367 |
| Advances from FHLB Seattle | 296,102 | 74,000 |
| Repayment of FHLB Seattle advances | (185,072) | (86,805) |
| Net change in securities sold subject to repurchase agreements and funds purchased | 27,189 | (67,291) |
| Proceeds from other borrowings | 54,000 | 0 |
| Repayment of other borrowings | (41,900) | (5,000) |
| Payments for fractional shares | (30) | (21) |
| Proceeds from exercise of stock options, net of repurchases | 583 | 672 |
| Deferred financing costs | (732) | 0 |
| Other | 236 | 316 |
| Net cash provided by financing activities | 345,764 | 41,554 |
| | | |
| Net change in cash and cash equivalents | 7,575 | (4,923) |
| Cash and cash equivalents, beginning of period | 77,065 | 65,654 |
| | | |
| Cash and cash equivalents, end of period | \$ 84,640 | \$ 60,731 |
| Supplemental disclosures: | | |
| Cash paid during the period for: | | |
| Interest | \$ 46,299 | \$ 47,780 |
| Income taxes | 9,457 | 7,868 |
| | | |
| Noncash financing and investing activities: | | |
| Loans converted into real estate owned | 1,309 | 5,354 |
| Common stock dividend | 28,699 | 23,809 |
| Common stock issued upon business combination | 28,107 | 0 |

The accompanying notes are an integral part of the consolidated financial statements.

STERLING FINANCIAL CORPORATION
Consolidated Statements of Comprehensive Income
(Unaudited)

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|--------------------------------|-----------|------------------------------|-----------|
| | 2003 | 2002 | 2003 | 2002 |
| | (Dollars in thousands) | | | |
| Net income | \$ 9,517 | \$ 5,736 | \$ 17,300 | \$ 11,317 |
| Other comprehensive income: | | | | |
| Change in unrealized gains (losses) on investments and ABS available-for-sale | (6,943) | 8,999 | (6,745) | 8,644 |
| Less deferred income taxes | 2,430 | (3,149) | 2,361 | (3,024) |
| Net other comprehensive income (loss) | (4,513) | 5,850 | (4,384) | 5,620 |
| Comprehensive income | \$ 5,004 | \$ 11,586 | \$ 12,916 | \$ 16,937 |

The accompanying notes are an integral part of the consolidated financial statements.

STERLING FINANCIAL CORPORATION
Notes to Consolidated Financial Statements

1. Basis of Presentation:

The foregoing unaudited interim consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X as promulgated by the Securities and Exchange Commission. Accordingly, these financial statements do not include all of the disclosures required by accounting principles generally accepted in the United States of America for complete financial statements. These unaudited interim consolidated financial statements should be read in conjunction with the audited consolidated financial statements for the year ended December 31, 2002. In the opinion of management, the unaudited interim consolidated financial statements furnished herein include all adjustments, all of which are of a normal recurring nature, necessary for a fair statement of the results for the interim periods presented.

The preparation of financial statements in accordance with accounting principles generally accepted in the United States of America requires the use of estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities known to exist as of the date the financial statements are published, and the reported amounts of revenues and expenses during the reporting period. Uncertainties with respect to such estimates and assumptions are inherent in the preparation of Sterling Financial Corporation's (Sterling's) consolidated financial statements; accordingly, it is possible that the actual results could differ from these estimates and assumptions, which could have a material effect on the reported amounts of Sterling's consolidated financial position and results of operations.

2. Other Borrowings:

The components of other borrowings are as follows (in thousands):

| | June 30, 2003 | December 31, 2002 |
|--|-------------------|----------------------|
| Term note payable(1) | \$ 25,000 | \$ 25,000 |
| Advances on revolving line of credit(2) | 0 | 0 |
| Sterling obligated mandatorily redeemable preferred capital securities of subsidiary trusts holding solely junior subordinated deferrable interest debentures of Sterling(3) | 78,000 | 64,000 |
| Floating Rate Notes Due 2006(4) | 30,000 | 30,000 |
| Other(5) | 6,782 | 8,682 |
| Total other borrowings | \$ 139,782 | \$ 127,682 |

(1) Sterling has a variable-rate term note with U.S. Bank, N.A. (U.S. Bank). This note matures on September 17, 2007. Interest accrues at the 30-day London Interbank Offering Rate (LIBOR) plus 2.50% (3.82% at June 30, 2003) and is payable monthly. Principal payments are due in annual installments of \$3.0 million commencing September 30, 2003, with the entire unpaid balance due at maturity. This note is collateralized by a majority of the Common and Preferred Stock of Sterling Savings Bank.

(2) Sterling has a \$5.0 million revolving line-of-credit with U.S. Bank. This line of credit matures on September 15, 2003. The interest rate is adjustable monthly at the 30-day LIBOR plus 2.50% (3.82% at June 30, 2003) and is payable monthly. This note is collateralized by a majority of the Common and Preferred Stock of Sterling Savings Bank. At June 30, 2003, no amounts were outstanding under this line.

(3) Sterling raises capital from time to time through the formation of trusts (Sterling Capital Trusts), which issue capital securities (Trust Preferred Securities) to investors. The Sterling Capital Trusts are business trusts in which Sterling owns all of the common equity. The proceeds from the sale of the Trust Preferred Securities are used to purchase junior subordinated deferrable interest debentures (Junior Subordinated Debentures) issued by Sterling. Sterling's obligations under the Junior Subordinated Debentures and related

documents, taken together, constitute a full and unconditional guarantee by Sterling of Sterling Capital Trusts' obligations under the Trust Preferred Securities. The Trust Preferred Securities are treated as debt of Sterling. Although Sterling, as a savings and loan holding company, is not subject to the Federal Reserve capital requirements for bank holding companies, the Trust Preferred Securities have been structured to qualify as Tier 1 capital, subject to certain limitations, if Sterling were to become regulated as a bank holding company. The Junior Subordinated Debentures and related Trust Preferred Securities generally mature 30 years after issuance and are redeemable at the option of Sterling under certain conditions. Interest is paid quarterly or semi-annually. Details of the Trust Preferred Securities are as follows:

| Subsidiary Issuer | Issue Date | Maturity Date | Mandatorily Redeemable Capital Security | Rate At June 30, 2003 | Amount (In Thousands) |
|------------------------------------|------------|---------------|---|-----------------------|-----------------------|
| Sterling Capital Trust VI | June 2003 | April 2033 | Floating Rate Capital Securities | 4.32% | \$ 10,000 |
| Sterling Capital Statutory Trust V | May 2003 | May 2033 | Floating Rate Capital Securities | 4.54% | 20,000 |