

STERLING FINANCIAL CORP /WA/

Form 10-Q

August 08, 2007

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**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, 2007
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
(Address of principal executive offices)

99201
(Zip Code)

(509) 458-3711

(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 a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated Filer Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (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
Common Stock (\$1.00 par value)

Outstanding as of August 1, 2007
51,341,243

STERLING FINANCIAL CORPORATION
FORM 10-Q
For the Quarter Ended JUNE 30, 2007
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PART I Financial Information
Item 1 Financial Statements
STERLING FINANCIAL CORPORATION
Consolidated Balance Sheets
(Unaudited)

	June 30, 2007	December 31, 2006
(Dollars in thousands)		
ASSETS:		
Cash and cash equivalents:		
Interest bearing	\$ 10,851	\$ 13,846
Non-interest bearing and vault	180,425	164,719
Total cash and cash equivalents	191,276	178,565
Restricted cash	1,125	1,150
Investment securities and mortgage-backed securities (MBS):		
Available for sale	1,697,424	1,820,583
Held to maturity	108,430	93,063
Loans receivable, net	8,507,423	7,021,241
Loans held for sale	84,613	91,469
Accrued interest receivable	60,436	55,519
Real estate owned and other collateralized assets, net	4,012	4,052
Office properties and equipment, net	96,361	93,796
Bank-owned life insurance (BOLI)	147,354	139,206
Goodwill	456,315	247,244
Other intangible assets, net	34,078	28,570
Mortgage servicing rights, net	10,130	7,335
Prepaid expenses and other assets, net	64,670	52,699
Total assets	\$ 11,463,647	\$ 9,834,492
LIABILITIES:		
Deposits	\$ 7,620,362	\$ 6,746,028
Advances from Federal Home Loan Bank (FHLB)	1,594,844	1,308,617
Securities sold subject to repurchase agreements and funds purchased	744,903	616,354
Other borrowings	250,074	240,226
Cashiers checks issued and payable	4,279	18,144
Borrowers reserves for taxes and insurance	2,418	2,348
Accrued interest payable	39,615	39,863
Accrued expenses and other liabilities	84,981	79,496
Total liabilities	10,341,476	9,051,076

Commitments and Contingencies

SHAREHOLDERS' EQUITY:

Preferred stock, \$1 par value; 10,000,000 shares authorized; no shares issued and outstanding	0	0
Common stock, \$1 par value; 100,000,000 shares authorized; 51,329,826 and 42,042,740 shares issued and outstanding	51,330	42,043
Additional paid-in capital	889,890	590,218
Accumulated other comprehensive loss:		
Unrealized losses on investment securities and MBS available-for-sale, net of deferred income taxes of \$26,368 and \$19,531	(44,974)	(33,350)
Retained earnings	225,925	184,505
Total shareholders' equity	1,122,171	783,416
Total liabilities and shareholders' equity	\$ 11,463,647	\$ 9,834,492

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

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STERLING FINANCIAL CORPORATION
Consolidated Statements of Income
(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
	(Dollars in thousands, except per share data)			
Interest income:				
Loans	\$ 172,825	\$ 103,356	\$ 325,588	\$ 195,467
MBS	19,356	22,473	39,824	45,818
Investments and cash equivalents	1,880	891	3,551	1,614
Total interest income	194,061	126,720	368,963	242,899
Interest expense:				
Deposits	70,666	40,909	134,386	75,719
Short-term borrowings	9,730	8,881	19,405	15,246
Long-term borrowings	24,625	15,881	45,516	31,929
Total interest expense	105,021	65,671	199,307	122,894
Net interest income	89,040	61,049	169,656	120,005
Provision for losses on loans	(3,975)	(4,650)	(8,200)	(9,300)
Net interest income after provision for losses on loans	85,065	56,399	161,456	110,705
Non-interest income:				
Fees and service charges	13,694	10,615	25,886	19,694
Mortgage banking operations	9,807	2,725	18,665	4,996
Loan servicing fees	410	482	1,093	751
Real estate owned and other collateralized assets operations	(93)	78	(138)	385
BOLI	1,717	1,203	3,264	2,386
Other non-interest expense	(757)	27	(544)	(165)
Total non-interest income	24,778	15,130	48,226	28,047
Non-interest expenses	69,891	46,989	135,560	91,229
Income before income taxes	39,952	24,540	74,122	47,523
Income tax provision	(12,971)	(7,609)	(24,220)	(15,176)
Net income	\$ 26,981	\$ 16,931	\$ 49,902	\$ 32,347

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Earnings per share	basic	\$	0.53	\$	0.48	\$	1.03	\$	0.92
Earnings per share	diluted	\$	0.52	\$	0.48	\$	1.02	\$	0.92
Weighted average shares outstanding	basic	51,189,438	35,077,647	48,230,619	35,012,510				
Weighted average shares outstanding	diluted	51,699,098	35,404,364	48,776,780	35,326,837				

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

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STERLING FINANCIAL CORPORATION
Consolidated Statements of Cash Flows
(Unaudited)

	Six Months Ended June 30,	
	2007	2006
	(Dollars in thousands)	
Cash flows from operating activities:		
Net income	\$ 49,902	\$ 32,347
Adjustments to reconcile net income to net cash provided by operating activities:		
Provisions for losses on loans and real estate owned	8,200	9,320
Accretion of deferred gain on sale of branches	(352)	(18)
Net gain on sales of loans, investment securities and MBS	(11,460)	(1,316)
Stock based compensation	627	181
Excess tax benefit from stock based compensation	(1,336)	(791)
Stock issuances relating to 401(k) match	1,172	896
Other gains and losses	1,504	387
Increase in cash surrender value of BOLI	(3,264)	(2,386)
Depreciation and amortization	12,135	9,230
Change in:		
Accrued interest receivable	2,123	(4,695)
Prepaid expenses and other assets	(6,957)	1,928
Cashiers checks issued and payable	(18,564)	(721)
Accrued interest payable	(2,221)	10,271
Accrued expenses and other liabilities	(4,580)	(7,955)
Proceeds from sales of loans originated for sale	676,063	62,018
Loans originated for sale	(667,682)	(60,702)
Net cash provided by operating activities	35,310	47,994
Cash flows from investing activities:		
Change in restricted cash	25	(159)
Loans funded and purchased	(2,376,666)	(2,128,822)
Loan principal received	2,026,361	1,485,011
Proceeds from sales of other loans	97,114	0
Purchase of investment securities	(47,195)	(40,300)
Proceeds from maturities of investment securities	23,379	10,088
Proceeds from sale of investments	5,609	0
Net cash and cash equivalents acquired	92,419	0
Principal payments on mortgage-backed securities	125,963	139,762
Purchase of office properties and equipment	(7,202)	(7,486)
Sales of office properties and equipment	2,792	5,702
Improvements and other changes to real estate owned	(9)	(221)
Proceeds from sales and liquidation of real estate owned	106	731
Net cash provided by (used in) investing activities	(57,304)	(535,694)

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

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STERLING FINANCIAL CORPORATION
Consolidated Statements of Cash Flows
(Unaudited)

	Six Months Ended June 30,	
	2007	2006
	(Dollars in thousands)	
Cash flows from financing activities:		
Net change in transaction and savings deposits	\$ 151,234	\$ 135,327
Proceeds from issuance of time deposits	1,547,770	1,781,541
Payments for maturing time deposits	(1,939,136)	(1,450,573)
Interest credited to deposits	119,812	65,195
Advances from FHLB	1,232,744	1,379,784
Repayment of advances from FHLB	(1,213,095)	(1,486,072)
Net change in securities sold subject to repurchase agreements and funds purchased	128,549	(28,635)
Proceeds from other borrowings	23,000	75,000
Repayments of other borrowings	(13,403)	0
Proceeds from stock purchases	3,070	3,340
Excess tax benefit from stock based compensation	1,336	791
Cash dividends paid to shareholders	(7,246)	(4,023)
Other	70	492
Net cash provided by (used in) financing activities	34,705	472,167
Net change in cash and cash equivalents	12,711	(15,533)
Cash and cash equivalents, beginning of period	178,565	131,307
Cash and cash equivalents, end of period	\$ 191,276	\$ 115,774
Supplemental disclosures:		
Cash paid during the period for:		
Interest	\$ 199,555	\$ 112,623
Income taxes	28,427	15,686
Noncash financing and investing activities:		
Loans converted into real estate owned and other collateralized assets	57	4,436
Common stock issued upon business combination	302,754	0
Common stock cash dividends accrued	8,482	2,282
Deferred gain on sale of branches	804	3,670
The accompanying notes are an integral part of the consolidated financial statements.		

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STERLING FINANCIAL CORPORATION
Consolidated Statements of Comprehensive Income
(Unaudited)

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2007	2006	2007	2006
	(Dollars in thousands)		(Dollars in thousands)	
Net income	\$ 26,981	\$ 16,931	\$ 49,902	\$ 32,347
Other comprehensive income:				
Change in unrealized gains (losses) on investment securities and MBS available-for-sale	(25,686)	(17,112)	(18,461)	(40,820)
Less deferred income taxes	9,507	6,335	6,837	15,110
Net other comprehensive income (loss)	(16,179)	(10,777)	(11,624)	(25,710)
Comprehensive income (loss)	\$ 10,802	\$ 6,154	\$ 38,278	\$ 6,637

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

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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 as disclosed in the annual report on Form 10-K for the year ended December 31, 2006. 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, 2007	December 31, 2006
Junior Subordinated Debentures	\$ 223,620	\$ 236,772
Other	26,454	3,454
Total	\$ 250,074	\$ 240,226

Sterling raises capital from time to time through the formation of trusts (Capital Trusts), which issue capital securities (Trust Preferred Securities) to investors. Sterling has also acquired Capital Trusts in connection with business acquisitions. These 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 the Capital Trusts obligations under the Trust Preferred Securities. The Trust Preferred Securities are treated as debt of Sterling. 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, including, with respect to certain of the Trust Preferred Securities, payment of call premiums. Interest is paid quarterly or semi-annually. Details of the Trust Preferred Securities are as follows:

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Subsidiary Issuer	Issue Date	Maturity Date	Call Date	Rate at		Carrying Value (in thousands)
				June 30, 2007		
Sterling Capital Trust VIII	Sept 2006	Sept 2036	N/A	Floating	6.99%	\$ 51,547
Sterling Capital Trust VII	June 2006	June 2036	N/A	Floating	6.89	56,702
Lynnwood Financial Statutory Trust II	June 2005	June 2035	N/A	Floating	7.16	10,310
Sterling Capital Trust VI	June 2003	Sept 2033	Sept 2008	Floating	8.56	10,310
Sterling Capital Statutory Trust V	May 2003	May 2033	June 2008	Floating	8.61	20,619
Sterling Capital Trust IV	May 2003	May 2033	May 2008	Floating	8.51	10,310
Sterling Capital Trust III	April 2003	April 2033	April 2008	Floating	8.61	14,433
Lynnwood Financial Statutory Trust I	Mar 2003	Mar 2033	Mar 2007	Floating	8.51	9,480
Klamath First Capital Trust I	July 2001	July 2031	June 2006	Floating	9.15	15,166
Sterling Capital Trust II	July 2001	July 2031	June 2006	Fixed	10.25	24,743
					7.94%*	\$ 223,620

* weighted average rate

Sterling has entered into a \$40.0 million revolving credit agreement (the Credit Facility) with Wells Fargo Bank, N.A., with amounts advanced on the Credit Facility included in the Other caption of other borrowings. As of June 30, 2007, \$23.0 million was drawn on the Credit Facility. Subsequent to June 30, 2007, the outstanding balance on the Credit Facility was paid in full. Amounts loaned pursuant to the Credit Facility bear interest, at Sterling's election, either floating at two percent below prime or fixed at LIBOR plus 90 basis points. The Credit Facility contains representations and warranties, and negative and affirmative covenants by Sterling, including financial covenants and restrictions on certain actions by Sterling, such as Sterling's ability to incur debt, make investments and merge into or consolidate with other entities. The Credit Facility may be terminated and loans under the Credit Facility may be accelerated if an event of default occurs, as defined in the Credit Facility. The Credit Facility is expected to be

renewed prior to it maturing in August 2007. If the Credit Facility is not renewed, any outstanding balance would be payable in full.

In April 2007, Sterling elected to exercise its early redemption right to call the Klamath First Capital Trust II debenture. The redemption occurred on April 23, 2007.

On July 25, 2007, Sterling's wholly owned subsidiary, Sterling Capital Trust IX, sold \$45.0 million of Trust Preferred Securities. The rate payable on these securities will be the 90-day LIBOR plus 1.40% and is adjustable and payable quarterly. These securities mature in 2037.

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In July 2006, the FASB issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN No. 48). This pronouncement requires a certain methodology for measuring and reporting uncertain tax positions, as well as disclosures regarding such tax positions. FIN No. 48 became effective for Sterling as of January 1, 2007. The following were estimated amounts as of the effective date:

	January 1, 2007 (Dollars in thousands)
Unrecognized Tax Benefit	\$ 1,553
Potential Effective Tax Rate Impact	1,245
Recognized Penalties and Interest	308

Sterling does not expect unrecognized tax benefits to significantly change within the next twelve months. Sterling's tax positions for the years 2003 through 2006 remain subject to review by the Internal Revenue Service. Penalties and interest associated with any potential estimate variances would be included in income tax expense on the Consolidated Statement of Income.

4. Earnings Per Share:

The following table presents the basic and diluted earnings per share computations.

	Three Months Ended June 30,					
	2007			2006		
	Net Income	Weighted Avg. Shares	Per Share Amount	Net Income	Weighted Avg. Shares	Per Share Amount
(Dollars in thousands, except per share amounts)						
Basic computations	\$ 26,981	51,189,438	\$ 0.53	\$ 16,931	35,077,647	\$ 0.48
Effect of dilutive securities:						
Common stock options and restricted shares	0	509,660	(0.01)	0	326,717	0.00
Diluted computations	\$ 26,981	51,699,098	\$ 0.52	\$ 16,931	35,404,364	\$ 0.48
Antidilutive options not included in diluted earnings per share		307,945			0	

	Six Months Ended June 30,					
	2007			2006		
	Net Income	Weighted Avg. Shares	Per Share Amount	Net Income	Weighted Avg. Shares	Per Share Amount
(Dollars in thousands, except per share amounts)						
Basic computations	\$ 49,902	48,230,619	\$ 1.03	\$ 32,347	35,012,510	\$ 0.92
Effect of dilutive securities:						

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Common stock options and restricted shares	0	546,161	(0.01)	0	314,327	0.00
Diluted computations	\$ 49,902	48,776,780	\$ 1.02	\$ 32,347	35,326,837	\$ 0.92
Antidilutive options not included in diluted earnings per share		254,613			0	

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The following table details the components of Sterling's total non-interest expenses:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
	(Dollars in thousands)			
Employee compensation and benefits	\$ 39,163	\$ 25,710	\$ 77,234	\$ 50,799
Occupancy and equipment	11,681	7,375	22,148	14,291
Data processing	4,176	3,523	8,373	6,855
Depreciation	3,341	2,432	6,536	4,715
Advertising	3,279	2,334	5,956	4,255
Travel and entertainment	2,133	1,444	3,641	2,586
Amortization of core deposit intangibles	1,226	555	2,267	1,111
Goodwill litigation costs	1,132	135	1,312	220
Legal and accounting	547	704	1,223	1,239
Insurance	513	316	908	599
Merger and acquisition costs	413	0	844	0
Other	2,287	2,461	5,118	4,559
Total	\$ 69,891	\$ 46,989	\$ 135,560	\$ 91,229

6. Segment Information:

For purposes of measuring and reporting financial results, Sterling is divided into five business segments:

The Community Banking segment consists of the operations conducted by Sterling's subsidiary, Sterling Savings Bank.

The Residential Mortgage Banking segment originates and sells servicing-retained and servicing-released residential loans through loan production offices of Sterling's subsidiary, Golf Savings Bank and Sterling Savings Bank's subsidiary, Action Mortgage Company (Action Mortgage).

The Commercial Mortgage Banking segment originates, sells and services commercial real estate loans and participation interests in commercial real estate loans through offices in the western region primarily through Sterling Savings Bank's subsidiary INTERVEST-Mortgage Investment Company (INTERVEST).

The Retail Brokerage segment markets fixed income and equity products, mutual funds, fixed and variable annuities, insurance and other financial products within the Sterling Savings Bank financial service center network through sales representatives of Sterling Savings Bank's subsidiary Harbor Financial Services, Inc.

The Other and Eliminations segment represents the parent company expenses and intercompany eliminations of revenue and expenses.

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The following table presents certain financial information regarding Sterling's segments and provides a reconciliation to Sterling's consolidated totals for the periods presented:

	As of and for the Three Months Ended June 30, 2007					
	Community Banking	Residential Mortgage Banking	Commercial Mortgage Banking	Retail Brokerage	Other and Eliminations	Total
	(Dollars in thousands)					
Interest income	\$ 179,487	\$ 12,365	\$ 2,044	\$ 0	\$ 165	\$ 194,061
Interest expense	(96,950)	(3,377)	0	0	(4,694)	(105,021)
Net interest income (expense)	82,537	8,988	2,044	0	(4,529)	89,040
Provision for loan losses	(3,900)	(75)	0	0	0	(3,975)
Noninterest income	20,036	7,561	1,967	1,006	(5,792)	24,778
Noninterest expense	(55,263)	(10,045)	(2,417)	(1,000)	(1,166)	(69,891)
Income before income taxes	\$ 43,410	\$ 6,429	\$ 1,594	6	\$ (11,487)	\$ 39,952
Total assets	\$ 11,179,900	\$ 364,419	\$ 8,984	\$ 622	\$ (90,278)	\$ 11,463,647

	As of and for the Three Months Ended June 30, 2006					
	Community Banking	Residential Mortgage Banking	Commercial Mortgage Banking	Retail Brokerage	Other and Eliminations	Total
	(Dollars in thousands)					
Interest income	\$ 120,406	\$ 3,775	\$ 2,406	\$ 0	\$ 133	\$ 126,720
Interest expense	(63,074)	0	0	0	(2,597)	(65,671)
Net interest income (expense)	57,332	3,775	2,406	0	(2,464)	61,049
Provision for loan losses	(4,650)	0	0	0	0	(4,650)
Noninterest income	13,478	2,465	1,246	1,015	(3,074)	15,130
Noninterest expense	(39,407)	(3,959)	(2,055)	(760)	(808)	(46,989)
Income before income taxes	\$ 26,753	\$ 2,281	\$ 1,597	\$ 255	\$ (6,346)	\$ 24,540
Total assets	\$ 8,091,408	\$ 14,446	\$ 9,922	\$ 907	\$ (72,345)	\$ 8,044,338

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	As of and for the Six Months Ended June 30, 2007					
	Community Banking	Residential Mortgage Banking	Commercial Mortgage Banking	Retail Brokerage	Other and Eliminations	Total
	(Dollars in thousands)					
Interest income	\$ 341,537	\$ 23,177	\$ 4,235	\$ 0	14	\$ 368,963
Interest expense	(184,201)	(6,251)	0	0	(8,855)	(199,307)
Net interest income (expense)	157,336	16,926	4,235	0	(8,841)	169,656
Provision for loan losses	(8,050)	(150)	0	0	0	(8,200)
Noninterest income	38,119	14,775	4,174	1,823	(10,665)	48,226
Noninterest expense	(106,192)	(20,324)	(5,329)	(1,839)	(1,876)	(135,560)
Income before income taxes	\$ 81,213	\$ 11,227	\$ 3,080	(16)	\$ (21,382)	\$ 74,122
Total assets	\$ 11,179,900	\$ 364,419	\$ 8,984	\$ 622	\$ (90,278)	\$ 11,463,647

	As of and for the Six Months Ended June 30, 2006					
	Community Banking	Residential Mortgage Banking	Commercial Mortgage Banking	Retail Brokerage	Other and Eliminations	Total
	(Dollars in thousands)					
Interest income	\$ 230,946	\$ 7,242	\$ 4,263	\$ 0	\$ 448	\$ 242,899
Interest expense	(118,156)	0	0	0	(4,738)	(122,894)
Net interest income (expense)	112,790	7,242	4,263	0	(4,290)	120,005
Provision for loan losses	(9,300)	0	0	0	0	(9,300)
Noninterest income	24,932	4,552	2,483	1,843	(5,763)	28,047
Noninterest expense	(76,847)	(7,775)	(3,923)	(1,471)	(1,213)	(91,229)
Income before income taxes	\$ 51,575	\$ 4,019	\$ 2,823	\$ 372	\$ (11,266)	\$ 47,523
Total assets	\$ 8,091,408	\$ 14,446	\$ 9,922	\$ 907	\$ (72,345)	\$ 8,044,338

7. Stock Based Compensation:

On January 1, 2006, Statement of Financial Accounting Standard No. 123 (R), Share Based Payment, became effective for Sterling. As a result, stock options issued as compensation are recorded as an expense at their estimated fair value.

During the six months ended June 30, 2007, stock option activity and related information was as follows:

Weighted

Aggregate

	Number	Average Exercise Price	Weighted Average Remaining Contractual Life (in years)	Intrinsic Value (in thousands)
Outstanding, December 31, 2006	1,485,661	\$ 19.72		
Granted	310,000	33.14		
Exercised	(251,694)	12.43		
Acquisitions	573,212	12.67		
Cancelled	(8,623)	18.35		
Outstanding, June 30, 2007	2,108,556	\$ 20.65	5.01	\$ 17,480
Exercisable, June 30, 2007	1,799,556	\$ 18.51	4.73	\$ 18,769

On April 24, 2007, Sterling adopted the 2007 Long-Term Incentive Plan, which allows for the issuance of up to an aggregate of 2.0 million options to purchase shares of Sterling's common stock. As of June 30, 2007, a total of 2,041,249 shares remained available for grant under Sterling's 2001, 2003 and 2007 Long-Term Incentive Plans. The options granted under these plans have terms of four, six or ten years.

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During the six months ended June 30, 2007 and 2006, the fair value of options granted were \$3.2 million and \$171,000, respectively, and the intrinsic value of options exercised were \$5.0 million and \$2.5 million, respectively. The Black-Scholes option-pricing model was used in estimating the fair value of option grants. The weighted average assumptions used are presented in the table below.

	Six Months Ended	
	June 30,	
	2007	2006
Expected volatility	28% - 29%	31%
Expected term (in years)	4.7 - 6.0	5.5
Expected dividend yield	0.90% - 1.10%	0.87%
Risk free interest rate	4.65% - 4.81%	4.36%

Other stock based compensation during the six months ended June 30, 2007 included the issuance to management of 85,000 shares of restricted stock, with a grant date fair value of \$2.8 million. These shares vest evenly over a four year period. Stock compensation expense recognized during the six months ended June 30, 2007 and 2006 was \$627,000 and \$181,000, respectively.

8. New Accounting Pronouncements:

In February 2007, the Financial Accounting Standards Board (FASB) issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities (SFAS No. 159). SFAS No. 159 provides a fair value measurement election for many financial instruments, on an instrument by instrument basis. SFAS No. 159 will be effective for Sterling as of January 1, 2008. Sterling is currently assessing the impact of this standard and does not expect SFAS No. 159 to have a material effect on Sterling.

In September 2006, the Emerging Issues Task Force (EITF) reached a consensus on Issue No. 06-4, Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements. Under the provisions of EITF Issue No. 06-4, Sterling will recognize the amount, if any, that is owed current or former employees under split dollar BOLI. EITF 06-4 is effective January 1, 2008. Sterling is currently assessing the potential impact of this standard.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements (SFAS No. 157). SFAS No. 157 defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. SFAS No. 157 will be effective for Sterling as of January 1, 2008. Sterling is currently assessing the impact of this standard and does not expect SFAS No. 157 to have a material effect on Sterling.

9. Derivatives and Hedging:

As part of its mortgage banking activities, Sterling issues interest rate lock commitments (rate locks) to prospective borrowers on residential one-to-four family mortgage loan applications. Pricing for the sale of these loans is fixed with various qualified investors, such as Fannie Mae, under both non-binding (best-efforts) and binding (mandatory) delivery programs at or near the time the interest rate is locked with the borrowers. For mandatory delivery programs, Sterling hedges Interest Rate Risk (IRR) by entering into offsetting forward sale agreements on MBS with third parties. Risks inherent in mandatory delivery programs include the risk that if Sterling does not close the loans subject to rate locks, it is nevertheless obligated to deliver MBS to the counterparty under the forward sale agreement. Sterling could incur significant costs in acquiring replacement loans or MBS and such costs could have a material adverse effect on mortgage banking operations in future periods.

Rate lock commitments to borrowers and best-effort loan delivery commitments from investors are off-balance-sheet commitments that are considered to be derivatives. Sterling accounts for these commitments by recording their estimated fair value on its balance sheet. As of June 30, 2007, Sterling had entered into best efforts forward commitments to sell \$142.7 million of mortgage loans, with the estimated fair value of rate locks issued and delivery commitments received on the unfunded portion valued as an offsetting asset and liability of approximately \$1.3 million. As of December 31, 2006, these rate locks and delivery commitments were valued at \$482,000. As of

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June 30, 2007, Sterling had loans locked with investors under mandatory delivery programs valued at \$54,000, and held offsetting forward sale agreements on MBS valued at \$39,000, with a net gain position reflected in mortgage banking income. As of December 31, 2006, Sterling did not have any loans subject to rate locks under mandatory delivery programs.

Sterling enters into interest rate swap derivative contracts with customers. The IRR on these contracts is offset by entering comparable broker dealer swaps. These contracts are carried as an offsetting asset and liability at fair value, and as of June 30, 2007 and December 31, 2006, were \$104,000 and \$404,000, respectively.

10. Cash Dividends:

The board of directors of Sterling from time to time evaluates the payment of cash dividends. The timing and amount of any future dividends will depend upon earnings, cash and capital requirements, the financial condition of Sterling and its subsidiaries, applicable government regulations and other factors deemed relevant by Sterling's board of directors. During 2006 and 2007, Sterling paid the following cash dividends:

Date Paid	Per Share Amount	Total
January 2006	\$ 0.055	\$1.9 million
April 2006	0.060	2.1 million
July 2006	0.065	2.3 million
October 2006	0.070	2.6 million
January 2007	0.075	3.2 million
April 2007	0.080	4.1 million
July 2007	0.085	4.3 million

11. Business Combination:

On April 11, 2007, Sterling announced the signing of a definitive agreement to acquire North Valley Bancorp (North Valley), headquartered in Redding, California. This pending acquisition required approval by the North Valley shareholders, which was received at a special meeting of the North Valley shareholders on July 31, 2007, and remains subject to regulatory approval and satisfaction of other customary closing conditions. The integration of North Valley into Sterling is expected to increase Sterling's total assets by approximately \$900 million, and would complement the recent growth of its business in northern California, increasing its presence there by 25 depository branches. The transaction was valued at \$196.2 million as of the date the parties agreed to merge.

On February 28, 2007, Sterling completed its acquisition of Northern Empire Bancshares (Northern Empire), a California corporation by issuing \$30.0 million in cash, and 8,914,815 shares of Sterling common stock valued at \$290.4 million in exchange for all outstanding Northern Empire shares. Northern Empire options totaling 646,018 were converted into options to purchase an aggregate of 573,212 shares of Sterling's common stock, valued at \$12.3 million. The total value of the transaction was \$332.8 million. Northern Empire merged with and into Sterling, with Sterling being the surviving corporation in the merger. Northern Empire's financial institution subsidiary, Sonoma National Bank, merged with and into Sterling's subsidiary, Sterling Savings Bank, with Sterling Savings Bank being the surviving institution. The Sonoma National Bank acquisition provided Sterling Savings Bank entry into the northern California market, enhanced the products and services available to the customers of both companies and strengthened Sterling's leadership position in the West.

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The following summarizes the fair values of the assets acquired and liabilities assumed as of the date of acquisition (in thousands):

	February 28, 2007
Cash and cash equivalents	\$ 110,775
Investments and MBS	22,574
Loans receivable, net	1,228,816
Goodwill	208,944
Core deposit intangible	7,775
Other assets	19,523
Total assets acquired	\$ 1,598,407
Deposits	\$ 987,694
Other borrowings	266,853
Other liabilities	11,093
Total liabilities assumed	1,265,640
Net assets acquired	\$ 332,767

The following summarizes the unaudited pro forma results of operations as if Sterling acquired Northern Empire on January 1, 2006 (in thousands, except per share amounts):

	Three Months Ended June		Six Months Ended June 30,	
	2007	2006	2007	2006
Pro forma interest income	\$ 194,061	\$ 150,075	\$ 385,941	\$ 287,941
Pro forma interest expense	105,021	76,926	208,305	144,148
Pro forma net interest income	89,040	73,149	177,636	143,793
Pro forma net income	26,981	21,475	48,809	41,071
Pro forma earnings per share basic	\$ 0.53	\$ 0.49	\$ 0.85	\$ 0.93
Pro forma earnings per share diluted	\$ 0.52	\$ 0.48	\$ 0.84	\$ 0.92

12. Subsequent Events:

In July 2007, Sterling announced a quarterly cash dividend of \$0.09 per share, payable on October 10, 2007 to shareholders of record as of September 28, 2007.

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PART I Financial Information (continued)

Item 2 Management's Discussion and Analysis of Financial Condition and Results of Operation

STERLING FINANCIAL CORPORATION

June 30, 2007

This report contains forward-looking statements. For a discussion about such statements, including the risks and uncertainties inherent therein, see Forward-Looking Statements. Management's Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with the Consolidated Financial Statements and Notes presented elsewhere in this report and in Sterling's 2006 annual report on Form 10-K.

General

Sterling Financial Corporation (Sterling) is a bank holding company, the significant operating subsidiaries of which are Sterling Savings Bank and Golf Savings Bank. The principal operating subsidiaries of Sterling Savings Bank are Action Mortgage Company (Action Mortgage), INTERVEST-Mortgage Investment Company (INTERVEST) and Harbor Financial Services, Inc. (Harbor Financial). Sterling Savings Bank commenced operations in 1983 as a Washington State-chartered federally insured stock savings and loan association headquartered in Spokane, Washington. On July 8, 2005, Sterling Savings Bank converted to a commercial bank. The main focus of Golf Savings Bank, a Washington State-chartered savings bank acquired by Sterling in July 2006, is the origination and sale of residential mortgage loans.

Sterling provides personalized, quality financial services and Perfect Fit banking products to its customers consistent with its Hometown Helpful philosophy. Sterling believes that its dedication to personalized service has enabled it to grow both its retail deposit base and its lending portfolio in the western United States. With \$11.46 billion in total assets at June 30, 2007, Sterling originates loans and attracts Federal Deposit Insurance Corporation (FDIC) insured deposits from the general public through 171 financial service centers throughout Washington, Oregon, California, Idaho and Montana. In addition, Sterling originates loans through Golf Savings Bank and Action Mortgage residential loan production offices and through INTERVEST commercial real estate lending offices in the western United States. Sterling also markets fixed income and equity products, mutual funds, fixed and variable annuities and other financial products through Harbor Financial service representatives located throughout Sterling's financial service center network.

Sterling continues to implement its strategy to become the leading community bank in the western United States by increasing its commercial real estate, commercial banking, consumer and construction lending, which generally produce higher yields than residential loans, as well as increasing its retail deposits, particularly transaction accounts. Such loans generally involve a higher degree of risk than financing residential real estate. Management believes that