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Sound Financial Bancorp, Inc.
Form 10-K
March 14, 2019
UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2018
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 001-35633

Sound Financial Bancorp, Inc.

(Exact Name of Registrant as Specified in its Charter)

Maryland

(State or other jurisdiction of incorporation or organization)

45-5188530

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

2400 3rd Avenue, Suite 150, Seattle Washington

(Address of principal executive offices)

98121

(Zip Code)

Registrant's telephone number, including area code: (206) 448-0884

Securities Registered Pursuant to Section 12(b) of the Act:

Common Stock, par value \$.01 per share

Securities Registered Pursuant to Section 12(g) of the Act:

Title of each class

None

Indicate by checkmark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

YES NO

Indicate by checkmark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.

YES NO

Indicate by checkmark whether the registrant (1) has filed all reports required to be filed by Section 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 checkmark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files).

YES NO

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Indicate by checkmark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§ 229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. x

Indicate by checkmark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company, or an emerging growth company. See the definition of "large accelerated filer," "accelerated filer," "smaller reporting company" and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer x

Non-accelerated filer Smaller reporting company x

Emerging growth company o

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. o

Indicate by checkmark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). YES NO x

The aggregate market value of the voting and non-voting common equity held by non-affiliates as of June 30, 2018, the last business day of the registrant's most recently completed second fiscal quarter, was approximately \$82.4 million. (The exclusion from such amount of the market value of the shares owned by any person shall not be deemed an admission by the registrant that such person is an affiliate of the registrant.)

Indicate the number of shares outstanding of each of the registrant's classes of common stock as of the latest practicable date: As of March 12, 2019, there were 2,547,236 shares of the registrant's common stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

PART III of Form 10-K – Portions of the Registrant's Proxy Statement for its 2019 Annual Meeting of Shareholders.

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SOUND FINANCIAL BANCORP, INC.

FORM 10-K

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PART I

Item 1. Business

Special Note Regarding Forward-Looking Statements

Certain matters discussed in this Form 10-K constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements relate to our financial condition, results of operations, plans, objectives, future performance or business. Forward-looking statements are not statements of historical fact, are based on certain assumptions and are generally identified by use of the words "believes," "expects," "anticipates," "estimates," "forecasts," "intends," "plans," "targets," "potentially," "probably," "projects," "outlook" or similar expressions or future or conditional verbs such as "may," "will," "should," "would" and "could." Forward-looking statements include statements with respect to our beliefs, plans, objectives, goals, expectations, assumptions and statements about, among other things, expectations of the business environment in which we operate, projections of future performance or financial items, perceived opportunities in the market, potential future credit experience, and statements regarding our mission and vision. These forward-looking statements are based upon current management expectations and may, therefore, involve risks and uncertainties. Our actual results, performance, or achievements may differ materially from those suggested, expressed, or implied by forward-looking statements as a result of a wide variety or range of factors including, but not limited to:

- our ability to access cost-effective funding;
- our ability to attract and retain deposits;
- fluctuations in interest rates;
- the risks of lending and investing activities, including changes in the level and direction of loan delinquencies and write-offs and changes in estimates of the adequacy of our allowance for loan losses;
- inability of key third-party providers to perform their obligations to us;
- fluctuations in the demand for loans, the number of unsold homes, land and other properties, and fluctuations in real estate values and both residential and commercial and multifamily real estate market conditions in our market area;
- secondary market conditions for loans and our ability to sell loans in the secondary market;
- results of examinations of Sound Financial Bancorp and Sound Community Bank by their regulators, including the possibility that the regulators may, among other things, require us to increase our allowance for loan losses or to write-down assets, change Sound Community Bank's regulatory capital position or affect our ability to borrow funds or maintain or increase deposits, which could adversely affect our liquidity and earnings;
- our ability to successfully integrate any assets, liabilities, clients, systems, and management personnel we may acquire into our operations and our ability to realize related revenue synergies and expected cost savings and other benefits within the anticipated time frames or at all;
- our ability to control operating costs and expenses;
- the use of estimates in determining fair value of certain of our assets, which estimates may prove to be incorrect and result in significant declines in valuation;
- our ability to keep pace with technological changes, including our ability to identify and address cyber-security risks such as data security breaches, "denial of service" attacks, "hacking" and identity theft, and other attacks on our information technology systems or on the third-party vendors who perform several of our critical processing functions;
- competitive pressures among financial services companies;
- changes in consumer spending, borrowing and savings habits;
- changes in accounting policies and practices, as may be adopted by the financial institution regulatory agencies or the Financial Accounting Standards Board, including additional guidance and interpretation on accounting issues and details of the implementation of new accounting methods;
- changes in economic conditions, either nationally or in our market area;
- legislative or regulatory changes such as the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") and its implementing regulations that adversely affect our business, as well as changes in regulatory policies and principles, or the interpretation of regulatory capital or other rules including changes related to Basel III;
-

monetary and fiscal policies of the Board of Governors of the Federal Reserve System ("Federal Reserve") and the U.S. Government and other governmental initiatives affecting the financial services industry;

- our ability to retain or attract key employees or members of our senior management team;
- costs and effects of litigation, including settlements and judgments;
- our ability to implement our business strategies;
- difficulties in reducing risks associated with the loans on our balance sheet;
- staffing fluctuations in response to product demand or the implementation of corporate strategies that affect our workforce and potential associated charges;

our ability to pay dividends on our common stock;
the availability of resources to address changes in laws, rules, or regulations or to respond to regulatory actions;
our ability to pay dividends on our common stock;
the possibility of other-than-temporary impairments of securities held in our securities portfolio;
adverse changes in the securities markets; and
other economic, competitive, governmental, regulatory, and technological factors affecting our operations, pricing, products and services and the other risks described from time to time in this Form 10-K and our other filings with the U.S. Securities and Exchange Commission (the "SEC").

We wish to advise readers not to place undue reliance on any forward-looking statements and that the factors listed above could materially affect our financial performance and could cause our actual results for future periods to differ materially from any such forward-looking statements expressed with respect to future periods and could negatively affect our stock price performance.

We do not undertake and specifically decline any obligation to publicly release the result of any revisions which may be made to any forward-looking statements to reflect events or circumstances after the date of such statements or to reflect the occurrence of anticipated or unanticipated events.

General

References in this document to Sound Financial Bancorp or the Company refer to Sound Financial Bancorp, Inc. and references to the "Bank" refer to Sound Community Bank. References to "we," "us," and "our" means Sound Financial Bancorp and its wholly-owned subsidiary, Sound Community Bank, unless the context otherwise requires.

Sound Financial Bancorp, a Maryland corporation, is a bank holding company for its wholly owned subsidiary, Sound Community Bank. Substantially all of Sound Financial Bancorp's business is conducted through Sound Community Bank, a Washington state-chartered commercial bank. As a Washington commercial bank, the Bank's regulators are the Washington State Department of Financial Institutions ("WDFI") and the Federal Deposit Insurance Corporation ("FDIC"). The Federal Reserve is the primary federal regulator for Sound Financial Bancorp. We also sell insurance products and services for consumer clients through Sound Community Insurance Agency, Inc., a wholly owned subsidiary of the Bank.

Sound Community Bank's deposits are insured up to applicable limits by the FDIC. At December 31, 2018, Sound Financial Bancorp had total consolidated assets of \$716.7 million, loans held for portfolio of \$619.5 million, deposits of \$553.6 million and stockholders' equity of \$71.6 million. The shares of Sound Financial Bancorp are traded on The NASDAQ Capital Market under the symbol "SFBC." Our executive offices are located at 2400 3rd Avenue, Suite 150, Seattle, Washington, 98121 and our telephone number is 206-448-0884.

Our principal business consists of attracting retail and commercial deposits from the general public and investing those funds, along with borrowed funds, in loans secured by first and second mortgages on one- to four- family residences (including home equity loans and lines of credit), commercial and multifamily real estate, construction and land, consumer and commercial business loans. Our commercial business loans include unsecured lines of credit and secured term loans and lines of credit secured by inventory, equipment and accounts receivable. We also offer a variety of secured and unsecured consumer loan products, including manufactured home loans, floating home loans, automobile loans, boat loans and recreational vehicle loans. As part of our business, we focus on residential mortgage loan originations, a portion of which we sell to Fannie Mae and the remainder of which we retain for our loan portfolio consistent with our asset/liability objectives. We sell loans which conform to the underwriting standards of Fannie Mae ("conforming") in which we retain the servicing of the loan in order to maintain the direct customer relationship and to generate noninterest income. Residential loans which do not conform to the underwriting standards of Fannie Mae ("non-conforming"), are either held in our loan portfolio or sold with servicing released. We originate and retain a significant amount of commercial real estate loans, including those secured by owner-occupied and nonowner-occupied commercial real estate, multifamily property, mobile home parks and construction and land development loans.

Market Area

We serve the Seattle Metropolitan Statistical Area ("MSA"), which includes King County (which includes the city of Seattle), Pierce County and Snohomish County within the Puget Sound region, and also serve Clallam and Jefferson

Counties, on the North Olympic Peninsula of Washington. We serve these markets through our headquarters in Seattle, eight branch offices, five of which are located in the Seattle MSA, two that are located in Clallam County and one that is located in Jefferson County. We also have two loan production offices, one located in the Madison Park neighborhood of Seattle and one located in Sequim. Based on the most recent branch deposit data provided by the FDIC, our share of deposits was approximately 0.14% in King

County, approximately 0.41% in Pierce County and in Snohomish County approximately 0.33%. In Clallam County and Jefferson County, we have approximately 16.5% and 6.8%, respectively, of the deposits in those markets. See "– Competition."

Our market area includes a diverse population of management, professional and sales personnel, office employees, health care workers, manufacturing and transportation workers, service industry workers and government employees, as well as retired and self-employed individuals. The population has a skilled work force with a wide range of education levels and ethnic backgrounds. Major employment sectors include information and communications technology, financial services, manufacturing, maritime, biotechnology, education, health and social services, retail trades, transportation and professional services. The largest employers headquartered in our market area include U.S. Joint Base Lewis-McChord, Navy Region Northwest, Microsoft, University of Washington, and Providence Health. Other significant employers include Costco, Boeing, Nordstrom, Amazon.com, Starbucks, Alaska Air Group and Weyerhaeuser.

Economic conditions in our markets continue to improve over the last year. Recent trends in housing prices and unemployment rates in our market areas reflect continuing improvement. For the month of December 2018, the preliminary Seattle metropolitan statistical area (MSA) reported an unemployment rate of 3.3%, as compared to the national average of 3.9%, according to the latest available information from the Bureau of Labor Statistics. Home prices in our markets also improved over the past year. Based on information from Case-Shiller, the average home price in the Seattle MSA increased 4.8% in 2018. This compares favorably to the national average home price index increase in 2018 of 4.5%.

King County has the largest population of any county in the state of Washington, covers approximately 2,100 square miles, and is located on Puget Sound. It has approximately 2.2 million residents and a median household income of approximately \$82,000. King County has a diversified economic base with many employers from various industries including shipping and transportation, retail, aerospace, and computer technology and biotech industries. Based on information from the Northwest Multiple Listing Service ("MLS"), the median home sales price in King County in December 2018 was \$597,000, a 2.1% increase from December 2017's median home sales price of \$585,000.

Pierce County covers approximately 1,700 square miles and is located along the southwestern Puget Sound and borders southern King County. It has approximately 861,000 residents and a median household income of approximately \$61,000. The Pierce County economy is diversified with the presence of military related government employment, transportation and shipping employment, and aerospace related employment. Based on information from the MLS, the median home sales price in Pierce County in December 2018 was \$340,000, a 7.9% increase from December 2017's median home sales price of \$315,000.

Snohomish County covers approximately 2,100 square miles and is located on Puget Sound touching the northern border of King County. It has approximately 789,000 residents and a median household income of approximately \$76,000. The economy of Snohomish County is diversified with the presence of military related government employment, aerospace related employment, and retail trade. Based on information from the MLS, the median home sales price in Snohomish County as of December 2018 was \$455,000, a 7.0% increase from December 2017's median home sales price of \$425,000.

Clallam County, with a population of approximately 75,000, is bordered by the Pacific Ocean and the Strait of Juan de Fuca and covers 1,700 square miles, including the westernmost portion of the continental United States. It has a median household income of approximately \$47,000. The economy of Clallam County is primarily manufacturing and shipping. The Sequim Dungeness Valley continues to be a growing retirement location. Our offices are in Port Angeles and Sequim, the two largest cities in the county. Based on information from the MLS, the median home sales price in Clallam County in December 2018 was \$270,000, an 8.3% decrease from December 2017's median home sales price of \$295,000.

Jefferson County, with a population of approximately 31,000, is bordered by Clallam County and the Pacific Ocean to the west and Hood Canal on the east and covers 1,800 square miles. The economy of Jefferson County is primarily based on tourism, agriculture, lumber, fish processing and ship repair and maintenance. It has a median household income of approximately \$49,000. Based on information from the MLS, the average home sales price in Jefferson County as of December 2018 was \$335,000, a 7.5% decrease from December 2017's median home sales price of \$362,000.

According to the latest available information from the Bureau of Labor Statistics, King and Snohomish Counties reported an unemployment rate of 3.3% and 3.6%, respectively, as of December 2018, as compared to the state and national unemployment rates of 4.3% and 3.9%, respectively. The unemployment rates for Clallam, Pierce and Jefferson Counties were above the state and national rates as of December 2018. The unemployment rate in Clallam County decreased to 6.9% as of December 2018 from 7.0% as of December 2017, while the unemployment rate in Pierce County decreased to 5.3% as of December 2018 from 5.4% as of December 2017. The unemployment rate in Jefferson County decreased to 5.9% as of December 2018 from 6.2% as of December 2017.

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Lending Activities

The following table presents information concerning the composition of our loan portfolio, excluding loans held-for-sale, by the type of loan for the dates indicated (dollars in thousands):

	December 31,		2017		2016		2015		2014	
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
Real estate loans:										
One- to four-family	\$ 169,830	27.3 %	\$ 157,417	28.5 %	\$ 152,386	30.3 %	\$ 141,125	30.5 %	\$ 133,031	30.9 %
Home equity	27,655	4.4 %	28,379	5.2 %	27,771	5.5 %	31,573	6.9 %	34,675	8.0 %
Commercial and multifamily	252,644	40.6 %	211,269	38.4 %	181,004	36.1 %	175,312	38.0 %	168,952	39.1 %
Construction and land	65,259	10.6 %	61,482	11.2 %	70,915	14.1 %	57,043	12.4 %	46,279	10.7 %
Total real estate loans	515,388	82.9 %	458,547	83.3 %	432,076	86.0 %	405,053	87.8 %	382,937	88.7 %
Consumer loans:										
Manufactured homes	20,145	3.2 %	17,111	3.1 %	15,494	3.1 %	13,798	3.0 %	12,539	2.9 %
Floating homes	40,806	6.6 %	29,120	5.3 %	23,996	4.8 %	18,226	4.0 %	11,680	2.7 %
Other consumer	6,628	1.1 %	4,902	0.9 %	3,932	0.8 %	4,804	1.0 %	5,195	1.2 %
Total consumer loans	67,579	10.9 %	51,133	9.3 %	43,422	8.7 %	36,828	8.0 %	29,414	6.8 %
Commercial business loans	38,804	6.2 %	40,829	7.4 %	26,331	5.3 %	19,295	4.2 %	19,525	4.5 %
Total loans	621,771	100.00%	550,509	100.0%	501,829	100.0%	461,176	100.0%	431,876	100.0%
Less:										
Deferred fees and discounts	(2,228)		(1,914)		(1,828)		(1,707)		(1,516)	
Allowance for loan losses	(5,774)		(5,241)		(4,822)		(4,636)		(4,387)	
Total loans, net	\$ 613,769		\$ 543,354		\$ 495,179		\$ 454,833		\$ 425,973	

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The following table shows the composition of our loan portfolio in dollar amounts and in percentages by fixed and adjustable rate loans for the dates indicated (dollars in thousands):

	December 31,		2017		2016		2015		2014	
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
Fixed-rate loans:										
Real estate loans:										
One-to-four family	\$94,237	15.2 %	\$117,590	21.3 %	\$142,537	28.4 %	\$129,762	28.1 %	\$118,083	27.3 %
Home equity	11,052	1.8	11,373	2.1	9,102	1.8	11,042	2.4	12,003	2.8
Commercial and multifamily	102,907	16.5	89,094	16.2	77,285	15.4	92,205	20.0	103,303	23.9
Construction and land	51,259	8.2	57,247	10.4	69,398	13.9	51,572	11.2	39,147	9.1
Total real estate loans	259,455	41.7	275,304	50.0	298,322	59.5				