STERLING FINANCIAL CORP /WA/
Form S-4
September 15, 2003

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**As filed with the Securities and Exchange Commission on September 15, 2003.**

**Registration No. 333-**

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# UNITED STATES SECURITIES AND EXCHANGE COMMISSION

**Washington, D.C. 20549**

# FORM S-4

## REGISTRATION STATEMENT
## UNDER
## THE SECURITIES ACT OF 1933

# STERLING FINANCIAL CORPORATION

(Exact name of registrant as specified in its charter)

| | | |
|---|---|---|
| **WASHINGTON** | **6719** | **91-1572822** |
| (State or other jurisdiction of incorporation or organization) | (Primary Standard Industrial Classification Code Number) | (I.R.S. Employer Identification No.) |

**111 North Wall Street**
**Spokane, Washington 99201**
**(509) 458-2711**

(Address, including zip code, and telephone number, including area code, of registrant's principal executive offices)

**Ned M. Barnes, Secretary**
**Sterling Financial Corporation**
**111 North Wall Street**
**Spokane, Washington 99201**
**(509) 458-2884**

(Name, address, including zip code, and telephone number, including area code, of agent for service)

**Copies of communications to:**

| | |
|---|---|
| **Donald J. Lukes, Esq.**<br>**Richard A. Repp, Esq.**<br>**Witherspoon, Kelley, Davenport & Toole, P.S.**<br>**1100 U.S. Bank Building**<br>**422 West Riverside Avenue**<br>**Spokane, Washington 99201**<br>**(509) 624-5265** | **John F. Breyer, Jr., Esq.**<br>**Breyer & Associates PC**<br>**8180 Greensboro Drive**<br>**Suite 785**<br>**McLean, Virginia 22102**<br>**(703) 883-1100** |

**Approximate date of commencement of proposed sale of the securities to public:** As soon as practicable after the effective date of this registration statement and the satisfaction or waiver of all other conditions to the merger described in the joint proxy statement/prospectus.

If the securities being registered on this Form are being offered in connection with the formation of a holding company and there is compliance with General Instruction G check the following box: o

If this Form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. o

If this Form is a post-effective amendment filed pursuant to Rule 462(d) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. o

**CALCULATION OF REGISTRATION FEE**

| Title of each class of securities to be registered | Amount to be registered(1) | Proposed maximum offering price per unit | Proposed maximum aggregate offering price(2) | Amount of registration fee(2) |
|---|---|---|---|---|
| Common Stock, par value $1.00 per share | 5,870,153 | N/A | $165,888,992 | $13,421 |

(1) Represents the maximum number of shares of common stock of Sterling Financial Corporation issuable or reserved for issuance upon consummation of the merger described herein.

(2) Pursuant to Rule 457(c) and 457(f), the registration fee is based on the high and low prices of Klamath First Bancorp, Inc. common stock as reported by Nasdaq on September 12, 2003 ($21.76) multiplied by 7,623,575 (the maximum number of shares of Klamath common stock to be converted in the merger).

**The registrant hereby amends this registration statement on such date or dates as may be necessary to delay its effective date until the registrant shall file a further amendment which specifically states that this registration statement shall thereafter become effective in accordance with Section 8(a) of the Securities Act of 1933 or until the registration statement shall become effective on such date as the Commission, acting pursuant to said Section 8(a), may determine.**

The boards of directors of Sterling Financial Corporation and Klamath First Bancorp, Inc. have unanimously approved an agreement to combine our companies. In the merger, Klamath will merge into Sterling, with Sterling being the surviving corporation. Each share of Klamath common stock will be converted into 0.77 shares of Sterling common stock. The exchange ratio is fixed and will not be adjusted based on changes in the prices of our common stock prior to the closing, except under certain circumstances that are described in the accompanying joint proxy statement/prospectus.

The value of the merger consideration received by Klamath's shareholders will fluctuate with the market price of Sterling common stock.

- Based upon the closing price for Sterling common stock on July 14, 2003 (the day prior to the public announcement of the merger) of $26.55 per share, the 0.77 exchange ratio represented approximately $20.44 in value for each share of Klamath common stock.

- Based upon the closing price for Sterling common stock on [October 31, 2003], the 0.77 exchange ratio represented approximately [$     ] in value for each share of Klamath common stock.

We urge you to obtain current market price quotations for Sterling and Klamath common stock. Sterling common stock is quoted on the Nasdaq National Market under the symbol "STSA." Klamath common stock is quoted on the Nasdaq National Market under the symbol "KFBI." We expect that the merger will be a tax free transaction for Klamath's shareholders.

Each of our companies will hold a special meeting of shareholders to vote on the proposed merger. Your vote is very important. Whether or not you plan to attend your special meeting, please take the time to vote by completing and mailing the enclosed proxy card to us. The date of both the Sterling and Klamath special meetings is [December 11, 2003] and notices of both meetings follow this letter.

The accompanying joint proxy statement/prospectus gives you important information about the proposed merger and related matters. You should read this entire document carefully, including the section entitled "Risk Factors" beginning on page [    ], before you decide how to vote on the merger and the transactions contemplated by the merger agreement.

The respective boards of directors of Sterling and Klamath have unanimously determined that the terms of the merger agreement and the merger are fair to and in the best interests of their respective shareholders. The financial advisors for Sterling and Klamath have reached the same conclusion. We enthusiastically join the other members of our boards of directors in recommending that you vote FOR approval of the merger.

| | |
|---|---|
| Harold B. Gilkey | Kermit K. Houser |
| Chairman and Chief Executive Officer | President and Chief Executive Officer |
| Sterling Financial Corporation | Klamath First Bancorp, Inc. |

**Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved the Sterling common stock to be issued in the merger or determined if this joint proxy statement/prospectus is accurate or adequate. Any representation to the contrary is a criminal offense. The securities offered through this document are not deposits, savings accounts or other obligations of a depository institution and are not insured by the Federal Deposit Insurance Corporation or any other governmental agency.**

This joint proxy statement/prospectus is dated [October    , 2003] and is first being mailed to shareholders on or about [November    , 2003].

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**REFERENCES TO ADDITIONAL INFORMATION**

This joint proxy statement/prospectus incorporates important business and financial information about Sterling and Klamath from other documents that are not included in or delivered with this document. This information is available to you without charge upon written or oral request. You can obtain documents relating to Sterling and Klamath that are incorporated by reference in this document through the SEC's website at *http://www.sec.gov* or by requesting them in writing or by telephone from the appropriate company:

| | |
|---|---|
| Sterling Financial Corporation | Klamath First Bancorp, Inc. |
| 111 North Wall Street | 540 Main Street |
| Spokane, Washington 99201 | Klamath Falls, Oregon 97601 |
| Attn: Investor Relations | Attn: Investor Relations |
| (509) 458-2711 | (541) 882-3444 |

**If you would like to request documents please do so by [December 1, 2003], in order to receive them before the special meeting of shareholders. See "Where You Can Find More Information" on page [    ].**

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**STERLING FINANCIAL CORPORATION**
**NOTICE OF SPECIAL MEETING OF SHAREHOLDERS**
**TO BE HELD ON DECEMBER 11, 2003**

A special meeting of shareholders of Sterling Financial Corporation will be held on the third floor of the headquarters of Sterling Financial Corporation located at 111 North Wall Street, Spokane, Washington, on [Thursday, December 11, 2003,] at 10:00 a.m., local time, for the following purposes:

1. To consider and vote upon a proposal to approve the Agreement and Plan of Merger dated as of July 14, 2003, by and between Sterling Financial Corporation and Klamath First Bancorp, Inc., a copy of which is attached as Annex A to the accompanying joint proxy statement/prospectus, pursuant to which Klamath will merge into Sterling on the terms and subject to the conditions contained in the merger agreement.

2. To transact such other business as may properly come before the special meeting or any adjournments thereof.

We have fixed October 13, 2003 as the record date for determining those shareholders entitled to vote at the special meeting and any adjournments or postponements of the special meeting. Accordingly, only shareholders of record at the close of business on that date are entitled to notice of, and to vote at, the special meeting and any adjournments or postponements of the special meeting.

YOUR VOTE IS IMPORTANT REGARDLESS OF THE NUMBER OF SHARES YOU OWN OR WHETHER OR NOT YOU PLAN TO ATTEND THE SPECIAL MEETING. EVEN IF YOU EXPECT TO ATTEND THE SPECIAL MEETING, WE URGE YOU TO COMPLETE, SIGN AND DATE THE ENCLOSED PROXY CARD AND RETURN IT PROMPTLY IN THE POSTAGE-PAID ENVELOPE.

By Order of the Board of Directors,

Ned M. Barnes
Secretary

Spokane, Washington
[October 31, 2003]

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**KLAMATH FIRST BANCORP, INC.**
**NOTICE OF SPECIAL MEETING OF SHAREHOLDERS**
**TO BE HELD DECEMBER 11, 2003**

NOTICE IS HEREBY GIVEN that a special meeting of shareholders of Klamath First Bancorp, Inc. will be held at the Ross Ragland Theater Cultural Center, 218 N. 7th Street, Klamath Falls, Oregon 97601, on [Thursday, December 11, 2003], at 10:00 a.m., for the following purposes:

1. To consider and vote upon a proposal to approve the Agreement and Plan of Merger dated as of July 14, 2003, by and between Sterling Financial Corporation and Klamath First Bancorp, Inc., a copy of which is attached as Annex A to the accompanying joint proxy statement/prospectus, pursuant to which Klamath will merge with and into Sterling on the terms and subject to the conditions contained in the merger agreement.

2. To consider and act upon such other matters as may properly come before the meeting or any adjournment thereof.

The proposed merger is discussed more fully in the joint proxy statement/prospectus attached to this notice. We urge you to read this document and its appendices carefully before voting.

Only Klamath shareholders of record at the close of business on October 13, 2003 are entitled to notice of and to vote at the special meeting, or any adjournment thereof. A majority of the shares of Klamath common stock outstanding on the record date must be voted in favor of the merger agreement in order for the merger to be completed. Therefore, your vote is very important.

All Klamath shareholders are cordially invited to attend the special meeting. However, we encourage you to vote by proxy so that your shares will be represented and voted at the meeting even if you cannot attend. You may vote by written proxy card using the instructions provided on the enclosed proxy card. Of course, this will not prevent you from voting in person at the meeting. Your failure to vote your shares is the same as voting against approval of the merger agreement.

After careful consideration, the board of directors of Klamath has determined that the merger and the merger agreement are fair and in the best interests of Klamath and its shareholders and unanimously recommends that Klamath shareholders vote FOR approval of the merger agreement.

By Order of the Board of Directors,

Craig M Moore
Secretary

Klamath Falls, Oregon
[October 31, 2003]
IMPORTANT: THE PROMPT RETURN OF PROXIES WILL SAVE THE COMPANY THE EXPENSE OF FURTHER REQUESTS FOR PROXIES. THEREFORE, PLEASE COMPLETE, SIGN AND DATE THE ENCLOSED PROXY CARD AND PROMPTLY RETURN IT. A SELF-ADDRESSED ENVELOPE IS ENCLOSED FOR YOUR CONVENIENCE. NO POSTAGE IS REQUIRED IF MAILED IN THE UNITED STATES.

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**QUESTIONS AND ANSWERS ABOUT THE MERGER**

**Q:**

**Why are the companies proposing to merge?**

A:

We are proposing to merge because we believe that the combined company will be a stronger, more competitive company. We also believe that the complementary distribution networks of our two companies will result in the combined company being a leading regional community bank in the Pacific Northwest. See "The Merger-Sterling's reasons for the merger" and "Klamath's reasons for the merger."

**Q:** **What will Klamath shareholders receive in the merger?**

A: Under the merger agreement, each outstanding share of Klamath common stock will be converted into 0.77 shares of Sterling common stock and cash in lieu of fractional shares.

**Q:** **What do I need to do now?**

A: First, please carefully read this joint proxy statement/prospectus. Then, whether or not you expect to attend your shareholders meeting, please mail your completed and signed proxy card in the enclosed return envelope as soon as possible so that your shares will be represented at your shareholders meeting. Your proxy card must be received prior to your shareholders meeting in order for your shares to be voted at your shareholders meeting, unless you attend and vote at your shareholders meeting. If you are able to attend your shareholders meeting, you may revoke your proxy and vote your shares in person even if you have previously completed and returned the proxy card. See "The Sterling Special Meeting" and "The Klamath Special Meeting" as applicable.

THE BOARDS OF DIRECTORS OF STERLING AND KLAMATH UNANIMOUSLY RECOMMEND THAT YOU VOTE "FOR" APPROVAL OF THE MERGER.

**Q:** **What vote is required to approve the merger?**

A: For the merger agreement to be approved by Sterling shareholders, a majority of the votes cast in person or by proxy at the special meeting must vote FOR approval of the merger agreement.

For the merger agreement to be approved by Klamath shareholders, a majority of all the votes entitled to be cast in person or by proxy at the special meeting must vote FOR approval of the merger agreement.

**Q:** **Can I dissent and require appraisal of my shares?**

A: Shareholders are not entitled to dissenters' appraisal rights in connection with the merger.

**Q:** **What do I do if I want to change my vote?**

A: You can change your vote in one of three ways at any time before your proxy is voted at your special meeting. First, you can send Klamath or Sterling, as appropriate, a written notice stating that you would like to revoke your proxy. Second, you can complete and send a new proxy card. Third, you can attend your special meeting and vote in person. If you have voted through a broker, bank or other nominee, you must follow the directions you receive from such entity to change your vote.

**Q:** **If my shares are held in "street name" by my broker, will my broker vote my shares for me?**

A: Your broker will vote your shares only if you provide instructions on how to vote. You should fill out the voter instruction form sent to you by your broker with this joint proxy statement/prospectus. Klamath shareholders who do not give instructions to their broker will, in effect, be voting against the merger agreement.

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**Q:** **Should I send in my Klamath stock certificates now?**

A:

No. After the merger is completed, we will send you written instructions for exchanging your Klamath stock certificates for Sterling stock certificates. Please do not send in your stock certificates with your proxy card. Sterling shareholders will continue to hold their certificates.

**Q:**

**When do you expect the merger to be completed?**

A:

We are working toward completing the merger as quickly as possible. We hope to complete the merger in early January 2004, if all required matters have been completed at that time.

**Q:**

**Will I recognize a taxable gain or loss on the transaction?**

A:

We expect that if the merger is completed, you will not recognize a gain or loss for United States federal income tax purposes as a result of the merger, except that Klamath shareholders will recognize a gain or loss with respect to cash received in lieu of a fractional share of Sterling common stock. However, we urge you to consult your own tax advisor to determine the tax consequences particular to your situation.

**Q:**

**Whom should I call with questions?**

A:

If you have any questions or if you need additional copies of the joint proxy statement/prospectus or other information, you should contact:

| | |
|---|---|
| Klamath First Bancorp, Inc.<br>Investor Relations<br>540 Main Street<br>Klamath Falls, OR 97601<br>(541) 882-3444 | Sterling Financial Corporation<br>Investor Relations<br>111 North Wall Street<br>Spokane, WA 99201<br>(509) 458-2711 |

You may also obtain additional information about Sterling and Klamath from documents we file with the Securities and Exchange Commission. See "Where You Can Find More Information" on page [ ].

**Q:**

**Are there any risks related to the proposed transaction or any risks related to owning Sterling common stock?**

A.

Yes. You should carefully review the section entitled "Risk Factors" beginning on page [ ] of this joint proxy statement/prospectus.



**SUMMARY OF THIS JOINT PROXY STATEMENT/PROSPECTUS**

This summary and the preceding "Questions and Answers about the Merger" highlight selected information from this joint proxy statement/prospectus and may not contain all of the information that is important to you. To understand the merger fully and for a more complete description of the legal terms of the merger, you should carefully read this entire joint proxy statement/prospectus and the other documents to which we refer you. See "Where You Can Find More Information" on page [ ]. We have included page references in parentheses to direct you to a more complete description of some of the topics presented in this summary.

**The Companies**

Sterling Financial Corporation
111 North Wall Street
Spokane, Washington 99201
(509) 458-2711
www.sterlingsavingsbank.com

Sterling Financial Corporation is a unitary savings and loan holding company, the significant operating subsidiary of which is Sterling Savings Bank. The principal operating subsidiaries of Sterling Savings Bank are Action Mortgage Company, INTERVEST-Mortgage Investment Company and Harbor Financial Services, Inc. Sterling Savings Bank commenced operations in 1983 as a Washington State-chartered, federally insured stock savings and loan association headquartered in Spokane, Washington.

Sterling provides personalized, quality financial services to its customers as exemplified by its "Hometown Helpful" philosophy. Sterling believes that this dedication to personalized service has enabled it to maintain a stable retail deposit base. With $4.09 billion in total assets at June 30, 2003, Sterling attracts Federal Deposit Insurance Corporation insured deposits from the general public through 83 retail branches located in Washington, Oregon, Idaho and Montana. Sterling originates loans through its branch offices as well as Action Mortgage residential loan production offices in the four-state area and through INTERVEST commercial real estate lending offices in Washington and Oregon. Sterling also markets tax-deferred annuities, mutual funds and other financial products through Harbor Financial and property and casualty insurance coverage through Dime Insurance Agency, a subsidiary of Sterling Savings Bank.

For additional information about Sterling's business, see Sterling's Annual Report on Form 10-K for the year ended December 31, 2002 and Quarterly Reports on Form 10-Q for the quarters ended March 31, 2003 and June 30, 2003 and other documents Sterling has filed with the SEC, which are incorporated into this joint proxy statement/prospectus by reference. See "Where You Can Find More Information" on page [ ].

Klamath First Bancorp, Inc.
540 Main Street
Klamath Falls, Oregon 97601
(541) 882-3444
www.Klamathfirst.com

Klamath First Bancorp, Inc. is a unitary savings and loan holding company, the significant subsidiary of which is Klamath First Federal Savings and Loan Association.

Klamath First Federal is a progressive, community-oriented savings and loan association that focuses on customer service within its primary market area. Klamath First Federal is primarily engaged in attracting deposits from the general public and using those and other available sources of funds to originate permanent residential one-to four-family real estate loans and loans on commercial real estate, multi-family residential properties, and to consumers and small businesses within its market



area. While Klamath First Federal has historically emphasized fixed rate mortgage lending, it has been diversifying its loan portfolio by focusing on increasing the number of originations of commercial real estate loans, multi-family residential loans, residential construction loans, commercial and industrial loans, business loans and non-mortgage consumer loans. A significant portion of these newer loan products carry adjustable rates, higher yields, or shorter terms than the traditional fixed rate mortgages. This lending strategy is designed to enhance earnings, reduce interest rate risk, and provide a more complete range of financial services to customers and the local communities served.

At June 30, 2003, Klamath had total consolidated assets of $1.45 billion, consolidated shareholders' equity of $121.5 million and 59 offices. In September 2003, Klamath announced that it had entered into an agreement to sell seven of its branches with aggregate deposits of approximately $66 million. The sale of such branches is expected to be completed in December 2003.

For additional information about Klamath's business, see Klamath's Annual Report on Form 10-K for the year ended September 30, 2002 and Quarterly Reports on Form 10-Q for the quarters ended December 31, 2002, March 31, 2003 and June 30, 2003, and other documents Klamath has filed with the SEC, which are incorporated into this joint proxy statement/ prospectus by reference. See "Where You Can Find More Information" on page [ ].

**Summary of the Transaction**

**The merger (page [ ]).**

In the merger, Klamath will merge with and into Sterling. The merger agreement is attached to this joint proxy statement/prospectus as Annex A and is incorporated herein by reference. We encourage you to carefully read the merger agreement and the discussion of the merger and merger agreement in this joint proxy statement/prospectus.

**Our reasons for the merger (pages [ ] and [ ]).**

We are proposing to merge our two companies because we believe that:

- the combined company will be positioned to compete successfully in a consolidating financial services industry and will be able to achieve financial performance beyond what our two companies could achieve separately;
- the combined company has good prospects for improved performance as the result of economies of scale and a broader distribution network;
- Klamath and its shareholders will benefit from a business combination with Sterling and mitigate the risks of continuing to operate as a stand-alone entity, including the risks related to transitioning to a commercial bank strategy; and
- When the merger was publicly announced, the exchange ratio represented a premium over the market price for shares of Klamath common stock existing before the public announcement of the merger; and
- Klamath shareholders will receive the merger consideration on a tax-deferred basis.

These potential benefits, however, may not be achieved. For a more complete description of the factors considered by the respective boards of directors, see "The Merger-Sterling's reasons for the merger" and "Klamath's reasons for the merger." In addition, there are potential risks related to the merger. See "Risk Factors" on page [ ] and "Forward-Looking Information" on page [ ].



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**Our boards of directors recommend that you vote for the merger (pages [ ] and [ ]).**

The Sterling and the Klamath boards of directors believe that the merger is fair to and in the best interests of their respective shareholders. The Sterling board and the Klamath board have each, by unanimous votes of their members, approved the merger agreement and the transactions contemplated thereby and unanimously recommends that you vote FOR the approval of the merger agreement.

**Our financial advisors say the merger consideration is fair (pages [ ] and [ ]; Annexes B and C).**

In deciding to approve the merger, Klamath's board of directors considered a written opinion, dated July 14, 2003, from its financial advisor, D.A. Davidson & Co., Inc. ("Davidson"), that the consideration to be received in the merger was fair from a financial point of view to holders of Klamath common stock.

In deciding to approve the merger, Sterling's board of directors considered a written opinion, dated July 14, 2003, from its financial advisor, Sandler O'Neill & Partners, L.P. ("Sandler O'Neill"), that the exchange ratio was fair to Sterling from a financial point of view.

**The exchange ratio (page [ ]).**

Pursuant to the merger agreement, each share of Klamath common stock will be converted into 0.77 shares of Sterling common stock. Instead of issuing fractional shares of stock, Sterling will pay cash for fractional shares based on the average closing price of Sterling common stock over a specified period of time before the closing of the merger.

**Possible adjustment of exchange ratio ([page [ ]).**

If the average closing price of Sterling's common stock during a specified period just prior to the closing date is less than $20.53 and the price has also declined since June 13, 2003 by 15% or more relative to a weighted average index of a certain group of financial institution holding companies, Klamath has the right to terminate the merger agreement under certain conditions. Sterling, however, will then have the option to avoid the termination by increasing the number of shares of Sterling common stock to be exchanged for shares of Klamath common stock.

**Special shareholders meetings (page [ ]).**

Klamath. The special meeting of Klamath's shareholders will be held on [Thursday, December 11, 2003], at 10:00 a.m., local time, at the Ross Ragland Theater Cultural Center, 218 N. 7th Street, Klamath Falls, Oregon. At the meeting, you will be asked to approve the merger agreement for the merger of Klamath with and into Sterling. You can vote at the special meeting only if you owned shares of Klamath common stock at the close of business on October 13, 2003, the record date.

Sterling. The special meeting of Sterling's shareholders will be held on [Thursday, December 11, 2003], at 10:00 a.m. local time, at the headquarters of Sterling, 111 North Wall Street, Spokane, Washington, on the third floor. At the meeting, you will be asked to approve the merger agreement for the merger of Klamath with and into Sterling. You can vote at the special meeting only if you owned shares of Sterling common stock at the close of business on October 13, 2003, the record date.

**Votes required for approval (page [ ]).**

Klamath. For the merger agreement to be approved by Klamath shareholders, a majority of all the votes entitled to be cast in person or by proxy at the special meeting must vote FOR approval of the merger agreement. Klamath's shareholders are entitled to cast one vote for each share of Klamath common stock they owned as of the record date. For a discussion of a certain limitation on voting rights, see "The Klamath Special Meeting-Record date; outstanding shares; shares entitled to vote."



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Sterling. For the merger to be approved by Sterling shareholders, a majority of the votes cast in person or by proxy by Sterling shareholders at the special meeting must vote FOR approval of the merger agreement. Sterling's shareholders are entitled to cast one vote for each share of Sterling common stock they owned as of the record date. As of the record date, Sterling's directors and executive officers collectively owned [ ] shares of Sterling common stock, or approximately [ ] percent of Sterling's outstanding shares.

**Klamath's directors and certain executive officers have agreed to vote in favor of the merger agreement (page [ ]).**

As a condition to the merger, Klamath's directors and certain executive officers, who collectively held approximately [ ] percent of Klamath's outstanding common stock as of October 13, 2003, the record date, have agreed to vote all the shares of Klamath common stock beneficially owned by them in favor of approval of the merger agreement.

**Interests of Klamath's directors and executive officers in the merger (page [ ]).**

When considering the recommendation of Klamath's board of directors, you should be aware that some of Klamath's directors and executive officers have interests in the merger that are different from, or in addition to, yours. These include indemnification rights, board appointments, and acceleration of vesting for options and restricted stock, and other benefits and payments under agreements and employee benefit and retention plans. Klamath's board of directors was aware of and considered the interests of Klamath's directors and executive officers in approving the merger and recommending that Klamath's shareholders approve the merger.

**The merger will generally be tax-free to shareholders (page [ ]).**

Sterling and Klamath intend the merger to qualify as a tax-free reorganization under the Internal Revenue Code. It is a condition to the completion of the merger that both parties receive an opinion from their tax counsel that the merger will so qualify. We expect that none of Klamath, Sterling or their respective shareholders will recognize a gain or loss for United States federal income tax purposes, except for taxes payable by Klamath shareholders for cash received instead of fractional shares of Sterling common stock. Because tax matters are complicated, however, we urge you to consult your own tax advisor to understand fully how the merger will affect you, including how any state, local or foreign tax laws may apply to you.

**Accounting treatment of the merger (page [ ]).**

Sterling expects to account for the merger using the purchase method of accounting in accordance with generally accepted accounting principles.

**Certain conditions must be met prior to completion of the merger (page [ ]).**

Klamath's and Sterling's respective obligations to effect the merger are subject to the prior satisfaction or waiver of specific conditions including the approval of the merger by shareholders of Sterling and Klamath.

**The merger agreement may be terminated (page [ ]).**

Even if Klamath's shareholders approve the merger, Sterling and Klamath can agree at any time to terminate the merger agreement without completing the merger. In addition, subject to qualifications, the merger agreement may be terminated by either Klamath or Sterling if certain conditions occur.



**Termination fees may become payable (page [ ]).**

Klamath must pay Sterling a termination fee of up to $6.0 million if the merger agreement is terminated under certain conditions. Sterling must pay Klamath a termination fee of $1.5 million if the merger agreement is terminated under certain conditions.

**Differences in rights of Klamath and Sterling shareholders (page [ ]).**

The rights of Klamath's shareholders are governed by Oregon law and Klamath's articles of incorporation and bylaws. When the merger is completed, Klamath's shareholders will become shareholders of Sterling. Because Sterling is a Washington corporation, the rights of Klamath's shareholders will be governed following the merger by Washington law and by Sterling's articles of incorporation and bylaws, which differ in some respects from Klamath's.

**Treatment of options (page [ ]).**

Pursuant to the terms of Klamath's stock option plan, as a result of the merger, each outstanding option to purchase shares of Klamath common stock will be converted into the right to purchase a number of shares of Sterling common stock, based upon the exchange ratio.

**Treatment of employee benefit plans (page [ ]).**

Klamath has agreed to terminate or withdraw from all of Klamath's employee benefit plans, except for the Klamath 401(k) Plan, at or as soon as reasonably practicable after the effective time of the merger. Sterling has agreed to merge the Klamath 401(k) Plan into Sterling's 401(k) Plan. Sterling will also offer Klamath employees who remain at Sterling benefits commensurate with the benefits it provides to comparable Sterling employees.

**Comparative common stock price and dividend information (page [ ]).**

Shares of both Sterling common stock and Klamath common stock are listed on the Nasdaq National Market under the symbols "STSA" and "KFBI," respectively. On July 14, 2003, the last full trading day before the public announcement of the proposed merger, Sterling's common stock closed at $26.55 per share and Klamath's common stock closed at $17.45 per share. On [October 31, 2003], a date just prior to the time of the printing of this joint proxy statement/prospectus, Sterling's common stock closed at [$ ] per share and Klamath's common stock closed at [$ ] per share. We urge you to obtain current market quotations.



**Selected Financial Data of Sterling**

The following tables set forth selected historical consolidated financial and other data of Sterling as of and for the five years ended December 31, 2002 and as of and for the six months ended June 30, 2003 and 2002. The historical consolidated financial data for the six months ended June 30, 2003 and 2002 is derived from unaudited consolidated financial statements. However, in the opinion of management, all adjustments, consisting of normal recurring accruals, necessary for a fair presentation at such dates and for such periods have been made. Operating results for the six months ended June 30, 2003 are not necessarily indicative of the results that may be expected for any interim period or the entire year ending December 31, 2003. The financial information for the five years ended December 31, 2002 is based on, and qualified in its entirety by, the consolidated financial statements of Sterling, including the notes thereto, which are incorporated by reference in this joint proxy statement/prospectus and should be read in conjunction herewith.

| | June 30, | | December 31, | | | | |
|---|---|---|---|---|---|---|---|
| | 2003 | 2002 | 2002 | 2001 | 2000 | 1999 | 1998 |
| | (Dollars in thousands) | | | | | | |
| BALANCE SHEET DATA | | | | | | | |
| Total assets | $ 4,094,587 | $ 3,088,078 | $ 3,506,064 | $ 3,038,593 | $ 2,652,709 | $ 2,546,925 | $ 2,314,587 |
| Loans receivable, net | 2,668,990 | 2,173,176 | 2,390,263 | 2,109,479 | 1,965,927 | 1,787,771 | 1,468,534 |
| Asset-backed securities | 980,791 | 580,042 | 743,610 | 617,569 | 314,434 | 343,310 | 405,725 |
| Investments | 95,912 | 78,080 | 86,558 | 76,479 | 171,748 | 162,420 | 180,680 |
| Deposits | 2,393,707 | 1,979,219 | 2,014,096 | 1,853,536 | 1,724,219 | 1,617,368 | 1,545,425 |
| FHLB Seattle advances | 995,119 | 620,249 | 874,515 | 633,054 | 530,652 | 490,503 | 319,540 |
| Reverse repurchase agreements | 276,958 | 151,258 | 249,769 | 118,549 | 110,326 | 179,515 | 195,074 |
| Other borrowings | 139,782 | 119,000 | 127,682 | 127,500 | 110,000 | 110,000 | 97,240 |
| Shareholders' equity | 246,343 | 186,778 | 203,656 | 165,690 | 141,338 | 117,639 | 119,017 |
| CAPITAL RATIOS(1) | | | | | | | |
| Core capital ratio | 7.43% | 8.22% | 7.57% | 8.00% | 7.10% | 6.77% | 6.39% |
| Tier I risk-based capital ratio | 10.10% | 10.55% | 10.03% | 10.83% | 9.71% | 9.50% | 9.40% |
| Total risk-based capital ratio | 11.05% | 11.44% | 10.96% | 11.69% | 10.25% | 10.36% | 10.30% |
| STATISTICAL DATA | | | | | | | |
| Number of: | | | | | | | |
| Employees (full time equivalents) | 1,058 | 944 | 953 | 890 | 822 | 817 | 746 |
| Full service offices | 83 | 77 | 79 | 77 | 77 | 77 | 77 |

(1) For Sterling Savings Bank.



**Selected Operating Data of Sterling(1)(2)**

| | Six Months Ended June 30, | | Years Ended December 31, | | | | |
|---|---|---|---|---|---|---|---|
| | 2003 | 2002 | 2002 | 2001 | 2000 | 1999 | 1998 |
| | (Dollars in thousands, except per share amounts) | | | | | | |
| OPERATING RESULTS | | | | | | | |
| Interest income | $ 104,136 | $ 95,867 | $ 197,313 | $ 201,385 | $ 205,310 | $ 177,109 | $ 155,763 |
| Interest expense | (45,525) | (49,110) | (96,965) | (116,516) | (125,544) | (102,004) | (96,558) |
| Net interest income | 58,611 | 46,757 | 100,348 | 84,869 | 79,766 | 75,105 | 59,205 |
| Provision for losses on loans | (4,800) | (4,313) | (11,867) | (8,000) | (4,600) | (3,900) | (5,325) |

| | Six Months Ended June 30, | | Years Ended December 31, | | | | |
|---|---|---|---|---|---|---|---|
| | | | | | | | |
| Net interest income after provision for losses on loans | 53,811 | 42,444 | 88,481 | 76,869 | 75,166 | 71,205 | 53,880 |
| Other income | 16,798 | 12,574 | 29,080 | 21,021 | 14,488 | 13,562 | 12,313 |
| Merger, acquisition and conversion costs | (188) | 0 | 0 | (283) | 0 | 0 | (5,464) |
| Amortization of goodwill and other intangibles | (105) | (644) | (644) | (5,377) | (5,490) | (5,692) | (3,971) |
| Goodwill litigation | (314) | (520) | (1,100) | (890) | (1,074) | (272) | 0 |
| Other operating expenses | (43,408) | (38,255) | (79,199) | (66,743) | (61,404) | (58,514) | (46,856) |
| Income before income taxes | 26,594 | 15,599 | 36,618 | 24,597 | 21,686 | 20,289 | 9,902 |
| Income tax provision | (9,294) | (4,282) | (11,031) | (8,409) | (8,033) | (7,470) | (3,679) |
| Net income | $ 17,300 | $ 11,317 | $ 25,587 | $ 16,188 | $ 13,653 | $ 12,819 | $ 6,223 |
| Earnings per share-basic(1) | $ 1.21 | $ 0.88 | $ 1.96 | $ 1.34 | $ 1.15 | $ 1.08 | $ 0.53 |
| Earnings per share-diluted(1) | $ 1.18 | $ 0.85 | $ 1.91 | $ 1.31 | $ 1.15 | $ 1.08 | $ 0.52 |
| Weighted average shares outstanding basic(1) | 14,244,227 | 12,903,754 | 13,027,884 | 12,105,546 | 11,857,657 | 11,834,358 | 11,753,117 |
| Weighted average shares outstanding diluted(1) | 14,602,015 | 13,392,933 | 13,432,770 | 12,364,029 | 11,911,639 | 11,919,534 | 12,005,381 |
| FINANCIAL RATIOS(1) | | | | | | | |
| Return on average assets | 0.92% | 0.75% | 0.80% | 0.58% | 0.52% | 0.52% | 0.30% |
| Return on average shareholders' equity | 15.0% | 13.2% | 13.9% | 10.5% | 11.0% | 10.7% | 5.4% |
| Shareholders' equity to total assets at end of period | 6.0% | 6.1% | 5.8% | 5.5% | 5.3% | 4.6% | 5.1% |
| Book value per share at end of period | $ 16.67 | $ 14.22 | $ 15.48 | $ 12.99 | $ 11.92 | $ 9.93 | $ 10.09 |
| Operating efficiency | 58.4% | 66.4% | 62.5% | 69.2% | 72.1% | 72.7% | 78.7% |
| Net interest margin | 3.33% | 3.30% | 3.37% | 3.27% | 3.25% | 3.33% | 3.05% |
| Nonperforming assets to total assets at end of period | 0.77% | 0.94% | 0.59% | 0.82% | 0.56% | 0.65% | 0.40% |
| Reported net income | $ 17,300 | $ 11,317 | $ 25,587 | $ 16,188 | $ 13,653 | $ 12,819 | $ 6,223 |
| Add back: goodwill amortization, net of tax(3) | 0 | 0 | 0 | 2,538 | 2,494 | 2,621 | 1,595 |
| Total | $ 17,300 | $ 11,317 | $ 25,587 | $ 18,726 | $ 16,147 | $ 15,440 | $ 7,818 |
| Basic earnings per share: | | | | | | | |
| Reported net income | $ 1.21 | $ 0.88 | $ 1.96 | $ 1.34 | $ 1.15 | $ 1.08 | $ 0.53 |
| Goodwill amortization | 0.00 | 0.00 | 0.00 | 0.21 | 0.21 | 0.22 | 0.14 |
| Adjusted earnings per share | $ 1.21 | $ 0.88 | $ 1.96 | $ 1.55 | $ 1.36 | $ 1.30 | $ 0.67 |
| Diluted earnings per share: | | | | | | | |
| Reported net income | $ 1.18 | $ 0.85 | $ 1.91 | $ 1.31 | $ 1.15 | $ 1.08 | $ 0.52 |
| Goodwill amortization | 0.00 | 0.00 | 0.00 | 0.21 | 0.21 | 0.22 | 0.13 |

| | Six Months Ended June 30, | | Years Ended December 31, | | | | |
|---|---|---|---|---|---|---|---|
| Adjusted earnings per share | $ 1.18 | $ 0.85 | $ 1.91 | $ 1.52 | $ 1.36 | $ 1.30 | $ 0.65 |

(1) All prior period per common share and weighted average common share amounts have been restated to reflect the 10% common stock dividend distributed in 2003.



Excluding the interim selected financial data, for the six months ended June 30, 2003 and 2002, the selected financial data (except the ratios and statistical data) of Sterling for each of the periods has been derived from Sterling's consolidated financial statements. Such consolidated financial statements for the years ended December 31, 2002 and 2001 have been audited by BDO Seidman, LLP. The consolidated financial statements for the years ended December 31, 2000, 1999 and 1998 have been audited by PricewaterhouseCoopers LLP.

(2) Comparability could be affected by past acquisitions. On February 28, 2003, Sterling acquired Empire Federal Bancorp, Inc, which had approximately $227.0 million in total assets. On September, 30, 2001, Sterling acquired Source Capital Corporation, which had approximately $44.0 million in total assets. On November 13, 1998, Sterling acquired Big Sky Bancorp, Inc., which had approximately $66.0 million in total assets. On June 15, 1998, Sterling acquired 33 branch offices of KeyBank. As a result of this transaction, Sterling's total assets increased by approximately $197.0 million. The Big Sky Bancorp acquisition was accounted for under the pooling method. The remainder of the acquisitions were accounted for under the purchase accounting method.

(3) Sterling adopted SFAS No. 142 "Goodwill and Intangible Assets" on January 1, 2002. The tabular presentation reflects retroactive application of SFAS No. 142, even though SFAS No. 142 by its terms applies prospectively.



## Selected Financial Data of Klamath

The following tables set forth selected historical consolidated financial and other data of Klamath as of and for the five years ended September 30, 2002, and as of and for the nine months ended June 30, 2003 and 2002. The historical consolidated financial data for the nine months ended June 30, 2003 and 2002 is derived from unaudited consolidated financial statements. However, in the opinion of management, all adjustments, consisting of normal recurring accruals, necessary for a fair presentation at such dates and for such periods have been made. Operating results for the nine months ended June 30, 2003 are not necessarily indicative of the results that may be expected for any interim period or the entire year ended September 30, 2003. The financial information for the five years ended September 30, 2002 and the periods ended June 30, 2003 and 2002, is based on, and qualified in its entirety by, the consolidated financial statements of Klamath, including the notes thereto, which are incorporated by reference in this joint proxy statement/prospectus and should be read in conjunction herewith.

| | June 30, | | September 30, | | | | |
|---|---|---|---|---|---|---|---|
| | 2003(1) | 2002 | 2002 | 2001 | 2000 | 1999 | 1998 |
| | (Dollars in thousands) | | | | | | |
| FINANCIAL CONDITION DATA | | | | | | | |
| Assets | $ 1,449,887 | $ 1,465,883 | $ 1,513,495 | $ 1,468,572 | $ 995,575 | $ 1,041,641 | $ 1,031,302 |
| Cash and cash equivalents | 58,989 | 67,814 | 45,791 | 118,389 | 29,947 | 24,523 | 66,985 |
| Loans receivable, net | 555,287 | 626,490 | 607,465 | 679,990 | 729,037 | 739,793 | 668,146 |
| Investment securities held to maturity | | 457 | | 135 | 267 | 560 | 2,889 |
| Investment securities available for sale | 141,347 | 141,267 | 119,542 | 154,676 | 116,628 | 158,648 | 203,224 |

| | June 30, | | September 30, | | | | |
|---|---|---|---|---|---|---|---|
| Mortgage-backed & related securities held to maturity | | 378 | | 1,621 | 2,160 | 2,601 | 3,662 |
| Mortgage-backed & related securities available for sale | 591,058 | 538,726 | 650,796 | 421,638 | 75,331 | 72,695 | 43,336 |
| Stock in FHLB of Seattle, at cost | 14,152 | 13,309 | 13,510 | 12,698 | 11,877 | 10,957 | 10,173 |
| Advances from FHLB of Seattle | 208,000 | 158,000 | 205,250 | 168,000 | 173,000 | 197,000 | 167,000 |
| Deposit liabilities | 1,081,010 | 1,148,589 | 1,142,006 | 1,152,824 | 695,381 | 720,401 | 689,541 |
| Shareholders' equity | 121,477 | 115,492 | 119,938 | 114,141 | 108,725 | 109,585 | 145,081 |

| | Nine Months Ended June 30, | | Years Ended September 30, | | | | |
|---|---|---|---|---|---|---|---|
| | 2003(1) | 2002 | 2002 | 2001 | 2000 | 1999 | 1998 |
| | | | (Dollars in thousands, except per share data) | | | | |
| SELECTED OPERATING DATA | | | | | | | |
| Total interest income | $ 54,345 | $ 66,447 | $ 87,293 | $ 70,133 | $ 72,158 | $ 71,691 | $ 69,733 |
| Total interest expense | 22,398 | 30,824 | 39,531 | 40,751 | 40,756 | 38,382 | 37,848 |
| Net interest income | 31,947 | 35,623 | 47,762 | 29,382 | 31,402 | 33,309 | 31,885 |
| Provision for loan losses | | 156 | 156 | 387 | 1,764 | 932 | 674 |
| Net interest income after provision for loan losses | 31,947 | 35,467 | 47,606 | 28,995 | 29,638 | 32,377 | 31,211 |
| Non-interest income | 12,970 | 8,256 | 12,614 | 11,013 | 4,094 | 3,629 | 3,202 |
| Non-interest expense | 42,826 | 36,929 | 50,171 | 28,720 | 23,773 | 21,186 | 19,523 |
| Earnings before income taxes | 2,091 | 6,794 | 10,049 | 11,288 | 9,959 | 14,820 | 14,890 |
| Provision for income tax | 605 | 2,374 | 3,260 | 3,717 | 3,533 | 5,665 | 5,339 |
| Net earnings | $ 1,486 | $ 4,420 | $ 6,789 | $ 7,571 | $ 6,426 | $ 9,155 | $ 9,551 |
| Basic earnings per share | $ 0.23 | $ 0.69 | $ 1.06 | $ 1.14 | $ 0.94 | $ 1.21 | $ 1.05 |
| Weighted average shares basic | 6,508,796 | 6,418,168 | 6,411,351 | 6,627,200 | 6,822,025 | 7,564,415 | 9,115,404 |



**Selected Financial Data of Klamath** (continued)

| | Nine Months Ended June 30, | | Years Ended September 30, | | | | |
|---|---|---|---|---|---|---|---|
| | 2003(1) | 2002 | 2002 | 2001 | 2000 | 1999 | 1998 |
| | (Annualized) | (Annualized) | | | | | |
| KEY OPERATING RATIOS | | | | | | | |
| Performance Ratios | | | | | | | |
| Return on average assets (net earnings (loss) divided by average assets) | 0.13% | 0.40% | 0.46% | 0.72% | 0.62% | 0.88% | 0.96% |
| Return on average equity (net earnings (loss) divided by average equity) | 1.65% | 5.19% | 5.92% | 6.64% | 5.82% | 7.55% | 6.52% |
| Interest rate spread (difference between average yield on interest-earning assets and average cost of interest-bearing liabilities) | 2.72% | 3.03% | 3.04% | 2.18% | 2.50% | 2.73% | 2.57% |
| Net interest margin (net interest income as a percentage of average interest-earning assets) | 0.03% | 3.47% | 3.48% | 2.93% | 3.14% | 3.37% | 3.36% |
| Average interest-earning assets to average interest-bearing liabilities | 117.14% | 114.58% | 115.18% | 118.37% | 115.71% | 116.47% | 119.84% |
| Net interest income after provision for loan losses to total non-interest | 74.60% | 96.04% | 94.89% | 100.96% | 124.39% | 152.82% | 159.87% |

| | Nine Months Ended June 30, | | Years Ended September 30, | | | | |
|---|---|---|---|---|---|---|---|
| expenses | | | | | | | |
| Non-interest expense to average total assets | 3.79% | 3.33% | 3.37% | 2.74% | 2.29% | 2.05% | 1.96% |
| Efficiency ratio (non-interest expense divided by net interest income plus non-interest income) | 95.34% | 84.16% | 83.10% | 55.48% | 66.97% | 57.36% | 55.64% |
| Dividend payout ratio (dividends declared per share divided by net earnings per share) | 169.57% | 56.52% | 49.06% | 45.61% | 54.79% | 38.98% | 34.50% |
| Book value per share | $ 18.31 | $ 18.28 | $ 18.84 | $ 17.40 | $ 16.25 | $ 15.52 | $ 16.30 |
| Asset Quality Ratios | | | | | | | |
| Allowance for loan losses to total loans at end of period | 1.23% | 1.22% | 1.19% | 1.13% | 0.54% | 0.32% | 0.28% |
| Non-performing assets to total assets | 0.12% | 0.07% | 0.12% | 0.05% | 0.16% | 0.46% | 0.05% |
| Non-performing loans to total loans, before net items | 0.21% | 0.17% | 0.18% | 0.04% | 0.11% | 0.43% | 0.07% |
| Capital Ratios(2) | | | | | | | |
| Equity to assets ratio | 8.38% | 7.88% | 7.92% | 7.77% | 10.92% | 10.52% | 14.07% |
| Tangible capital ratio | 6.89% | 6.46% | 6.55% | 5.16% | 10.35% | 8.91% | 8.26% |
| Core capital ratio | 6.89% | 6.46% | 6.55% | 5.16% | 10.35% | 8.91% | 8.26% |
| Risk-based capital ratio | 12.95% | 13.52% | 14.01% | 10.36% | 20.30% | 17.41% | 16.13% |
| Other Data | | | | | | | |
| Number of loans outstanding | 10,660 | 12,183 | 11,835 | 12,624 | 8,807 | 9,297 | 9,155 |
| Number of deposit accounts | 125,971 | 130,516 | 131,001 | 111,542 | 85,706 | 85,112 | 82,585 |
| Number of full service offices | 59 | 57 | 57 | 52 | 35 | 34 | 34 |

(1) The results for the period ended June 30, 2003 reflect a non-cash charge to earnings of approximately $2.5 million after tax in connection with "other-than-temporary" impairment on two Federal Home Loan Mortgage Corporation and one Federal National Mortgage Association issues of variable rate non-cumulative preferred stock held in Klamath's available for sale investment portfolio. See Exhibit 99.1 of Klamath's report filed with the SEC on Form 8-K dated August 13, 2003.

(2) For Klamath First Federal Savings and Loan Association.



## Comparative Stock Price and Dividend Information

Klamath common stock is listed on the Nasdaq National Market under the symbol "KFBI." Sterling common stock is listed on the Nasdaq National Market under the symbol "STSA." The following table sets forth the high and low sale prices of shares of Sterling common stock and Klamath common stock as reported on the Nasdaq National Market, and the Klamath cash dividends declared per share for the dates indicated. Sterling has not declared cash dividends in the past. Sales prices in the table have been adjusted to reflect stock dividends.

| | Sterling Common Stock | | Klamath Common Stock | | |
|---|---|---|---|---|---|
| | High | Low | High | Low | Dividends |
| **2003** | | | | | |

| | Sterling Common Stock | | Klamath Common Stock | | |
|---|---|---|---|---|---|
| Quarter ended June 30 | $ 24.75 | $ 18.91 | $ 17.64 | $ 16.32 | $ 0.13 |
| Quarter ended March 31 | 19.30 | 17.01 | 17.75 | 15.86 | 0.13 |
| **2002** | | | | | |
| Quarter ended December 31 | $ 18.67 | $ 15.23 | $ 16.44 | $ 13.24 | $ 0.13 |
| Quarter ended September 30 | 18.45 | 14.43 | 16.25 | 13.35 | 0.13 |
| Quarter ended June 30 | 21.00 | 16.86 | 16.75 | 13.05 | 0.13 |
| Quarter ended March 31 | 18.80 | 12.19 | 13.67 | 13.00 | 0.13 |
| **2001** | | | | | |
| Quarter ended December 31 | $ 12.42 | $ 11.14 | $ 13.71 | $ 11.91 | $ 0.13 |
| Quarter ended September 30 | 13.04 | 10.86 | 15.22 | 12.60 | 0.13 |
| Quarter ended June 30 | 11.47 | 9.92 | 15.00 | 12.95 | 0.13 |
| Quarter ended March 31 | 10.21 | 8.61 | 14.13 | 11.94 | 0.13 |
| **2000** | | | | | |
| Quarter ended December 31 | N/A | N/A | $ 13.23 | $ 10.81 | $ 0.13 |

Pursuant to the merger agreement, Klamath may continue to pay quarterly cash dividends of up to $0.13 per share consistent with past practice, but may not declare other dividends without Sterling's written consent. Sterling has paid stock dividends in the past but has never paid cash dividends on its shares of common stock. The board of directors of Sterling is currently evaluating the payment of cash dividends in the future although it has reached no decision in this regard. The timing and amount of any future dividends will depend upon earnings, cash requirements, capital requirements, the financial condition of Sterling and its subsidiaries, applicable government regulations and other factors deemed relevant by Sterling's board of directors.

The following table presents closing sales prices for Sterling common stock and Klamath common stock on the Nasdaq National Market on July 14, 2003, which was the last full trading day prior to the public announcement of the signing of the merger agreement and [October ], 2003, which was the



last full trading day for which information was available prior to the date of the printing of this joint proxy statement/prospectus.

| | Closing Sales Price | | |
|---|---|---|---|
| | **Sterling** | **Klamath** | **Klamath Equivalent(1)** |
| Price per share: | | | |
| July 14, 2003 | $ 26.55 | $ 17.45 | $ 20.44 |
| [October ], 2003 | [ ] | [ ] | [ ] |

(1) The equivalent prices per share of Klamath common stock on the indicated dates were determined by multiplying the assumed exchange ratio of 0.77 by the closing price per share of the Sterling common stock on the indicated date.

We advise you to obtain current market quotations for Sterling common stock and Klamath common stock. Past price performance is not necessarily indicative of likely future performance. The market prices of Sterling common stock and Klamath common stock at any time before the merger, and the market price of Sterling common stock at any time after the merger, may fluctuate. The exchange ratio will not be adjusted for any increases or decreases in the market price of Sterling common stock that occur before the merger becomes effective.

**Selected Combined Consolidated Unaudited Pro Forma Financial Data**
**(In thousands, except shares and per share amounts)**

The following table shows information about Sterling's financial condition and operations, including per share data and financial ratios, after giving effect to the merger. This information is called pro forma information in this joint proxy statement/prospectus. The table sets forth the information as if the merger had become effective on June 30, 2003, with respect to financial condition data, and as of January 1, 2002 and carried through the interim period, with respect to operations data. Sterling's fiscal year end is December 31st and Klamath's fiscal year end is September 30th. Therefore, the information presented below for the twelve months includes Sterling's year ended December 31, 2002 and Klamath's year ended September 30, 2002. The six month periods presented below includes Sterling's six months ended June 30, 2003 and Klamath's six months ended March 31, 2003. The pro forma data in the tables assume that the merger is accounted for using the purchase method of accounting. This table should be read in conjunction with and is qualified in its entirety by, the historical financial statements, including the notes thereto, of Sterling and Klamath incorporated by reference herein and the more detailed pro forma financial information, including the notes thereto, appearing elsewhere in this joint proxy statement/prospectus. See "Where You Can Find More Information" on page [ ] and "Pro Forma Financial Information" on page [ ].

We anticipate that the merger will provide the combined company with financial benefits that include reduced operating expenses. The pro forma information, while helpful in illustrating the financial characteristics of the combined company under one set of assumptions, does not reflect the benefits of expected cost savings or opportunities to earn additional revenue and, accordingly, does not attempt to predict or suggest future results. It also does not necessarily reflect what the historical



results of the combined company would have been had our companies been combined during these periods.

| | June 30, 2003 |
|---|---|
| SELECTED STATEMENT OF FINANCIAL CONDITION DATA: | |
| Total assets | $ 5,607,986 |
| Asset-backed securities | 1,571,849 |
| Investments | 237,259 |
| Loans receivable, net | 3,274,902 |
| Deposits | 3,474,717 |
| Borrowed funds(1) | 1,674,202 |
| Shareholders' equity | 391,787 |

| | Six Months Ended June 30, 2003 | Year Ended December 31, 2002 |
|---|---|---|
| SELECTED STATEMENTS OF INCOME DATA: | | |
| Interest income | $ 141,134 | $ 284,606 |
| Interest expense | 59,417 | 132,879 |
| Net interest income | 81,717 | 151,727 |
| Provision for losses on loans | (4,800) | (12,023) |
| Net interest income after provision for losses on loans | 76,917 | 139,704 |
| Other operating income | 24,915 | 41,694 |
| Non-interest expense | 69,585 | 131,545 |
| Income before income tax expense | 32,247 | 49,853 |
| Income tax expense | (11,119) | (15,438) |
| Net income | $ 21,128 | $ 34,415 |

| | Six Months Ended June 30, 2003 | Year Ended December 31, 2002 |
|---|---|---|
| WEIGHTED AVERAGE COMMON SHARES: | | |
| Basic | 19,203,473 | 17,964,624 |
| Diluted | 19,678,516 | 18,434,303 |
| | | |
| PER COMMON SHARE DATA:(2) | | |
| Basic earnings | $ 1.10 | $ 1.92 |
| Diluted earnings | 1.07 | 1.87 |
| Cash dividends declared | 0.09 | 0.18 |
| Book value per share at end of period | 19.45 | N/A |
| | | |
| SELECTED FINANCIAL RATIOS:(2) | | |
| Return on average assets(3) | 0.81% | 0.74% |
| Return on average shareholders' equity(4) | 12.1 | 11.5 |
| Shareholders' equity to total assets | 7.0 | N/A |
| Efficiency ratio(5) | 65.3 | 68.0 |

(1) Borrowed funds includes $276,958 in Federal funds purchased and securities sold under agreements to repurchase; $1,230,157 in FHLB Seattle advances, and $167,087 in long-term debt.

(2) Per Common Share Data and Selected Financial Ratios are presented only for data relating to the pro forma combined condensed consolidated statements of income for the year ended December 31, 2002 and for the six months ended June 30, 2003 and data relating to the pro forma combined consolidated statement of financial condition at June 30, 2003.

(3) Calculated by dividing pro forma net income by pro forma average assets at the end of the period reported.

(4) Calculated by dividing pro forma net income by pro forma average shareholders' equity at the end of the period reported.

(5) Efficiency ratio represents pro forma operating expense, divided by the sum of pro forma net interest income plus other pro forma operating income.



**Selected Combined Consolidated Unaudited Pro Forma Comparative Per Share Data**

The following table sets forth for Sterling common stock and Klamath common stock certain historical, pro forma and pro forma-equivalent per share financial information. The pro forma and pro forma equivalent per share information gives effect to the merger as if the merger had been effective on the dates presented, in the case of the book value data presented, and as if the merger had become effective at the beginning of the periods presented, in the case of the earnings per common share and dividends declared data presented. The pro forma data in the tables assume that the merger is accounted for using the purchase method of accounting. See "Accounting treatment of the merger" on page [ ]. The information in the following table is based on, and should be read together with, the historical financial information that Sterling and Klamath have presented in prior filings with the SEC and the pro forma financial information that appears elsewhere in this document. See "Where You Can Find More Information" on page [ ] and "Pro Forma Financial Information" on page [ ].

We anticipate that the merger will provide the combined company with financial benefits that include reduced operating expenses. The pro forma information, while helpful in illustrating the financial characteristics of the combined company under one set of assumptions, does not reflect the benefits of expected costs savings or opportunities to earn additional revenue and, accordingly, does not attempt to predict or suggest future results. It also does not necessarily reflect what the historical results of the combined company would have been had our companies been combined during these periods.

| | Sterling Historical | Klamath Historical | Pro Forma Combined(2) | Per Equivalent Klamath Share(3) |
|---|---|---|---|---|
| Earnings for fiscal year 2002(1) | | | | |
| Basic | $ 1.96 | $ 1.06 | $ 1.92(4) | $ 1.48 |
| Diluted | 1.91 | 1.05 | 1.87(4) | 1.44 |
| Earnings for the first six months of fiscal year 2003(1) | | | | |
| Basic | 1.21 | 0.44 | 1.10 | 0.85 |
| Diluted | 1.18 | 0.43 | 1.07 | 0.82 |
| Cash dividends declared: | | | | |
| For fiscal year 2002(1) | 0.00 | 0.52 | 0.18(5) | 0.14 |
| For the first six months of fiscal year 2003(1) | 0.00 | 0.26 | 0.09(5) | 0.07 |
| Book value: | | | | |
| As of December 31, 2002 | 15.48 | 18.84 | N/A | N/A |
| As of June 30, 2003 | 16.67 | 18.31(6) | 19.45 | 14.98 |

(1) Sterling's fiscal year end is December 31. Klamath's fiscal year end is September 30.

(2) Amounts have been restated to reflect Sterling's 10% common stock dividend distributed in May 2003.

(3) Per equivalent Klamath share is pro forma combined multiplied by 0.77.

(4) The pro forma earnings per share amounts are calculated by totaling the historical net income (adjusted for pro forma adjustments) of Sterling and Klamath and dividing the resulting amount by the average pro forma shares of Sterling and Klamath giving effect to the merger. The average pro forma shares of Sterling and Klamath reflect Sterling's historical basic and diluted shares, plus historical basic and diluted average shares of Klamath as adjusted for an exchange ratio of 0.77 of a share of Sterling common stock for each share of Klamath common stock. The pro forma earnings per share amounts do not take into consideration any operating efficiencies that may be realized as a result of the merger.

(5) Sterling has never paid a cash dividend. Therefore pro forma cash dividends only reflect the Klamath historical amount divided by pro forma shares outstanding.

(6) Klamath historical value per share as of June 30, 2003, as adjusted for the exchange ratio of 0.77 of a share of Sterling common stock for each share of Klamath common stock is $14.10. For a description of the adjustment, see Note D to "Notes to Unaudited Pro Forma Combined Condensed Consolidated Financial Statements as of June 30, 2003.



## RISK FACTORS

In addition to the other information contained or incorporated by reference into this joint proxy statement/prospectus, including the matters addressed under the caption "Forward-Looking Information" beginning on page [ ], you should carefully consider the following risk factors in deciding whether to vote for approval of the merger agreement and the transactions contemplated thereby.

**Because the market price of Sterling common stock may fluctuate, Klamath shareholders cannot be sure of the value of the merger consideration that they will receive.**

The market value of Sterling common stock is likely to change, both before and after the merger, and no one can accurately predict what the market value will be at any given time. Market prices of Sterling and Klamath common stock may vary for many reasons, including changes in the business, operations or prospects of Sterling or Klamath, market assessments of the likelihood that the merger will be completed and general market and economic conditions. Because the merger will be completed after the special meetings, the prices of Sterling and Klamath common stock on the date of the special meetings may not be indicative of their prices on the date the merger is completed. We urge you to obtain current market quotations for Sterling and Klamath common stock.

**The exchange ratio for Sterling common stock to be received in the merger is fixed and limits the amount of shares that Klamath shareholders will receive.**

Regardless of the market prices of Sterling and Klamath common stock at the effective time of the merger, Klamath shareholders will receive no more than 0.77 shares of Sterling common stock for each share of Klamath common stock they own except under certain circumstances described in this proxy statement/prospectus. See "The Merger-Exchange ratio; possible adjustment of exchange ratio."

**We may fail to realize the anticipated benefits of the merger and the costs relating to the merger could reduce Sterling's future earnings per share.**

The success of the merger will depend on, among other things, Sterling's ability to realize anticipated cost savings and to combine the businesses of Sterling and Klamath in a manner that does not materially disrupt the existing business of Sterling or result in the loss of key customers or employees. If Sterling is not able to successfully achieve these objectives, the anticipated benefits of the merger may not be fully realized or may take longer to realize than expected. Sterling believes that it has reasonably estimated the likely costs of integrating the operations of Klamath into Sterling, and the incremental costs of operating as a combined company. However, it is possible that unexpected transaction costs or unexpected future operating expenses could have a material adverse effect on the results of operations and financial condition of Sterling after the merger.

**Failure to complete the merger could negatively impact prices and future business and operations.**

If the merger is not completed for any reason, the price of Sterling and Klamath common stock may decline to the extent that the current market prices reflect an assumption that the merger will be completed. Costs related to the merger must be paid even if the merger is not completed. In certain circumstances, the parties may be obligated to pay termination fees if the merger agreement is terminated. Further, if the merger agreement is terminated and Klamath's board of directors determines to seek another merger or business combination, it may not be able to find a partner willing to pay an equivalent or more attractive price than what Sterling would have paid in the merger. Finally, while the merger agreement is in effect, subject to limited exceptions, Klamath is prohibited from soliciting, initiating, participating in any negotiations regarding, or entering into specified extraordinary



transactions, such as a merger, sale of assets or other business combination with any party other than Sterling.

**The price of Sterling common stock may be affected by factors different from those affecting the price of Klamath common stock.**

Upon completion of the merger, the holders of Klamath common stock will become holders of Sterling common stock. Sterling's business differs from that of Klamath, and Sterling's results of operations and the price of Sterling common stock may be affected by factors different from those that affected Klamath's results of operations and the price of Klamath common stock before the merger. Sterling's results could also be adversely affected if losses on Klamath's assets are higher than currently anticipated. For a discussion of Sterling's and Klamath's businesses and factors to consider in connection with those businesses in connection with the merger, you should carefully review the financial statements and other documents which are incorporated by reference into this joint proxy statement/prospectus. See "Where You Can Find More Information" on page [ ].

**Directors and officers of Klamath have a potential conflict of interest in the merger.**

You should be aware that some directors and officers of Klamath have interests in the merger that are different from, or in addition to, the interests of Klamath shareholders generally. For example, certain executive officers and directors will receive severance payments or payments pursuant to various benefit plans in connection with the merger. These agreements may create potential conflicts of interest. These agreements and certain other additional interests of Klamath's directors and officers may cause some of those persons to view the proposed transaction differently than you view it. See "The Merger Interests of Klamath's directors and executive officers in the merger."



## THE STERLING SPECIAL MEETING

### Date, time, place and purpose of Sterling's special meeting

The special meeting of Sterling's shareholders will be held at 10:00 a.m. local time on [December 11, 2003], on the third floor of the headquarters of Sterling located at 111 North Wall Street, Spokane, Washington. At the meeting, Sterling's shareholders as of the record date will be asked to approve the merger with Klamath. This joint proxy statement/prospectus is first being sent to holders of Sterling common stock on or about [November , 2003] and is accompanied by a form of proxy that is being solicited by the Sterling board of directors for use at the special meeting and any adjournment or postponement thereof.

### Record date; outstanding shares; shares entitled to vote

Only holders of record of Sterling common stock at the close of business on the record date, October 13, 2003, are entitled to notice of and to vote at the special meeting. As of the record date, there were [ ] shares of Sterling common stock outstanding and were held of record by approximately [ ] shareholders. Each holder of Sterling common stock is entitled to one vote for each share of Sterling common stock owned as of the record date.

### Quorum; vote required

The required quorum for the transaction of business at the special meeting is a majority of the shares of Sterling common stock outstanding on the record date, represented in person or by proxy. For the merger agreement to be approved by Sterling shareholders, a majority of the votes cast in person or by proxy at the special meeting must vote FOR approval of the merger agreement. As of the record date, directors and executive officers of Sterling and their affiliates had the right to vote [ ] shares of Sterling common stock or [ %] of the total number of shares of Sterling common stock outstanding.

### Voting of proxies

The Sterling board of directors requests that you return the proxy card accompanying this joint proxy statement/prospectus for use at the special meeting. Please complete, date and sign the proxy card and promptly return it in the enclosed postage-paid envelope. All properly signed proxies received by Sterling and not revoked before the vote at the special meeting will be voted at the special meeting according to the instructions indicated on the proxies or, if no instructions are given, to approve the merger agreement.

If you are a participant in Sterling's 401(k) Employment Savings and Incentive Plan and Trust, your completed proxy will serve as voting instructions to the plan trustee. The deadline for returning your voting instructions is December [ ], 2003. In accordance with the terms of the plan, if you fail to instruct the plan trustee how to vote your plan shares, the trustee will vote your plan shares in accordance with the recommendations of the 401(k) Advisory Committee.

We do not expect that any matter other than approval of the merger agreement will be brought before the special meeting. If other matters are properly presented and are within the purpose of the special meeting, however, the persons named as proxies will vote in accordance with their judgment with respect to those matters.



### How to revoke your proxy

You may revoke your proxy at any time by taking any of the following actions before your proxy is voted at the meeting:

delivering to Sterling a written notice bearing a date later than the date of the proxy card, stating that you revoke the proxy;

signing and delivering to Sterling a proxy card relating to the same shares and bearing a later date; or

attending the meeting and voting in person, although attendance at the meeting will not, by itself, revoke a proxy.

Please note, however, that if you have voted through your broker, bank or other nominee and you wish to change your vote, you must follow the instructions received from such entity to change your vote.

**Abstentions and broker non-votes**

Brokers who hold shares of Sterling common stock in street name for a customer who is the beneficial owner of those shares may not give a proxy to vote the customer's shares without specific instructions from the customer. These non-voted shares are referred to as broker non-votes. If your broker holds your Sterling stock in street name, your broker will vote your shares only if you provide instructions on how to vote by filling out the voter instruction form sent to you by your broker with this joint proxy statement/prospectus. Abstentions and broker non-votes will be included in determining the presence of a quorum, but will have no effect on the proposal to approve the merger agreement.

**Voting electronically via Internet or telephone**

A large number of banks and brokerage firms provide shareholders whose shares are registered in the name of such firms the opportunity to vote via the Internet or by telephone. The voting form sent to a beneficial owner will provide instructions if such options are available.

**Expenses of proxy solicitation**

The enclosed proxy for the Sterling special meeting is solicited by and on behalf of Sterling's board of directors. Sterling will pay the expenses of soliciting proxies to be voted at the meeting. Following the original mailing of the proxies and other soliciting materials, Sterling and its agents also may solicit proxies by mail, telephone, facsimile or in person. Sterling intends to reimburse persons who hold Sterling stock of record but not beneficially, such as brokers, custodians, nominees and fiduciaries, for their reasonable expenses in forwarding copies of proxies and other soliciting materials to, and requesting authority for the exercise of proxies from, the persons for whom they hold the shares. Sterling has retained Mellon Shareholder Services LLC to serve as proxy solicitor and information agent and will pay that firm $5,000 plus reasonable costs and expenses for its services.

**Certificates**

You should not send in any certificates representing Sterling common stock. Following the effective time of the merger, you will continue to hold your Sterling stock certificates.

**Recommendation of Sterling's board of directors**

Sterling's board of directors unanimously recommends that you vote FOR approval of the merger agreement.



## THE KLAMATH SPECIAL MEETING

**Date, time, place and purpose of Klamath's special meeting**

The special meeting of Klamath's shareholders will be held at 10:00 a.m., local time, on [December 11, 2003], at the Ross Ragland Theater Cultural Center, 218 N. 7th Street, Klamath Falls, Oregon 97601. At the meeting, Klamath's shareholders as of the record date will be asked to approve the merger agreement that provides for the merger of Klamath with and into Sterling. This joint proxy statement/prospectus is first being sent to holders of Klamath common stock on or about [November , 2003] and is accompanied by a form of proxy that is being solicited by the Klamath board of directors for use at the special meeting and any adjournment or postponement thereof.

**Record date; outstanding shares; shares entitled to vote**

Only holders of record of Klamath common stock at the close of business on the record date, October 13, 2003, are entitled to notice of and to vote at the special meeting. As of the record date, there were [ ] shares of Klamath common stock outstanding and held of record by approximately [ ] shareholders. Each holder of Klamath common stock is entitled to one vote for each share of Klamath common stock owned as of the record date, subject to limited exceptions. If you do not vote, either in person or by proxy, it will have the same effect as voting against approval of the merger agreement.

Although Klamath is not aware, as of the date hereof, of any person owning more than 10% of its common stock, Klamath's articles of incorporation materially limit the voting power of 10% shareholders under certain conditions. See "Comparison of Rights of Holders of Klamath Common Stock and Sterling Common Stock."

**Quorum; vote required**

The required quorum for the transaction of business at the special meeting is a majority of the shares of Klamath common stock outstanding on the record date, represented in person or by proxy. For the merger agreement to be approved by Klamath shareholders, a majority of all the votes entitled to be cast in person or by proxy at the special meeting must vote FOR approval of the merger agreement.

**Voting of proxies**

The Klamath board of directors requests that you return the proxy card accompanying this joint proxy statement/prospectus for use at the meeting. Please complete, date and sign the proxy card and promptly return it in the enclosed postage-paid envelope. All properly signed proxies received by Klamath and not revoked before the vote at the meeting will be voted at the meeting according to the instructions indicated on the proxies or, if no instructions are given, to approve the merger agreement.

We do not expect that any matter other than approval of the merger agreement will be brought before the special meeting. If other matters are properly presented and are within the purpose of the special meeting, however, the persons named as proxies will vote in accordance with their judgment with respect to those matters.

**Participants in the Klamath First Federal ESOP**

If a shareholder is a participant in the Klamath First Federal Employee Stock Ownership Plan ("ESOP"), the proxy card represents a voting instruction to the trustee of the ESOP as to the number of shares in the participant's plan account. Each participant may direct the trustee as to the manner in which shares of common stock allocated to the participant's plan account are to be voted. Unallocated shares of common stock held by the ESOP, and allocated shares for which no voting instructions are



received from participants, will be voted by the trustee, to the extent not inconsistent with its fiduciary obligations, in the same proportion as shares for which the trustee has received voting instructions.

**How to revoke your proxy**

You may revoke your proxy at any time by taking any of the following actions before your proxy is voted at the meeting:

- delivering to Klamath a written notice bearing a date later than the date of the proxy card, stating that you revoke the proxy;
- signing and delivering to Klamath a proxy card relating to the same shares and bearing a later date; or
- attending the meeting and voting in person, although attendance at the meeting will not, by itself, revoke a proxy.

Please note, however, that if you have voted through a broker, bank or other nominee and you wish to change your vote, you must follow the instructions received from such entity to change your vote.

**Abstentions and broker non-votes**

Only shares affirmatively voted for approval of the merger agreement, including shares represented by properly executed proxies that do not contain voting instructions, will be counted as votes FOR the merger agreement. Abstentions and broker non-votes will be included in determining the presence of a quorum, but will have the same effect as voting against the merger agreement.

Brokers who hold shares of Klamath common stock in street name for a customer who is the beneficial owner of those shares may not give a proxy to vote the customer's shares without specific instructions from the customer. These non-voted shares are referred to as broker non-votes. If your broker holds your Klamath stock in street name, your broker will vote your shares only if you provide instructions on how to vote by filling out the voter instruction form sent to you by your broker with this joint proxy statement/prospectus.

**Voting electronically via Internet or telephone**

A large number of banks and brokerage firms provide shareholders whose shares are registered in the name of such firms the opportunity to vote via the Internet or by telephone. The voting form sent to a beneficial owner will provide instructions if such options are available.

**Expenses of proxy solicitation**

The enclosed proxy for the Klamath special meeting is solicited by and on behalf of Klamath's board of directors. Klamath will pay the expenses of soliciting proxies to be voted at the special meeting. Following the original mailing of the proxies and other soliciting materials, Klamath and its agents also may solicit proxies by mail, telephone, facsimile or in person. Klamath intends to reimburse persons who hold Klamath stock of record but not beneficially, such as brokers, custodians, nominees and fiduciaries, for their reasonable expenses in forwarding copies of proxies and other soliciting materials to, and requesting authority for the exercise of proxies from, the persons for whom they hold the shares. Klamath has retained Mellon Shareholder Services LLC to serve as proxy solicitor and information agent and will pay that firm $5,000 plus reasonable costs and expenses for its services.



**Certificates**

You should not send in any certificates representing Klamath common stock. Following the effective time of the merger, you will receive instructions for the surrender and exchange of your Klamath stock certificates.

**Share ownership of management**

As of the record date, Klamath's directors and executive officers collectively owned [ ] shares of Klamath common stock, or approximately [ ] percent of Klamath's outstanding shares. All of Klamath's directors and certain executive officers have executed voting agreements with Sterling, under which they have agreed to vote their shares for approval of the merger agreement.

**Recommendation of Klamath's board of directors**

Klamath's board of directors unanimously recommends that you vote FOR approval of the merger agreement.

## THE MERGER

This section of the joint proxy statement/prospectus describes the proposed merger. While we believe that this description covers the material terms of the merger agreement, this summary may not contain all of the information that is important to you. You should carefully read this entire joint proxy statement/prospectus and the other documents to which we refer for a more complete understanding of the merger. In particular, you should read the entire merger agreement attached to this document as Annex A because it is the legal document that governs the merger.

**Background of the merger**

Klamath First Federal was organized in 1934 and grew gradually over the next 60 years while offering traditional thrift products, primarily mortgage loans and savings or time deposits. In 1995, Klamath was organized and went public as a unitary thrift holding company in connection with Klamath First Federal's conversion from mutual to stock form. Management then began actively looking for expansion opportunities to utilize the excess capital created from the sale of stock. In July 1997, Klamath First Federal purchased 25 branches from Wells Fargo Bank increasing assets to approximately $980 million, and establishing a presence through most of rural Oregon. Also, to improve returns on equity, stock repurchase programs were periodically conducted and in January 1999 Klamath completed a Modified Dutch Auction Tender in which it repurchased 1,984,000 shares or 20% of its outstanding shares of common stock. A sales and service culture and related training were introduced in early 2001, with the intent of changing its operations to those more similar to a commercial bank by expanding product offerings, and diversifying the loan portfolio. This was supported with the purchase of 13 full-service branches from Washington Mutual Bank in September 2001, which included a portfolio of commercial loans and a team of seasoned commercial lenders. The delivery of retail services began to expand at about the same time with the opening of nine consumer branches in Wal-Mart stores.

In the fall of 2002, management's focus was to continue asset growth and profitability both internally and through acquisition, which was considered necessary for Klamath's long-term success. A comprehensive, independent compensation study was authorized and conducted to ensure that high quality executives and other employees could be attracted and/or retained. The study generally included market pricing of about one-third of all Klamath First Federal positions, with the remainder set aside based on a matrix of position characteristics. In addition, the executive portion of the study included both cash and equity based compensation, and was conducted through use of proxy information and multiple survey data analyses. There was little stock available for additional restricted stock or stock



option awards, and the board of directors felt that other compensation incentives were necessary to entice long-term retention of key management. Therefore, funding of retention benefits through the purchase of bank-owned life insurance ("BOLI") began to be evaluated, with insurance purchased in December 2002, which included director fee continuation agreements, executive salary continuation agreements, and shared life insurance benefits. Employment contracts were also reviewed, with changes recommended. During the design of the benefits, the board of directors considered the amount of the cost that would be funded by income from the BOLI and the cost of accelerated vesting of these benefits in the event of a change in control. The preparation and completion of formal documents relating to these benefits took several months and were approved by the board of directors at the end of April 2003.

Davidson was engaged on November 28, 2002 by the board of directors to assist Klamath in the identification and analysis of potential acquisition targets. In connection therewith, Davidson agreed to assist in negotiating terms, coordinating due diligence efforts, and issuing a fairness opinion. The agreement was non-exclusive until Davidson presented a potential transaction to Klamath's board, then would be exclusive as to the particular transaction. The term of the engagement was through May 30, 2003, but subject to extension. Through March 2003, several acquisition targets were identified and analyzed, with offers made to two potential targets, but no transaction was consummated. One target had no interest in a transaction and the other was found to have higher risk characteristics than expected.

After the two targeted acquisitions did not materialize, a strategic planning retreat with the board of directors and executive management of Klamath was held on April 28, 2003, with a Davidson representative present. The retreat included reviews of the economic landscape affecting Klamath, including financial and market performance relative to peers. Discussions were held regarding Klamath's strengths, weaknesses, opportunities and threats, plus the process and timelines for completing the business plan for the next fiscal year.

The Klamath board and management recognized that financial results were lagging the peer group, primarily as a result of the impact of the low interest rates which would continue to pressure earnings if rates remained depressed. The reduction in the balance of residential mortgage loan assets because of refinancing activity, coupled with sales in the secondary market of new and refinanced residential mortgage loans to reduce interest rate risk was not offset by new consumer loan and commercial loan originations. Klamath First Federal had also entered into long-term borrowings with the Federal Home Loan Bank when interest rates were higher than current market rates, which resulted in a further reduction in earnings. These borrowings could not be prepaid without incurring significant penalties. Further, the investment portfolio had largely been structured with regular cash flows from mortgage-backed securities, which would provide greater returns through reinvestment in a rising rate environment but reduced returns in periods of low and declining interest rates as currently existed.

Opportunities identified for further investigation and implementation included opening commercial loan production offices in major metropolitan areas, expanding more aggressively into key markets, reevaluating the retail branch structure from a market presence and efficiency perspective, emphasizing more non-deposit retail investment sales, implementing more aggressive expense controls, and reevaluating and adjusting service fees. Management was directed by the Klamath board of directors to overhaul and redraft the business plan in light of the current business, economic and interest rate environment, and with a view to improving financial results. A follow-up retreat to present the next fiscal year's business plan was scheduled for mid-September 2003.

On May 7, 2003, Kermit K. Houser, President and Chief Executive Officer, and Marshall J. Alexander, Executive Vice President and Chief Financial Officer, attended the D.A. Davidson Financial Services Investor Conference in Seattle, Washington. While there, Messrs. Houser and Alexander were informally approached by Harold Gilkey, Sterling Corporation's Chairman & Chief Executive Officer,



to find out Klamath's philosophy regarding mergers. A similar informal discussion was initiated by another financial institution's representative who was also attending the meeting. A few days later, Mr. Houser received a call from Mr. Gilkey requesting a dinner meeting during the week of May 12, 2003, when both individuals would be attending the Federal Home Loan Bank annual meeting in Seattle, Washington. Mr. Houser notified Rodney N. Murray, Chairman of the board of directors of Klamath Bancorp of the request. During the dinner meeting on May 14, 2003, Mr. Gilkey suggested that Sterling and Klamath merge. Additional informal discussions about that possibility were held the following day among the Sterling and Klamath representatives who attended the Federal Home Loan Bank meeting. Early the following week, Chairman Murray was informed of Sterling's interest. Klamath executed a confidentiality agreement with Sterling on May 27, 2003.

At its regular board of directors meeting on May 28, 2003, the Klamath board of directors was informed of Sterling's interest in a merger, considered whether to extend the Davidson engagement beyond its May 30, 2003 expiration date, and decided to meet with Mr. Gilkey. Mr. Al Glowasky of Davidson facilitated a discussion which included, but was not limited to, the factors that affect the value of the Klamath franchise such as trailing earnings, dividend yield, level of non-performing loans, core competencies, stability and cost of deposits, market capitalization and performance of regional thrifts and banks; comparisons to Klamath's and Sterling's results; Klamath's business plan projections and the impact of Klamath's various budget forecast scenarios; the combined geographic market area with a Sterling merger, and possible board and management structures relating to Sterling's proposed merger. Mr. Glowasky and the board of directors also reviewed other alternatives to enhance shareholder value. The board of directors approved the extension of the Davidson engagement, and agreed to meet with Mr. Gilkey. Special Counsel, John F. Breyer, Jr., of Breyer & Associates PC was engaged to assist in advising the board of directors in connection with Sterling's expression of interest.

Mr. Gilkey met with the Klamath board of directors in Klamath Falls, Oregon, on June 3, 2003. Mr. Gilkey discussed Sterling's history and philosophy, strengths and weaknesses, and reasons why a business combination was of interest. Sterling's general expectations to obtain cost savings and earnings contribution, as well as timing for a possible transaction to be successful were presented. Sterling's past merger experiences and resolution of social issues with acquired management and boards of directors were described. The members of the board of directors of Klamath were invited to visit Sterling's headquarters to meet members of Sterling's board of directors and senior management team, and to tour its headquarters. Most Klamath directors traveled to Spokane, Washington and visited Sterling a few days later. Subsequent to that visit, Klamath and Sterling representatives, with their advisors present, held off-site discussions on June 10, 2003 to address potential earnings improvements and cost savings in the event of a merger. Klamath received proposed merger terms on June 13, 2003.

Klamath held a meeting of its board of directors on June 17, 2003, with its special counsel Breyer & Associates PC, investment advisor Davidson, and executive management to review the proposed merger terms. The board of directors was advised of its fiduciary duties, alternatives to consider such as remaining independent compared to methods of soliciting indications of interest such as a market auction, limited auction or negotiating on an exclusive basis, stock compared to cash transactions, disclosure requirements and related regulatory matters, and terms to consider when evaluating a merger transaction. The investment advisor provided a presentation that covered Klamath's operations and stock performance as compared to the market, management forecasts along with probability of success and execution risks, the Sterling proposed merger terms from a financial perspective, a comparison of the proposed merger terms to management forecasts, and a likely merger timeline. Other possible merger partners were discussed. Mr. Glowasky stated that he had contacted eight other financial institutions who would be likely acquirers, of which three had no interest in purchasing a thrift institution, such as Klamath First Federal, and one had no interest in Klamath. The others were either not currently targeting Oregon or were otherwise unwilling or unable to pay a price or exchange rate similar to the Sterling offer. Analyst coverage of Sterling was also reviewed. Initial



pricing was proposed as a stock exchange with Klamath shareholders receiving shares of Sterling common stock for each share of Klamath common stock, which the investment advisor's initial analysis indicated should be fair from a financial perspective. The investment advisor also recommended that due diligence in connection with the proposed transaction be pursued as a result of the various information presented, especially the company's forecast that two to three years would be required to implement the internal business plan and regain the momentum and profitability of a year ago. In addition, the execution risk in the current economy and financial marketplace was deemed high. The board of directors engaged in extensive discussions regarding the proposal and other information presented. The board of directors then authorized management, Davidson and its special counsel to begin negotiating a definitive merger agreement and to conduct due diligence on Sterling.

Sterling performed most of its due diligence review of Klamath from June 19 through July 1, 2003. Klamath performed most of its due diligence review of Sterling from June 25 through July 1, 2003. The Klamath board held a special meeting on July 3, 2003, when the initial draft of the merger agreement was delivered and due diligence results were shared. Due diligence reports were given which covered lending, operations, legal, compliance, internal control, human resources, accounting, tax, and investments. The Klamath board concluded that there were no issues presented by the due diligence reports that should stop the merger discussions from proceeding. Special Counsel John F. Breyer, Jr. of Breyer & Associates PC also reviewed the initial draft of the merger agreement in detail, discussed various negotiating points, and advised further regarding fiduciary duties. The merger agreement continued to be negotiated through July 14, 2003.

On July 9, 2003 the board of directors and its investment advisor met to discuss the status of the negotiations with Sterling and the open issues that were being negotiated including the termination provisions contained in the proposed merger agreement. Sterling representatives had expressed that they would only negotiate on an exclusive basis and were not willing to enter into the transaction without the protection of the current termination provision and fee. After considering factors such as the results that could be attained under the current Klamath First Federal business plan, Davidson's work in identifying and analyzing other potential suitors and its opinion that if Klamath did not proceed with the Sterling proposal that it was unlikely that there would be a comparable or better proposal available, the board of directors concluded it was in the best interest of the Klamath shareholders to continue merger negotiations with Sterling.

On July 14, 2003, the Klamath board held a special meeting to review the definitive merger agreement and a presentation including the fairness opinion delivered by Davidson. Special Counsel reviewed in detail the merger agreement. It was noted that pricing had changed slightly from the original proposal to an exchange rate of 0.77 shares of Sterling common stock for each Klamath share, primarily attributable to the costs associated with terminating vendor contracts, though the change in the exchange rate is only a partial absorption of the cost. Other aspects of the merger were also discussed. Mr. Glowasky made a presentation regarding the financial terms of the transaction and its fairness from a financial point of view. He again presented the various factors the Klamath board of directors considered in determining to proceed with the merger, which are discussed in further detail below. After discussion, the Klamath directors, all of whom were present, unanimously approved and authorized the execution of the merger agreement.

Klamath and Sterling executed the merger agreement and related documents on July 14, 2003. On July 15, 2003, before trading commenced on the Nasdaq National Market, the companies issued a joint press release announcing the execution of the merger agreement.

**Sterling's reasons for the merger**

At its July 14, 2003 meeting, the Sterling board unanimously determined that the merger is fair to and in the best interests of Sterling and its shareholders. In reaching its decision to approve the merger



and to unanimously recommend that Sterling shareholders approve the merger agreement, the board considered numerous factors taken as a whole, none of which were accorded any particular or relative weight, and consulted with senior bank management as well as its legal, accounting and financial advisors. The factors considered included:

- the benefits to Sterling, its shareholders, customers, employees and communities of operating as a substantially larger organization with enhancements in products and services, greater geographical diversity for loan and deposit originations, higher lending limits, and greater financial resources;
- current industry conditions and each of Sterling and Klamath's financial and operational history and prospects, including earnings, return on equity, return on assets, capital levels and asset quality;
- the likelihood of receiving required regulatory approvals in a timely fashion and the likelihood that the merger would be completed;
- the terms of the merger agreement; and
- the written opinion of Sandler O'Neill delivered to the board of directors to the effect that the merger is fair to Sterling's shareholders from a financial point of view.

**Recommendation of Sterling's board of directors**

After carefully evaluating relevant factors, including the above, Sterling's board of directors has determined that the merger is fair to and in the best interests of Sterling and its shareholders. Sterling's board of directors unanimously recommends that you vote FOR approval of the merger agreement.

**Klamath's reasons for the merger**

At the Klamath board of directors' meetings held June 17, 2003 to consider the merger proposal from Sterling, and on July 14, 2003, when the Klamath board of directors authorized execution of the merger agreement and recommended Klamath shareholder approval of the merger, the various reasons for the merger were discussed. The Klamath board of directors consulted with financial and legal advisors in considering several factors. The Klamath board of directors believes that the merger enhances shareholder value, because the companies' strengths are complementary, Sterling has a history of strong financial performance, and the business combination allows Klamath to achieve financial goals sooner than if it were to remain independent. The material factors considered by the Klamath board of directors in connection with its approval and recommendation of the merger, including the interests of the directors and certain officers in the merger, are detailed below:

Terms of the Merger. The board considered the terms of the merger, including the exchange ratio and various other documents related to the merger and the structure of the merger, including the fact that the merger is intended to qualify as a type of transaction that is generally tax-free for U.S. federal income tax purposes. The board of directors also considered the fact that when the merger was publicly announced, the exchange ratio represented a premium over the market price for shares of Klamath common stock existing before the public announcement of the merger.

Balance Sheet Strength. Klamath's balance sheet with strong core deposits complements Sterling's loan production volumes and capacity. Klamath's capital position also provides support to Sterling in reaching optimal leverage for earnings and loan growth.

Business plan implementation. The Klamath First Federal business plan was to expand and convert to a commercial-bank structure. The timing to complete such a change was expected to require another two to four years. Financial performance has lagged peers, and to overcome the

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challenge of low interest rates would require aggressive net growth of lending, particularly commercial loans. The mix of loans had changed toward the planned structure over the past two years. However, as noted above, the increases in commercial and consumer lending had not overcome the run-off of existing mortgage loans, and most new mortgage residential production was being sold into the secondary markets. Aggressive expansion of lending without compromising credit quality would require, among other actions, establishing a strong commercial lending presence in major metropolitan areas along with seasoned and respected lenders. While the board of directors believes that these objectives could ultimately be realized, the execution risk was deemed high to enter new markets, attract the right personnel, and see positive results in a relatively short time. In evaluating the merger proposal against the business plan, the board of directors determined that the merger proposal was superior because Klamath's goals could be achieved much earlier and with much less business risk.

Products & Services. Klamath First Federal customers will be afforded new products and services not previously available. For instance, in support of larger credit relationships, international banking services and enhanced cash management services will be available.

Geographic expansion. Klamath First Federal's market area primarily comprises the state of Oregon and the Tri-cities area of Washington, but does not currently include the Portland metropolitan areas. The board of directors deems this an excellent contiguous fit with Sterling Savings Bank's market areas, which include most of Washington, northern Idaho, and Montana. Sterling Savings Bank's presence in Oregon is primarily in the Portland metropolitan area and some communities near Salem, Oregon. The only area where both companies have retail branches is in the Tri-cities area of Washington. The merger will provide Klamath First Federal customers more locations to receive services.

Market capitalization. The board of directors believes that the larger number of shareholders and combined capitalization may result in increased interest in Sterling stock from institutional investors, market professionals and other investors, and may provide greater liquidity for shareholders.

Due diligence results. Since Klamath shareholders will become Sterling shareholders with this merger, the board of directors considered it essential that on-site due diligence be performed. This was completed from June 25 through July 1, 2003 at Sterling's offices in Spokane, Washington and Lake Oswego, Oregon. Management's presentation of due diligence results indicated that Sterling is appropriately managed with internal controls in place. Operational functions are deemed capable of handling the increased volume associated with integration.

Directorships. Sterling has committed to appoint one member of Klamath's board of directors to Sterling's board of directors, and to appoint two members of Klamath's board of directors to the Sterling Savings Bank board of directors.

Future prospects. The board of directors believes, based on pro-forma financial statements, that future earnings prospects will be stronger on a combined basis.

Industry Trends. The board of directors considered trends such as the consolidation occurring in the banking industry and the increased competition from other financial institutions.

Other Strategies. The board of directors reviewed with its legal and financial advisors alternatives to the merger, the range and possible value to Klamath shareholders obtainable through such alternatives and the timing and likelihood of the alternatives.

Career opportunities. Although the merger will include the consolidation of certain back-office functions, the board of directors believes that the merger will generally expand the career opportunities available to many Klamath First Federal employees.



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Corporate values. Klamath First Federal has emphasized ethical "selling from the HEART," that is, sales with values of Honesty, Enthusiasm, Accountability, focusing on customer Relationships, and achieving results with Teamwork. Products and services are sold to meet customer needs, not to reach quotas. Klamath's board of directors considers the Sterling Savings Bank "Hometown Helpful" philosophy to be fully compatible with Klamath's values. Personal and friendly customer service are paramount values for both organizations.

Approvals. The board of directors considered the likelihood of receiving required regulatory approvals in a timely fashion and the likelihood that the merger would be completed. Sterling has successfully completed several acquisitions in recent years.

Fairness opinion. Davidson provided an opinion, discussed below in "Opinion of Klamath's financial advisor," that as of July 14, 2003, the merger consideration was fair, from a financial point of view, to the Klamath shareholders.

In the course of its deliberations regarding the merger, the Klamath board of directors also considered the following information which the Klamath board of directors determined did not outweigh the benefits to Klamath and its shareholders expected to be generated by the merger:

the fact that the number of shares in the exchange ratio is fixed at 0.77 and will not change, except in certain limited circumstances, with increases or decreases in the market price of either company's stock before the closing of the merger, and the possibility that the value of Sterling common stock at closing may be more or less than the value of Sterling common stock at the signing of the merger agreement;

the possible disruption to Klamath First Federal's business that may result from the announcement of the merger and the resulting distraction of its management's attention from the day-to-day operations of Klamath First Federal's business;

the difficulty inherent in integrating two businesses and the risk that the cost efficiencies, synergies and other benefits expected to be obtained in the merger may not be fully realized;

the restrictions contained in the merger agreement on the operation of Klamath's and Klamath First Federal's business during the period between the signing of the merger agreement and completion of the merger;

the termination fee of up to $6 million to be paid to Sterling if the merger agreement is terminated under certain circumstances, such as the receipt and acceptance of a superior proposal prior to consummation of the merger;

the possibility that the merger might not be completed and the effect of the resulting public announcement of termination of the merger agreement on, among other things, the market price of Klamath common stock and Klamath's operating results, particularly in light of the costs incurred in connection with the transaction;

the fact that Klamath currently pays a cash dividend to its shareholders of $0.13 per quarter. Sterling has not paid a cash dividend in its recent history; however, it has from time to time paid stock dividends. For further information concerning Sterling's dividends, see the section entitled "Comparative Stock Price and Dividend Information."

other matters described in the sections entitled "Risk Factors" and "The Merger Interests of Klamath's directors and executive officers in the merger."

The foregoing discussion of the information considered by the Klamath board of directors is not intended to be exhaustive but includes all of the material factors considered by the Klamath board. In reaching its determination to approve and recommend the merger, the Klamath board did not assign any relative or specific weights to the factors considered in reaching that determination and individual



directors may have given differing weights to different factors. Given the above, Klamath's board of directors determined that the merger agreement is in the best interests of Klamath and its shareholders and unanimously approved the merger.

**Recommendation of Klamath's board of directors**

After carefully evaluating the above factors, both positive and negative, Klamath's board of directors has determined that the merger is fair to and in the best interests of Klamath and its shareholders. Klamath's board of directors unanimously recommends that you vote FOR approval of the merger agreement.

**Opinion of Sterling's financial advisor**

By letter dated June 3, 2003, Sterling retained Sandler O'Neill to act as its financial advisor in connection with a possible merger transaction with Klamath based on Sandler O'Neill's experience in mergers and acquisitions and in securities valuation generally. Sandler O'Neill is a nationally recognized investment banking firm whose principal business specialty is financial institutions. In the ordinary course of its investment banking business, Sandler O'Neill is regularly engaged in the valuation of financial institutions and their securities in connection with mergers and acquisitions and other corporate transactions.

Sandler O'Neill acted as financial advisor to Sterling in connection with the proposed merger and participated in certain of the negotiations leading to the execution of the merger agreement. At the July 14, 2003 meeting at which Sterling's board considered and approved the merger agreement, Sandler O'Neill delivered to the board its oral opinion, subsequently confirmed in writing, that, as of such date, the merger consideration Sterling proposed to pay Klamath shareholders was fair to Sterling from a financial point of view. The full text of Sandler O'Neill's opinion is attached as Annex B to this joint proxy statement/prospectus. The opinion outlines the procedures followed, assumptions made, matters considered and qualifications and limitations on the review undertaken by Sandler O'Neill in rendering its opinion. The description of the opinion set forth below is qualified in its entirety by reference to the opinion. We urge you to read the entire opinion carefully in connection with your consideration of the proposed merger.

Sandler O'Neill's opinion speaks only as of the date of the opinion. The opinion was directed to the Sterling board and is directed only to the fairness of the merger consideration to Sterling from a financial point of view. It does not address the underlying business decision of Sterling to engage in the merger or any other aspect of the merger and is not a recommendation to any Sterling shareholder as to how such shareholder should vote at the special meeting with respect to the merger.

In connection with rendering its opinion, Sandler O'Neill reviewed and considered, among other things:

- the merger agreement and certain related documents;
- certain publicly available financial statements and other historical financial information of Sterling that they deemed relevant;
- certain publicly available financial statements and other historical financial information of Klamath that they deemed relevant;
- internal financial projections for Sterling for the years ending December 31, 2003 and 2004 furnished by and reviewed with management of Sterling and earnings per share estimates for Sterling for the same periods published by I/B/E/S;
- internal financial projections for Klamath for the years ending December 31, 2003 and 2004 furnished by Klamath and reviewed with managements of Sterling and Klamath, respectively,



and earnings per share estimates for Klamath for the fiscal years ending September 30, 2003 and 2004 published by I/B/E/S;

- the pro forma financial impact of the merger on Sterling, based on assumptions relating to earnings, transaction expenses, purchase accounting adjustments and cost savings determined by senior managements of Sterling and Klamath;
- the relative contributions of assets, liabilities, equity and earnings of Sterling and Klamath to the resulting institution;
- the publicly reported historical price and trading activity for Sterling's and Klamath's common stock, including a comparison of certain financial and stock market information for Sterling and Klamath with similar publicly available information for certain other companies the securities of which are publicly traded;
- the financial terms of certain recent business combinations in the savings institution industry, to the extent publicly available;
- the current market environment generally and the banking environment in particular; and
- such other information, financial studies, analyses and investigations and financial, economic and market criteria as they considered relevant.

Sandler O'Neill also discussed with certain members of Sterling's senior management the business, financial condition, results of operations and prospects of Sterling. Sandler O'Neill also held similar discussions with certain members of senior management of Klamath regarding the business, financial condition, results of operations and prospects of Klamath.

In performing its reviews and analyses and in rendering its opinion, Sandler O'Neill assumed and relied upon the accuracy and completeness of all the financial information, analyses and other information that was publicly available or otherwise furnished to, reviewed by or discussed with it and further relied on the assurances of management of Sterling and Klamath that they were not aware of any facts or circumstances that would make such information inaccurate or misleading. Sandler O'Neill was not asked to and did not independently verify the accuracy or completeness of any of such information and they did not assume any responsibility or liability for the accuracy or completeness of any of such information. Sandler O'Neill did not make an independent evaluation or appraisal of the assets, the collateral securing assets or the liabilities, contingent or otherwise, of Sterling or Klamath or any of their respective subsidiaries, or the collectibility of any such assets, nor was it furnished with any such evaluations or appraisals. Sandler O'Neill is not an expert in the evaluation of allowances for loan losses and it did not make an independent evaluation of the adequacy of the allowance for loan losses of Sterling or Klamath, nor did it review any individual credit files relating to Sterling or Klamath. With Sterling's consent, Sandler O'Neill assumed that the respective allowances for loan losses for both Sterling and Klamath were adequate to cover such losses and will be adequate on a pro forma basis for the combined entity. In addition, Sandler O'Neill did not conduct any physical inspection of the properties or facilities of Sterling or Klamath.

Sandler O'Neill's opinion was necessarily based upon market, economic and other conditions as they existed on, and could be evaluated as of, the date of its opinion. Sandler O'Neill assumed, in all respects material to its analysis, that all of the representations and warranties contained in the merger agreement and all related agreements are true and correct, that each party to such agreements will perform all of the covenants required to be performed by such party under such agreements and that the conditions precedent in the merger agreement are not waived. Sandler O'Neill also assumed, with Sterling's consent, that there has been no material change in Sterling's or Klamath's assets, financial condition, results of operations, business or prospects since the date of the last financial statements made available to them, that Sterling and Klamath will remain as going concerns for all periods



relevant to its analyses, and that the merger will qualify as a tax-free reorganization for federal income tax purposes.

In rendering its opinion, Sandler O'Neill performed a variety of financial analyses. The following is a summary of the material analyses performed by Sandler O'Neill, but is not a complete description of all the analyses underlying Sandler O'Neill's opinion. The summary includes information presented in tabular format. In order to fully understand the financial analyses, these tables must be read together with the accompanying text. The tables alone do not constitute a complete description of the financial analyses. The preparation of a fairness opinion is a complex process involving subjective judgments as to the most appropriate and relevant methods of financial analysis and the application of those methods to the particular circumstances. The process, therefore, is not necessarily susceptible to a partial analysis or summary description. Sandler O'Neill believes that its analyses must be considered as a whole and that selecting portions of the factors and analyses considered without considering all factors and analyses, or attempting to ascribe relative weights to some or all such factors and analyses, could create an incomplete view of the evaluation process underlying its opinion. Also, no company included in Sandler O'Neill's comparative analyses described below is identical to Sterling or Klamath and no transaction is identical to the proposed merger. Accordingly, an analysis of comparable companies or transactions involves complex considerations and judgments concerning differences in financial and operating characteristics of the companies and other factors that could affect the public trading values or merger transaction values, as the case may be, of Sterling or Klamath and the companies to which they are being compared.

The earnings projections used and relied upon by Sandler O'Neill in its analyses were, in the case of Sterling, furnished by Sterling and reviewed by management of Sterling and, in the case of Klamath, furnished by Klamath and reviewed by management of each of Sterling and Klamath, respectively. With respect to such financial projections and all projections of transaction costs, purchase accounting adjustments and expected cost savings relating to the merger, Sterling's and Klamath's managements confirmed to Sandler O'Neill that they reflected the best currently available estimates and judgments of such managements of the future financial performance of Sterling and Klamath, respectively, and Sandler O'Neill assumed for purposes of its analyses that such performances would be achieved. Sandler O'Neill expressed no opinion as to such financial projections or the assumptions on which they were based. The financial projections for Sterling and Klamath were prepared for internal purposes only and not with a view towards public disclosure. These projections, as well as the other estimates used by Sandler O'Neill in its analyses, were based on numerous variables and assumptions that are inherently uncertain and, accordingly, actual results could vary materially from those set forth in such projections.

In performing its analyses, Sandler O'Neill also made numerous assumptions with respect to industry performance, business and economic conditions and various other matters, many of which cannot be predicted and are beyond the control of Sterling, Klamath and Sandler O'Neill. The analyses performed by Sandler O'Neill are not necessarily indicative of actual values or future results, which may be significantly more or less favorable than suggested by such analyses. Sandler O'Neill prepared its analyses solely for purposes of rendering its opinion and provided such analyses to the Sterling board at the July 14th meeting. Estimates on the values of companies do not purport to be appraisals or necessarily reflect the prices at which companies or their securities may actually be sold. Such estimates are inherently subject to uncertainty and actual values may be materially different. Accordingly, Sandler O'Neill's analyses do not necessarily reflect the value of the common stock of Sterling or Klamath or the prices at which Sterling's or Klamath's common stock may be sold at any time.

*Summary of Proposal.* Sandler O'Neill reviewed the financial terms of the proposed transaction. Based upon the closing price of Sterling's common stock on July 11, 2003 of $26.15 and an exchange ratio of 0.77 shares of Sterling for each share of Klamath, Sandler O'Neill calculated an implied



transaction value of $20.14 per share. Based upon Klamath's March 31, 2003 financial information, Sandler O'Neill calculated the following ratios:

**Transaction Ratios**

| | |
|---|---|
| Transaction value/LTM earnings per share | 18.5x |
| Transaction value/LTM core earnings per share(1) | 21.7x |
| Transaction value/Book value per share | 110.0% |
| Transaction value/Tangible book value per share | 162.6% |
| Tangible book premium/Core deposits(2) | 6.0% |

(1) Assumes core earnings per share for Klamath of $0.93.

(2) Assumes Klamath's total core deposits are $1.01 billion.

For purposes of Sandler O'Neill's analyses, earnings per share were based on fully diluted earnings per share. The aggregate transaction value was approximately $144.5 million, based upon 6.96 million shares of Klamath common stock outstanding and including the intrinsic value of options to purchase 642,940 shares of Klamath common stock with a weighted average exercise price of $13.27 per share. Sandler O'Neill noted that the transaction value represented a 15.7% premium over the July 11, 2003 closing price of Klamath's common stock of $17.40.

*Stock Trading History.* Sandler O'Neill reviewed the history of the reported trading prices and volume of the common stock of Sterling and Klamath and the relationship between the movements in the prices of those stocks to movements in certain stock indices, including the Standard & Poor's 500 Index, the Standard & Poor's Bank Index, the Nasdaq Bank Index and the median performance of a composite peer group of publicly traded regional savings institutions for each of Sterling and Klamath selected by Sandler O'Neill. During the one year period ended July 11, 2003, the common stock of Sterling outperformed each of the indices to which it was compared while the common stock of Klamath underperformed its peer group while outperforming each of the other indices to which it was compared.

**Sterling's and Klamath's One-Year Stock Performance**

| | Beginning Index Value July 11, 2002 | Ending Index Value July 11, 2003 |
|---|---|---|
| Sterling | 100.00% | 144.91% |
| Sterling Peer Group | 100.00 | 118.33 |
| Nasdaq Bank Index | 100.00 | 107.63 |
| S&P Bank Index | 100.00 | 107.41 |
| S&P 500 Index | 100.00 | 106.48 |

| | Beginning Index Value July 11, 2002 | Ending Index Value July 11, 2003 |
|---|---|---|

| | Beginning Index Value July 11, 2002 | Ending Index Value July 11, 2003 |
|---|---|---|
| Klamath | 100.00% | 115.76% |
| Klamath Peer Group | 100.00 | 128.16 |
| Nasdaq Bank Index | 100.00 | 107.63 |
| S&P Bank Index | 100.00 | 107.41 |
| S&P 500 Index | 100.00 | 106.48 |

*Comparable Company Analysis.* Sandler O'Neill used publicly available information to compare selected financial and market trading information for Klamath and two groups of selected financial



institutions. The first group, or Regional Group, consisted of Klamath and the following publicly traded savings institutions:

| | |
|---|---|
| Washington Federal Inc. | FirstFed Financial Corp. |
| PFF Bancorp Inc. | Hawthorne Financial Corp. |
| Quaker City Bancorp Inc. | United PanAm Financial Corp. |
| Provident Financial Holdings | Commercial Capital Bancorp |
| Horizon Financial Corp. | First Mutual Bancshares Inc. |
| EverTrust Financial Group, Inc. | |

Sandler O'Neill also compared Klamath to a group of publicly traded savings institutions that had a return on average equity (based upon earnings for the twelve months ended March 31, 2003) greater than 16% and a price-to-tangible book value greater than 190%. This High Performing Group was comprised of the following institutions:

| | |
|---|---|
| Anchor BanCorp Wisconsin | Dime Community Bancshares Inc. |
| First Federal Capital Corp | TrustCo Bank Corp NY |
| Hawthorne Financial Corp. | First Financial Holdings Inc. |
| Quaker City Bancorp Inc. | United PanAm Financial Corp |
| Commercial Capital Bancorp | NASB Financial Inc. |
| Coastal Financial Corp. | First Mutual Bancshares Inc. |

The analysis compared publicly available financial information for Klamath for each of the years ended September 30, 1998 through 2002 and as of and for the twelve months ended March 31, 2003 and the median data for each of the Regional Group and High Performing Group as of and for each of the years ended December 31, 1998 through 2002 and as of and for the twelve months ended March 31, 2003. The table below sets forth the comparative data as of and for the twelve months ended March 31, 2003, with pricing data as of July 11, 2003.

| | Klamath | Regional Group | High Performing Group |
|---|---|---|---|
| Total assets (in millions) | $ 1,478 | $ 1,195 | $ 1,891 |
| Tangible equity/ tangible assets | 5.59% | 8.57% | 6.82% |
| Intangible assets/total equity | 32.34% | 0.47% | 4.19% |
| Net loans/total assets | 38.80% | 80.75% | 74.63% |
| Gross loans/total deposits | 52.80% | 120.07% | 115.27% |
| Total borrowings/total assets | 14.19% | 23.73% | 23.16% |
| Non-performing assets/total assets | 0.15% | 0.14% | 0.27% |
| Loan loss reserves/gross loans | 1.25% | 1.18% | 0.98% |
| Net interest margin | 3.32% | 3.84% | 3.76% |
| Non-interest income/average assets | 0.87% | 0.61% | 0.81% |
| Non-interest expense/average assets | 3.34% | 2.17% | 2.25% |
| Efficiency ratio | 85.26% | 49.49% | 48.89% |
| Return on average assets | 0.47% | 1.34% | 1.47% |
| Return on average equity | 6.07% | 16.16% | 17.19% |
| Price/tangible book value per share | 145.7% | 178.25% | 235.27% |
| Price/LTM earnings per share | 15.69x | 12.76x | 12.93x |
| Dividend payout ratio | 47.7% | 9.0% | 22.2% |
| Dividend yield | 3.0% | 0.49% | 1.42% |

*Analysis of Selected Merger Transactions.* Sandler O'Neill reviewed merger transactions announced from January 1, 2003 to July 14, 2003 involving publicly traded savings institutions as acquired institutions with transaction values greater than $15 million. Sandler O'Neill reviewed 13 transactions



announced nationwide and three transactions in the Western region. Sandler O'Neill reviewed the multiples of transaction price at announcement to last twelve months' earnings per share, transaction price to book value per share, transaction price to tangible book value per share, tangible book premium to core deposits and premium to market price and computed median multiples and premiums for both groups of transactions. These multiples were applied to Klamath's financial information as of and for the twelve months ended March 31, 2003. As illustrated in the following table, Sandler O'Neill derived an imputed range of values per share of Klamath's common stock of $9.96 to $34.85 based upon the median multiples for nationwide transactions and $10.10 to $27.96 based upon the median multiples for transactions in the Western region. The implied transaction value of the merger as calculated by Sandler O'Neill was $20.14 per share.

**Nationwide & Western Region Transaction Multiples**

| | Nationwide | | Western Region | |
|---|---|---|---|---|
| | **Median Multiple** | **Implied Value** | **Median Multiple** | **Implied Value** |
| Transaction value/LTM earnings per share(1) | 16.46x | $ 15.23 | 16.35x | $ 15.13 |
| Transaction value/Book value | 162.07% | $ 28.11 | 155.39% | $ 26.95 |
| Transaction value/Tangible book value | 164.50% | $ 19.31 | 155.39% | $ 18.24 |
| Tangible book premium/Core deposits(2) | 15.64% | $ 34.85 | 10.98% | $ 27.96 |
| Premium to market(3) | 21.52% | $ 21.14 | 20.78% | $ 21.02 |

(1) Assumes core earnings per share for Klamath of $0.93.

(2) Assumes Klamath's core deposits total $1.01 billion.

(3) Based on Klamath's July 11, 2003 closing price of $17.40.

*Discounted Dividend Stream and Terminal Value Analysis.* Sandler O'Neill performed an analysis that estimated the future stream of after-tax dividend flows of Klamath through December 31, 2007 under various circumstances, assuming Klamath's projected dividend stream and that Klamath performed in accordance with the earnings projections provided by Klamath and reviewed with managements of Sterling and Klamath. To approximate the terminal value of Klamath common stock at December 31, 2007, Sandler O'Neill applied price/earnings multiples ranging from 8x to 22x and multiples of tangible book value ranging from 87.5% to 175%. The dividend income streams and terminal values were then discounted to present values using different discount rates ranging from 8% to 14% chosen to reflect different assumptions regarding required rates of return of holders or prospective buyers of Klamath common stock. As illustrated in the following tables, this analysis indicated an imputed range of values per share of Klamath common stock of $10.46 to $32.90 when applying the price/earnings multiples and $10.69 to $24.57 when applying multiples of tangible book value. The implied transaction value of the merger as calculated by Sandler O'Neill was $20.14 per share.

***Earnings Per Share Multiples***

| **Discount Rate** | **8x** | **12x** | **14x** | **16x** | **18x** | **22x** |
|---|---|---|---|---|---|---|
| **8.0**% | $ 13.13 | $ 18.78 | $ 21.60 | $ 24.43 | $ 27.25 | $ 32.90 |

| Discount Rate | 8x | 12x | 14x | 16x | 18x | 22x |
|---|---|---|---|---|---|---|
| **10.0**% | 12.15 | 17.35 | 19.95 | 22.55 | 25.15 | 30.35 |
| **12.0**% | 11.26 | 16.06 | 18.46 | 20.85 | 23.25 | 28.05 |
| **14.0**% | 10.46 | 14.89 | 17.10 | 19.31 | 21.53 | 25.96 |



***Tangible Book Value Per Share Multiples***

| Discount Rate | 87.5% | 112.5% | 125% | 137.5% | 150% | 175% |
|---|---|---|---|---|---|---|
| **8.0**% | $ 13.42 | $ 16.61 | $ 18.20 | $ 19.79 | $ 21.39 | $ 24.57 |
| **10.0**% | 12.42 | 15.36 | 16.82 | 18.29 | 19.75 | 22.69 |
| **12.0**% | 11.52 | 14.22 | 15.57 | 16.92 | 18.28 | 20.98 |
| **14.0**% | 10.69 | 13.19 | 14.44 | 15.69 | 16.93 | 19.43 |

Sandler O'Neill performed a similar analysis that estimated the future stream of after-tax dividend flows of Sterling through December 31, 2007 under various circumstances, assuming Sterling's projected dividend stream and that Sterling performed in accordance with earnings projections for 2003 and 2004 provided by and reviewed with Sterling's management. For periods after 2004, Sandler O'Neill assumed an annual growth rate of earning per share of 11% to 12%**.** To approximate the terminal value of Sterling common stock at December 31, 2007, Sandler O'Neill applied price/earnings multiples ranging from 8x to 22x and multiples of tangible book value ranging from 100% to 275%. The dividend income streams and terminal values were then discounted to present values using different discount rates ranging from 8% to 14% chosen to reflect different assumptions regarding required rates of return of holders or prospective buyers of Sterling common stock. As illustrated in the following table, this analysis indicated an imputed range of values per share of Sterling common stock of $14.65 to $52.80 when applying the price/earnings multiples and $14.19 to $51.14 when applying multiples of tangible book value.

***Earnings Per Share Multiples***

| Discount Rate | 8x | 12x | 14x | 16x | 18x | 22x |
|---|---|---|---|---|---|---|
| **8.0**% | $ 19.20 | $ 28.80 | $ 33.60 | $ 38.40 | $ 43.20 | $ 52.80 |
| **10.0**% | 17.52 | 26.28 | 30.65 | 35.03 | 39.41 | 48.17 |
| **12.0**% | 16.01 | 24.01 | 28.01 | 32.02 | 36.02 | 44.02 |
| **14.0**% | 14.65 | 21.98 | 25.64 | 29.30 | 32.97 | 40.29 |

***Tangible Book Value Per Share Multiples***

| Discount Rate | 100% | 150% | 175% | 200% | 225% | 275% |
|---|---|---|---|---|---|---|
| **8.0**% | $ 18.60 | $ 27.89 | $ 32.54 | $ 37.19 | $ 41.84 | $ 51.14 |
| **10.0**% | 16.97 | 25.45 | 29.69 | 33.93 | 38.17 | 46.66 |
| **12.0**% | 15.50 | 23.26 | 27.13 | 31.01 | 34.88 | 42.64 |
| **14.0**% | 14.19 | 21.29 | 24.83 | 28.38 | 31.93 | 39.02 |

In connection with its analyses, Sandler O'Neill considered and discussed with the Sterling board of directors how the present value analyses would be affected by changes in the underlying assumptions, including variations with respect to the growth rate of assets, net income and dividend payout ratio. Sandler O'Neill noted that the discounted dividend stream and terminal value analysis is a widely used valuation methodology, but the results of such methodology are highly dependent upon the numerous assumptions that must be made, and the results thereof are not necessarily indicative of actual values or future results.

*Pro Forma Merger Analysis.* Sandler O'Neill analyzed certain potential pro forma effects of the merger, assuming the following: (1) the merger closes in the first quarter of 2004, (2) 6,958,902 Klamath shares of common stock are exchanged for 5,358,355 shares of Sterling common stock, (3) earnings per share projections for Sterling and Klamath are consistent with management projections, and (4) purchase accounting adjustments, charges and transaction costs associated with the merger and cost savings are consistent with determinations of the senior managements of Sterling and Klamath. The analysis indicated that for the year ending December 31, 2004, the merger would be accretive to the combined company's projected earnings per share and dilutive to tangible book value per share. The actual results achieved by the combined company may vary from projected results and the variations may be material.

**Pro Forma Merger Analysis**

| | Stand-alone | Pro Forma |
|---|---|---|
| Projected 2004 EPS | $ 2.50 | $ 2.60 |
| Projected Tangible Book Value | $ 17.42 | $ 16.36 |
| *(at December 31, 2004)* | | |

*Contribution Analysis.* Sandler O'Neill reviewed the relative contributions to be made by Sterling and Klamath to the combined institution, based on financial information at and for the twelve months ended March 31, 2003. The percentage of pro forma shares owned was determined using the exchange ratio of 0.77. This analysis indicated that the implied contributions to the combined entity were as follows:

| | Sterling | Klamath |
|---|---|---|
| Total assets | 72.1% | 27.9% |
| Total cash and securities | 56.5 | 43.5 |
| Total net loans | 81.7 | 18.3 |
| Total goodwill | 55.6 | 44.4 |
| Total deposits | 67.5 | 32.5 |
| Total borrowings | 85.0 | 15.0 |
| Tangible equity | 70.6 | 29.4 |
| Total equity | 67.0 | 33.0 |
| LTM Net income | 79.6 | 20.4 |
| Percentage of pro forma shares owned | 73.4 | 26.6 |

Sterling has agreed to pay Sandler O'Neill a transaction fee in connection with the merger equal to 0.50% of the aggregate purchase price, or approximately [$793,000] based upon the closing price of Sterling common stock on [September 12], 2003, $184,000 of which was paid upon execution of the merger agreement and the balance of which is contingent and payable upon closing of the merger. Sterling has also paid Sandler O'Neill $100,000 for rendering its opinion. Sterling has also agreed to reimburse certain of Sandler O'Neill's reasonable out-of-pocket expenses incurred in connection with its engagement up to a maximum of $40,000 and to indemnify Sandler O'Neill and its affiliates and their respective partners, directors, officers, employees, agents, and controlling persons against certain expenses and liabilities, including liabilities under securities laws. In the past, Sandler O'Neill has also provided certain other investment banking services to Sterling and received compensation for such services and may provide, and receive compensation for, such services in the future, including the period in which the merger is pending. Sandler O'Neill has also provided certain investment banking services to Klamath in the past two years and has received compensation for such services.



In the ordinary course of its business as a broker-dealer, Sandler O'Neill may purchase securities from and sell securities to Sterling and Klamath and their respective affiliates and may actively trade the debt and/or equity securities of Sterling and Klamath and their respective affiliates for its own account and for the accounts of customers and, accordingly, may at any time hold a long or short position in such securities.

**Opinion of Klamath's financial advisor**

On May 28, 2003, Klamath's board of directors extended an existing financial advisory engagement with Davidson, retaining Davidson as its financial advisor. The extended engagement also contemplated the issuance of a fairness opinion regarding the merger with Sterling if the Klamath board of directors decided to proceed with the merger. Davidson, as part of its investment banking business, is engaged in the valuation of banking and other businesses and their securities in connection with mergers and acquisitions, negotiated underwritings, competitive biddings, secondary distributions of listed and unlisted securities, private placements and valuations for estate, corporate and other purposes. Klamath's board of directors retained Davidson based upon its reputation and experience as a financial advisor in mergers and acquisitions of financial institutions and its knowledge of financial institutions.

On July 14, 2003, Davidson presented its fairness opinion to the Klamath board of directors at the meeting during which the directors considered and approved the merger agreement. Davidson has also delivered to the board a written opinion dated [October , 2003], which is substantially identical to its July 14th opinion. The Davidson fairness opinion states that, as of the date of the opinion, the merger consideration to be paid by Sterling pursuant to the merger agreement is fair from a financial point of view to the holders of Klamath common stock.

Davidson's opinion is directed to the Klamath board of directors and addresses only the merger consideration specified in the merger agreement. It does not address the underlying business decision to proceed with the merger and does not constitute a recommendation to any shareholder as to how the shareholder should vote at the special meeting of shareholders with respect to the merger. Davidson has consented to the inclusion herein of the summary of its opinion to the Klamath board and to reference to the entire opinion attached hereto as Annex C.

*Summary of Financial Terms of Proposed Merger.* Davidson reviewed the financial terms of the proposed transaction. Based on the closing price of Sterling's stock on July 11, 2003 of $26.15 per share, Davidson calculated an implied transaction value per share of Klamath common stock of $20.14. The implied aggregate transaction value was approximately $144.5 million at that date, which includes $140.1 million for all common stock, as well as $4.4 million for all outstanding Klamath options to purchase Klamath common stock. Based upon the implied transaction value and Klamath's March 31, 2003 financial information, Davidson calculated the following ratios:

| | |
|---|---|
| Implied value/Book Value | 1.1x |
| Implied value/Tangible Book Value | 1.6x |
| Implied value/Last twelve months EPS | 18.5x |
| Implied value/Assets | 9.8% |

Davidson noted that the implied transaction value represented a 15.7% premium over the July 11, 2003 closing price of Klamath of $17.40.

*Review Procedures.* In connection with providing its opinion, Davidson:

- reviewed the merger agreement;



- reviewed certain publicly available financial statements and regulatory information concerning Klamath and Sterling;
- reviewed certain internal financial statements and other financial and operating data of Klamath and Sterling provided to it by management of Klamath and Sterling;
- discussed the past and current operations, and financial condition of Klamath and Sterling, as discussed with management of each company;
- analyzed the future prospects of Klamath and Sterling, as discussed with management, including by not limited to, the interest rate environment and competitive market environments;
- reviewed securities data of publicly traded financial institutions;
- reviewed financial terms, to the extent available, of certain other thrift merger and acquisition transactions; and
- performed other analyses and reviews, as it deemed appropriate.

In connection with its review, Davidson relied upon and assumed the accuracy and completeness of all of the information listed above that it was provided or obtained through publicly available sources. Davidson does not assume any responsibility for independent verification of the information. Davidson assumed that the assumptions and estimates of both managements used to build their forecasts were reasonably prepared, reflecting the best currently available estimates and judgments of the future financial performance of the combined company. Davidson did not independently verify the validity of the assumptions used by management of Klamath or Sterling.

Davidson did not make any independent evaluation or appraisal of the assets and liabilities of Klamath or Sterling, nor was it furnished with any appraisals. Davidson did not examine individual loan files of Klamath or Sterling. Davidson is not an expert in the evaluation of loan portfolios for the purpose of assessing the adequacy of the allowance for loan losses and assumed that these allowances are, in the aggregate, adequate to cover future losses.

Davidson provided its opinion without regard to the necessity for, or level of, any restrictions, obligations, undertakings or other actions, which may be imposed or required in the course of obtaining regulatory approval for the merger. Davidson's opinion is necessarily based upon economic, market and other conditions, and on the information made available to it as of July 14, 2003, and updated as of [October , 2003]. No limitations were imposed on Davidson regarding the scope of its investigation or otherwise by Klamath or Sterling.

*Valuation Methods.* In connection with providing its opinion, Davidson performed a variety of financial analyses, including those summarized below. The information provided below is not a complete description of the analyses Davidson used in reaching its opinion. Preparation of a fairness opinion involves various determinations and judgments as to the most appropriate and relevant methods of financial analysis and the application of these methods to the particular circumstances.

Davidson provided the Klamath board with the results of the various analyses that are described below and advised the Klamath board that it believes that all of its analyses must be considered as a whole and that selecting portions of its analyses and factors considered by the analyses, without considering all analyses and factors, or attempting to ascribe relative weights to some or all such analyses and factors, or including other discrete analyses or factors could create an incomplete view of the evaluation process underlying its opinion. The preparation of a fairness opinion is a complex process involving subjective judgments and is not necessarily susceptible to partial analyses or summary descriptions. With respect to the comparable public company analysis and thrift acquisition transaction analysis, no company or transaction utilized as a comparison is identical to Klamath, or the merger, and such analyses necessarily involve complex considerations concerning the differences in financial



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characteristics of the companies and other factors that could affect the acquisition or public trading values of the companies concerned.

In performing its analyses, Davidson made numerous assumptions with respect to industry performance, general business and economic conditions and other matters, many of which are beyond the control of Klamath, Sterling, the combined company and Davidson.

The summary presented by Davidson to Klamath's board of directors on July 14, 2003 included the following:

- comparable public company analysis;
- historical trends;
- stock trading data history;
- analysis of relative contribution of parties;
- analysis of thrift acquisition transactions;

discounted dividend analysis; and

pro forma merger analysis and accretion/dilution analysis.

The following table summarizes the valuation methodologies and ranges of values that Davidson believed to be material in supporting its fairness conclusion:

| Methodology | Range of Values |
|---|---|
| Comparable Public Company Market Capitalization | $40 to $635 million |
| Klamath on July 11, 2003 | $120 million |
| Sterling on July 11, 2003 | $386 million |
| Stock Trading Data History | |
| Stock Value Range since Oct. 5, 1995 | $9.75 to $24.25 per share |
| 52 Week Trading Range | $13.24 to $17.75 per share |
| Relative Contribution Analysis | $53 to $200 million |
| Thrift Acquisition Transactions | $96 to $234 million |
| All Thrifts in U.S. (Group 1) | $120 to $222 million |
| Thrifts in the Western U.S. (Group 2) | $96 to $207 million |
| U.S. Thrifts: ROAA < 0.75% (Group 3) | $101 to $200 million |
| U.S. Thrifts: $500 M < Assets < $5 B (Group 4) | $117 to $234 million |
| U.S. Thrifts: ROAA < 0.75% and $500 Mil < Assets < $5 B (Group 5) | $115 to $167 million |
| Discounted Dividend Analysis | $97 to $164 million |
| 12% Discount Rate | $112 to $164 million |
| 14% Discount Rate | $104 to $152 million |
| 16% Discount Rate | $97 to $141 million |

*Comparable Public Company Analysis.* Using publicly available information, Davidson compared financial information of Klamath and Sterling based on various measures of earnings performance, operating efficiency, capital adequacy and asset quality generally applied to thrifts. For the purpose of such analysis, the financial information used by Davidson was as of and for the three months ended March 31, 2003. The thrifts examined included representative thrifts with assets over $250 million and



below $5 billion, which were located in the four Western U.S. states where there are publicly traded thrifts (Washington, Oregon, Idaho and California). They included the following:

| | |
|---|---|
| Commercial Capital Bancorp, Inc. | Heritage Financial Corporation |
| EverTrust Financial Group, Inc. | Horizon Financial Corp. |
| FirstBank NW Corp. | PFF Bancorp Inc. |
| FirstFed Financial Corp. | Provident Financial Holdings, Inc. |
| First Mutual Bancshares, Inc. | Quaker City Bancorp, Inc. |
| First PacTrust Bancorp Inc. | Riverview Bancorp, Inc. |
| Harrington West Financial Group, Inc. | Timberland Bancorp, Inc. |
| Hawthorne Financial Corporation | |

To provide some historical context for the performance of both Klamath and Sterling, and the comparable thrifts, and establish the underlying trends in the data for Klamath, Sterling, and the comparable thrifts, Davidson compared data for these companies for the three months ending March 31, 2003 (the most recent reported quarter) to data for the three months ending March 31, 2002 and March 31, 2001. The results of this analysis are presented in the following table.

| | Klamath | | | Sterling | | | Comparable Public Thrifts | | |
|---|---|---|---|---|---|---|---|---|---|
| | 2001 | 2002 | 2003 | 2001 | 2002 | 2003 | 2001 | 2002 | 2003 |
| | | | | | (numbers are %) | | | | |
| Return on Average Assets | 1.18 | 0.46 | 0.25 | 0.54 | 0.74 | 0.85 | 0.97 | 1.16 | 1.21 |
| Return on Average Equity | 10.4 | 6.0 | 3.2 | 10.0 | 13.2 | 14.5 | 8.8 | 11.1 | 13.7 |
| Net Interest Margin | 3.04 | 3.55 | 3.04 | 3.25 | 3.28 | 3.31 | 3.49 | 3.90 | 3.81 |
| Efficiency Ratio | 56.4 | 82.9 | 90.5 | 65.8 | 64.8 | 58.6 | 58.6 | 55.0 | 55.9 |
| Loan Loss Reserve/Loans | 0.77 | 1.21 | 1.23 | 0.86 | 1.00 | 1.19 | 1.07 | 1.12 | 1.20 |
| NPA's/Assets | 0.14 | 0.04 | 0.15 | 0.63 | 0.73 | 0.74 | 0.39 | 0.36 | 0.16 |

This historic perspective reveals the performance trends of Klamath, Sterling and the comparable thrift group. Klamath's trends reveal deteriorating performance, while both Sterling's and the comparable group's median performance reflect generally improving metrics over the same two-year period. As of the most recent reported quarter, Klamath's performance was substantially weaker than the comparable group's median performance; although it maintained a slightly larger loan loss reserve, its credit quality was the same as the comparable group's median.

In addition, Davidson examined various measures of market performance, including, but not limited to, price to: book value, tangible book value, earnings and assets and took the median multiples of the thrift universe and applied those to Klamath's results. The data reflects share prices as of July 11, 2003.

| | Klamath | Sterling | Comparable Company Medians |
|---|---|---|---|
| Price to book value | 0.95x | 1.60x | 1.64x |
| Price to tangible book value | 1.41x | 2.00x | 1.68x |
| Price to TTM Earnings | 16.0x | 12.9x | 13.8x |
| Price to 2003 Earnings(1) | 23.2x | 11.7x | 12.5x |
| Price to 2004 Earnings(1) | 15.8x | 10.5x | 11.1x |
| Price to assets | 8.1% | 10.1% | 16.4% |

(1) IBES estimates as of July 1, 2003.

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Klamath trades at a discount to the comparable company median on price to book value and price to tangible book value, but trades at a significant premium on all three price to earnings ratios. Sterling trades at approximately the median of the comparable companies on price to book value, at a premium on price to tangible book value and at a discount on all three price to earnings ratios. Both Klamath and Sterling trade at a sizable discount on price to assets when compared to the comparable company median.

Currently, Klamath pays a quarterly cash dividend and no stock dividend, while Sterling pays an annual stock dividend and no cash dividend.

*Historical Trends.* Since 2000, interest rates have fallen dramatically. While the decline in consumer residential mortgage rate has had a positive impact on financial performance at most thrifts, this same trend has been particularly detrimental at Klamath because of its strong reliance on its investment securities portfolio and its fixed rate borrowings from the Federal Home Loan Bank. This effect is likely to continue in the short term.

In addition to being negatively affected by falling interest rates, Klamath has experienced a severe run-off in revenue producing loans, reflected in its declining loan-to-deposit ratio as illustrated in the table below. Without evidence that this trend is reversing, Klamath is not likely to generate greater net interest income in the short term. The composition of Klamath's loan portfolio and the loan deposit ratios are presented in the following table.

**Klamath's Loan Portfolio Composition and Loan/Deposit Ratio**

| | June 30, 2001 | June 30, 2002 | March 31, 2003 |
|---|---|---|---|
| | (Dollars in millions) | | |
| Real Estate | | | |
| 1-4 Family | $ 421.8 | $ 367.9 | $ 255.5 |
| Construction | $ 22.4 | $ 15.5 | $ 13.5 |
| Commercial and other | $ 67.7 | $ 123.6 | $ 154.4 |
| Non Real Estate | | | |
| Home Equity | $ 10.5 | $ 60.4 | $ 86.7 |
| Other Consumer | $ 8.7 | $ 19.9 | $ 18.5 |
| Commercial Business | $ 6.3 | $ 55.7 | $ 61.4 |
| Total Gross Loans | $ 537.3 | $ 643.0 | $ 590.0 |
| Loan/Deposit Ratio | 73.6% | 55.2% | 52.8% |

*Stock Trading Data History.* Davidson reviewed daily stock price data for Klamath common stock and Sterling common stock compared to the comparable thrift group listed above and the S&P 500 over a one-year period from July 1, 2002 to July 1, 2003. This analysis showed that over this period, Klamath's common stock increased in value 13%, the value of Sterling's stock increased 40% and the value of the comparable thrift index increased 25%, while the S&P 500 index increased 3%.

Additionally, Davidson reviewed daily stock price data for Klamath common stock and Sterling common stock compared to the comparable thrift group and the S&P 500 over a three-year period from July 1, 2000 to July 1, 2003. This analysis showed that over this period, Klamath's common stock increased in value 55%, the value of Sterling's common stock increased 242% and the value of the comparable thrift index increased 143%, while the S&P 500 index decreased 33%.

The trading valuation for Klamath common stock at July 11, 2003 appeared to be significantly higher on a price to book value and price to trailing twelve months and to forward 2003 and 2004 forecast earnings than the valuations for other comparable thrifts when taking into consideration return on average assets and return on average equity.

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*Analysis of Relative Contribution of Parties.* In preparing its opinion, Davidson also reviewed the relative financial contributions of Klamath and Sterling to certain pro forma balance sheet and income statement items of the combined entity. The chart below shows these percentage contributions.

**Relative Contributions as of and for the three months ended March 31, 2003**

| | Klamath | Sterling | Exchange Ratio | Implied Per Share Value(1) |
|---|---|---|---|---|
| Est. CY 2003 Net Income | 12% | 88% | 0.29x | $ 7.63 |
| Est. CY 2004 Net Income | 15% | 85% | 0.38x | $ 9.89 |
| Net Loans | 18% | 82% | 0.48x | $ 12.57 |
| TTM Net Income | 20% | 80% | 0.55x | $ 14.30 |
| Market Capitalization | 24% | 76% | 0.67x | $ 17.40 |
| Total Assets | 28% | 72% | 0.82x | $ 21.47 |
| Tangible Equity | 29% | 71% | 0.88x | $ 22.90 |
| Deposits | 33% | 67% | 1.02x | $ 26.77 |
| Equity | 33% | 67% | 1.05x | $ 27.40 |

(1) Based on the closing price of Sterling common stock of $26.15 on July 11, 2003**.**

The per share consideration, using the Sterling closing price on July 11, 2003 of $26.15, is $20.14, or $144.5 million in aggregate, which compares favorably with the implied per share value range in the table above of $7.63 to $27.40, or $53 million to $200 million in the aggregate.

Considering the 5,358,355 common shares of Sterling to be exchanged for all of the outstanding common shares of Klamath, Klamath shareholders will own approximately 26.6% of the combined company based upon the relative amounts of common stock owned by Klamath and Sterling common shareholders following closing of the transaction.

*Analysis of Thrift Acquisition Transactions.* After completing its analysis of the fairness of the total merger consideration based on the relative contributions of the parties, Davidson reviewed other thrift merger and acquisition transactions to further confirm its opinion. Davidson examined the following comparison groups:

Group 1 Group of 124 thrift transactions in the United States that were announced from January 1, 2001 through July 11, 2003. This includes all transactions, regardless of size or other characteristics, announced in the United States during that time period. These acquired thrifts ranged in size from $8.5 million to $54.1 billion in assets at announcement.

Group 2 Group of 11 thrift acquisitions in the Western United States (Washington, Oregon, California, Idaho, Nevada, Hawaii, Montana, Wyoming, Colorado and New Mexico) announced between January 1, 2001 and July 11, 2003. These acquired thrifts ranged in size from $21.5 million to $54.1 billion in assets at announcement.

Group 3 Group of 75 thrift acquisitions of institutions with less than 0.75% return on average assets. These transactions were announced in the United States from January 1, 2001 through July 11, 2003. The acquired thrifts ranged in size from $8.5 million to $2.2 billion in assets at announcement.

Group 4 Group of 29 thrift acquisitions where the target's assets were greater than $500 million, but less than $5 billion in assets. These transactions were announced in the United States from January 1, 2001 through July 11, 2003. These acquired thrifts ranged in size from $507.1 million to $2.9 billion in assets at announcement.



Group 5 Group of 10 thrift acquisitions where the target's assets were greater than $500 million but less than $5 billion and return on average assets was less than 0.75%. These transactions were announced in the U.S. from January 1, 2001 through July 11, 2003. These acquired thrifts ranged in size from $507.1 million to $2.2 billion in assets at announcement.

Below is a table that displays the median value of the targets in each group of transactions.

| | Group 1 | Group 2 | Group 3 | Group 4 | Group 5 |
|---|---|---|---|---|---|
| Assets ($ Mil) | $ 147.1 | $ 213.3 | $ 93.9 | $ 948.3 | $ 937.3 |
| ROAA | 0.67% | 1.00% | 0.38% | 1.00% | 0.58% |
| ROAE | 6.5% | 12.7% | 3.5% | 11.9% | 8.1% |
| Efficiency Ratio | 73.2% | 57.6% | 82.3% | 59.0% | 72.8% |
| NPA's/Assets | 0.37% | 0.68% | 0.45% | 0.31% | 0.68% |

Davidson reviewed the multiples of transaction value for common stock shareholders at announcement to last twelve months' earnings, tangible book value, assets and premium to market value. These multiples were applied to Klamath's financial information for the last twelve months ending March 31, 2003.

Davidson derived an imputed range of values for Klamath of $96 million to $234 million based on the median multiples. A summary is shown below:

| | |
|---|---|
| Group 1 Imputed Value Range | $120 million to $222 million |
| Group 2 Imputed Value Range | $96 million to $207 million |
| Group 3 Imputed Value Range | $101 million to $200 million |
| Group 4 Imputed Value Range | $117 million to $234 million |
| Group 5 Imputed Value Range | $115 million to $167 million |

| | Group 1 | | Group 2 | | Group 3 | | Group 4 | | Group 5 | |
|---|---|---|---|---|---|---|---|---|---|---|
| | **Median** | **Implied Value** | **Median** | **Implied Value** | **Median** | **Implied Value** | **Median** | **Implied Value** | **Median** | **Implied Value** |
| | **(Dollars in millions)** | | | | | | | | | |
| TTM EPS | 19.5x | $ 140.4 | 13.3x | $ 95.8 | 27.4x | $ 197.3 | 16.3x | $ 117.4 | 15.9x | $ 114.5 |
| Tangible Bk Value | 1.49x | $ 120.0 | 1.53x | $ 123.2 | 1.25x | $ 100.6 | 2.12x | $ 170.7 | 1.46x | $ 117.5 |
| Assets | 15.0% | $ 221.7 | 14.0% | $ 206.9 | 13.5% | $ 199.5 | 15.8% | $ 233.5 | 11.3% | $ 167.0 |
| Market Premium | 31.5% | $ 157.0 | 30.6% | $ 155.9 | 40.2% | $ 167.4 | 23.0% | $ 146.7 | 31.0% | $ 156.4 |

Based on just the imputed valuations of these transaction groups, Davidson reported that the valuation for Klamath would be in a range of $96 million to $234 million. Assuming the July 11, 2003 price of the Sterling common stock, Davidson calculated the value of the consideration in the merger to be $144.5 million. Davidson stated that the most significant determinants of the valuation for Klamath are the Trailing Twelve Months Earning Per Share (TTM EPS) and tangible book value multiples.

The median values of the five comparison groups are shown below.

| | TTM EPS | Tangible Book Value | Assets | Market Premium |
|---|---|---|---|---|
| | **(Dollars in millions)** | | | |
| Median | $ 117.4 | $ 120.0 | $ 206.9 | $ 156.4 |

When compared to the median valuation metrics values, the merger valuation of $144.5 million is above the median when valued on a TTM EPS and tangible book value basis. Predictably, the merger valuation is significantly lower than the valuation predicted by the group medians for assets because of Klamath's reduced earnings when compared to its significant total assets and the relatively large percentage of its assets that consists of investment securities rather than higher yielding loans.

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*Discounted Dividend Analysis.* Using a discounted dividend stream analysis, Davidson examined the value of Klamath by adding the present value of estimated earnings that could be paid out as dividends, using management's assumptions and guidance, for calendar years 2003 through 2007 and an estimated terminal value for Klamath's stock assuming a sale at the end of 2007. The terminal value was then estimated by applying a range of multiples of 12 to 18 times estimated 2007 earnings. Davidson discounted the dividend stream and terminal value using discount rates of between 12% and 16%. These rates were chosen to reflect different assumptions regarding required rates of return to holders or prospective buyers of Klamath common stock. The analysis provided three valuation ranges, based on the various discount rates. The 12% discount rate produced a range of $112 million to $164 million, the 14% discount rate produced a range of $104 million to $152 million, and the 16% discount rate produced a range of $97 million to $141 million. The midpoints of these three ranges were $138 million, $128 million and $119 million, respectively. These values compare to the acquisition consideration of approximately $144.5 million, using closing price of Sterling common stock on July 11, 2003 of $26.15.

*Pro Forma Acquisition Analysis.* Davidson reviewed projections prepared by the managements of Klamath and Sterling for year-end 2003, 2004 and 2005.

The earnings projections for Klamath and Sterling used by Davidson in its analysis were based upon internal projections by Klamath and Sterling for the years ending December 31, 2003, December 31, 2004 and December 31, 2005. The earnings projections furnished to Davidson were prepared for internal purposes only and not intended for public disclosure. The projections assume that there will be no substantial shift in future economic, financial market, competitive and regulatory conditions, all of which are difficult or impossible to predict and largely beyond the control of both parties to this merger. With respect to all financial projections prepared by Klamath's and Sterling's management used by Davidson in its analysis, Davidson assumed that they reflected the best currently available estimates and judgments of the respective managements of the respective future financial performances of Klamath and Sterling and that such performances will be achieved. Davidson expressed no opinion as to such financial projections or the assumptions on which they were based.

Actual results achieved by the combined company following the merger may vary from this and other forecasts, and the variations may be material. Like all forward-looking statements, this analysis produces results that are inherently uncertain.

*Accretion/Dilution Analysis.* This review examined whether and by how much the proposed transaction is expected to be accretive to Sterling's earnings in calendar year 2004, the first year of the combined company's operations. The critical part of this analysis is the set of assumptions which drive the earnings per share estimate.

Davidson concurs with the assertion of management of both companies that the proposed merger will be accretive to Sterling shareholders in 2004.

*Relationship of Davidson to Klamath and Sterling.* Klamath agreed to pay Davidson for its financial advisory services and for rendering its fairness opinion, a fee of 0.75% of the aggregate consideration paid by Sterling or approximately [$1,190,000] based upon the closing price of Sterling common stock on [September 12], 2003, of which $175,500 has already been paid. Klamath has also agreed to reimburse Davidson for its reasonable out-of-pocket expenses incurred in connection with its engagement. Klamath also agreed to indemnify Davidson, its affiliates, directors, officers, agents, managers, members, attorneys, stockholders, employees and controlling persons against certain expenses and liabilities in connection with its engagement.

Davidson has in the past provided investment banking services to Klamath unrelated to the merger, for which it has received compensation. Davidson has also received compensation for



investment banking services provided to Sterling unrelated to the merger, including acting as one of the placement agents in connection with a trust preferred securities offering for Sterling.

Davidson makes a market in the common stock of Klamath, and publishes a research recommendation on and makes a market in the common stock of Sterling. In the ordinary course of Davidson's business, Davidson and its affiliates may actively trade securities of Klamath and Sterling for their own and for the accounts of customers, and may, therefore, at any time hold a long or short position in such securities.

**Structure of the merger**

Subject to the terms and conditions of the merger agreement and in accordance with Washington and Oregon law, at the completion of the merger, Klamath will merge with and into Sterling. Sterling will be the surviving corporation and will continue its corporate existence under the laws of Washington and under the name "Sterling Financial Corporation." When the merger is completed, the separate corporate existence of Klamath will terminate. Sterling's articles of incorporation and bylaws will be the articles and bylaws of the combined company. The board of directors of Sterling will continue as the board of directors of the combined company.

The merger agreement provides that Sterling may change the structure of the merger. However, no such change may reduce the amount or change the form of consideration to be delivered to Klamath shareholders, adversely affect the anticipated tax consequences to Klamath shareholders in the merger, or delay or jeopardize receipt of any required regulatory approvals to complete the merger.

**Exchange ratio; possible adjustment of exchange ratio**

At the effective time of the merger, each outstanding share of Klamath common stock will be converted into 0.77 shares of Sterling common stock. The closing price for Sterling common stock on [October 31, 2003] was [$ ]. The market value for Sterling common stock will fluctuate prior to the closing of the merger. The merger exchange ratio is fixed. Therefore, regardless of the market price of Sterling common stock at the time of closing, you will receive no more than 0.77 of a share of Sterling common stock for each share of Klamath common stock that you own. Thus, you may receive more or less than the equivalent of $[ ] per share of Klamath common stock in the merger. You will receive cash for any fractional share you would otherwise receive in the merger. The exchange ratio was determined through arm's-length negotiations between Sterling and Klamath.

The amount of cash that Sterling will pay you in lieu of a fractional share will equal the average closing price of Sterling common stock on the Nasdaq National Market over the ten trading days ending on and including the fifth trading day before the closing date, multiplied by the fraction of a share of Sterling common stock to which you would otherwise be entitled. Klamath shareholders will not receive interest on cash payments in lieu of fractional shares.

At the effective time of the merger, shares of Klamath common stock will no longer be outstanding, will automatically be canceled and will cease to exist. Holders of certificates representing shares of Klamath common stock will cease to have any rights as shareholders of Klamath except the right to receive certificates representing shares of Sterling common stock and the right to receive cash for any fractional share of Sterling common stock.

**Treatment of options and employee stock purchase and benefit plans**

At the effective time of the merger, each stock option granted by Klamath under the Klamath Stock Option Plan shall be automatically converted into an option to purchase shares of Sterling common stock, based upon the exchange ratio, subject to the terms of the merger agreement and the Klamath Stock Option Plan.



Sterling has agreed to allow any unallocated shares of Klamath common stock in the Klamath ESOP (following retirement of all borrowings of the Klamath ESOP) to be allocated to participants and to cause any overfunding to be allocated to participants as earnings. For the period prior to the effective time of the merger, Klamath may make contributions to the Klamath ESOP, payments on the Klamath ESOP loan and one additional allocation, in October 2003, to the accounts of participants in the Klamath ESOP consistent with past practices on the regularly scheduled payment dates.

Sterling has agreed to merge the Klamath 401(k) Plan into Sterling's 401(k) Plan. Sterling will also offer Klamath employees who remain at Sterling benefits commensurate with the benefits it gives to comparable Sterling employees. To the extent that credited periods of service determine eligibility, vesting and benefit accruals under any Sterling employee benefit plan, Sterling will credit former Klamath employees for any service credit recognized by Klamath or its subsidiaries with respect to eligibility and vesting under the Sterling plans, but not with respect to benefit accruals.

Except as provided above, Klamath has agreed to terminate or withdraw from all of Klamath's employee benefit plans at or as soon as reasonably practicable after the effective time of the merger. Sterling and Klamath have agreed to cooperate in taking the appropriate actions.

**Interests of Klamath's directors and executive officers in the merger**

When considering the recommendation of Klamath's board of directors, you should be aware that some of Klamath's directors and executive officers have interests in the merger and have arrangements that are different from, or are in addition to, their interests as shareholders of Klamath generally. These include, among other things, indemnification rights, potential acceleration of option vesting and other benefits and payments under certain agreements and employee benefit and retention plans.

Board of directors. The merger agreement provides that Sterling shall appoint one member of Klamath's board of directors, selected by Sterling, to Sterling's board of directors and two members of Klamath's board of directors, selected by Sterling, to Sterling Savings Bank's board of directors.

Stock options. All outstanding Klamath options at the time of the merger shall be automatically converted into an option to purchase shares of Sterling common stock in an amount and at an exercise price as provided in the merger agreement and otherwise subject to the terms of Klamath's 1996 Stock Option Plan under which such option was granted. The merger agreement provides that the amount and exercise price of the options shall be determined by the same exchange ratio and fractional share provisions as the outstanding shares of Klamath common stock. See "Exchange ratio; possible adjustment of exchange ratio." The 1996 Stock Option Plan also provides that all outstanding options become fully vested and exercisable as of the effective date of a change in control. The completion of the merger between Sterling and Klamath will constitute a change of control for such purposes. The following directors and executive officers will have options for Klamath shares vest early as a result of the completion of the merger: Donald N. Bauhofer 23,243 shares at an exercise price of $16.846 per share; Walter F. Dodrill 16,000 shares at an exercise price of $13.10 per share; and Frank X. Hernandez 12,000 shares, Craig M Moore 9,000 shares, and James E. Essany 9,000 shares, all at an exercise price of $13.063 per share. A total of 79,743 options will vest early for all directors and employees of Klamath as a result of the completion of the merger.

Restricted stock. All outstanding Klamath restricted stock at the time of completion of the merger shall be automatically converted into shares of Sterling common stock at the same exchange ratio and fractional share provisions as the outstanding shares of Klamath common stock. See "Exchange ratio; possible adjustment of exchange ratio." The 1996 Management Development and Recognition Plan also provides that all awarded restricted stock (including the right to receive previously paid cash dividends with respect thereto and accrued interest thereon)