Five Star Bancorp

Third Quarter 2022 Earnings

October 25, 2022, at 1:00 p.m. Eastern

CORPORATE PARTICIPANTS

James Beckwith - *President and Chief Executive Officer*

Heather Luck - *Senior Vice President and Chief Financial Officer*

PRESENTATION

Operator
Good day, everyone. And welcome to the Five Star Bancorp Third Quarter Earnings Webcast. Please note, this is a closed conference call and you're encouraged to listen via the webcast. After today's presentation, there will be an opportunity for those provided with a dial-in number to ask questions. To ask a question, you may press star and then one on your telephone keypad. To withdraw your questions, you may press star then two.

Before we get started, let me remind you that today's meeting will include some forward-looking statements within the meaning of applicable securities laws. These forward-looking statements relate to, among other things, current plans, expectations, events, including the continuing impact of the COVID-19 pandemic and industry trends that may affect the company's future operating results and financial position. Such statements involve risks and uncertainties and future activities and results may differ materially from these expectations. For a more complete discussion of the risks and uncertainties that may cause actual results to differ materially from the company's forward-looking statements, please see the company's annual report on Form 10-K for the year ended December 31, 2021, and in particular the information set forth in Item 1A, Risk Factors therein.

Please refer to slide 2 of the presentation, which includes disclaimers regarding forward-looking statements, industry data and non-GAAP financial information included in this presentation, as well as reconciliations to non-GAAP financial measures to the most directly comparable GAAP figures, which is included in the appendix to the presentation. Please note, this event is being recorded.

And at this time I'd like to turn the floor over to James Beckwith, Five Star Bancorp President and CEO. Please go ahead.

James Beckwith
Thank you for joining us to review Five Star Bancorp's financial results for the third quarter of 2022. Joining me today is Heather Luck, Senior Vice President and Chief Financial Officer. Our comments today will refer to the financial information that was included in the earnings announcement released yesterday. To obtain a copy of the release, please visit our website at fivestarbank.com and click on the Investor Relations tab. In the company overview section, we have provided a brief overview of our geographic footprint and executive management team.

The third quarter of 2022 exhibited continued execution of our organic growth strategy, as evidenced by our earnings, expense management and balance sheet trends during the quarter. Additionally, loans, deposits and total assets have consistently grown since the prior periods. Our pipeline continues to remain substantial at the end of the third quarter of 2022 within the verticals we have historically operated in, as presented in the loan portfolio diversification slide.

Loans held for investment increased during the quarter by $202.5 million or 8.51% from the prior quarter, primarily within the commercial real estate concentration of the loan portfolio. Loan originations during the quarter were approximately $321.3 million and payoffs were $118.7 million. All PPP loans have been forgiven or paid off by the borrower at September 30, 2022.

Asset quality continues to remain strong, with non-performing loans representing only 0.02% of the portfolio, slightly decreasing from the last several quarters. At quarter end, there were no loans on COVID-19 deferments.

At the end of the third quarter, the allowance for loan losses totaled $27.8 million. We recorded a $2.3

million provision for loan losses during the quarter, primarily related to loan growth. The ratio of the allowance for loan losses to total loans was 1.08% at quarter end.

Loans designated as substandard totaled approximately $0.5 million at the end of the quarter, representing a decrease in substandard loans of approximately $0.8 million from the previous quarter.

Now that we have discussed the loan portfolio, I will hand it over to Heather to discuss deposits, capital and the results of operations. Heather?

Heather Luck
Thank you, James, and hello, everyone. During the third quarter, deposits increased by $113 million or 4.52% as compared to the previous quarter. Non-interest-bearing deposits as a percent of total deposits at the end of the third quarter decreased to 39% from 40.2% at the end of the previous quarter.

We have had strong deposit growth over the last several quarters, with deposit balances increasing when compared to the prior quarter. Non-interest-bearing deposits increased by $14.6 million, while interest-bearing deposits increased by $98.5 million. The cost of total deposits was 43 basis points during the third quarter.

We continue to be well capitalized with all capital ratios well above regulatory thresholds for the quarter. Additionally, we completed a private placement of $75 million in aggregate principal amount of fixed to floating rate subordinated notes due September 1, 2032, on August 17th.

The proceeds received from the subordinated notes, net of debt issuance costs and required debt servicing reserves will be used to redeem $28.8 million of previously existing subordinated notes on December 15, 2022, with the remaining $39 million downstream to Five Star Bank during the quarter.

Net income for the quarter was $11.7 million, return on average assets was 1.6% and return on average equity was 19.35%. New loan originations drove increases in the daily average balance of loans period-over-period. Average loan yield for the quarter was 4.74%, representing an increase of 27 basis points over the prior quarter. As a result of these factors, our net interest margin was 3.84% for the quarter, while net interest margin for the prior quarter was 3.7%.

The change in the yield curve as a result of interest rate hikes that occurred during the quarter had a negative impact on the company's accumulated other comprehensive income during the quarter in the amount of $4.7 million, primarily in our mortgage-backed and municipal securities portfolios, resulting in decreases to each of those portfolios of $3 million and $1.7 million, respectively.

This further decline in tangible book value per share, which is a non-GAAP financial measure discussed in our press release. This decline was offset by increases to tangible book value per share due to an increase in equity as a result of net income earned in the quarter for a net increase in tangible book value per share of $0.35.

Non-interest income decreased to $1.5 million in the third quarter from $2 million in the previous quarter, due primarily to a $0.3 million decrease in gain on sale of loans relating to lower volumes of loans sold during the quarter and a $0.2 million decrease in loan related fees due to lower swap referral fees earned during the quarter.

Non-interest expense remained relatively flat quarter-over-quarter, with increased professional services of $0.2 million related to legal expenses incurred for corporate organizational matters completed in

2022, offset by declines in other operating expenses of $0.3 million related to reduced travel expenses incurred during the quarter related to attendance of professional events, conferences and other business related travel combined with a $0.1 million of lower loan related expenses incurred.

Now that we have discussed the overall results of operations, I'll now hand it back to James to provide some closing remarks.

James Beckwith
Thank you, Heather. I want to thank everyone for joining us as we discuss the third quarter results. The strength of the Bank's third quarter financial results is emblematic of a reputation built on trust, speed to serve and certainty of execution, which support our clients' success.

Our financial results are also the result of a truly differentiated customer experience, which powers the demand for Five Star Bank's relationship-based services. We attribute sustained success through our prudent business model and treating customers with an empathetic spirit, understanding and care. We are very proud to have earned the trust of those we serve, including our shareholders.

Looking to the remainder of 2022 and 2023, we will be guided by a focus on shareholder value as we monitor market conditions. We are confident in the company's resilience in any interest rate environment and we'll continue to execute on our organic growth strategy and disciplined business practices, which we believe will benefit our customers, employees, community and shareholders.

We appreciate your time today. This concludes today's presentation. Now Heather and I will be happy to take any questions you might have.

QUESTIONS AND ANSWERS

Operator
Ladies and gentlemen, we'll begin the question and answer session. Once again, to ask a question, you may press star and then one using a touchtone telephone. If you are using a speakerphone, we do ask that you please pick up the handset prior to pressing the numbers to ensure the best sound quality. If you decide to withdraw your question, you may do so by pressing star and then two. Once again, that is star and then one to join the question queue. We'll pause momentarily to assemble the roster.

And our first question today comes from Andrew Terrell from Stephens. Please go ahead with your question.

Andrew Terrell
Hey. Good morning, James. Good morning, Heather.

James Beckwith
Good morning, Andrew. How you doing?

Andrew Terrell
Good. How are you guys?

James Beckwith
We're here bright and shiny.

Andrew Terrell
Good. Good. Thanks for the time. Maybe if I could start, James, on loan growth, it came in I think a bit

better than we anticipated this quarter and maybe a bit better than we spoke about on last quarter's call. I think your comments about strength and resiliency in the pipeline, I'm just curious if you could maybe provide us expectation for growth in the fourth quarter. I am assuming we should think about a moderation from here, but would love to hear your thoughts on the cadence of loan growth moving forward and then any specific areas of the portfolio that you think will drive that strength.

James Beckwith
Sure. We did experience strong loan growth in the third quarter. And as we roll into the fourth quarter, we're into it already, we don't expect our loan growth to be the same, but it will still be decent. Our pipeline right now as we sit here today, Andrew, is substantially less than what it was at its peak, and we have seen things slow down in all of our segments, in all of our verticals. I think that the opportunities for loan growth, or at least loan growth as it's been at Five Star Bank, I think, those are waning, but we still expect decent loan growth. As we move forward, we're very comfortable with the 10% to 15% loan growth on an annualized basis as we move forward finishing up 2022, and more importantly, rolling into 2023.

What's happened in the commercial real estate space is that cap rates have increased, obviously, interest rates have increased, so deal volume is just off across all segments. And that's going to cause, I think some slowdown in loan growth. Now the business is still there, okay, but not in the same degree as it was in the first three quarters of 2022.

Andrew Terrell
Yes, understood. I appreciate that. And as you think about being comfortable with that 10% to 15% loan growth range, on the other side of the balance sheet, I know deposit growth has been kind of tougher across the industry the past couple of quarters. Do you think going forward you can kind of core fund that level of loan growth, and can you maybe speak to just what you're seeing from a deposit perspective within your growth pipeline?

James Beckwith
Sure. We believe we can fund that with core deposits for the remainder of the year and also as we roll into 2023. What gets me comfortable about that statement, Andrew, is that we have a very well-developed business development team. We have 20 people that that's what they do, that's their job. And we think we're unique in that respect. And we have the right incentives, we have the right technology, we have the right service capability really to grow our core deposits. So I feel pretty confident that we'll be able to do that.

Certainly, it's an area of emphasis right now, it's probably top of the number one thing that we're trying to do right now is grow core deposits. So it's certainly got all of our attention and all of our efforts to do that. So I feel very confident that we'll be able to achieve that.

Andrew Terrell
Okay.

James Beckwith
And probably in the neighborhood of, I'm going to say slightly more than our loan growth, that's what we're planning in 2023, to have a deposit growth of anywhere between 2% to 4% greater than our loan growth.

Andrew Terrell
Okay. Very good. That's helpful color. I appreciate it. Maybe if I could shift gears, Heather, on the non-interest expense, I think came in a bit better than we were forecasting. I'm curious kind of your

expectations, I know there's probably a lot of moving pieces with inflation and everything, just curious your expectations on the expense base, is this a good kind of run rate heading into the fourth quarter? And then, can you remind us how we should think about the cadence of expenses throughout the year in 2023?

Heather Luck
Sure. So, Q3 was a really good proxy for where we think expenses are going to land for Q4 from a salaries perspective. The wildcard is usually just timing of travel and timing of attendance of professional events. So I believe Q3 should be a good proxy and then as we grow, you can take that ratio of the expenses as a percent of total assets and just walk it forward with that, I think that would be a good method for your model.

One item I do want to highlight though that we will see in Q4, is we will be recognizing about $300,000 of additional subordinated note debt issuance costs when we redeem the original tranches of the subordinated notes. Those were previously amortized to the maturity date rather than the call date, so we will be recognizing about $300,000 there.

James Beckwith
Just to add on to that, Andrew, if I could, I think you're aware of this, is that we do have a carry on that $28.8 million of subordinated notes all the way through December 15th. So we'll be dealing with that in the fourth quarter but not in 2023. So just want to make sure you're aware of that.

Andrew Terrell
Yes, absolutely. But I appreciate the flag. Okay. Thanks for taking my questions. Congrats on a good quarter, and I'll hop back in the queue.

Heather Luck
Thank you.

Operator
And our next question comes from Gary Tenner from D.A. Davidson. Please go ahead with your question.

Gary Tenner
Thanks. Good morning. I wanted to go back to the questions about loan deposit growth for the third quarter. I think, James, on the call last quarter, as well as may be intra-quarter, there was commentary around the deposit pipeline running ahead of the loan pipeline and maybe an expectation that this quarter you'd be able to fund or match the growth of loans with that deposit. So I guess I'm just curious, your deposit growth was obviously strong and last quarter was flat, so stronger than that. Was the loan growth or the net loan growth more of a positive surprise this quarter versus the deposit growth being "disappointing," if I put that in quotes?

James Beckwith
Sure. Yes. It's a very fluid matter with respect to deal flow that we see. We have a tendency to do some loans of $5 million to $10 million that will move the needle. So they come up frequently and so we've taken advantage of those opportunities, if they're priced well, well-structured and have great sponsorship and relative safe loans. So that was, I think, a nice surprise for us.

But today as we sit, Gary, we still have a substantial deposit pipeline that's significantly more than our loan pipeline. That condition still exists today. Now, I don't know if it's wishful thinking, but I can tell you that developing core deposits is a lot more lengthy process than making loans, I think that the industry understands that also well. And so sometimes to onboard a major customer it takes a lot longer. And so that's what exist in our deposit pipeline, and those efforts are ongoing and it could take up to six months to nine months sometimes to on board a deposit customer, a substantial deposit customer. So, I'm still very bullish on the fact of us being able to grow core deposits, and as we go forward, and especially in 2023, we expect our deposit growth to be greater than our loan growth.

Gary Tenner
I appreciate that. I'm sure once those deposits are in the door, they're quite sticky, but I think conversion from pipeline to bringing them in-house might be a little more fickle. Is that a fair comment?

James Beckwith
It takes longer.

Gary Tenner
Yes. Okay. And then just, Heather, your comment on the $300,000, I think, you said, of those sub-debt cost so that you're going to redeem, is that through non-interest expense or is that going to be through interest income?

Heather Luck
That will be through interest income.

Gary Tenner
Okay.

Heather Luck
$300,000.

Gary Tenner
Great. Thank you.

Heather Luck
Yes.

Operator
Once again, if you would like to ask a question, please press star and then one. To withdraw your questions, you may press star and two. Our next question comes from Woody Lay from KBW. Please go ahead with your question.

Woody Lay
Hey. Good morning, guys.

James Beckwith
Good morning.

Woody Lay
The interest-bearing deposit beta was a little over 30% in the quarter from my calculation. Do you think it's fair to expect that deposit beta to trend up in the quarters ahead or is this a pretty good run rate going forward?

Heather Luck
We've looked at it on a quarterly basis and a monthly basis, and I think a 30% beta is still a fair

estimate, because what you'll see is, all of our pricing is customized and unique to each customer. And so on a monthly basis it will peak in value, but it will even out at about 30% for the quarter.

Woody Lay
Got it. And then I know there will be some noise in the NIM just with the debt issuance and the redemption. But stripping out those moving parts, how should we think about the NIM going forward? Do you think it's relatively stable or could we see some additional expansion from here?

James Beckwith
Well, as we look at it, we think it's going to be anywhere between 3.8% and 3.9% on a go forward basis as we roll into 2023, and that's kind of what we're planning to see. And so we have to execute on that. And what makes it, I'm not going to say difficult to predict, but certainly they have to understand how we price our funding cost. And as Heather mentioned, our relationships with our deposit customers, pricing is unique, and especially in a rising rate environment. So I think we're going to be able to maintain that 30% deposit beta and also maintain our margins between 3.8% and 3.9% on a go forward basis.

Woody Lay
That's good to hear. And then last, just shifting to credit, credit remained super clean from an NPA and classified loan point of view. As you talk to your borrowers, how are you feeling about the credit environment as we head into the fourth quarter?

James Beckwith
We feel good about it, but we're very cautious also. We recognize that some of our borrowers may have some stress. But I think you need to look at, Woody, look at the composition of our loan portfolio. We have a lot of mobile home community loans and we think that asset class is very stable in any economic environment. And so we think it's going to perform better in a recession than any other asset class. So we feel like we're a bit protected, if you will.

Our office component, which is a concern, it's certainly not our top CRE concentration, in fact it's probably well down the rung at this point, and very manageable. So we're focused on that particular segment and we think that we've got good credits in there and good sponsorship. So we're comfortable with our credit quality as we exist here today, but we do understand that dark clouds are ahead of us and we want to make sure we're prepared, that we're reserving appropriately and that any action that we may take on a credit, we'll act quickly to mitigate any downside risk.

Woody Lay
All right. That's great color. That's all from me. Thanks, guys.

James Beckwith
Thank you.

Operator
And our next question is a follow-up from Andrew Terrell from Stephens. Please go ahead with your follow-up.

Andrew Terrell
Hey. Thanks for the follow-up. I wanted to dovetail off the last question on credit. I'm just curious if you're altering any of your underwriting standards, kind of tightening the reins at all in go forward credit or have you made changes more recently in terms of portfolio monitoring, just contemplating the current backdrop?

James Beckwith
In terms of any changes in our deal terms and whatnot, I will tell you that we've increased our spreads, so what that really forces borrowers who want to do business with us, they're going to have to put more money in every deal. And so their down payments and their sponsorship is going to have to be that much more significant.

So we have solid underwriting practices to begin with, but we have increased our spreads to compensate, one, for interest rate risk, but also we want to make sure that as we move forward and we're putting on credit at this particular point that it's very, very solid. There's business to be had, but it's got to be really good business.

Andrew Terrell
Yes. Okay. And then on capital CET1 ratio low 9% territory this quarter, can you just remind us what your targeted capital metric is? And I guess given kind of the current backdrop and your expectation for balance sheet growth moving forward, is it fair to think that the capital ratio is across the board build from this level?

James Beckwith
Yes. As we look at our plan going out with Heather, we're right in the middle of our planning process looking at our plan going out for five years, so we believe we'll be able to grow our capital levels with a 10% loan growth factor. So we're comfortable with that scenario given our current payout ratios. So we think that we will be building tangible book value and regulatory capital.

Andrew Terrell
Yes. And do you have kind of targeted metric, whether it's CET1 or total capital, just any targeted capital metric that you focus on?

James Beckwith
Well, historically, we've been very oriented towards total capital. We like it to be north of 11%, target 11.5% to 12% Tier 1 capital. Now that we did another round of subordinated debt, we're focused on trying to grow that to 10%. We're not there yet, it's going to take a few quarters to get there, but that's our goal.

Andrew Terrell
Okay. Thanks for the follow-ups.

CONCLUSION

Operator
Ladies and gentlemen, with that, we have reached the end of today's question-and-answer session. I'd like to turn the floor back over to management for any closing remarks.

James Beckwith
Great. Thank you. Five Star Bancorp is on a continued path of robust organic growth as we execute on strategic initiatives, which include growing our verticals and geographies while attracting and retaining talent. Our people, technology, operating efficiencies, conservative underwriting practices and expense management have also contributed to the success we share with our employees and shareholders. At Five Star Bancorp we seize opportunities, embrace challenges and value the intrinsic reward of serving others. We look forward to speaking with you again in January to discuss earnings for the fourth quarter of 2022. Have a great day and thank you for listening.

Operator
And with that, we'll conclude today's presentation. We do thank you for joining. You may now disconnect your lines.