Five Star Bancorp

First Quarter Earnings Webcast

Tuesday, April 26, 2022, 1:00 PM Eastern

CORPORATE PARTICIPANTS

James Beckwith - *President, Chief Executive Officer*

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

PRESENTATION

Operator
Welcome to the Five Star Bancorp First Quarter Earnings Webcast. Please note this is a closed conference call and you are 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 "*" then "1" on your telephone keypad. To withdraw your question, please press "*" then "2."

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 31st, 2021, and in particular, the information set forth in Item 1A, risk factors therein.

Please refer to slide two 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 their most directly comparable GAAP figures, which is included in the appendix in the presentation. Please note this event is being recorded.

I would now like to turn the presentation over to James Beckwith, Five Star Bancorp, President and CEO.

James Beckwith
Thank you for joining us to review Five Star Bancorp's financial results for the first 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. In the first quarter of 2022 it exhibited a continued execution of our organic growth strategy, as evidenced by our earnings, expense management and balance sheet trends during the quarter. Additionally, loans and deposits, and total assets have consistently grown since the previous quarter.

Our pipeline continues to remain substantial at the end of the first quarter of 2022, within the verticals we have historically operated in, as presented in the loan portfolio diversification slide.

Non-PPP loans held for investment, a non-GAAP measurement that is reconciled in our press release, increased during the quarter by $166.3 million, or 8.7% from the prior quarter, primarily within the commercial real estate concentration of the loan portfolio. Approximately $20.6 million of PPP loans were forgiven and $0.6 million of PPP income was recognized during the first quarter, leaving $1.5 million of PPP loans outstanding and $42,000 of deferred fees to be recognized at quarter end. We anticipate the full balance of the PPP loans to be forgiven in the near term.

Loan originations, excluding PPP loans, during the quarter were approximately $312 million, and payoffs, excluding PPP loans, were $146.6 million. Additionally, $20.6 million of PPP loans were forgiven, ultimately resulting in a net increase of loans of $145.7 million from the prior quarter.

Asset quality continues to remain strong, with nonperforming loans representing only 0.06% of the portfolio, increasing from the last several quarters. At quarter end, there were six loans totaling $12.2 million in aggregate on the COVID-19 deferment. We anticipate all borrowers to return to their pre COVID-19 contractual payment status after their COVID-19 deferments end.

At the end of the first quarter, the allowance for loan losses totaled $23.9 million. We recorded a $1 million provision for loan losses during the quarter. The ratio of the allowance for total loan losses to total loans, excluding PPP loans, a non-GAAP measure that is reconciled in our press release, was 1.15% at quarter end.

Loans designated as watch and substandard totaled approximately $17 million at the end of the quarter, representing an increase in watch loans of $5.4 million and a decrease in substandard loans of $7.6 million from the previous quarter. This reduced our reserves related to classified and watch loans by approximately a $100,000, which is offset by additional provisions for loan growth during the 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 first quarter, deposits increased by $217.2 million, or 9.5% as compared to the previous quarter. Approximately $39.2 million of the change related to non-interest bearing deposits. Non-interest bearing deposits as a percent of total loans for the first quarter decreased to 37.6% from 39.5% in the previous quarter. We have had strong deposit growth over the last several quarters, including the current quarter. Cost of total deposits was 9 basis points during the first quarter of 2022. We continue to be well-capitalized, with all capital ratios well above regulatory thresholds for the quarter.

Net income for the quarter was $9.9 million. Return on average assets was 1.53% and return on average equity was 17.07%. Average loan yield for the quarter was 4.53% and average loan yield, excluding PPP loans, a non-GAAP measure that is reconciled in our presentation, was 4.43%, representing a decrease of 13 basis points over the prior quarter. This decrease was primarily due to changes in the macroeconomic environment which caused the majority of the company's fixed rate loans funded in the current quarter to recognize lower yields than those recognized in prior quarters.

As a result of these factors, our net interest margin was 3.6% for the quarter, which included $600,000 of PPP income recognized based on forgiven loans while net interest margin for the prior quarter was 3.67%, which included $1.1 million of PPP income recognized based on forgiven loans.

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 in the amount of $7.2 million, primarily in our mortgage-backed and municipal securities portfolios of $4.4 million and $2.6 million, respectively. This caused a decline in tangible book value per share, which is a non-GAAP financial measure discussed in our press release, which was partially offset by increases to equity as a result of net income earned in the quarter, for a net decline tangible book value per share of $0.25.

Noninterest income increased to $2.2 million in the first quarter from $1.8 million in the previous quarter due primarily to increases in loan-related fees from the recognition of $300,000 in swap referral fees during the quarter, and a $300,000 gain recorded on a distribution received on an investment in a venture-backed fund. These increases were partially offset by a decrease in gain on sale of loans of $200,000, largely due to a decline in effective yields as a result of declining premiums paid in the secondary market and uncertainty surrounding the timing of rising interest rates.

Noninterest expense increased to $9.6 million in the first quarter from $9 million in the previous quarter, driven primarily by increased salaries and employee benefits as a result of increases in headcount and increases in employer taxes for commissions and executive bonus payments made during the quarter.

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

James Beckwith
Thank you, Heather. I want to thank everybody for joining us as we discussed our first quarter results. We recognize that entrepreneurs are the foundation of a strong and growing economy, and we consistently provide them a greater level of service than our competitors can provide, which has resulted in seized market opportunities and growth in loans and deposits. The strength of the bank's first quarter financial results is truly emblematic of a reputation built on trust, speed to serve and certainty of execution, all of which support our clients' own success.

In addition to earning the trust of our customers, our approach to banking has also led to an earned industry recognition. In the first quarter, we learned that Five Star Bank ranked on the 2021 S&P Global Market Intelligence Top 100 Best Performing Community Banks in the nation with assets less than $3 billion. The bank also was awarded the prestigious 2021 Raymond James Community Bankers Cup, ranking in the top 10% of community banks in the nation. We are honored and humbled to be so recognized.

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

QUESTIONS AND ANSWER

Operator
Thank you. We will now begin the question and answer session. To ask a question those dialed in may press "*" then "1" on your telephone keypad. If you are using a speakerphone, please pick-up your handset before pressing the keys, to withdraw your question, please press "*" then "2." Questions will be taken in the order they're received.

And the first question will come from Stuart Lotz with KBW. Please go ahead.

Stuart Lotz
Hey, guys. Good morning.

James Beckwith
Good morning.

Heather Luck
Good morning.

Stuart Lotz
I guess my first question, if we could start off on your outlook for the margin, looking back at my notes from last quarter and from the first quarter call, a lot has changed both in terms of the forward curve and just given the expectation for accelerated hikes this year. I think your previous guidance was you expected about a $75,000 per month benefit to NII per hike. Just wanted to see how…if that's still a good run rate just given your expectation for the accelerated pace of hikes this quarter.

And then I guess the second part to that question is, regarding deposit betas, how you are thinking about the outlook for CDs and for money market demand accounts given we saw a slight increase in the first quarter ,we got the hike late in March. Sorry to that…a lot going on there, but yes, just starting on the margin. Thanks.

James Beckwith
Sure. Thanks, Stuart. Yes, there's a lot of dynamics going on with the margin as we look forward in the quarter and for the remainder of the year. You had 125 [ph] basis point hike and then expectations for next week is going to be another 50 basis points. So we've certainly taken a look at that in terms of what it might mean just that particular dynamic in terms of Fed Fund hikes and result in prime rate hikes, what it might mean. So Heather, for 100 basis points, what are we thinking on an annualized basis?

Heather Luck
Yes. So on an annualized basis, we're estimating about a $3.8 million lift to net interest income. And then as part of that assumption, we're assuming a deposit beta of about 30%.

Stuart Lotz
Appreciate that color. And in terms of, I guess, this quarter, I was kind of surprised to see core loan yields falling…as per your comments in the release, some of that had to do with just the timing of repricing. So just given, I think, the majority of your loan book is really tied to the five year treasury, and we've seen that kind of really climb over the last probably two months or so, how are you thinking about, I guess, core loan yields this quarter with the anticipation for a 50 basis point hike, I mean, do you think we've reached the bottom?

James Beckwith
I don't think so. And I think it has everything to do with the timing of how we process and originate loans. We do have provisions in which we allow our customers and prospects to lock a rate. Those fundings can happen up 60 days, maybe in some cases, 70 days after that rate lock. So what you saw in the first quarter is some rates that were, I'm going to say pre 10 year move being funded. I think we still have a little bit of that left in the pipeline, not much. I think as we look at the pipeline, as it exists today, which is quite substantial, you're going to see mid fours, and maybe some five handles [ph] in terms of our production. So I'm anticipating our

margins, our loan yields are probably going to drop maybe seven basis points per quarter for the next two quarters and then level out after that and begin to rise.

Heather Luck
And then just add a little bit more color, Stuart, on the loans that are scheduled to re-price that are tied to this five year treasury this year, we only have about like a little over $45 million that'll reprice this year of loans originated five years ago. So hopefully that adds a little more information to that in your assumptions.

Stuart Lotz
Okay. Yes. That's certainly helpful. And I guess, James, turning to the growth outlook, I think last quarter, just given the strong 40% growth last year, you'd guided to kind of a more measured pace of growth this year, but the first quarter, we saw another, 30% plus growth. I was just curious what the pipeline looks like today and maybe what you're, given the strong growth in the quarter, are you raising that guidance for this year?

James Beckwith
Some dynamics with respect to the comments that on the last quarter, just to give you some insight, we had a substantial fourth quarter production, and as we entered into the year, our pipeline was well down from what it had been in Q3 and Q4 last year. So, my expectation was well, it's, not going to be…certainly, it's not going to be as strong and without any visibility in terms of, as expressed by what our pipeline is, that's why I guided that way.

As we move forward and has everything to do with the fact that we're very, we're really executing on the front our pipeline is substantial right now, probably the highest it's ever been. Now, you never know, Stuart, what you're going to pull through ultimately, but we think that the first quarter results in terms of dollars, we think that that's certainly, we're very capable of continuing that. So, we're excited about where Q2 and Q3 is going to lead us. So, I would have an expectation of being able to do in terms of net loan growth, the same amount in Q2, as we saw in Q1.

Stuart Lotz
And is that, is that really most of that growth stemming from the manufacturing home community portfolio? I think the last quarter is that's about half of your total growth.

James Beckwith
Yeah. I think a lot of it is. Yeah. ……….But we've got a lot of other deals in the pipeline outside of that particular vertical. So, it's certainly, we lead with that, but there's a lot of other deals that are around that are not in that space, that are commercial real estate oriented. We're executing well and certainly in that space and also in our…in storage, but also in our faith-based business. We're excited about the prospects there. So, as we continue to bring on new customers in California, most of those new customers that we're bringing on are quite substantial in our faith-based vertical. So, I think it's a mix that certainly mobile home parks are a big component of that and the biggest component.

Stuart Lotz
Okay, great. And maybe just one more from me just in terms of capital plan. I don't think the AOCI hit this quarter was a bigger factor for your capital versus some of your peers because given your outlook for pretty stronger growth this year and I think you've mentioned in the past, you were looking at possibly redeeming the sub debt later this year and maybe turned to lock in more attractive rates. So, just what's your appetite for new capital at this point?

James Beckwith
I think that that's certainly what we talked about internally is we're coming up on five years and so we'll have a chance to kind of refi that out and maybe take down another chunk. So that's what we're thinking about. We've got to execute on that. With the IPO proceeds, it gives us a better ability or a larger ability to raise sub debt and, we like to maintain it a double leverage ratio of 125% or less. So, we do have some capacity that's probably towards the end of the year, probably a Q4 or maybe even a Q1 type of execution. We don't have all that button down just yet, but that's probably going to be outside of internally generating capital probably what we're looking to do. We still think you can execute in at reasonable rates. Certainly not what we saw in 2021 and in terms of some of the bigger issuers, but given our earnings performance and our return on equity, it has every chance of being highly accretive to raise that debt.

Stuart Lotz
Great. Alright. Thanks for taking my questions. I will hop back in the queue.

James Beckwith
Thank you, Stewart.

Operator
And the next question will come from Andrew Terrell with Stephens. Please go ahead.

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

James Beckwith
Good morning.

Heather Luck
Good morning.

Andrew Terrell
Maybe to start, Heather, I think we discussed last quarter 1Q might be the I think, low point on expenses and then build throughout the year. I think expenses came in a little higher than I was thinking this quarter, but just, can you help talk us through kind of the put and takes for expenses as we move forward just throughout the balance of the year.

Heather Luck
Yeah. So, we're still projecting about a 140 net non-interest expense to assets ratio. Yeah, they did tick up just a little bit, just more on the employer taxes side this quarter, but you will see the commission's expense ramp up as BDOs get through their tiers rateably or throughout the year as their production hits the mark. But yeah, we're still budgeting about a 140 ratio.

Andrew Terrell
Okay, got it.

James Beckwith
Yeah, I think we've seen some headcount increases, Andrew, to take advantage of some opportunities; we've brought on some, at least one new BDO this year and actually two. And so, we're looking for those opportunities to continue to push growth in the verticals in which we want to be in. So, I think, you bring on a producer, Andrew, and then that's just not it.

Sometimes you've got to have some people around him and so I think our headcount is certainly up from 12/31.

Heather Luck
Yeah. We added seven heads since 12/31.

Andrew Terrell
Alright. That's perfect. That's, where my next question was headed, James. So, for the two videos you said higher this quarter. I guess first was that's a net number and then any specific kind of lending verticals, they're more geared towards, or just kind of broader commercial bankers.

James Beckwith
One guy's an ad guy. One of the hires was an ad guy and the other one more of a practice person, optometrist, dentist, veterinary, that type of a professional, but specifically with the skillset to deal with those two verticals.

Andrew Terrell
Got it. Okay. And then was hoping I know the SBA income [indiscernible] came in a bit this quarter kind of as expected. Was hoping you could just provide some updated expectations, both on kind of the SBA sold loan volume as well as kind of gain on sale margin.

James Beckwith
Well, it's a very difficult thing to predict. As we move forward, I think that our production is going to be less granular. So you can have some pretty big credits coming there, if we're going to finance a business acquisition loan. And so, that will certainly not make the revenue stream smooth per se. You could have a big month and then the next month, not so much. I think generally speaking, premiums are down, okay, probably from 1.14 down to 1.12. So that that's a headwind with respect to that business, but it's going to be slow and steady. I think that we guided, I'm going to say around $300,000 on an average a month in terms of gains and that sounds about right as I look forward, for the remainder of the year, hope that's helpful.

Andrew Terrell
Now, that's, very helpful. I appreciate it. And then I wanted to go back to some of the core loan yield commentary as well. I hear you on kind of the, maybe locking rate for 60 days to 70 days or so, but just curious and you may have provided, and I missed it and I guess, where you're originating credit at today from a yield perspective versus where you were at kind of 90 days ago. And I guess where I'm going is trying to get the lift in kind of new originations, but then have you also seen any kind of spread compression as you're pricing new credit?

James Beckwith
So, we price off the five and the 10 for the most part, and those spreads can be either, 200 to 225, sometimes 250 over those indexes. So, if you price off that, you're…let's take a 250 spread. And then you've got a, 540 rate and that's what's going on right now. I think it's taken the market. It's taken the market a long time for these rate increases to kind of work through borrowers' expectations. I'm going to say Q3, Q4 last year, everybody thought, hey, I think I can get a three handle loan. Well, that's not happening anymore. The stuff that we're currently originating are all 4% or 4% 4.25%, 4.50%, 4.75%. So, I think production in terms of current production is going to equal, where we are right now in our overall portfolio yield, but we still have to work through a couple, I'm going to call legacy locks, if you will. And as I guided earlier,

that's going to have an impact of maybe seven basis points for the next two quarters and then I expect portfolio yields to rise after that.

Andrew Terrell
Understood. Okay. I appreciate you both taking my questions.

James Beckwith
Sure.

Operator
Again, if you have a question, please press "*" then"1." The next question will be from Gary Tenner from D.A. Davidson. Please go ahead.

Gary Tenner
Thanks. Good morning. Not, to beat the dead horse on the production yield and loan yield questions, but average loan yield 4.53%, I think you are in the first quarter and that seems to be pretty well in line with what you were just talking about, James, in terms of production. So, I guess, I guess that maybe there would be some more downward pressure in the second quarter if you've got some locks to work through. But given where the five year is now as you start looking forward to the third quarter, what would be the dynamic that might result another six, seven basis point downward move in millennial's because it seems like we should kind of be through those old locks at that point.

James Beckwith
Yeah, I think it's just the impact of that type of production. Well, we certainly hope to do better than that and there is going to be some type of a lift that's going to come out of our prime based loans and also our swap loans. We've got about probably as we sit here right now about $130 million that are either LIBOR or SOFR related that are going to move up, well, 50 basis points in the next move. So, the reason why I'm guiding that way is that we still have a fair amount in our pipeline that the rates were blocked,60 days ago that were done at low four handles and so as that works through it's going to have an impact in terms of our overall portfolio yield. A lot of dynamics going on with respect to this, but that's what my expectation is right now. Hope to do better, okay, but that's what the expectation is right now.

Gary Tenner
Okay. Fair enough. And then just on the credit side of things, as you're looking it out, we talk about the uncertainty and different dynamics in the world right now and I know the expectation for loan production for second quarter, third quarter is solid, beyond third quarter visibility looks a little dimmer for the whole universe or the whole bank industry. So, how are you thinking of any risk areas that you'd want to avoid or maybe avoid new production in or anything along those lines?

James Beckwith
Well, in terms of particular asset classes that we have concern about, certainly office, something that we're shying away from, we focus on sponsorship and the character of our borrowers and when we get to know them fairly well, like all the verticals we're in but if I was to single out something, it's office. You also have to be careful from an Ag perspective, water carries a huge issue now. It's always been an issue, but it's a really big issue now in California. And you got to be careful about folks that are financing, I'm going to say orchard development loans. You have to really assure yourself about the long-term viability of their water sources, whether they have

district water or ground water. So that's something that we're going to be extremely careful about also.

Financing homes, subdivisions and whatnot, something that we're also kind of going to be extremely careful about. It's just you don't know the impact of rising rates in the mortgage market what that's going to really kind of pull through to people's ability to buy a home. If you're looking at 30 year mortgages, mid fours, pushing fives, that has a substantial impact on people's ability to pay. So, we think that that's going to kind of maybe cool some of the single-family development. People still needed a place to live. So, we're still bullish on apartments. But those are some of the dynamics, as we move forward. It's difficult to predict the impact of inflation and interest rates on the small business community, but it's something that we have to be very keenly aware of and making sure that our customers are in the best possible situations they can be. So small business credit is something that is certainly I'm not going to say at risk, but certainly we're concerned about it.

Gary Tenner
If, I could ask one more follow-up, James, and I appreciate the color, as you talk about small business and just broadly, kind of loans where rates and coupons are going to go up as the fed tightens. Have you sensitized the portfolio to any degree in terms of, 250, 200 basis points, higher rates and what's your comfort level there?

James Beckwith
Well, we're predominantly a CRE lender. So, we like that collateral position and our C&I book is with some really good names. So, we're pretty comfortable with that. There is exposure in our SBA book. We've got $46 million on our books right now of the non-guaranteed portion of an SBA loan. We feel like we're very well reserved against them. We have north of 10 points against the portfolio. So that is something that we're keenly aware of that those borrowers are going to be sensitive to rate moves not just in their own business, but the fact that they're…what they have to pay to service their debts going up, every quarter. So, we look at that all the time. We've got a lot of eyes on that portfolio and we're very quick to act with respect to it. So, we feel like we've got good risk management practices associated with it.

Gary Tenner
Thank you.

Operator
And the next question is a follow-up question from Andrew Terrell with Stevens. Please go ahead.

Andrew Terrell
Hey, thanks for taking the follow-up. Heather, I quickly wanted to ask, I think, if I remember correctly, you started running parallel Cecil, maybe this quarter, at the start the year, just curious any kind of preliminary results you could share with that, is what the model kind of suggests pretty comparable to where you are holding the reserve at today.

Heather Luck
We did start our parallel. We're still doing a fine tuning of the qualitative factor assumptions and forecasts. So, we came in slightly above. I don't have a solid rate yet to provide, but I will have a better figure to provide in the Q2 call, but we did run parallel and overall, I feel like it was a successful first run just to get it under our belts, but once we understand the model a little better and understand the assumptions, we'll be able to provide a little bit more guidance on that.

Andrew Terrell
Okay, perfect. And then also just on tax rate around 27% this quarter, is that kind of fair way to think about it for 2022,

Heather Luck
That one, for Q1, it was slightly lower than what we're anticipating for the full year. So, we're estimating still about 29.3%. So, in the current quarter, we did record our return to provision true-up because we finalized our 2021 tax return. So, there was about $250,000 that we recorded as a true-up based on that.

Andrew Terrell
Got it. Okay. Perfect. And thanks again for the time.

Operator
Ladies and gentlemen, this concludes our question and answer session. I would like to turn the conference back over to management for any closing remarks

CONCLUSION

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

Operator
The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.