Five Star Bancorp

Third Quarter 2023 Earnings

October 31, 2023 at 1:00 p.m. Eastern

CORPORATE PARTICIPANTS

James Beckwith – *President & CEO*

Heather Luck – *SVP & Chief Executive Officer*

PRESENTATION

Operator
Welcome to the Five Star Bancorp Third 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 star then one on your telephone keypad. To withdraw your question, please press star then two.

Before we get started, let me remind you that today's meeting will include some forward-looking statements within the meanings of applicable securities laws. These forward-looking statements relate to, among other things, current plans, expectations, events 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, 2022 and Quarterly Report on Form 10-Q for the quarter ended June 30, 2023 and in particular, the information set forth in Item 1A, Risk Factors, in those reports.

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. Reconciliations of non-GAAP financial measures to their most directly comparable GAAP measures are included in the appendix to 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. Please go ahead.

James Beckwith
Thank you for joining us to review Five Star Bancorp's Financial Results for the Third Quarter of 2023. 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.

During the 3 months ended September 30, 2023, our return on average assets and return on average equity were 1.30% and 16.09%, respectively, positioning us to remain near the top of our peer group. In the third quarter, we enhanced our expansion into the Bay Area market with an addition of another seasoned team of professionals.

Our organic growth story also continued in the third quarter with the addition of new deposit accounts and relationships as seen in the growth of non-broker deposits of $137.5 million in the 3 months ended September 30, 2023. Despite expected headwinds on the horizon, our ability to conservatively underwrite, as evidenced by a 51% LTV on commercial real estate, manage expenses with our 42% efficiency ratio and deliver value to shareholders with our $0.20 per share dividend, we believe we are well positioned to continue to endure and succeed as conditions change.

In the company overview section, we have provided a brief overview of our geographic footprint and executive management team. In the third quarter of 2023, exhibited continued execution of our 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 solid at the end of the third quarter of 2023 within verticals we have historically operated in as presented in the loan portfolio diversification slide. Loans held for investment increased during the quarter by $82.5 million or 2.82% from the prior quarter, primarily within the commercial real estate concentration of the portfolio. Loan originations during the quarter were approximately $134.6 million, while payoffs and pay downs were $52.1 million.

Asset quality continues to remain strong, though non-performing assets have increased from the last several quarters as a result of financial challenges experienced by a small subset of our borrowers. They represent 0.07% of the portfolio. At the end of the third quarter, the allowance for credit losses totaled $34.0 million. We recorded a $1.1 million provision for credit losses during the quarter, primarily related to loan growth, loan type mix and updates to the macro environment. The ratio of the allowance for credit losses to total loans held for investment was 1.13% at quarter end. Loans designated as substandard totaled approximately $2.0 million at the end of the quarter, which was an increase from $0.3 million at the end of the previous quarter.

Now that we have discussed the loan portfolio, we will continue on to deposits and capital. During the third quarter, deposits increased $102.5 million or 3.5% as compared to the previous quarter. Non-interest-bearing deposits as a percent of total deposits at the end of the third quarter decreased slightly to $27.5 million from 28.4% at the end of the previous quarter.

To offer more detail on our deposit composition, I want to highlight that deposit relationships totaling at least $5 million constituted approximately 60% of our total deposits and the average age on these accounts was approximately 9 years. Local agency depositors accounted for approximately 25% of deposits as of September 30, 2023.

As noted earlier, we are pleased we have net deposit inflows for the 3 months ended September 30, 2023. Our ability to grow deposit accounts supports our differentiated customer-centric model that our customers trust and value. As seen through the mix of high dollar accounts and the duration of certain customer relationships, we believe we have a reliable core deposit base.

Overall, deposit balances have increased when compared to the prior quarter. Non-broker deposits increased by $137.5 million, interest-bearing deposits increased by $101.7 million and non-interest-bearing deposits increased by $0.8 million. Total cost of deposits was 218 basis points during the third quarter.

We continue to be well capitalized with all capital ratios well above regulatory thresholds for the quarter. Our common equity tier 1 ratio increased from 9.05% to 9.07% between June 30, 2023 and September 30, 2023. On Friday, October 20th, we announced a declaration by our board, a cash dividend of $0.20 per share on the company's voting common stock expected to be paid on November 13, 2023 to shareholders of record as of November 6, 2023.

On that note, I will hand it over to Heather to discuss the results of operations. Heather?

Heather Luck

Thank you, James and hello, everyone. Net income for the quarter was $11 million. Return on average assets was 1.3% and return on average equity was 16.09%. Average loan yield for the quarter was 5.57%, representing an increase of 7 basis points over the prior quarter as rate increases continued with the fourth increase this year taking place in July.

Our net interest margin was 3.31% for the quarter, while net interest margin for the prior quarter was 3.45%. The most recent Fed rate increase continues to put pressure on deposit costs. As a result of changes in interest rates and other factors, our other comprehensive loss was $3 million during the 3 months ended September 30, 2023, as unrealized losses, net of tax effect, increased on available-for-sale debt securities from $12.9 million as of June 30th to $15.9 million as of September 30, 2023.

Non-interest income decreased to $1.4 million in the third quarter from $2.8 million in the previous quarter, due primarily to a $1.3 million gain in other income recognized on distributions received on investments and venture-backed funds during the 3 months ended June 30th. Non-interest expense grew by $36,000 in the 3 months ended September 30th as compared to the three months ended June 30th, primarily due to a $0.5 million increase in salaries and employee benefits, which was partially offset by decreases of $0.3 million and $0.2 million in other operating and advertising and promotional expenses.

Now that we've 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 everyone for joining us as we discuss third quarter results. Five Star Bank has a reputation built on trust, speed to serve and certainty of execution, which supports our clients' success. Our financial performance is the result of a truly differentiated customer experience, which continues to power the demand for Five Star Bank's relationship-based services. We attribute sustained success to our prudent business model and treating customers with an empathetic spirit, understanding and care. We are very proud to earn the trust of those we serve, including our shareholders.

In the third quarter, our efforts were recognized as we were listed among Piper Sandler's Sm-All Stars for 2023 as a top performing small-cap bank, acknowledged for outperformance in several metrics, including growth, profitability, asset quality and capital. We were also listed among *Sacramento Business Journal*'s Best Places to Work.

Looking to the remainder of 2023, we will be guided by a continued focus on shareholder value as we monitor market conditions. We are confident in the company's resilience in any environment and remain focused on the future and our long-term strategy. We will continue to execute our organic growth 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 may have.

Question-and-Answer Session

Operator
We will now begin the question and answer session. To ask a question, those dialed in may press star then one on your telephone keypad. If you're using a speakerphone, please pick up your handset before pressing the keys. To withdraw your question please press star then two. Questions will be taken in the order received.

The first question today comes from Gary Tenner with D.A. Davidson. Please go ahead.

Gary Tenner
Thanks. Good morning.

James Beckwith
Good morning, Gary.

Gary Tenner
Wanted to ask about the loan growth this quarter. The commercial real estate growth looked pretty concentrated between manufactured, home community, RV park and multifamily. So just wondering what you could tell us about kind of the ongoing demand, particularly in those loan areas and maybe what the new loans coming on board right now, what they look like from a debt service coverage, LTV, any underlying metrics around the new loan production there?

James Beckwith
Sure. Well, Gary, things have slowed. We expect to see that in the fourth quarter and probably well into the first quarter, given where cap rates are and interest rates are, generally speaking. Our underwriting for all of our loan portfolio, new originations, it's been very consistent over the years. We haven't changed anything. We do have higher standards for out-of-state credit than in-state credit, so it's been very consistent.

We continue to focus on manufactured home communities and RV parks and we expect to see same or similar in the fourth quarter, but we are starting to grow our C&I book where hopefully that can be attractive business proposition for our prospects to come bank with us. We do have a pretty significant effort going on, Gary, right now down in the Bay Area, but also up here in the Sacramento, in the capital region, if you will.

So nothing's really changed from an underwriting perspective. I think you can see in the deck what our LTVs are. We're very much cash flow lenders, so we always like to have a very nice cash flow. I think $135 (million) is at origination in terms of our mobile home park book of business, but we've been very consistent over the years.

Gary Tenner
Great, James. I appreciate that. Then a second question, I don't know that I saw it in the deck, so I apologize if I missed it, but the deposit spot rate as of September 30th, Heather, if you could provide that for us— either interest-bearing or total deposits?

Heather Luck
Yes. Total spot rate was 224.

Gary Tenner
Okay. The average was 218. So was there a kind of notable slowdown in the pace of change over the course of the third quarter?

James Beckwith
Yes, very much so. There's still pressure, but I think that the pace of change has slowed. We're very— a lot of our customers, given that we have such a big book in our local agency, are very rate sensitive and so, it's really depending upon what the Fed does, we could see some reaction there, but the pace of change has slowed.

Gary Tenner
Thanks very much.

Operator
The next question comes from Andrew Terrell with Stephens. Please go ahead.

Andrew Terrell
Hey, good morning.

James Beckwith
Hey, good morning, Andrew.

Heather Luck
Good morning.

Andrew Terrell
I wanted to ask about some of the recent expansion of the Bay Area. It looked like the teams there or the team there did $29 million of deposits in the third quarter, so obviously, hitting the ground running. I was just curious, were those mostly non-interest-bearing deposits? I know there's a more C&I oriented focus there. So, were they mostly NIBs or was it across the board? Then separately, just anything on the loan production side from those teams this quarter and just how the pipeline is shaping up there for both deposits and for loans?

James Beckwith
Sure. Right now, as we sit here today, I think we've got about $38 million in deposits from our Bay Area folks, San Francisco folks. I think that that's equally split between non-interest-bearing and interest-bearing. The reason for that is the typical account that we're picking up right now, we're getting their operating account, Andrew, but we're also getting their liquidity. So when you kind of mush those together, we're looking anywhere, depending upon the relationship of those balances, anywhere between 2% to 2.5% all in. So, we expect that to be same or similar.

From a lending perspective, I think we've got $5 million of credit booked so far. A lot of it is C&I. There's some CRE, but most of it is lines of credit. As we move forward, we expect same and similar in terms of credit. Mostly C&I, but having some smattering of CRE in there. That really is owner-occupied whereas a distribution company has got a warehouse that they want us to finance and we want the entire relationship, so we'll pick up that piece of CRE, a line of credit and then of course, all their operating accounts and their liquidity, so it's an all-in relationship.

Andrew Terrell
Yes. Understood. Okay. I appreciate it. Then just going back to the point on loan growth, I heard some of the commentary that maybe production was slowing down. I think we certainly saw that this quarter at $135 million of originations. Would your expectation be that origination levels moderate from that $135 million into the fourth quarter? Then just overall, could you share maybe your expectations for kind of net balance sheet growth, both loan and deposit growth, moving forward?

James Beckwith
Sure. We're seeing a slowdown in loan production given market conditions. So, I don't expect it will originate that level in fourth quarter. I would say probably as we sit here today, we probably are going to do probably something $10 (million) to $20 million less than that. We do expect some payoffs, so our net loan growth in the fourth quarter will probably be no better than it was in the third quarter. I think that's probably a safe statement.

From a depository perspective, we've got a pretty substantial pipeline, probably more so than we've had in the last six to nine months. We've got some potentially some very large customers coming on that relate to some of the verticals in which we're in. So we're excited about that, but again, these things take time and we do expect our deposit growth to exceed our loan growth in the fourth quarter. I think you could see that we did that marginally in the third quarter and we expect same or similar results in the fourth quarter but at reduced levels, certainly on the loan side, maybe not so much on the deposit side, but certainly on the loan side.

Heather Luck
And as we look through to 2024, also, I know we've given this guidance before, but we are still looking at 10% loan growth, 8% deposit growth— oh sorry, flip that, 10% deposit growth, 8% loan growth for the forecast period.

James Beckwith
I think we're pretty much right on top of that year-to-date, maybe a little lower on deposits, but right about that on loans, but certainly, deposit growth has exceeded loan growth.

Andrew Terrell
Yes. I appreciate it. The last one for me, the $135 million of originations made this quarter, do you have what the weighted average yield was for new originations?

Heather Luck
Yes. That was 7.70%.

Andrew Terrell
Got it. Okay, I will step back into queue. Thanks for taking the questions.

James Beckwith
Thank you, Andrew.

Operator
Again, if you have a question, please press star then one to enter the question queue.

The next question comes from Gary Tenner with D.A. Davidson. Please go ahead.

Gary Tenner
Hey, thanks for the follow-up. Heather, I just want to clarify the comment you just made on the loan and deposit growth. That was relative to 2023?

Heather Luck
Correct, so annual—

Gary Tenner
Any kind of early thoughts on the kind of similar metrics and outlook for 2024?

Heather Luck
Yes, similar thing— 10% deposits, 8% loans.

Gary Tenner
Okay, perfect. Thank you.

Operator
The next question comes from Andrew Terrell with Stephens. Please go ahead.

Andrew Terrell
Hey, thanks for the follow-up. Heather, I wanted to get an idea, so you guys have certainly done a good job in hiring this year, but when I look at expenses, the expense run rate has also been, I'd call it, pretty well contained. I wanted to get your thoughts on maybe the expense run rate heading into the fourth

quarter and then any preliminary thoughts on expense growth in 2024?

Heather Luck
So thank you for acknowledging that. We're always mindful on our expenses, right. We want to make sure that we are spending money effectively and efficiently. For Q4, whenever we look at this, I think if you add about $500,000 to the non-interest expenses, that should give you a pretty good estimate. We did hire new people in the Bay. We'll continue to add more people, but we also do have some one-time events that happened in Q4. So, I think about $500,000 can get you there for the rest of the year and then I think you could probably use that as a proxy for the first two quarters of next year.

James Beckwith
Yeah.

Andrew Terrell
Okay. So around a $12.5 million quarter level feels good?

Heather Luck
Yes, I think that's a pretty good estimate for now for the next three quarters.

Andrew Terrell
Okay. Perfect. Then maybe one more for James. Just to that point on hiring and the teams that you've added. I mean, certainly, it's been great to see. Where do you feel like you stand today? Is there a need in your mind to continue hiring or to continue building out the Bay Area or do you feel like you have what you need there in place already today? Then anywhere else across your footprint where you're seeing market opportunity and what's your kind of appetite to incrementally hire from here?

James Beckwith
Well, we think we have a little ways to go in the Bay Area, Andrew. We're targeting probably four to five more people. When they come on, they may come on in January and— I think or maybe at least one will be coming on here before the end of the quarter. So, we think with that team, we're going to be in very good shape in San Francisco proper and the surrounds.

Now there are several potential hires that are in the Bay Area, whether they'd be in the North Bay or in the East Bay that we're starting those dialogs. So ultimately, we could have upwards of 20 people in the Bay that are covering all aspects of that market down there. So, we just have to see how time goes right now.

Right now, we have nine people and we've got some folks that are pretty near-term right now in terms of potential hires. We've met with them several times. There's a cycle that occurs down there given all the turmoil, if you will, various stagings for, I'm going to say, stay bonuses and whatnot that we're sensitive to, that you have to take into account and comprehend. So, I think that that is a consideration, a driver in terms of timing. So we just have to stay close and look for the best opportunities. We're getting some really quality people. They're expensive, but they're of high quality.

Andrew Terrell
Yes, very good. I appreciate the color. If I could sneak one more in, just on the margin. Heather, I appreciate the comment on the spot rate and it does look like the deposit costs really kind of slowed into quarter end. I guess, when you pair that with the other side of the balance sheet, does it feel like the margin is kind of at a point of inflection heading into the fourth quarter or would you expect maybe some further compression in 4Q or early into 1Q?

Heather Luck
Yes, we will see some compression. There's definitely some pressure. We're targeting right now to be between 3.25 and 3.30 on our NIM. I think that's a pretty good assumption for Q4 and Q1.

Andrew Terrell
Yes. Okay. So relatively stable to 3Q levels, maybe off a few basis points or so.

Heather Luck
That's correct.

Andrew Terrell
Okay, perfect. Thank you for the follow-ups. I appreciate it.

Operator
Again, if you have a question, please press star then one to enter the question queue.

CONCLUSION

Operator
This concludes our question-and-answer session. I would like to turn the conference back over to management for any closing remarks.

James Beckwith
Great. Thank you. Five Star Bancorp is on a continued path of 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.

We are very pleased with the recent industry recognition from Piper Sandler and the *Sacramento Business Journal*. We were also pleased, the company maintains a BauerFinancial Superior Rating of 5 out of 5 stars and an IDC Superior Rating. The company is also a super performing bank with The Findley Reports.

We are a driving force for economic development, a trusted resource for our customers and a committed advocate for our community. We look forward to speaking with you again in January to discuss earnings for the fourth quarter of 2023.

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.