Five Star Bancorp

Second Quarter Earnings Webcast

Tuesday, July 25, 2023, 1:00 PM Eastern

CORPORATE PARTICIPANTS

James Beckwith - *President, Chief Executive Officer*

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

PRESENTATION

Operator
Good day, and welcome to Five Star Bancorp Second 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 4question, you may press "*" and then "1" on your telephone keypads, to withdraw your questions, you may press "*" and "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 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 ending March 31st, 2023 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 the most directly comparable GAAP figures, which is included in the appendix to this presentation. Please note today's event is being recorded.

At this time, I would like to turn the floor over to James Beckwith, Five Star Bancorp President and CEO. Sir, please go ahead.

James Beckwith
Thank you for joining us to review Five Star Bancorp's financial results for the second 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 three months ended June 30, 2023, our return on average assets and return on average equity were 1.55% and 19.29%, respectively, positioning us to remain near the top of our peer group. In the second quarter, we announced our expansion into the San Francisco Bay Area market.

Our organic growth story also continued in the second quarter with the addition of new deposit accounts and relationships as seen in the growth of non-broker deposits of $25 million in the three months ended June 2023.

Despite headwinds on the horizon, our ability to conservatively underwrite, manage expenses and deliver value to shareholders continues. 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. The second 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 second quarter of 2023 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 $57.6 million or 2.01% from the prior quarter, primarily within the commercial real estate concentration of the loan portfolio. Loan originations during the quarter were approximately $254.4 million and payoffs were $196.8 million.

Asset quality continues to remain strong with non-performing loans representing only 0.01% of the portfolio, remaining largely unchanged from the last several quarters.

At the end of the second quarter, the allowance for credit losses totaled $34 million. We recorded a $1.3 million provision for credit losses during the quarter, primarily related to loan growth, loan type mix and updates to the macroeconomic environment. The ratio of the allowance for credit losses to total loans held for investment was 1.16% at quarter end.

Loans designated as substandard totaled approximately $0.3 million at the end of the quarter, which was a decrease from $0.4 million at the end of previous quarter.

Now, that we've discussed the loan portfolio, we continue on to deposits and capital. During the second quarter, deposits increased by $9.3 million or 0.32% as compared to the previous quarter. Noninterest-bearing deposits as a percentage of total deposits at the end of the second quarter decreased slightly to 28.5% from 28.6% at the end of the previous quarter.

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

As noted earlier, we are pleased that we had a net deposit inflow for the three months ended June 30, 2023, including inflows during the month of June. Our ability to grow deposit count 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, which we believe we have a reliable core deposit base.

Overall, deposit balances have increased when compared with prior quarter. Non-broker deposits increased by $25 million, interest-bearing deposits increased by $12.3 million and noninterest-bearing deposits decreased by $3 million. The cost of total deposits was 192 basis points during the second 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 9.02% to 9.07% between March 31, 2023, and June 30, 2023. On Friday, July 21st, we announced a declaration by our board of a cash dividend of $0.20 per share on the company's voting common stock expected to be paid on August 14th, 2023, to shareholders of record as of August 07th, 2023.

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

Heather Luck
Thank you, James, and hello, everyone. Net income for the quarter was $12.7 million, return on average assets was 1.55% and return on average equity was 19.29%. Average loan yield for the quarter was 5.5%, representing an increase of 14 basis points over the prior quarter as rate increases continued in May 2023, with the third increase this year.

Our net interest margin was 3.45% for the quarter, while net interest margin for the prior quarter was 3.75%. The most recent Fed rate increases continue to put pressure on deposit costs.

As a result of changes in interest rates and other factors, our other comprehensive loss was $1 million during the three months ended June 30, 2023, as unrealized losses, net of tax effect, increased on available for sale debt securities from $12 million as of March 31st, 2023, to $13 million as of June 30, 2023.

Noninterest income increased to $2.8 million in the second quarter from $1.4 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 three months ended June 30, 2023.

Noninterest expense grew by $0.9 million in the three months ended June 30, 2023, as compared to the three months ended March 31st, 2023, primarily due to increases of $500,000 in operating expenses largely related to seasonal travel and conference fees, $300,000 in advertising and promotional for business development expenses and $100,000 in data processing and software corresponding with growth of the bank, partially offset by a $200,000 decrease in salaries and employee benefits.

Now that we've 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 discussed second quarter results. Five Star Bank has a reputation built on trust, speed to serve and certainty of execution, which support 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 have earned the trust of those we serve, including our shareholders. In the second quarter, our efforts were recognized as we received the Raymond James Community Bankers Cup for 2022, which was created to award community banks that are building long-term shareholder value.

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 we'll continue to execute on our organic growth strategy and disciplined business practices which we believe will benefit our customers, our 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 that you may have.

QUESTION AND ANSWER

Operator
Ladies and gentlemen, at this time, if you would like to ask a question, please press "*" and then "1" using a touchtone telephone. If you are using a speakerphone, we do ask that you please pickup your handset before pressing the keys to ensure the best sound quality. To withdraw your questions, you may press "*" and "2." Once again that is "*" and then "1" to join the question queue. Questions will be taken in the order they are received.

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.

Heather Luck
Good morning.

Andrew Terrell
Hey, James, if I could just start on the team hired this quarter, maybe getting into some of the specifics. Just how many frontline bankers or BDOs came with the team? How does that compare to the size of your current BDO staff? And then what type of book of business on both the loan and the deposit side do you think this team can build over time?

James Beckwith
Sure. To-date, we've hired five people, three are experienced Business Development Officers and two are more in a Relationship Manager role. And so, that's so far what we've done in that particular market. We expect that we may do some more. So, we certainly will keep everybody posted on that. The book of business that they're going after is very similar to what we do up here from a depository perspective. And these individuals are deposit-forward Business Development Officers. C&I on the lending side, I expect they'll probably do some commercial real estate lending, owner-occupied commercial real estate lending. But that's kind of their emphasis that they've had in their career, and they've been very successful.

Andrew Terrell
Okay. Very good. And then on the expense front, Heather, I know expenses stepped up just a little bit this quarter, and obviously some hiring and capitalizing on end market opportunities for you guys. Just can you maybe help us out with thinking about the expense run rate moving forward?

Heather Luck
Yes. So if you shave off probably about $100,000 from what we incurred in Q2, that would be a good run rate for the remainder of the year for expenses.

Andrew Terrell
Got it. And then James, I heard your prepared remarks, just on the strength of the pipeline heading into the third quarter. It sounded like referencing loans specifically, and perhaps you've got some tailwinds with some C&I oriented bankers. But just what about the pipeline on the deposit side? How does that compare to the lending pipeline heading into the back half of the year? And then how should we think about the incremental mix of the deposit growth from here?

James Beckwith
The deposit pipeline continues to be higher…significantly higher than our loan pipeline. So we're very happy about that. And we expect that pipeline to continue to grow with the addition of these…of our team down in San Francisco and also continued execution of our folks out here in the capital region, you know, up and down the valley. So the mix, I think, is going to be probably more oriented towards noninterest-bearing deposits and liquidity for businesses that we bring on board. As you probably know, there's a mix that a lot of these commercial accounts have. They have their operating accounts and then they have where their liquidity is. So I think you'll see growth in those areas. I think what you'll also see may be a diminishment of I'm going to say, more wholesale deposits as we carry on for the remainder of the year. Certainly, it's our goal to buy 12/31 to eliminate our broker deposit book right now, which decreased Heather, from as of 30 June to…from March 21, I think, by the way.

Heather Luck
We declined broker deposits during the second quarter by $15 million. And then we've also continued to pay down the broker deposits since quarter end.

James Beckwith
Yes. So I think what we're trying to do is kind of diminish that wholesale aspect, if you will, Andrew, of our deposit mix. And I think we've had some success, and we're looking forward to more success in that…in those particular deposit mix structures.

Andrew Terrell
I appreciate it. No, it was great to see that in the second quarter. I will step back on the queue. Thanks for taking the questions.

James Beckwith
Thank you.

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

Gary Tenner
Thanks. Good morning. I wanted to kind of ask another question regarding the deposit versus loan pipeline. I know coming into the year and even during April earnings, the commentary about the size of the deposit pipeline versus loan pipeline was pretty significantly weighted towards deposits. I think at one point you had maybe 2x in the deposit pipeline versus loans. Obviously, a lot of unusual times here in the second quarter. So I'm not trying to hold you to

that number in terms of the relative growth. But obviously, it didn't translate to core deposit growth outweighing or outpacing net loan growth in the quarter. So I'm just wondering, James, if you could comment about kind of churn within the deposit portfolio, maybe intra-quarter trends in the core deposit book just to give us a sense of kind of what the quarter looked like from April...

James Beckwith
Sure. Yes, I think as we previously mentioned, there's a diminishment…slight diminishment of broker deposits. So that was…I think that was a good trend, and we expect that to continue as we move forward for the remainder of the year. Here's the interesting thing about deposit pipelines versus loan pipelines. Loans in your pipeline get booked a lot more quickly than deposits relationships being brought on. And so, I would say that if I was to kind of maybe quantify that in terms of length in the pipeline, I'm going to say that deposit pipelines have a kind of a duration of 2x what a loan would be, i.e., if you book a loan, it's going to take you maybe 60 days to 65 days, which is I think is our average when it hits our pipeline and a deposit relationship could take twice that and sometimes three times that. So, they don't necessarily come on board at the same time. So that's why you want your deposit pipeline to be significantly higher than your loan pipeline. And what we saw in the second quarter, you saw loan growth outpace deposits. On a year-to-date basis, I think our deposit growth is slightly ahead of loan growth, 5.3% year-to-date as opposed to loan growth of 4.9%. We're targeting a 10% deposit growth for the year, Gary, and an 8% loan growth. So, we're not way off that mark.

What's important, I think, as we move forward, we're going to be replacing some wholesale deposits with good core deposits. So, you may see deposits not like grow appreciably but the mix is going to change, which is really what we're trying to accomplish here. And it's just going to be...we operate in a very competitive environment in which I think you all know, and it's significantly more difficult to bring on deposit growth in those relationships than it is to bring on a loan. But now I think they're all coming together. I think that we're getting a little better at what we do from a relationship onboarding process. We've got a great group of relationship managers that help us do that and a great group of business development officers. We now have 21 business development officers. If you don't include me and my Mike Rizzo, if you do, it's a little higher. So, we're excited about what we're doing system-wide, and we've had great success in terms of bringing on new very large deposit relationships, which we think are going to continue to expand for the remainder of the year.

Gary Tenner
I appreciate the thoughts there. And then a follow-up just in terms of...again, on deposits, but Heather, can you provide the interest-bearing deposit spot rate as of June 30? And if possible, maybe the core interest-bearing deposits, if that's something that's available?

Heather Luck
Yes. So, the spot rate was 2.04 at the end of the quarter. And that's just our interest-bearing all-in.

Gary Tenner
2.04 interest bearing, was that all deposits?

Heather Luck
At June 30, yes, for all deposits.

James Beckwith
That's everything. Yes, full deposit cost, yes.

Gary Tenner
Got it, okay. Thanks very much for taking my question.

Operator
Yes, once again if you would like to drop back in the question queue, you may press "*" and then "1." To withdraw yourself you may press "*" and "2."

Our next question comes from Woody Lay from KBW. Please go ahead with your question.

Woody Lay
Yes, thanks for taking my question. Just wanted to follow-up on the deposit and maybe NIM outlook based on that spot rate. So, it looks like a lot of the heavy lifting was done sort of towards the beginning of the quarter. I mean, do you think the NIM can begin to stabilize here coming into the next quarter?

James Beckwith
Yes, our sense, you're going to see...you may be a little bit more decline in NIM in the third quarter, probably anywhere between 3.3 to 3.35. So, I think that, that's probably where it's going to settle out. Again, that's going to be a function of how rapidly we can bring on and execute on our pipeline, our deposit pipeline. But we do expect there's going to be some decline in NIM in the third quarter, Woody, to that particular level.

Woody Lay
Got it. And then, I mean, assuming we sort of hit a stable rate period, how would you think the NIM reacts from there? Do you think it's more so just holding it steady? Or do you think it's...with the loans you're bringing on, if we get a level interest rate environment, we could see increases?

James Beckwith
It's our expectation that, that would represent kind of a steady range in Q3 and Q4. And we hope as we look forward to 2024, that we'd see a 10 to 15 basis point improvement from that level. Now that's if the Fed just...I'm not going to say...it wouldn't be a pause, it would just be a stop in...and we're not...at this point, we're not in those comments. We're not anticipating any declines in...at the Fed funds rate. That's what we think we'll be able to settle out on. Now if there are declines, I think you can see some strong improvement of our NIM.

Woody Lay
Right. That makes a little sense. And then last from me, more just a housekeeping item, but I know there was some noise in the tax rate for the quarter. Just on a go-forward basis, do you expect that to increase back up closer to the 29% level?

Heather Luck
It will still...we're targeting about 29.03%. That's what we're forecasting. We did a state tax study during the second half of the year, and we'll have some amended returns and returns to file in new state. But going forward, we anticipate about 29.03% is our tax rate.

Woody Lay
Got it. Thanks.

Heather Luck
Okay.

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 questions here. I'm looking at the loan originations in the quarter, and it seemed pretty healthy, a pretty healthy step-up versus the first quarter, but the payoffs and the pay downs also stepped up pretty materially. I was just curious, James, was there anything unusual from a payoff or pay down perspective this quarter?

James Beckwith
Well, we had, we were just talking about that, Andrew. We had a pretty significant office loan payoff, which we were all happy to see. We normally have a fair amount of churn within our MHC portfolio as our operator investors kind of reposition their portfolios. So that's always present and just normal amortizations really, but there were some large payoffs, which we're happy to see. We're…as those loans pay off, they are usually at lower rates, and it gives us an opportunity to redeploy into higher loans, principally loans. And so, we think that in the long term that's going to help our margins. I don't know if we're going to anticipate the same degree of originations in Q3 as we saw in Q2. I think it will be diminished. And, so I wouldn't expect that on a go-forward basis. We're still going to stick to our 8% loan growth that we expect for the full year, Andrew.

Andrew Terrell
Got it. Understood, I appreciate the color there. And then on the new originations this quarter, what was the weighted average yield that those were made at?

Heather Luck
Yes. So those were originated at about 7.77%.

Andrew Terrell
Okay, got it. And then James, the…I guess, at an 8% loan growth rate, the…it seems like your capital position should build modestly from here, but it does sound like there are some kind of growth tailwinds in your back as well. So just wanted to get kind of updated thoughts on the capital position where you stand today?

James Beckwith
Well, we certainly would like to grow common tangible equity to risk-weighted assets. So that's our focus. We saw a slight improvement in the second quarter. So that's our orientation in terms of what we're trying to do there, so we think that we can sustain this now with respect to this type of growth, i.e. the 8% loan growth, 10% deposit growth. We think we can sustain our capital positions and grow our capital position. So, time will tell. If we have opportunities to grow, certainly on the deposit side that outpace that, we'll take advantage of that. Now we understand that may require additional capital, and Andrew, as you know, we did file a shelf in Q1, $250 million, and that's good for three years. And so, that's available. I don't…I'm not suggesting that the capital markets are open right now. So…but certainly, things have improved over the last couple of weeks. So, it's there, whether we take advantage…right now, we don't

think we need to take advantage of that. And our…again, our focus is growing common tangible equity to risk-weighted assets.

Andrew Terrell
Yes, okay. Understood. I appreciate the opportunity for the follow-ups.

James Beckwith
Thank you.

Operator
And ladies and gentlemen, that will conclude our question and answer session. At this time, I'd like to turn the floor back over to management for any closing remarks.

CONCLUSION

James Beckwith
Great, thank you. Five Star Bank is on a continued growth path 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.

Recent successes include the company earning the #1 ranking on the S&P Global Market Intelligence annual rankings of 2022's best-performing community banks in the nation with assets between $3 billion and $10 billion. We are very pleased to be recognized and believe this ranking builds upon the trust we have created with our customers and communities. The company also has a Bauer Financial Superior Rating of 5 out of 5 and an IDC Superior Rating of 300 out of 300. The company has also a super premier performing bank with The Findley Reports. We are a driving force for economic development, a trusted resource for our customers and a committed advocate of our community. We look forward to speaking with you again in October to discuss earnings for the third quarter of 2023. Have a great day, and thank you for listening.

Operator
Ladies and gentlemen, the conference has now concluded. We thank you for attending today's presentation. You may now disconnect your lines.