Five Star Bancorp

Fourth Quarter and Yearend Earnings Webcast

Tuesday, January 31, 2023, 1:00 PM Eastern

CORPORATE PARTICIPANTS

James Beckwith - *President, Chief Executive Officer*

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

PRESENTATION

Operator
Welcome to the Five Star Bancorp Fourth Quarter and Yearend 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, 2022…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 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 sir.

James Beckwith
Thank you for joining us to review Five Star Bancorp's financial results for the fourth quarter and year ended December 31, 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 our executive management team.

The fourth quarter of 2022 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 strong at the end of 2022 within verticals we have historically operated in, as presented in the loan portfolio diversification slide.

Loans held for investment increased during the quarter by $208.3 million, or 8.07% from the prior quarter and increased by $856.9 million, or 44.29% year-over-year, primarily within the commercial real estate concentration of the loan portfolio. Loan originations during the quarter were approximately $295.3 million, and payoffs were $86.8 million. During 2022, loan originations were approximately $1.4 billion, and payoffs were $513.9 million.

Asset quality continues to remain strong, with nonperforming loans representing only 0.01% of the portfolio, slightly decreasing from the last several quarters. As of December 31st, 2022, the allowance for loan losses totaled $28.4 million. We recorded a $1.3 million provision for loan losses during the fourth quarter, primarily related to loan growth, for a total provision for loan losses of $6.7 million for the year. The ratio of the allowance for loan losses to total loans held for investment was 1.02% at year-end.

Loans designated as substandard totaled approximately $0.4 million at the end of 2022, representing a decrease in substandard loans of approximately 26,000 from the previous quarter and a decrease of approximately $10.2 million from the previous year-end.

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 fourth quarter, deposits increased by $167.7 million or 6.41% as compared to the previous quarter. During 2022, deposits increased by $496.1 million or 21.7% since the end of the prior year, of which $69.1 million of the growth related to noninterest-bearing deposits. Noninterest-bearing deposits as a percent of total deposits at the end of the fourth quarter decreased to 34.9% from 39% at the end of the previous quarter and 39.5% at the end of the previous year.

We've had strong deposit growth over the last several quarters with deposit balances increasing when compared to the prior quarter and year. Noninterest-bearing deposits decreased by $49.4 million, while interest-bearing deposits increased by $217.1 million quarter-over-quarter. Cost of total deposits was 95 basis points during the fourth quarter and 43 basis points during 2022 overall. We continue to be well capitalized with all capital ratios well above regulatory thresholds for the quarter and the year.

As disclosed in our prior quarter call, we redeemed $28.8 million of previously existing subordinated notes on December 15th, 2022, with the proceeds received from our private placement of $75 million in aggregate principal amount of fixed to floating rate subordinated notes due on September 1st, 2032, completed on August 17th, 2022.

Net income for the quarter was $13.3 million. Return on average assets was 1.7% and return on average equity was 21.5%. Net income for the year was $44.8 million. Return on average assets was 1.57% and return on average equity was 18.8%. New loan originations drove increases in the daily average balance of loans period-over-period.

Average loan yield for the quarter was 5.12% representing an increase of 37 basis points over the prior quarter. Average loan yields for 2022 was 4.75%, representing a decrease of 7 basis points over 2021. As a result of these factors, our net interest margin was 3.83% for the quarter, while net interest margin for the prior quarter was 3.86%. Our net interest margin was 3.75% for the year, while net interest margin was…for the prior year was 3.64%.

The change in the yield curve as a result of interest rate hikes that occurred during the year had a negative impact on the company's accumulated other comprehensive income. The negative impact on the company's accumulated other comprehensive income improved slightly during the quarter ended December 31st, 2022, in the amount of $3.7 million. Primarily in our mortgage-backed and municipal securities portfolios, resulting in lower unrealized losses in each of these portfolios of $1.5 million and $2.1 million, respectively.

The negative impact caused a 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 earned in the quarter for a net increase in tangible book value per share of $0.79.

Noninterest income increased to $1.6 million in the fourth quarter from $1.4 million in the previous quarter, due primarily to a $100,000 increase in gain on sale of loans related to higher volumes of loans sold and a $100,000 increase in other income related to a gain on distribution received on an investment in a venture backed fund earned during the quarter.

Noninterest income decreased to $7.2 million in 2022 from $7.3 million in 2021, due primarily to increases in loan-related fees earned of $0.9 million, and other income of $0.4 million from gains recorded on investments in venture-backed funds during the year. The remaining increases related to FHLB dividends and earnings on BOLI during the year. These increases were partially offset by a decrease in gain on sale of loans of $1.1 million, related to lower yields on loans sold during the year, and a $0.7 million reduction in the net gain on sale of securities year-over-year, due to minimal sales of securities during 2022 compared to 2021.

Non-interest expense remained relatively flat quarter-over-quarter, with decreased professional services of $0.2 million related to legal expenses incurred for corporate organizational matters completed in Q3 2022, offset by increases in other operating expenses of $0.5 million, primarily related to $300,000 of expenses recognized on unamortized subordinated debt issuance costs upon the redemption of the subordinated notes in December 2022, combined with increased expenses incurred related to travel and fees paid for attendance of professional events, conferences, and other business-related events during Q4 of 2022.

Non-interest expense increased from 2021 to 2022, relating to increased salaries and employee benefits of $3.6 million due to a 9.2% increase in headcount, partially offset by $1.0 million in loan origination costs related to increased production during 2022.

Other operating expenses also increased year-over-year, related to the previously discussed expenses recognized on the subordinated debt redemption and other employee travel and conference-related expenses. These increases were partially offset by a $1.3 million reduction in professional services due to increased audit, consulting, and legal costs incurred to support corporate organizational matters leading up to our IPO in 2021 which did not recur in 2022.

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 everyone for joining us as we discussed the fourth quarter results. The strength of the bank's 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 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.

Looking to 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 will continue to execute on our 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.

QUESTION 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, we ask you to please pick-up your handset before pressing the keys, to withdraw your question please press "*" then "2." Questions will be taken in the order received.

Today's first question comes from Gary Tenner with DA Davidson. Please go ahead.

Clark Wright
Hi there. Good morning. This is Clark Wright on for Gary Tenner. Last quarter you mentioned that you think you can grow deposits to the 4% higher than loan growth in 2023. Do you continue to believe that that's going to be the case?

James Beckwith
Yes, we do. Our expectations about loan growth in 2023 will be around 10%, we expect we will be able to grow our deposits by 12%, which is about 2% higher, so we're confident that we will be able to do that at this point, and we look forward to that opportunity.

Clark Wright
Great. And then in terms of loan growth guide you just gave…would that be primarily from the historic areas that you've seen growth in with manufactured housing? Or are you seeing any shifts there in terms of where originations are coming from?

James Beckwith
No, we don't expect any major shifts. Deal flow so far for the first part of this first quarter is really been centered around the manufacturing housing space. And so we expect more of the same.

Clark Wright
Thank you. I will step back in the queue.

James Beckwith
Thank you.

Operator
And our next question today comes from Andrew Terrell with Stephens. Please go ahead.

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

James Beckwith
Good morning Andrew.

Andrew Terrell
Hey, maybe just to follow up on the last one to start on deposit growth, wanted to get a sense for during the fourth quarter, how much of the deposit growth was driven by brokered CDs or brokered money market funding? And then within the 12% deposit growth expectation for 2023, are you assuming any incremental brokered deposits? Or do you anticipate that 12% to be a core deposit growth number?

James Beckwith
Yes, the fourth quarter, I think you rightfully point out that we funded a lot of our growth through what I would call wholesale opportunities. And so, we expect as we move forward into 2023, that we will…our growth will be funded by core deposits. We are hopeful being able to diminish our wholesale positions, if you will on the depository side, and time will tell, but that's our orientation Andrew. We think that we'll be able to achieve that.

Andrew Terrell
Okay. Very good. And maybe just on that point, any realignment of lender incentives that have occurred recently, or anything changed in terms of how you're going about gathering deposits that would kind of, it seems like you certainly have confidence in this deposit growth guidance. Just wanted to get a sense of maybe some of the drivers there that lead you to that confidence?

James Beckwith
Well, I'm glad you bring that up. Yes, we have had a realignment of how our incentive programs for our business development team. Much more deposit oriented, the minimum standards that are deposit oriented in that half of their production has to be deposits. Some of our special incentives are all deposit oriented.

And so, this is what's we pivoted. We started to pivot with respect to our orientation on business development in the fourth quarter. And we're really coming on strong right now with respect to our expectations and also our biz-dev [ph] expectations. We've had a successful January so far in terms of new account and new relationship, onboarding, probably going to be our biggest month ever, in terms of new relationship onboarding. So we're excited about that. So that's our orientation. Yes, we have changed how we pay people, and it's going to be much more oriented to deposit generation.

Andrew Terrell
Very good. Okay, I appreciate the color there James and it's helpful. If I can move over to the margin, just briefly. Heather, it looks like the FHLB were added pretty late in the quarter. Do you have what the weighted average rate was on the FHLB borrowings...the weighted average...

Heather Luck
Those were slightly under 4% for the FHLB borrowings and then our broker…wholesale fundings were about 3.88. We do our FHLB borrowings are very short term in nature. So we only have a week to maybe two weeks at the most outstanding during any period. So those should have a minimal impact on the margin.

Andrew Terrell

Okay. Understood. And then do you have the spot deposit costs either interest bearing or total at the end of the year?

Heather Luck
End of the year, I believe we landed at…

James Beckwith
Well, I would take December.

Heather Luck
Take December stuff…

Andrew Terrell
Yes, December.

Heather Luck
Let me take that out for your one moment. Apologies.

Andrew Terrell
No problem we can. I'll ask one more really quick for James on the CET1, just a little bit less than 9% this quarter. Just wanted to get your thoughts on current capital position…comfortability around the current capital position and outlook moving into 2023, and where capital targets might be?

James Beckwith
Sure. We're comfortable with our capital position right now. We intend to grow our tangible book value per share in 2023. But we always want to prepare ourselves and be in a good position to…with respect to raising any additional capital. So I think that we're oriented that way. We want to be good stewards of our capital position, and continue to be mindful of where we are. As we mentioned, our expected growth in 2023 is going to be a lot different from what we've experienced in the past five years. And so, we expect we'll be able to build our capital positions in 2023 through internally generated earnings.

Andrew Terrell
Okay, very good. That's it from me. And thank you guys for time today.

Heather Luck
Andrew, we can close that loop. So our cost of funds was 1.17%. And that's all in including CDs as well.

Andrew Terrell
That's for the month of December.

Heather Luck
Yes.

Andrew Terrell
Okay, 1.17% including CDs and the non-interest bearing deposits?

Heather Luck
Yes.

Andrew Terrell
Okay. Very good. Thank you.

Operator
And our next question today comes from Woody Lay with KBW. Please go ahead.

Woody Lay
Hey, good morning guys.

James Beckwith
Good morning Woody.

Woody Lay
I wanted to sort of focus on the loan growth in the quarter. It came better than what I was expecting and maybe a little bit better than maybe your expectations heading into the quarter. Do you think that growth just represents a pull through in the year or in the year ahead, or was there just new customers that were unexpected that drove the growth or any color you can give on the fourth quarter growth?

James Beckwith
Sure, we didn't really get a sense that anything was being pulled from 2023 in terms of the originations, Woody, just that it was new business that happened within the quarter, within the verticals in which we operate in. And I think it was just more of the same week. As I mentioned, previously, we have seen…we expect a decline in originations in loan growths in 2023, and certainly where we are with respect to our pipeline as we entered into 2023, is representative of that notion. So I wouldn't say any pull through, it's just business that was there. And we did it because it was good business.

Woody Lay
Yes, it's really strong growth, good to see. Maybe moving over to the NIM, I know, it'll get a little bit of a pickup from that sub-debt redemption. But sort of excluding the impacts from there. I mean, do you think the NIM is under pressure just from the intense deposit competition, or any thoughts on your margin for the expectations in 2023?

James Beckwith
Yes. I think that every depository institution is under some degree of pressure. We're not immune to that. What we've seen is, we've had some of our liquidity positions by some of our long-term customers go out of the bank, as they invested in treasury securities. At this point, we're unable to match what they can get on those short-term treasuries. We do our best. But we're mindful of the fact that it's difficult for us to match those rates.

Having said that, what we’re really interested is banking their operating accounts. These are businesses that have been around for a long time. We expect that liquidity potentially if rates do decline to come back on balance sheet. But it’s a very competitive environment right now. And it’s not necessarily with other institutions, it’s really with the big brokerage houses that can create positions or ladders, if you will, treasury securities ladders for our clients. We're in great standing with them. And we certainly understand what they're trying to accomplish, but we think it's a near term thing, hopefully. And so, we definitely recognize the environment in which we're in. And, but having said that, we're also excited about what we're being able to do on the business development side in terms of bringing in core deposits.

Woody Lay
Right, okay. And then, last for me, I just wanted to touch on credit. All the underlying metrics look super clean. Just anecdotally, are you seeing anything in the market that gives you concern at this time or is it really just a waiting game? And then just as a follow up to that I know, you're adopting CECL in the first quarter. Do you expect that they have a material impact to reserve levels with implementation?

James Beckwith
Well, let's take the first part of that question first. We're very happy with where we are with respect to our portfolio and how we manage it. Our loan portfolio is different than others. We're in some very, well I should say safer asset classes than other institutions that have a commercial real estate concentration. And you can see that when you add up mobile home communities and recreational vehicle parks, if you will, that represents about 40% of our CRE portfolio. We like that space. When you add in storage, which we also think is very safe, we like our position. Our office book, if you will, which I think is the most risky part of any CRE portfolio right now, I think is around 6%. So I think we're different than, I'm going to say the average bank in California with respect to the composition of our CRE portfolio. And we know that those asset classes perform better in downturns. Historical data would suggest that they perform a lot better than other CRE classes.

Now, with respect to CECL, Heather you want to give some color on that?

Heather Luck
Sure. Yes, so we have successfully completed a year of parallel runs. We're currently going through with our auditors the final review of our day one adjustment, but we are anticipating a day one adjustment between the reserve and then the reserve for unfunded all in ranging anywhere between $6 (million) to $7 million for an increase for our day one adjustment, which we’ll have finalized and ready for Q1.

Woody Lay
Got it. Alright, thanks for taking my questions.

James Beckwith
You bet.

Operator
And ladies and gentlemen, as a reminder, to ask a question please press “*” then “1.”

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

Andrew Terrell
Hey, thanks for the follow up. Back on the margin, just a quick one here, I wanted to get a sense for what new production kind of on a weighted average basis is coming on the portfolio just as we think about. I know there's maybe some pressure on the funding cost side and competition there just trying to think about what the incremental margin looks like?

Heather Luck

Yes, so for Q4, our overall weighted average rate for new loans [indiscernible] was about 6.54%, definitely saw a pick up from the rising interest rate environment. For Q1, though, we're looking at an overall NIM ranging anywhere from like 3.75 to 3.85.

James Beckwith
Yes. Our standard pricing is 300 over the five year for our typical CRE portfolio loan, and as the five year jumps around and what not, you could have as high as 7, 7.15 to 6.5 right now or 6…almost 6 in three quarters. So that's what we expect in terms of production where that will land in 2023. And certainly saw that in the fourth quarter, which resulted in really moving our loan yields up quarter-over-quarter.

Andrew Terrell
Yes, okay. Now, last one from me. Just for Heather on the expense base, just working on 2023, can you just remind us the normal seasonality that we might cadence statistically throughout the year and then any estimate on clean run rate starting out the year in Q1 '23?

Heather Luck
Sure. I really do think, I know you all stripped out the $300,000 of subject costs that we ran through Q4. But I really do feel like Q4 is a good proxy for our expenses going forward. As we look for the year, you could estimate about 1.33, as far as non-interest expense to assets. But Q4 is a pretty good proxy to exclude those subject costs.

Andrew Terrell
Okay. Very good. Thank you for taking the follow up questions.

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

CONCLUSION

James Beckwith
Well, thank you, and appreciate everybody being on the call. Five Star Bank continues to execute on strategic initiatives, which include growing our verticals in geographies while attracting and retaining talent, our people, our technology, our 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 April to discuss our earnings for the first 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 your lines and have a wonderful day.