Five Star Bancorp

Second Quarter Earnings Webcast

Tuesday, July 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 Second 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 may result…differ materially from these expectations. For a more complete discussion of the risks and uncertainties that may cause actual results to differ materially from the company's forward-looking statements, please see the company's annual report on Form 10-K for the year ended December 31, 2021, and in particular, the information set forth in Item 1A, risk factors therein.

Please refer to slide 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 a reconciliation 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.

James Beckwith
Thank you for joining us to review Five Star Bancorp's financial results for the second quarter of 2022. Joining me here today is Heather Luck, Senior Vice President and Chief Financial Officer. Our comments today will refer to the financial information that was included in the earnings announcement released yesterday. To obtain a copy of the release, please visit our website at fivestarbank.com and click on the investor relations tab.

In the company overview section, we have provided a brief overview of our geographic footprint and executive management team. The second quarter of 2022 exhibited continued execution of our organic growth strategy as evidenced by our earnings, expense management, and balance sheet trends during the quarter.

Additionally, loans and deposits and total assets have consistently grown since the prior periods. Our pipeline continues to remain substantial at the end of the second 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 measure that is reconciled in our press release, increased during the quarter by $301,900,000 or 14.52% from the prior quarter, primarily within the commercial real estate concentration of the loan portfolio. All PPP loans have been forgiven, paid off by the borrower, or charged off as of June 30, 2022. Loan originations, excluding PPP loans during the quarter were approximately $440.5 million and payoffs excluding PPP loans were $138.1 million. Additionally, $1.5 million of PPP loans were forgiven, ultimately resulting in a net increase in loans of $300.4 million from the prior quarter.

Asset quality continues to remain strong with nonperforming loans representing 0.02% of the portfolio, slightly decreasing from the last several quarters. At quarter end, there were two loans totaling $0.1 million in the aggregate on 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 second quarter, the allowance for loan losses totaled $25.8 million.

We recorded a $2.3 million provision for loan losses during the quarter, primarily related to loan growth. The ratio of the allowance for loan losses to total loans, excluding PPP loans, a non-GAAP measure that is reconciled in our press release, was 1.08 at quarter end. Loans designated as substandard totaled $1.2 million at the end of the quarter, representing a decrease in substandard loans of approximately $1.8 million from the previous quarter.

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

Heather Luck
Thank you, James, and hello, everyone. During the second quarter, deposits decreased slightly by $1.8 million or 0.07% as compared to the previous quarter. Noninterest-bearing deposits as a percent of total deposits at the end of the second quarter increased to 40.2% from 37.6% at the end of the previous quarter.

We have had strong deposit growth over the last several quarters with deposit balances remaining relatively consistent from the prior quarter. Noninterest-bearing deposits increased by $64.8 million, while interest-bearing deposits decreased by $66.6 million. Cost of total deposits was 17 basis points during the second quarter. We continue to be well capitalized with all capital ratios well above regulatory thresholds for the quarter.

Net income for the quarter was $10 million. Return on average assets was 1.45% and return on average equity was 17.2%. New loan originations drove increases in the daily average balance of loans period over period. Additionally, the company recognized $24,000 of PPP income recognized based on forgiven loans during the quarter. Average loan yield for the quarter was 4.47%, representing a decrease of 6 basis points over the prior quarter.

As a result of these factors, our net interest margin was 3.7% for the quarter, while net interest margin for the prior quarter was 3.6%, which also included $600,000 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 $5.5 million, primarily in our mortgage backed and municipal securities portfolios, resulting in decreases to each of those portfolios of $7.3 million and $5.2 million, respectively.

This 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 a slight increase in equity as a result of net income earned in the quarter paired with a decline in total shares outstanding at the end of the period as a result of various stock forfeitures that occurred during the quarter. This resulted in a net increase in tangible book value per share of $0.12.

Non-interest income decreased to $2 million in the second quarter from $2.2 million in the previous quarter, due primarily to a decrease in other income as a result of a $300,000 gain recorded on a distribution received on an investment in a venture-backed fund in the prior quarter, which did not recur during the current quarter. This decrease was partially offset by an increase in loan related fees of $200,000 due to an increase in swap referral fees recognized during the quarter.

Non-interest expense increased to $10.2 million in the second quarter from $9.6 million in the previous quarter, driven largely by an increase in other operating expenses as a result of an increase in travel related to attendance of professional events, conferences and other business-related travel 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 everyone for joining us today as we discuss the second quarter results. The strength of the bank's second quarter financial results continues to be emblematic of a reputation built on trust, speed to serve, and certainty of execution which supports our clients' success. Our financial results are also a result of truly differentiated customer experience, which powers the demand for Five Star Bank's relationship-based services.

We are pleased to have recently received a Super Premier rating from The Findley Reports and IDC rating of Superior. Additionally, the company's Bauer rating is a 5-star rating. We attribute these ratings 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 the second half of 2022, we will be guided by a continued focus on shareholder value as we monitor market conditions. We are confident of the company's resilience in any interest rate environment and we'll continue to execute for our organic growth strategy and disciplined business practices, which we believe will benefit our customers, employees, community and shareholders. We appreciate your time today.

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

QUESTION AND ANSWER

Operator
We will now begin the question and answer session. To ask a question, you may press "*" then "1" on your touchtone phone. If you are using a speakerphone, please pick up your handset before pressing the keys. If at any time your question has been addressed and you would like to withdraw your question, please press "*" then "2." At this time, we will pause momentarily to assemble our roster.

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

Andrew Terrell
Hey. Good morning.

James Beckwith
Good morning, Andrew.

Heather Luck
Good morning.

Andrew Terrell
James, maybe just to start, one, this was just an exceptional kind of growth quarter. I was hoping you could discuss maybe how the pipeline or give us a sense for the pipeline in the third quarter was shaping up versus the prior quarter? Are you seeing any kind of a slowdown given kind of the move up in rates we've seen? And then, I would assume also on the other end, payoffs were slowing down as well too. So hopefully, you could just provide us kind of updated expectations on how overall net growth shapes up, net loan growth shapes up in the second half of the year?

James Beckwith
Sure. Our loan pipeline is less than what it was when we entered into the second quarter by a fair amount. Our deposit pipeline has actually grown, so where we sit today is that our deposit pipeline is substantially larger than our loan pipeline. I think it's safe to say, it'd be very difficult for us to experience the same amount of loan growth in the second half of the year as we saw in the first half. The deal flow has slowed, but it's still there. We're still very busy. But I don't think we're going to experience the same degree of loan growth that we saw in the first half of the year and in particular the second quarter for Q3 and Q4 as we go out. So, expectations are probably a 5% to 10% loan growth for the remaining of the year and probably if we perform well on the deposit side…deposit growth between 10% to 15% for the remainder of the year. We have a lot of large relationships that we're onboarding right now. And we're excited about those opportunities and everything else that the market is bringing us right now.

Andrew Terrell
Great. That's really encouraging to hear, especially on the deposit growth front. I think last quarter, we might have talked about loan yields, I think potentially laying down a bit for the next couple of quarters just before expanding. As a function of kind of the pipeline funding up, I was just hoping to get a sense of where new originations came on at during the second quarter? And then I would imagine just given the volatility in rates upward that we've seen that you're kind of funding loan growth at a higher yield now. Just hoping to get a sense of kind of trajectory of the loan yields?

Heather Luck
Yes. So I can take that, Andrew. For Q2, we…our weighted average rate was about 4.65% and then driving that primarily with our fundings in the multi-family concentration, which came in about 4.57%, that was pretty much the bulk of the funding for the period. I'll let James provide some color around…

James Beckwith
Sure. The loans that we're approving in committee over the last months are substantially all of which had five panels on it. So we are pricing up, naturally speaking. We're a spread shop and we spread off the five year or the 10 year with our CRE lending. And so, we are seeing the actual rates on those deals being higher than our loan yield that we currently have in our loan

portfolio. So it's our expectations that loan yields will grow and based upon the amount of volume that we put on so which is nice to see. For the longest period of time, Andrew, we were making loans that were less in terms of yields were less than what was in the portfolio, which is not a winning strategy per se, but we think that that's turned around.

Andrew Terrell
Yes. Okay. Got it. Maybe thinking on kind of the margin, if I look at the move in the interest-bearing deposit costs this quarter, I guess if I just run the math, I get to like 20% interest bearing deposit beta for 2Q. Maybe for Heather, do you think that beta should kind of hold around 20% through the rate cycle or are you seeing deposit rate competition kind of more meaningfully accelerate so far in the third quarter? And then can you just remind us overall of where you kind of of target the deposit beta through the cycle?

Heather Luck
Sure. Yes. So we actually use an internal estimate of about 30% for our betas on deposits. We do have our large governmental book that kind of holds that steady as we have inflows and outflows. So, we're kind of using 30% as our estimate.

Andrew Terrell
Got it. Okay. And then do you have the spot either interest bearing or total deposit costs that's at June 30?

Heather Luck
Well, total cost of deposits at June 30 was 22 basis points. But, you know, we could kind of see that almost doubling by the end of September just given the composition of our deposit book, you know, the rising rates on the lease rates that we tie our governmental book to. So all-in that go up to 44 basis points to 50 basis points by the end of Q3.

James Beckwith
Yes. And I think it's important to note because of the fact that we don't have a very granular deposit base per se. We've got a lot of large relationships. Each one of those relationships have negotiated pricing. And so you could…so it's difficult to kind of across the board determine where that's going to end up. We're responsive from a pricing perspective, and I think that it's with each Fed move, there's more pressure with respect to some of our interest-bearing deposits to move up, but each relationship stands on its own in terms of the negotiated pricing associated with it.

Andrew Terrell
Okay, understood. Well, I'll step back in the queue. I appreciate you taking my questions.

James Beckwith
Sure.

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

Gary Tenner
Thanks. Good morning, everybody.

James Beckwith
Hey Gary.

Gary Tenner
Hey. I appreciate the thoughts on the deposit pipeline. Obviously, with the loan deposit ratio creeping up as it did during the quarter, it should have moderated a bit. Can you give us a sense as to kind of what the rate of that deposit pipeline looks like? I know Heather, you just provided some thoughts on where deposits could go by the end of the quarter, but just curious kind of what the marginal cost of funding looks like right now?

James Beckwith
So a lot of commercial accounts…so if I was to blend it, it's probably maybe at or slightly above where we are right now at the end of second quarter. I think that would be new production per se. We expect to continue to grow our non-interest-bearing deposits. Gary, you can see a pretty substantial increase in the first half of the year. I think through 30 June, over $100 million in non-interest-bearing deposits. So that has a tendency to kind of drive down, obviously, your costs and our pipeline is replete with those types of opportunities as we continue to take advantage of folks in the market, in particular, the mergers and other, I'm going to say, merger-related entities or merger-affected entities, which has been kind of a nice little windfall for us.

Gary Tenner
Got it. Thank you. On the fee side, obviously, a pretty steep drop that we've seen at your institution and others as it relates to SBA premiums. Any thoughts on kind of keeping more on portfolio given how low those premiums are, or does balance sheet management and funding dictate that you continue to sell?

James Beckwith
Well, that's a great question. We've never portfolio-ed any SBA loans, we've always have originated for sale, and I expect we're going to continue to do that. There is some things going on in SBA's of note. SBA is moving up their MAX pricing, if you will, pretty substantially, frankly. And we're not in a position to determine like what do we want to do here. I think it's a wait-and-see with respect to what the investors, the folks who buy our loans. What do they make about those pricing increases which are in the 50 basis points to 100 basis points higher than what the MAX pricing SBA allowed? I'm not sure about the policy behind it. But nevertheless, it's going to be in place, I think, in first week of August. So that could affect premiums. We just don't know what that looks like right now. The premiums have drifted down, as you noted. Our SBA function is still very profitable. And the volumes, we wish they were a little higher, but they are what they are. So we'll continue to sell.

Gary Tenner
Great. And then lastly from me, I think, historically, your comp program set up to whereas your development officers kind of hit their numbers, you have that ramp of comp in the back half of the year. And I think, particularly with your thoughts on the pipeline, which I know is a big part of that incentive program, should we expect to see sort of that upward trajectory again in the back half of this year based on how that pipeline looks?

James Beckwith
Well, I think we do have some special incentives for deposits. With the loan production in the first half of the year was $0.75 billion, so a lot of guys are already at the highest tier, I'm going to say, at least half of them are. And so, Q2 commissions were pretty good for them. We're happy to be able to do that. But I think that you probably could see some maybe slightly less

consistent with last year in terms of commission growth. But it all depends on how well we execute on the deposit side in terms of new accounts and new relationships.

Gary Tenner
Okay. Thanks for taking my questions.

Operator
Our next question comes from Stuart Lotz with KBW. Please go ahead with your question.

Stuart Lotz
Hey, guys. Good morning. How's it going?

James Beckwith
Hey, Stuart. How are you doing?

Heather Luck
Good morning.

Stuart Lotz
Good. Heather, I was wondering if you could kind of quantify the...or sorry, James, quantify your... the loan growth outlook. You know, what is... I appreciate the pullback just given the backdrop. But this quarter, $300 million, and I think over the last about four quarters, you've averaged above the 30% annualized growth. So just in terms of dollar amounts, how are you thinking about the growth pipeline for the back half?

James Beckwith
Probably in the neighborhood of $100 million to $125 million per quarter remainder of the year. Is that helpful?

Stuart Lotz
Yes. And I mean, just given the mix in recent quarters has really come from the manufactured housing book or manufactured home book. Could we expect that to continue to drive the growth from here? Or do you anticipate, you know, pulling back just given concentration issues or concentration opportunity?

James Beckwith
Yes. Thank you. But we don't anticipate pulling back in terms of that particular vertical and lending into that space. We really like the credit characteristics. We like the granularity, geographic granularity associated with that business. And we just think that that asset class, based upon our research, has always performed well in any type of economic environment, and in particular, a downturn. So we think that we're well protected in terms of lending into that space. So we don't plan to stop or modify what we're doing. But we'll say that the market has slowed. I think there's less acquisition, park acquisition going on. And I think rates have clicked up. So buyer and seller expectations, maybe they're a little widespread than they once were with cap rates rising. So we've definitely seen a slowdown in that business, but it's still pretty decent.

Stuart Lotz
Okay. Got it. Great. And maybe warming in a capital question. I think historically, you've operated with the CRE as high as about 700% of total risk-based capital. And kind of by my math, this quarter, you guys are kind of back in that range. So any thoughts about potential

capital? I know you're looking at potential sub-debt rates at some point to reprice your existing sub-debt, but I just want to get your thoughts on how high you're willing to let that ratio go before looking to raise some additional capital for growth?

James Beckwith
Well, Stuart, as you know that we've always talked about us executing on that refinance and I think that we're…our thinking is consistent with respect to that. So I think that there should be or could be an expectation that we would execute on that by the end of the year. So…and that could provide us, if we do it, that could provide us with additional capital into the bank and lower those concentration levels for CRE that you just referenced.

Stuart Lotz
And would you potentially look at just given your, the strength of the currency right now, of raising equity capital, just given how high kind of sub debt pricing is today and maybe what would kind of drop from one or the other from here?

James Beckwith
Well, that's a good question. So let's do the math together, if we could. We're nowhere near $125 double leverage ratio right now. We kind of like that number as a ceiling, Stuart. So you could probably back into that in terms of what the additional or what size would be if we did a sub debt deal number one. If we're making 17% after a $2.3 million provision on equity, I think that my understanding in the current sub debt market in terms of an interest rate we do pretty well with that, don't you think?

Stuart Lotz
Yes. I would agree. Just given kind of what we've seen, I mean obviously there's been a pullback in that market, but just given the strength of your currency from a price intangible book standpoint, I feel like common equity might make sense at these levels too?

James Beckwith
Sure. We want to make sure that we don't blinders [ph] on with respect to capital at all. We want to make sure that we comprehend any opportunity that might be out there in the marketplace. And we are trading at a…I think a pretty nice premium to book which not everybody enjoys. So definitely hear you when you say where our valuations are favorable with respect to future equity raises.

Stuart Lotz
Appreciate all your color there. Maybe, one more for Heather, just turning back to expenses. Do you have what the deferred loan origination costs were this quarter and maybe if you could kind of hone in on a run rate for what you think the third quarter expense base could be?

Heather Luck
Let me, yes, let me pull up that really quickly. I don't think we, did we break that out in the earnings release for you all? I believe we did.

Stuart Lotz
I may have missed it.

Heather Luck
Let me pull it up for you, one moment. Actually, let me get back to you on that one. We can hop in, hop out of queue and hop back in, I'll pull that for you.

Stuart Lotz
Okay. That's great. Alright. Thanks for taking my questions.

James Beckwith
Thank you.

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

Andrew Terrell
Hey thanks for the follow-up. James, I wanted to ask you, you've I think alluded to it maybe a little bit in some of your prepared remarks, but I know part of the organic growth story has been driven by just your success and your ability in hiring talent away from other institutions. Just was hoping to get an update on any kind of progress made over the past quarter in terms of new business development hires? And then what the pipeline for that specifically looks like going forward?

James Beckwith
Well, right now, as we sit here, there's nobody that's…we have our eye on a few people, but there's no…somebody who's actively in the queue at this point. We have a pretty complete business development team that is doing a great job. We've had the opportunity to build out a couple of our verticals with additional hires this year, whether it's in our faith-based business, our venture banking business, and also our ag business. So we feel like we've got a pretty strong complement right now. We usually like to have, Andrew, to visit our people in each vertical we're in each substantial vertical. And I think that we certainly have that and we're doing quite well even in our practice group. We've got fundamentally 2.5 people in there now. So seeing a lot of growth come through that particular business. And I'm talking about the dentistry and the veterinary clinics and whatnot, some extent CPA practices. So that's…so we kind of like where we are right now. Now that's not to say we wouldn't…if it came to pass that we have an opportunity to land somebody, we wouldn't jump all over it. But right now, where we are, we think we're very strong and from a business development perspective. So to answer your question, we don't really…we're not looking to, we don't have anybody in the queue right now.

Andrew Terrell
Okay. Now that's really helpful. I appreciate the color. And then last one for Heather, looking at the reserve ratio, it ticked down a little bit this quarters, given the strong loan growth. I know you're running CECL parallel right now. Curious, if you had any kind of preliminary day one CECL estimates that you are able to share with us?

Heather Luck
Yes. So at this moment, we don't have a preliminary day one estimate. We did do our first parallel run as of June 30. But we are still working through our qualitative factors. This is definitely a learning experience for all of us navigating CECL adoption for first year adopters. And we're finding our quantitative side is coming out rather high. And so, we need to make sure that we're looking at our underwriting practices and our experience of management and what we're doing in house to adjust for those qualitative factors to make sure that we have an appropriate reserve. Hopefully in Q3, we'll be able to provide at least an estimate so in that way you all can start looking as we get closer to the end of the year.

Andrew Terrell
Okay, perfect. Thanks for the follow-up questions.

Operator
This concludes our question and answer session. I would like to turn the conference back over to James Beckwith 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 strategic initiatives, which include growing our verticals and geographies, while attracting and retaining talent. Our people, technology, operating efficiencies, conservative underwriting practices and expense management have also contributed to the success we share with our employees and shareholders. At Five Star Bancorp, we seize opportunities and embrace challenges and value the intrinsic reward of serving others. We look forward to speaking with you again in October to discuss earnings for the third 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.