Five Star Bancorp

Second Quarter 2024 Earnings Webcast

Thursday, July 25, 2024, 1:00 PM Eastern

CORPORATE PARTICIPANTS

James Beckwith - *President, Chief Executive Officer*

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

PRESENTATION

Operator
Good afternoon, everyone, and welcome to the Five Star Bancorp's Second Quarter 2024 Earnings Webcast. Please note that this is a closed conference call, 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 "*" and "1" using your telephone keypad, to withdraw your questions you may 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 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 on 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, and quarterly report on Form 10-Q for the quarter ending September 30th, 2023. And in particular, the information set forth in Item 1A, risk factors in those reports.

Please refer to slide two of the presentation, which includes disclaimers regarding forward-looking statements, industry data and non-GAAP financial information included in the presentation. Reconciliations of non-GAAP financial measures to their most directly comparable GAAP figures are included in the appendix in the presentation. Please note this event is being recorded.

At this time, I'd like to turn the conference call over to James Beckwith, Five Star Bancorp's 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 2024. 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.

Our organic growth story continued in the second quarter with a successful close of our public offering, resulting in the issuance of 3,967,500 additional shares of common stock with net proceeds of approximately $80.9 million, allowing us to continue our momentum in the San Francisco Bay Area.

We added five more seasoned professionals to support this expansion and also continue to add new core deposit accounts and relationships as seen in the increase of non-wholesale deposits of $118.3 million during the three months ended June 30, 2024.

Despite continued external headwinds we maintained our ability to conservatively underwrite as evidenced by a 50% loan to value on commercial real estate, manage expenses with our 44%

efficiency ratio and delivered value to our shareholders with our $0.20 per share dividend for the first quarter and second quarters of 2024.

The second quarter of 2024 exhibited continued execution of our growth strategy and efforts to position for future growth as evidenced by our earnings, expense management and balance sheet trends during the quarter.

Additionally, we saw a positive turn in margin compression and loans, total assets and deposits have grown since prior periods. Our pipeline continues to remain solid at the end of the second quarter of 2024, within verticals we have historically operated in, as presented in the loan portfolio diversification slide.

Loans held for investment increased during the quarter by $162.2 million or 5.2% from the prior quarter primarily relating to the purchase of loans with the consumer concentration of the loan portfolio, representing $73.3 million of the increase. Total originations during the quarter were approximately $390 million, while payoffs and pay-downs were $72.8 million and $155 million, respectively.

Asset quality continues to remain strong. Though nonperforming loans increased in the beginning of the third quarter of 2023, they continue to represent only 0.06% of the portfolio at the end of the quarter.

At the end of the second quarter, the allowance for credit losses totaled $35.4 million, we recorded a $2 million provision for credit losses during the quarter, with loan growth and increases in net charge-offs as the leading drivers. The allowance for credit losses to total loans held for investment was 1.08% at quarter end. Loans designated as substandard totaled approximately $1.9 million at the end of the quarter, which is unchanged from the end of the previous quarter.

During the second quarter, deposits increased by $193.9 million or 6.56% as compared to the previous quarter. Noninterest-bearing deposits as a percent of total deposits at the end of the second quarter decreased slightly from 26.2%...to 26.2% from 27.7% at the end of the previous quarter.

As noted earlier, we are pleased we had a net non-wholesale deposit inflows for the three months ended June 30, 2024. 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 had a reliable core deposit base.

To 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 of these accounts was approximately eight years. Local agency depositors accounted for approximately 22% of deposits as of June 30th, 2024.

Overall, deposit balances have increased when compared to the prior quarter. Wholesale deposits, which we defined as broker deposits and public time deposits, increased by $75.5 million. Non-wholesale deposits increased by $118.3 million, driven by a $110 million increase in non-wholesale interest-bearing deposits and an $8.3 million increase in noninterest-bearing deposits. Cost of total deposits was 247 basis points during the second quarter, a decrease of 6 basis points from the first quarter.

We continue to be well capitalized with all capital ratios well above regulatory thresholds for the quarter. The additional common stock issued through the public offering that closed in April of 2024 is noticeable in our capital ratios for the second quarter. Our common equity Tier 1 ratio increased from 9.13% to 11.28% between March 31, 2024, and June 30th, 2024.

On July 18, our board declared a cash dividend of $0.20 per share on the company's loading common stock expected to be paid on August 12th, 2024, to shareholders of record as of August 05th, 2024.

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 $10.8 million. Return on average assets was 1.23%, and return on average equity was 11.72%. Average loan yield for the quarter was 5.83%, representing an increase of 12 basis points over the prior quarter.

Our net interest margin was 3.39% for the quarter, while net interest margin for the prior quarter was 3.14%, with loan growth at higher yields and decreased reliance on wholesale deposits as the primary drivers.

As a result of changes in interest rates and other factors, our other comprehensive income was $0.2 million during the three months ended June 30, 2024, as unrealized losses, net of tax effect decreased on available for sale debt securities from $12.4 million as of March 31st to $12.2 million as of June 30, 2024.

Noninterest income decreased to $1.6 million in the second quarter from $1.8 million in the previous quarter due primarily to a reduction in gains from distributions received on equity investments and venture-backed funds during the three months ended June 30, 2024. This decrease was partially offset by an increase in gains on the sale of loans during the three months ended June 30.

Noninterest expense grew by $28 million in the three months ended June 30 compared to the three months ended March 31st, primarily due to increases in commissions related to higher loan production, travel, conferences and professional membership fees and sponsorships and donations during the quarter.

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 second 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 have earned the trust of those we serve, including our shareholders.

As we continue to lean into 2024, we are 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 on 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 that you might have.

QUESTION AND ANSWER

Operator
And once again, if you would like to ask a question, please press "*" and "1." Our first question today comes from Andrew Terrell from Stephens. Please go ahead with your question.

Andrew Terrell
Hi, good morning.

James Beckwith
Hi, good morning, Andrew.

Heather Luck
Hi.

Andrew Terrell
Maybe just to start off, can you talk a little bit about the consumer loan purchase in the quarter, kind of what these loans were specifically? What kind of the yield and the credit profile looks like there? And then just more broadly talk about the strategy behind it, particularly kind of considering the recent capital raise and what it feels like is the ramping kind of organic growth profile?

James Beckwith
Sure. These loans were originated by Bankers Health Group, BHG. Their credit profile is very strong. I think I'm going to say mid-750 FICOs. These are the professional individuals throughout the United States. We've been involved with BHG for several years now and have had a really strong credit experience with loans that we purchased from them. We're buying them, Andrew, at an 8.25% yield. That was kind of the average yield for purchases in Q2. And they've been operating like this for several years now very strong franchise, a lot of banks throughout the United States utilize them. We first got into it by wanting to make sure that we had appropriate coverage for our small business loans from a CRA perspective. And that's expanded given our very favorable credit experience with them. So, it's a shocking [ph] arm. Certainly, we're not going to rely on it in terms of overall growth of the loan portfolio, but its additive, and it's coming on at a nice margin, nice rate, nice yield and we like the credit characteristics.

Andrew Terrell
Yes. Understood. Okay. And was the purchase made...do you have kind of a specific timing throughout the quarter. Just trying to get a better sense, I mean, loan yields are up 12 basis points in the quarter and may in the quarter here, obviously helps that. Just trying to get a sense of whether there's some carry-forward on the loan yields in the 3Q?

James Beckwith
Yes, we will see that, it was pretty much done the last half of the quarter. And so, I think that will carry forward into Q3 of 2024. We'll be looking at maybe doing some more of that, but time will tell. But certainly it will carry forward in terms of overall...and impacting positively overall loan yields. Now, there is a lot other things that's affecting our loan yields too, the loans that we're looking outside of the BHG purchase have rates from 7.5 to 8.25 also. And we had a pretty strong quarter for loan originations outside of this, what I would call a wholesale play. And we're also seeing some pay downs of the portfolio, lower rates being paid off. And so, we're…overall, that's really pushing loan yields up as you can see in our Q2 numbers.

Andrew Terrell
Yes. Got it. Okay. And then last for me, really quickly, just the SBA gain on sale income picked up this quarter. I was hoping you could just maybe update us as to what you're seeing within that business? Is this kind of a lift upward in 2Q durable and then just overall kind of expectations?

James Beckwith
Yes, we don't expect it to be durable. In fact, we've kind of turned the sales of the origination function. So, our expectations about gains on a go-forward basis are certainly less in Q3 and Q4 that we saw in the first half of the year. So, we've diminished the import of that business. We're still an active lender, but we're not going to be originating any near the levels of volumes we've had historically. And so, our efforts from a loan origination perspective are really what we're doing now in the Bay Area and what we're doing in all our other verticals in terms of putting on credit. So, gain on sales will definitely diminish. You're probably running from 50 to 100 grants [ph] for the remainder of the year on a monthly basis.

Andrew Terrell
Understood. Thank you for taking the questions. I step back in the queue.

James Beckwith
Thank you, Andrew.

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

Gary Tenner
Thanks. Good morning.

James Beckwith
Hi, Gary.

Heather Luck
Hi Gary.

Gary Tenner
Hi. First, I wanted to ask about the expense run rate, you know, decent quarter-over-quarter pickup. It doesn't look like there was anything particularly unusual in the numbers. So, I was curious for your thoughts for the back half of the year?

Heather Luck
Yes. So, I was a little short, I think whenever we did our estimate. We had a few more events and just overall conferences that we attended in Q2. So that drove our expenses a little higher. So, I think for the run rate for the rest of the year, you can add about $250,000 per quarter to what we incurred in Q2. I think that will be a good run rate for the rest of the year. We do have some exciting things happening in Q3. We'll do our big celebration for our grand opening of our San Francisco branch in September. So, we'll have that as an added expense and then employee celebrations and things like that. So I think 250 would be a good run rate each quarter of additional expense.

Gary Tenner
Okay. I appreciate it. And then on the deposit side, you talked about the split between, kind of the net growth in non-wholesale deposits, which was positive for the quarter. But obviously, the loan growth will outpace that. So, I'm just trying to get a sense of kind of your target comfort level on wholesale funding percentage, where you are right now? And, I guess, similar question around the loan deposit ratio, which is a little over 100% right now.

James Beckwith
Sure. We'll continue to lean into wholesale deposits as a source of funding. We did put on a $75 million corporate deposit towards the end of the quarter. We're going to…and we do anticipate rates declining. So that particular type of funding may be more attractive as we look at the remainder of the year, but it is a tool. We could…Gary, if we wanted to we could have a loan deposit ratio that's significantly less than what it is right now, because we have the availability to do so. We're trying to make sure that we act prudently, really try to protect our margin, and then…but also make sure we have appropriate liquidity to fund the loans that have come on. Historically, we've operated less than 100% loan-to-deposit ratio and we're looking to kind of target 95% loan-to-deposit ratio. And we could get there tomorrow if we chose to. But we're really just trying to grow our core deposits and we've been successful in that, but we just need to see to continue to stay at it. And hopefully, we'll see some more visibility of that in Q3 and Q4.

Gary Tenner
Got it. Thank you very much.

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

Wood Lay
Hi, thanks for taking my question.

James Beckwith
Hi.

Heather Luck
Hi.

Wood Lay
I wanted to start on the deposit growth you saw with the Bay Area team. I mean, it was really strong in the quarter. Could you just sort of walk through the traction you're getting in those markets and how you expect growth to trend in the back half of the year in the Bay Area?

James Beckwith
Well, we expect it to be similar or even higher than it was in Q2 rolling into Q3 and Q4. We've added a lot more talent and some pretty big producers, historically big producers at their previous financial institutions. So, we kind of like where we're going in terms of the traction that we're getting within the Bay Area. It's still…in San Francisco proper, and I'm going to say throughout the Bay Area, although you could argue there's down in San Jose in the South Bay, it's pretty stable. But it's still pretty much in turmoil. And that just creates opportunities for us.

The conversion that JPM Chase had in the second quarter, I think it was over in the Memorial Day weekend, Woody, from the old FRB platform into the Chase's platform. That didn't go necessarily well from what we hear from our prospects. And so, we think that we'll be able to continue to take advantage of that transition. And especially, since we've hired a lot of folks were ex-First Republic folks who have deep relationships. We're very excited about where we think we can take growth in that market, and we're spending a lot of time down there personally. Our grand opening is going to be the last week of September for our offices, which is in the Downtown Financial District of San Francisco. A lot of outreach is going on right now. And it's exciting times for us down there.

Wood Lay
That's great to hear. Any commentary on the loan growth trends you're seeing in those markets?

James Beckwith
Let's see. We've had in terms of the teams that we brought in total loan commitments of what was that, Sarah?

Sarah
$85.

James Beckwith
That was $85 million total loan commitments that's not all outstanding. But that's what we're seeing. We do expect to…for that operation to be a net contributor to liquidity of the overall entity. And with our pipelines in terms of our composite pipelines down there are very strong, and our loan pipeline down there is very strong. So, we're excited about the good work that our new team members are putting in down there. And it's just a great group of new clients that we're bringing on. And it's awfully exciting to see that market traction down there. Our leader down there, DJ Kurtze, is doing a great job and we appreciate what the whole team is doing down there.

Wood Lay
Yes. That's great to hear. Maybe shifting over to the margin, you know, it took a pretty sizable step-up in the second quarter. What's the outlook for the third quarter? Just trying to get a sense of what the pull-through could be in the third quarter, if we see another step up in the third quarter? Just what's the expectations?

James Beckwith
I think it's going to kind of moderate a little bit. So, we're going to…we're thinking 3.40 to 3.45 as we…for the third quarter, hopefully, we'll be able to do better than that, but that's what our sense of it is right now. And we'll just have to see how that goes. In terms of our margin, it is impacted by a greater reliance or greater outstanding of wholesale deposits because you're fundamentally getting those deposits right on the marginal cost, which is right now about 5.25.

So, the extent that, we do more of that will have an impact on our margin. But we hope that our core deposit generation, we will accelerate in the third quarter. But that's our sense of it right now, Woody, is 3.40 to 3.45.

Wood Lay
Alright. Thanks for taking my questions. Good luck with the grand opening.

James Beckwith
Thank you.

Heather Luck
Thank you.

Operator
And once again, if you would like to ask a question please press "*" and then "1", to withdraw your questions you may press "*" and "2." And it is "*" and then "1" if you would like to join the question queue. And ladies and gentlemen, at this time, I'm showing no additional questions. I'd like to turn the floor back over to management for any closing remarks.

CONCLUSION

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 successes we share with our employees and shareholders. These successes include numerous ratings and awards.

In the first half of 2024, we were recognized with the 2024 Greater Sacramento Economic Council Sustainability Award, and 2023 Raymond James Community Cup Bankers Cup. And additionally, we were listed among S&P Global Markets Intelligence 2023 top 20 best-performing community banks in the nation.

Our company leadership was also recognized in the first half of 2024 with the Sacramento Business Journal Women Who Mean Business Award, a Sacramento Business Journal C-suite Award, a National Association of Women Business Owners Outstanding Women Leadership Executive Board, and Independent Community Bankers of America 40 under 40, Emerging Community Bank Leaders award. Five Star Bank continues to be a driving force of economic development, a trusted resource for our customers, and a committed advocate for our communities.

We look forward to speaking with you again in October to discuss earnings for the third quarter of 2024. Have a great day, and thank you for listening.

Operator
Ladies and gentlemen, that does conclude today's conference call and presentation. We thank you for joining. You may now disconnect your lines.