First Sound Bank

Experienced. Innovative. Sound.

Dear Shareholders: November 4, 2020

I am pleased to report the third quarter 2020 financial results for First Sound Bank ("the Bank").

Following the two significant non-recurring events we experienced during Q2 of 2020, those being the large loss on sale of the Mastro OREO property and the significant offsetting gains from our successful PPP lending program, Q3 of 2020 was relatively uneventful. We continued to execute our new strategic plan for the Bank, which has involved building out a new lending team, restructuring both the asset and liability sides of our balance sheet, re-engineering our operating costs to improve efficiency, and most importantly, continuing to grow our earning assets. In Q3 we made continued progress on all these initiatives and we generated a small operating profit as will be described below.

Regarding the balance sheet at 9/30/2020:

- Loans are up 35% from a year ago, but this number is skewed by two items. First, our PPP loan balances of $30.8 million are temporary and we anticipate most of them will gradually pay off over the next 6-9 months as they are forgiven by the SBA; our net income margin on the PPP loans is only 65 basis points, so these leaving our balance sheet will not materially impact our future earnings. Second, as part of our new business model we have been purposefully exiting the equipment finance ("EFA") business; between 9/30/2019 and 9/20/2020, our EFA loan balances dropped from $16.4 million to $6.1 million. Fortunately, our new core loan production continues to be robust which roughly offset those EFA payoffs. During the same time period from 2019 to 2020, our core portfolio of commercial and residential loans grew 13% year over year; by industry standards 13% is a very good metric, however it is below my personal aspiration which is continued core loan growth at the rate of 15% or more. So, our team is focused squarely on new loan production, and we continue to have a strong pipeline of loans for both existing and new customers for the months and quarters to come.
- Deposits are up 15% from a year ago, which far exceeds both our budget and our most optimistic expectations. We believe this is a reflection of three factors. First, our team's purposeful effort to continue to replace transactional deposits with relationship deposits. Second, through the PPP program we gained dozens of new customers, and many of those have turned into meaningful depositors. Finally, the combination of low interest rates, an aggressively priced stock market, and the COVID-induced soft economy have all resulted in an industry-wide increase in bank deposits. We are seeing many businesses and individuals making less investments and leaving more cash on the sidelines. Our bank's deposit mix is more favorable than it was a year ago, with 35% of our deposits being non-interest bearing. Overall, the Bank's liquidity position is exceptionally strong.
- As of 9/30/2020 it is noted that the Bank had an unusually high amount of borrowings from the Federal Reserve, about $27 million. On the surface it would appear counterintuitive to be borrowing from the Fed at a time when our liquidity is so strong. The reason is the PPP loans; the Bank decided to take advantage of a temporary Fed program established by Treasury to assist small banks in funding their PPP loans. The cost is only 35 basis points, these Fed borrowings will gradually pay down as the PPP loans go away, and in the meantime by using the Fed program it improves the Bank's regulatory capital ratios.

Regarding the income statement at 9/30/2020:

- The Bank generated modest net income for the third quarter of $78 thousand, and year to date 2020 the Bank has net income of $64 thousand, virtually identical to the Bank's year to date net income one year ago. However, comparisons of bottom line net income from 2019 to 2020 are less than meaningful because there are so many nonrecurring items included in those numbers and also the Bank's business model is materially different than it was one year ago.
- Looking at year to date total interest income at the end of Q3 2020 compared to 2019 illustrates several key trends that are impacting our Bank's profitability, both positively and negatively. YTD loan interest at 9/30/2020 of $3.8 million is 52% higher than the same period last year, despite this year's lower interest rate environment, because our core loan portfolio is growing, we had success with the PPP loans, and we are collecting more commercial loan fees. Offsetting this are two negative trends, one of which we budgeted and the other we did not. As budgeted, our EFA loans are running off and the corresponding interest income from them is down 55% year to date compared to 2019. What we did not budget was the unexpectedly aggressive response of the Federal Reserve to the COVID pandemic, resulting in the Fed funds rate dropping to near zero; as a result, our year to date interest income from the Bank's overnight deposits at the Fed is down 83% compared to last year. This is an industry-wide issue that is affecting all banks, with small community banks being impacted to a greater degree because our business model is so heavily reliant on interest income. But through the end of Q3 2020 the positive trends are outweighing the negative trends and our overall interest income is up 22% from last year. This illustrates the importance of core loan growth as a key priority for the Bank.
- Non-interest income, much of which is derived from SBA lending, is roughly flat from 2019 which is what we had budgeted as we continue to have success with our rejuvenated SBA program. Steven Evans, our SVP of Lending is doing an excellent job maintaining and continually improving our SBA efforts. Note that the negative year to date number for non-interest income at 9/30/2020 is because it includes last quarter's Mastro OREO loss of about $600 thousand.
- Operating expenses continue to be tightly controlled, and through the end of Q3 2020 the Bank's total non-interest expense is only up 5% from the same period in 2019 despite the numerous additions we have made to our lending, credit, and operations teams.

During the past few months we have had several important personnel changes which we believe will enhance the Bank's performance going forward. Jessica Higgins, our senior underwriter and credit administrator, has been promoted to SVP. Tammy Hanson, who expertly manages the entire operation of our bank, has been promoted to COO. And we are very fortunate to have recently hired a new Chief Credit Officer, Elliott Pierce, who is a long-time well-respected bank executive in our market.

The plan from this point forward is to continue to grow the Bank's core loan portfolio, run off the remaining EFA loans, control operating expenses, focus on SBA origination and sales, and work toward getting the Bank back to increased core profitability.

Thank you for your continued support of the Bank. Please contact me at any time if you have questions, concerns, business referrals, or ideas.

Sincerely,

Marty Steele
President & CEO

First Sound Bank

Statement of Condition

(In 000's) Unaudited

	As of September 30, 2020	As of September 30, 2019
ASSETS		
Cash and cash equivalents	$ 1,754	$ 2,020
Fed funds and interest-bearing deposits	29,520	18,172
Investment Securities	5,697	3,369
Loans on accrual	113,488	84,576
Loans on nonaccrual	2,621	1,893
Total loans, gross	116,109	86,469
Allowance for Loan Losses	(1,380)	(1,461)
Total loans, net	114,729	85,008
Premises and equipment	151	178
Other real estate owned	0	1,769
Other assets	953	823
Total assets	$ 152,804	$ 111,339
LIABILITIES		
Noninterest-bearing deposits	$ 38,840	$ 31,133
Interest-bearing deposits	72,872	66,130
Other liabilities	27,431	417
Total liabilities	139,143	97,680
SHAREHOLDERS' EQUITY		
Common stock and related surplus	61,391	59,814
Accumulated deficit	(47,730)	(46,155)
Total Shareholders' Equity	13,661	13,659
TOTAL LIABILITIES & EQUITY	$ 152,804	$ 111,339

Statement of Operations

(In 000's) Unaudited

	For the Quarter Ended September 30, 2020	For the Quarter Ended September 30, 2019	For the Nine Months Ended September 30, 2020	For the Nine Months Ended September 30, 2019
INTEREST INCOME				
Loans	$ 974	$ 827	$ 3,806	$ 2,548
Equipment finance	67	156	258	571
Fed funds & interest-bearing deposits	5	72	45	259
Investment securities	30	29	76	63
Total interest income	1,076	1,084	4,185	3,441
INTEREST EXPENSE				
Deposits/Borrowings	152	138	436	446
Net interest income before provision	924	946	3,749	2,995
PROVISION FOR LOAN LOSSES	-	-	-	-
Net interest income after provision	924	946	3,749	2,995
NONINTERST INCOME	104	202	(259)	325
NONINTERSEST EXPENSE				
Salaries and benefits	506	589	1,915	1,569
Occupancy expenses	128	177	473	549
Other expenses	316	350	1,038	1,137
Total noninterest expense	950	1,116	3,426	3,255
INCOME TAXES	-	-	-	-
NET INCOME	$ 78	$ 32	$ 64	$ 65