



Dear Shareholders:

November 16, 2023

I am pleased to report the third quarter 2023 financial results for First Sound Bank (“the Bank”).

Before discussing the financials, on behalf of the Bank’s Board of Directors I want to express my appreciation to all of you who voted by proxy for our proposed merger with Harborstone Credit Union. At our Special Shareholder Meeting held yesterday here at the Bank, we announced that we have in fact obtained shareholder approval for the proposed merger. We are still working to obtain regulatory approval, and we expect that process to take a few more months. Thank you for your support during this transaction, which we believe is a very positive outcome for our shareholders, employees, customers, and the Seattle community.

For the nine months ending September 30, 2023 the Bank generated net income of \$406 thousand before merger-related expenses, compared to virtually identical net income of \$397 thousand before merger-related expenses for the same period in 2022. Actual net income for the nine months ending 9/30/2023 was \$178 thousand after merger-related expenses of \$228 thousand. Our 2023 core earnings are below plan year to date, primarily because of the unexpectedly high interest rate environment. The high interest rates have negatively impacted our bank in three ways. First, our deposit and borrowing costs are now much higher than we expected. Second, like many community banks we experienced a decline in our liquidity as customers moved funds out of the bank and into alternatives such as Treasury bills; to preserve liquidity, we purposefully slowed down our loan production which has reduced our interest and fee income. And third, because of the high rate environment the demand for our highest-margin loan category -- small business loans -- is significantly down. Between now and the proposed Harborstone merger, our focus will continue to be on cautious and selective loan growth, finding as many small business and SBA loans as we can, working to restore our deposit growth, and very strong expense control.

Regarding the balance sheet at 9/30/2023:

- Total loans are up 4% from a year ago, however this number includes two non-recurring loan categories. First, our PPP loans are almost completely paid off; our total PPP loans declined by \$4.5 million between 9/30/2022 and 9/30/2023. Second, our equipment finance (“EFA”) loans are also almost completely paid off, declining by \$150 thousand from a year ago. Offsetting these non-recurring paydowns was our new core loan production which as mentioned above has been purposefully slowed down; after backing out both the PPP and EFA loans, the Bank’s core loan portfolio grew by 8% during the twelve months ending 9/30/2023. This loan growth rate is much slower than what we were reporting last year, and in fact our total loan portfolio has actually declined by 3% from last quarter. This is the first time the Bank has experienced negative loan growth since 2018, but as mentioned we did this to preserve liquidity.
- Deposits are up 3% from a year ago, and they are up 7% from last quarter-end. This is good news and is the result of aggressive marketing on our part to bring back the customer deposits we lost during the first half of the year. We have had no choice but to increase our rates on certain deposit products, which has increased our cost of funds and reduced our net interest margin. As I mentioned last quarter, a large part of our decision to choose Harborstone as our

merger partner, over other parties we were talking to, was the credit union's strong deposit base and liquidity; post-closing that liquidity will help us to once again accelerate our loan growth. Our Bank's deposit mix continues to be favorable, with 44% being non-interest bearing, which is higher than the Bank's historical average of about 35%.

Regarding the income statement at 9/30/2023:

- The Bank's gross interest income for the nine months ended 9/30/2023 was 48% higher than the same period in 2022 due to higher loan balances and higher interest rates on both loans and our overnight cash at the Federal Reserve. Offsetting this was a substantial increase in our cost of funds, which increased almost 5 times, due to higher rates on our deposit products and our borrowings at the Federal Home Loan Bank. The net impact was roughly a breakeven, with a year over year increase in net interest income of only about 1%.
- Non-interest income is up slightly from last year but still below our budget due to SBA loan sales being below plan. The current interest rate environment is materially impacting the SBA business in two ways. First, at these high interest rates SBA loan demand is down because the projects and properties to be financed often cannot produce enough cash flow to cover the loan payments. Second, with rates on alternative investments such as Treasuries so high, the typical buyers of SBA loans have less appetite for them and are willing to pay us less of a cash premium when we sell them. So as a result we had not sold any SBA loans as of 9/30/2023, although as of today's date we have successfully sold one loan and we have several more in the pipeline. SBA lending continues to be an important part of our business plan going forward.
- Backing out the non-recurring merger expenses, the Bank's operating expenses YTD 2023 have increased by 3% compared to last year, which is better than our budget. The primary driver of our operating expense increase is related to higher personnel costs. As a small community bank we know that our employees are our most important asset. It is also important to note that as a percentage of total assets, the Bank's annualized operating expenses are still below 3.0%, which is an important industry benchmark. We continue to be very focused on expense control.

Our plan from this point forward is to continue to cautiously grow the Bank's core loan portfolio, continue our efforts to grow deposits, control operating expenses, focus on SBA origination and sales, and work toward increasing the Bank's core profitability. As we receive news on the regulatory approval process for our proposed merger, we will promptly inform you, our shareholders.

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

**Statement of Condition**

(In 000's) Unaudited

	As of September 30,	
	2023	2022
<b>ASSETS</b>		
Cash and cash equivalents	\$ 1,303	\$ 1,011
Fed funds and interest-bearing deposits	10,762	16,468
Investment Securities	7,450	7,993
Loans on accrual	136,791	130,904
Loans on nonaccrual	1,375	1,478
Total loans, gross	138,166	132,382
Allowance for Loan Losses	(1,638)	(1,480)
Total loans, net	136,528	130,902
Premises and equipment	72	89
Other real estate owned	0	0
Other assets	4,749	4,929
Total assets	<u>\$ 160,864</u>	<u>\$ 161,392</u>
<b>LIABILITIES</b>		
Noninterest-bearing deposits	\$ 53,466	\$ 41,458
Interest-bearing deposits	68,642	76,664
Other liabilities	23,761	28,542
Total liabilities	145,869	146,664
<b>SHAREHOLDERS' EQUITY</b>		
Common stock and related surplus	60,147	60,322
Accumulated deficit	(45,152)	(45,594)
Total Shareholders' Equity	14,995	14,728
<b>TOTAL LIABILITIES &amp; EQUITY</b>	<u>\$ 160,864</u>	<u>\$ 161,392</u>

**Statement of Operations**

(In 000's) Unaudited

	For the Quarter Ended September 30,		For the Nine Months Ended September 30,	
	2023	2022	2023	2022
<b>INTEREST INCOME</b>				
Loans	\$ 1,875	\$ 1,463	\$ 5,606	\$ 3,839
Equipment finance	(18)	(5)	(69)	43
Fed funds & interest-bearing deposits	110	58	381	88
Investment securities	51	47	148	119
Total interest income	2,018	1,563	6,066	4,089
<b>INTEREST EXPENSE</b>				
Deposits/Borrowings	956	246	2,496	540
Net interest income before provision	1,062	1,317	3,570	3,549
<b>PROVISION FOR LOAN LOSSES</b>				
Net interest income after provision	1,062	1,317	3,570	3,549
<b>NONINTEREST INCOME</b>				
	191	111	354	262
<b>NONINTEREST EXPENSE</b>				
Salaries and benefits	675	709	2,030	1,901
Occupancy expenses	183	193	530	550
Other expenses	526	328	1,186	1,008
Total noninterest expense	1,384	1,230	3,746	3,459
<b>INCOME TAXES</b>				
	-	-	-	-
<b>NET INCOME</b>	<u>\$ (131)</u>	<u>\$ 198</u>	<u>\$ 178</u>	<u>\$ 352</u>