First Sound Bank

Experienced. Innovative. Sound.

Dear Shareholders: January 31, 2021

I am pleased to report the fiscal year end 2020 financial results for First Sound Bank ("the Bank").

Following the two significant non-recurring events we experienced in 2020, those being the large loss on sale of the Mastro OREO property and the offsetting gains from our successful PPP lending program, the Bank had a net loss of $207 thousand in 2020. Without the Mastro loss the Bank would have had a significant profit in 2020, and we are striving for meaningful profitability in 2021 and beyond. We are continuing 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.

Regarding the balance sheet at 12/31/2020:

- Loans are up 40% from a year ago, but this number is skewed by two items. First, our PPP loan balances of $29.9 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 those 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 12/31/2019 and 12/31/2020, our EFA loan balances dropped from $13.5 million to $4.5 million. Fortunately, our new core loan production continues to be robust which more than offset the EFA payoffs. During 2020 our core portfolio of commercial and residential loans grew 21%; this loan growth far exceeded our budget and will position us for improved earnings in the months and quarters to come.
- Deposits are up 14% from a year ago, which far exceeded 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. Our bank's deposit mix is more favorable than it was a year ago, with 31% of our deposits being non-interest bearing. Overall, the Bank's liquidity position is exceptionally strong.
- As of 12/31/2020 it is noted that the Bank had an unusually high amount of borrowings from the Federal Reserve, about $30 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 the US Treasury to assist small banks in funding their PPP loans. The cost is only 35 basis points, and these Fed borrowings will gradually pay down as the PPP loans go away; in the meantime by using this Fed program it improves the Bank's regulatory capital ratios.

Regarding the income statement at 12/31/2020:

- The Bank posted a loss of $207 thousand for 2020 net of the Mastro property loss of approximately $600 thousand, compared to a small net income of $40 thousand in 2019. However, comparisons of bottom line net income from 2019 to 2020 are less than meaningful because there were so many nonrecurring items included in those numbers. In addition, the Bank's business model is materially different than it was one year ago.
- Looking at total interest income from 2019 to 2020 illustrates several key trends which impacted our Bank's profitability, both positively and negatively. YTD loan interest in 2020 was up by 33% compared to 2019 despite the significantly lower interest rate environment, due to our core loan portfolio growth and our success with the PPP loan program. Offsetting this were 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 56% year over year compared to 2019. What we did not budget was the unexpectedly aggressive response of the Federal Reserve to the COVID pandemic, with the Fed funds rate dropping to near zero; as a result, our 2020 interest income from the Bank's overnight deposits at the Fed was down 85% compared to last year. This is an industry-wide issue which 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.
- Non-interest income, much of which is derived from SBA lending, is roughly equal compared to 2019 which is what we had budgeted as we continue to have success with our rejuvenated SBA lending program. Steven Evans, our Bank's Chief Lending Officer, is doing an excellent job maintaining and continually improving our SBA efforts. Note that the net negative 2020 number for non-interest income at 12/31/2020 is because it includes the Mastro OREO loss.
- The Bank's management team, including CFO Debby McDaniel, COO Tammy Hanson, and CCO Elliott Pierce, continued to keep operating expenses tightly controlled during 2020. The Bank's total non-interest expense was up less than 1% compared to 2019 despite the numerous additions we have made to our lending, credit, and operations teams.

Our 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 December 31, 2020	As of December 31, 2019
ASSETS		
Cash and cash equivalents	$ 926	$ 663
Fed funds and interest-bearing deposits	13,984	13,116
Investment Securities	8,233	3,187
Loans on accrual	122,821	86,824
Loans on nonaccrual	2,545	1,893
Total loans, gross	125,366	88,717
Allowance for Loan Losses	(1,407)	(1,485)
Total loans, net	123,959	87,232
Premises and equipment	136	179
Other real estate owned	0	1,769
Other assets	2,316	759
Total assets	$ 149,554	$ 106,905
LIABILITIES		
Noninterest-bearing deposits	$ 32,366	$ 26,600
Interest-bearing deposits	73,732	66,254
Other liabilities	30,090	465
Total liabilities	136,188	93,319
SHAREHOLDERS' EQUITY		
Common stock and related surplus	61,096	59,741
Accumulated deficit	(47,730)	(46,155)
Total Shareholders' Equity	13,366	13,586
TOTAL LIABILITIES & EQUITY	$ 149,554	$ 106,905

Statement of Operations

(In 000's) Unaudited

	For the Quarter Ended December 31,		For the Twelve Months Ended December 31,	
	2020	2019	2020	2019
INTEREST INCOME				
Loans	$ 755	$ 877	$ 4,561	$ 3,425
Equipment finance	54	$ 134	312	705
Fed funds & interest-bearing deposits	6	$ 72	51	331
Investment securities	20	$ 36	96	99
Total interest income	835	1,119	5,020	4,560
INTEREST EXPENSE				
Deposits/Borrowings	188	149	624	595
Net interest income before provision	647	970	4,396	3,965
PROVISION FOR LOAN LOSSES	-	-	-	-
Net interest income after provision	647	970	4,396	3,965
NONINTERST INCOME	31	105	(228)	430
NONINTERSEST EXPENSE				
Salaries and benefits	454	694	2,369	2,263
Occupancy expenses	214	179	687	728
Other expenses	281	227	1,319	1,364
Total noninterest expense	949	1,100	4,375	4,355
INCOME TAXES	-	-	-	-
NET INCOME	$ (271)	$ (25)	$ (207)	$ 40