First Sound Bank

Experienced. Innovative. Sound.

Dear Shareholders: August 23, 2023

I am pleased to report the second quarter 2023 financial results for First Sound Bank ("the Bank").

Before discussing the financials, for those of you who have not already heard the news I am excited to announce that First Sound Bank reached a definitive agreement earlier this month to be acquired by Harborstone Credit Union of Tacoma. The Bank's shareholders will receive 100% cash consideration in the range of $6.90 to $7.10 per share, depending on the Bank's adjusted equity at closing. The transaction is subject to shareholder and regulatory approval, with an anticipated closing date of early Q1 2024. I view this as a very positive outcome for our shareholders, employees, customers, and the Seattle community. Harborstone's objective is to expand their commercial banking presence in the Seattle market, and so our Seattle branch and people and business model will remain largely intact but we will gain access to the credit union's large branch network, expanded products and services, ample liquidity and capital, increased lending capacity, and strong commitment to community development. You will all be receiving proxy materials for the shareholder vote within the next two months.

For the six months ending June 30, 2023 the Bank generated net income of $309 thousand compared to net income of only $153 thousand during the same period in 2022. The two primary drivers of the earnings improvement were good loan growth year over year, and also the fact that in 2022 the Bank was negatively impacted by out of pocket expenses and resources devoted to our previously proposed BMTX merger. It is true that in 2023 we will be incurring expenses and devoting resources to the newly proposed Harborstone transaction, but this merger is much simpler by its nature and will be much less of a distraction for management and our employees. Regarding transactions expenses, this year to date through 6/30 we have incurred only $28 thousand of merger related expenses, but these will increase materially as we get closer to closing the Harborstone merger. Meanwhile, our focus will be on cautious loan growth, successful SBA loan closings, good deposit growth, and strong expense control.

Regarding the balance sheet at 6/30/2023:

- Total loans are up 8% 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 $5.7 million between 6/30/2022 and 6/30/2023 and are now down to only $200 thousand. Second, our equipment finance ("EFA") loans are almost completely paid off, with a total balance today of less than $200 thousand. Offsetting these non-recurring paydowns is our new core loan production which has been strong; after backing out both the PPP and EFA loans, the Bank's core loan portfolio grew by 13% during the twelve months ending 6/30/2023. This loan growth rate is less than what we have recently been reporting, and reflects the fact that we have purposefully slowed down our loan production as a strategy to preserve liquidity.

- Deposits are flat from a year ago, and they are down 25% from last quarter-end 3/31/2023. This sharp drop in deposits is not because we have lost customers, in fact we gained several new customers during the quarter. Rather, there were two causes. First, several of our large depositors are professional service firms who make partner distributions and IRS tax payments in early Q2; this represented about 50% of the decline. The rest of the decline was a direct result of the Federal Reserve's rapid and steep interest rate hikes this year; we had numerous large depositors who purchased treasury securities as an alternative to bank deposits. To combat this trend, we have had no choice but to increase our rates on certain deposit products and run a CD campaign for new deposits, and as a result today our total deposits are back up by 10% compared to quarter-end. But this will increase our cost of funds and eventually reduce our net interest margin. 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 46% being non-interest bearing, which is higher than the Bank's historical average of about 32%.

Regarding the income statement at 6/30/2023:

- The Bank's gross interest income for the six months ended 6/30/2023 was 60% 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 more than 5 times, due to higher rates on our deposit products and our borrowings at the Federal Home Loan Bank. But the net impact was still positive, with a year over year increase in our net interest income of 12%.

- Non-interest income was 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 like 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 have sold no SBA loans year to date. The SBA loans we have made are still on our books, although we do have two new loans in the pipeline which we plan to sell in Q3 and Q4. SBA lending continues to be an important part of our business plan.

- Backing out the non-recurring merger expenses, the Bank's operating expenses YTD 2023 have increased by 5% compared to last year, which is on 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 operating expenses are actually slightly down from last year – our annualized operating expense as a percentage of assets was 2.9% YTD in 2023 compared to 3.0% for the same period in 2022. 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, grow deposits, control operating expenses, focus on SBA origination and sales, and work toward increasing the Bank's 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 June 30, 2023	As of June 30, 2022
ASSETS		
Cash and cash equivalents	$ 1,354	$ 1,457
Fed funds and interest-bearing deposits	3,635	9,042
Investment Securities	7,647	8,193
Loans on accrual	141,499	130,438
Loans on nonaccrual	1,375	1,525
Total loans, gross	142,874	131,963
Allowance for Loan Losses	(1,638)	(1,476)
Total loans, net	141,236	130,487
Premises and equipment	80	92
Other real estate owned	0	0
Other assets	5,031	4,786
Total assets	$ 158,983	$ 154,057
LIABILITIES		
Noninterest-bearing deposits	$ 51,909	$ 41,973
Interest-bearing deposits	62,166	72,428
Other liabilities	29,914	25,025
Total liabilities	143,989	139,426
SHAREHOLDERS' EQUITY		
Common stock and related surplus	60,146	60,225
Accumulated deficit	(45,152)	(45,594)
Total Shareholders' Equity	14,994	14,631
TOTAL LIABILITIES & EQUITY	$ 158,983	$ 154,057

Statement of Operations

(In 000's) Unaudited

	For the Quarter Ended June 30, 2023	For the Quarter Ended June 30, 2022	For the Six Months Ended 30, 2023	For the Six Months Ended 30, 2022
INTEREST INCOME				
Loans	$ 1,909	$ 1,225	$ 3,731	$ 2,376
Equipment finance	(23)	19	(51)	48
Fed funds & interest-bearing deposits	117	25	271	30
Investment securities	45	44	97	72
Total interest income	2,048	1,313	4,048	2,526
INTEREST EXPENSE				
Deposits/Borrowings	813	156	1,540	294
Net interest income before provision	1,235	1,157	2,508	2,232
PROVISION FOR LOAN LOSSES	-	-	-	-
Net interest income after provision	1,235	1,157	2,508	2,232
NONINTERST INCOME	78	98	163	151
NONINTERSEST EXPENSE				
Salaries and benefits	697	617	1,355	1,192
Occupancy expenses	155	183	347	357
Other expenses	330	314	660	681
Total noninterest expense	1,182	1,114	2,362	2,230
INCOME TAXES	-	-	-	-
NET INCOME	$ 131	$ 141	$ 309	$ 153