

North State Bancorp (Not Publicly Traded)

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August 3, 2020

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ASSETS: \$1.2 BB

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2ND QUARTER HIGHLIGHTS:

EPS WERE A PENNY ABOVE
ESTIMATES EVEN THOUGH THE
PROVISION INCREASED
SUBSTANTIALLY

WHILE NET INCOME WAS UP
3%, PRETAX INCOME BEFORE
THE PROVISION AND
FORECLOSED ASSET COSTS
INCREASED 50%

THE BANK FUNDED 1,069
LOANS AMOUNTING TO \$118
MILLION IN PPP LOANS

Price: *	\$16.00	EPS	2018A:	\$1.65	P/E	2018A:	9.7x
52 Wk. Range:	N/A	(FY: DEC)	2019A:	\$1.95		2019A:	8.2x
Distributions (Estimated):	\$1.32		2020E:	\$1.70		2020E:	9.4x
Shares:	6.0 mm	Book Value:		\$8.75	Price/Book Value:		1.83x

* Stock is not actively traded. Last known trade.

Background

North State Bancorp (the “Company”) is a single bank holding company headquartered in Raleigh, North Carolina with approximately \$1.2 billion in assets as of June 30, 2020. Its bank subsidiary is North State Bank, a commercial bank that began operations on June 1, 2000. North State Bancorp serves Wake and New Hanover Counties through seven full-service offices. The Company focuses on serving the total banking needs of small businesses and individuals, professional firms, professionals, property management companies, churches and non-profits who highly value a mutually beneficial banking relationship. Market areas include Raleigh, Garner, greater Wake County and New Hanover County. Product deposit services include demand deposits, savings, money market accounts, consumer and business time deposits and sweep accounts. Loan products include business products, such as commercial lines of credit, lease financing, loans for equipment and owner occupied commercial mortgages and other commercial real estate loans and personal lines of credit, such as home equity loans and first and second mortgages. North State Bancorp also offers online mobile banking, digital banking, cash management, payroll and merchant services, in addition to courier services for businesses, same day banking (i.e., transactions are processed on the same day they occur), lockbox and remote deposit capture capabilities. Additional service enhancements include a Mortgage Division, staffed by experienced mortgage professionals; CommunityPLUS, a division serving property management firms throughout North Carolina and other states with companies who have a close working relationship with the Bank, and an SBA and USDA Lending division, which allows the Bank to fund loans for owner-operated businesses, on a nationwide basis. (North State has been granted “preferred lender” status from the SBA, which allows it to have greater flexibility and often expedited processing times when considering a borrower’s risk profile.) The Company is an S-Corporation for tax purposes.

Pretax Income Before the Provision Increased 50%

North State Bancorp reported earnings for the second quarter of 2020 that were in line with the year-ago level, although the provision for loan losses was much higher than normal, reflecting the Bank’s commitment to more conservatively position itself given the pandemic. From a more normalized earnings standpoint, if we add back the provision (as well as a modest amount of foreclosed asset

Quarterly Results (\$000s)	2019 Q2	2020 Q2
Untaxed Income	2,893	2,982
Eliminate:		
Provision	150	1,645
Net Cost Foreclosed Assets	49	-
Adjusted Untaxed Earnings	3,092	4,627

expense), we see that the pre-provision earnings were actually well above (+50%) the year-ago results. While the quarter was significant from the standpoint of this impressive jump in pre-provision earnings, it was even more significant in terms of the role North State played in helping customers affected by the pandemic. During the second quarter of 2020, North State originated 1,069 PPP loans, totaling approximately \$118 million. The funding of those loans led to a surge in loan growth, but also to deposits, as most of the funds went into North State deposit accounts. In our view, the goodwill generated from North State’s highly responsive team will pay dividends long into the future. So bottom line, it was a significant quarter not only from the standpoint of solid earnings but also from a customer goodwill/franchise value standpoint.

EPS: \$0.49 vs. \$0.49

NONINTEREST INCOME WAS STRONG

MORTGAGE OPERATIONS FEE INCOME, WHICH ACCOUNTED FOR 83% OF TOTAL NONINTEREST INCOME, MORE THAN DOUBLED

THE MORTGAGE PIPELINE STILL LOOKS STRONG

NET INTEREST INCOME WAS UP 2%, WITH EARNING ASSET GROWTH OFFSETTING A CONTRACTION IN MARGINS

FIRST HALF HIGHLIGHTS:

PRETAX INCOME BEFORE THE PROVISION GREW 30%

FROM 6/30/19 TO 6/30/20:
NET LOANS GREW 21%,
DEPOSITS INCREASED 22% AND
TOTAL ASSETS WERE UP 32%

NPAS/ASSETS: 0.46%, VERSUS
0.61% FOR THE NC PEER
GROUP MEDIAN

RESERVES/LOANS: 0.71%

EPS:
2018A: \$ 1.65
2019A: \$ 1.95
2020E: \$ 1.70

Reported net income for the second quarter of 2020 was \$2,982,000, or \$0.49 per share, versus \$2,893,000, or \$0.49 per share, in the year-ago quarter. As was stated earlier, a much higher than normal provision for loan losses (it was \$1,645,000 in 2020's second quarter, versus \$150,000 in the year-ago quarter) distorted the degree of improvement in the earnings. The real driver of the surge in operating earnings was the strength of the mortgage operation, which made up over 83% of total noninterest income and had fees that more than doubled compared to the year-ago period. In total, noninterest income was \$6,343,000 in 2020's second quarter, up from \$3,173,000 in the year-ago quarter. While we don't expect the level of noninterest income to remain nearly this high, we would note that management has indicated that pipelines remain quite high, so with rates remaining historically low, refinancings may continue to propel this area for another quarter or so. Net interest income was up 2%, with pressure on margins being offset by higher average earning asset balances. Noninterest expense totaled \$10,912,000 in 2020's second quarter, versus \$9,160,000 in the year-ago quarter. Finally, we would note that North State's profitability and efficiency ratios were excellent. In the second quarter of 2020, annualized ROAA was 1.03% and the annualized ROAE was 22.45%. The efficiency ratio in 2020's second quarter was 70%, an improvement from 75% in the year-ago quarter.

	Q2 19	Q2 20	Q2 20 % of Total	Growth Q2 19-Q2 20
Mortgage Operations	1,990	5,275	83.2%	165.1%
SBA fees/Gns on Sale	569	590	9.3%	3.7%
Dep. Svc. Chrgs/Fees	175	50	0.8%	-71.4%
Merchant Card	195	196	3.1%	0.5%
BOLI	65	68	1.1%	4.6%
Wealth Mngmt. Fees	0	3	0.0%	0.0%
Other	179	161	2.5%	-10.1%
Total	3,173	6,343	100.0%	

Results for the first half of 2020 likewise were affected by a higher provision for loan losses, which was \$1,870,000, as compared to \$420,000 in the first half of 2019. Net income totaled \$5,683,000, or \$0.94 per share, up 7% from \$5,321,000, or \$0.90 per share, in the year-ago period. Pretax earnings before the provision and foreclosed asset costs increased 30% over this period. Net interest income grew 1%, noninterest income was up 89% and noninterest expense increased 18%. As mentioned previously, balance sheet growth has been inflated by the participation in PPP, though organic growth remains positive. From June 30, 2019 to June 30, 2020, total assets were up 32%, deposits increased 22% and net loans were up 21%. Of the increase in loans, about \$40 million of the \$158 million total increase over the past year was non-PPP loans. Shareholders' equity was \$52.8 million, or 4.33% of total assets, at June 30, 2020.

North State's NPAs/Assets Ratio Was Better than the Majority of NC Peers

While North State Bancorp's nonperforming assets ("NPAs") rose at June 30, 2020, the Bank's asset risk profile remains steady, and the level of NPAs/assets was better than the majority of the Company's NC peers. As of June 30, 2020, NPAs were \$5.6 million, or 0.46% of total assets, versus \$3.7 million, or 0.38% of total assets, at March 31, 2020, and \$1.3 million, or 0.15% of total assets, at the year-ago date (the median NPAs/assets ratio for the NC peer group was 0.61%). The allowance for loan losses was \$6.5 million, or 0.71% of total loans, at June 30, 2020, which was up from \$4.5 million, or 0.61% of total loans, at the year-ago date. The June 30, 2020 allowance, as a percentage of non-PPP loans (guaranteed) was 0.81%.

Projections

We expect the provision to be higher than normal for the next few quarters, though the fees from PPP loans (which total around \$3.8 million and will be recognized over the lives of the loans) are likely to offset this increase. While projections remain difficult to gauge, we are tentatively projecting 2020 earnings of \$10.3 million, or \$1.70 per share. As stated previously, actual earnings could vary substantially from these projections given the uncertainties of the COVID-19 crisis.

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