

## North State Bancorp (Not Publicly Traded)

**John A. (Buddy) Howard, CFA**  
**November 18, 2018**

5003 Falls of Neuse Road

Raleigh  
North Carolina  
27609

919-876-8868 ph

<b>Price: *</b>	\$13.00	<b>EPS **</b>	<b>2016A:</b>	\$1.80	<b>P/E</b>	<b>2016A:</b>	NA
<b>52 Wk. Range:</b>	N/A	(FY: DEC)	<b>2017A:</b>	\$1.60		<b>2017A:</b>	NA
<b>Distributions (Estimated):</b>	\$1.21		<b>2018E:</b>	\$ 1.92		<b>2018E:</b>	NA
<b>Shares:</b>	5.9 mm	<b>Book Value: ***</b>		\$7.60	<b>Price/Book Value:</b>		NA

\* Stock is not actively traded. Last known trade. \*\* Earnings per share are diluted. \*\*\* Tangible book value is \$7.34 per share.

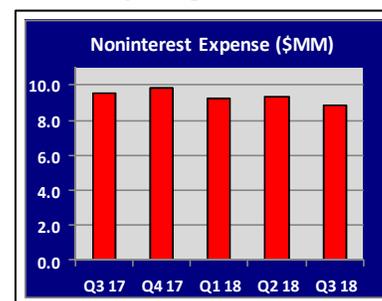
[www.equityresearch.com](http://www.equityresearch.com)

### Background

North State Bancorp (the “Company”) is a single bank holding company headquartered in Raleigh, North Carolina with approximately \$883 million in assets as of September 30, 2018. 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 professional firms, professionals, property management companies, churches, non-profits, small businesses and individuals 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, money market accounts, consumer and business time deposits and sweep accounts. Loan products include business products, such as commercial lines of credit, 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.) Finally, in 2018, the Company created a lease financing group. The Company is an S-Corporation for tax purposes.

### Third Quarter Earnings Were Stable; Excellent Cost Containment As Mortgage Slows

North State Bancorp reported solid results in the third quarter of 2018. Although there was some weakness in the mortgage area, the Bank has been doing a great job of building its net interest income over the past several quarters, which has been the product of excellent margin expansion combined with an expansion in average earning assets. That has occurred at the same time that North State has been shifting its asset mix away from cash and into loans, another positive from an earnings standpoint. In addition, the Bank continues to be highly responsive to changes in mortgage activity by adjusting expenses to origination activity, the result being that the mortgage slowdown (which has occurred nationally) has had a reduced impact on earnings. This was clearly evident in this quarter’s results. So even though earnings were essentially unchanged from the year-ago level, it was actually a pretty impressive quarter given the drop in mortgage income, which decreased by \$1.8 million from 2017’s third quarter to 2018’s third quarter. Finally, asset quality remained excellent, with NPAs at a new 10+ year low.



**ASSETS: \$883 MM**

**HQ: RALEIGH, NC**

**CONTACT:**  
**STACY REEDY**  
**(919) 278-2301**

#### 3<sup>RD</sup> QUARTER HIGHLIGHTS:

**ALTHOUGH EARNINGS WERE ESSENTIALLY UNCHANGED, WE FOUND THAT QUITE COMMENDABLE GIVEN THE SLOWDOWN IN THE MORTGAGE AREA**

**NET INTEREST INCOME HAS REMAINED STRONG AND HAS OFFSET MUCH OF THE MORTGAGE WEAKNESS**

**LOWER EXPENSES WERE ALSO A CONTRIBUTING FACTOR TO THE FAVORABLE RESULTS**

**EPS: \$0.49 vs. \$0.49**

**NET INTEREST INCOME  
INCREASED 17%**

**THE NET INTEREST MARGIN  
GREW TO 3.93% FROM 3.57%**

**NONINTEREST INCOME  
DECLINED DUE TO A \$1.8  
MILLION DROP IN MORTGAGE  
RELATED FEES**

**NONINTEREST EXPENSES  
DROPPED 7%**

**ROAE: 24.8%; ROAA: 1.28%**

**FIRST NINE MONTHS  
HIGHLIGHTS:**

**EPS: \$1.34 vs. \$1.31**

**LOANS GREW 12% OVER THE  
PAST YEAR**

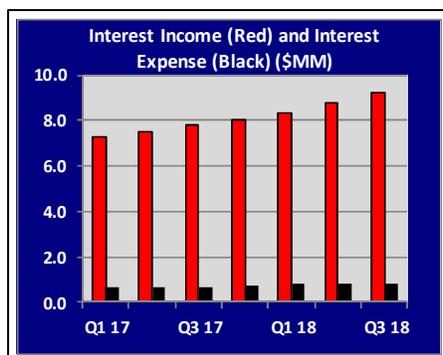
**ASSET QUALITY IS EXCELLENT**

**NPAs/ASSETS: 0.11%**

**RESERVES/LOANS: 0.57%**

**EPS:  
2016A: \$ 1.80  
2017A: \$ 1.60  
2018E: \$ 1.73**

Net income for the third quarter of 2018 was \$2,858,000, or \$0.49 per diluted share, versus \$2,850,000, or \$0.49 per diluted share, in the year-ago quarter. As was mentioned earlier, one of the keys to the quarterly performance was the growth in net interest income, which can be seen in the chart below. Interest income has been building steadily for the past several quarters, and has grown much more than interest expense. The net effect is that over the past year, net interest income grew 17% to \$8,370,000 in the third quarter of 2018 from \$7,145,000 in the year-ago quarter. Again, some of this improvement came from margin expansion, as the net interest margin increased to 3.93% in 2018's third quarter from 3.57% in the year-ago quarter. Noninterest income declined 37% to \$3,260,000 in 2018's third quarter, versus \$5,213,000 in the year-ago quarter, with the majority of that drop coming from the previously mentioned \$1.8 million decline in fees from mortgage operations. However, as a result of a reduction in mortgage offices and staff, as well as other ongoing cost containment initiatives, noninterest expense declined 7% to \$8,832,000 in 2018's third quarter from \$9,508,000 in the year-ago quarter. The provision for loan losses was not a major



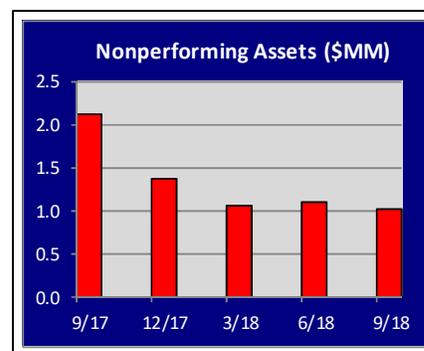
factor in the comparisons, as it was a credit of \$60,000 in the third quarter of 2018, versus no provision in the year-ago quarter. Annualized ROAE remained excellent at 24.8% in 2018's third quarter, versus 26.9% in the year-ago quarter, while annualized ROAA was 1.28%, versus 1.34% over the same respective quarters.

### First Nine Months Earnings Were Likewise Impressive

Much as was the case with the quarterly results, North State reported particularly noteworthy earnings in the context of the headwinds of the mortgage market. Specifically, the Company reported net income of \$7,874,000, or \$1.34 per diluted share, up from \$7,575,000, or \$1.31 per diluted share, in the year-ago period. Similar to the quarter, what made this increase all the more impressive were the facts that mortgage fees dropped \$3.6 million over the two periods and that there was a \$646,000 negative swing in the provision for loan losses over the period (the latter being the result of loan growth, not slippage in quality). From a balance sheet standpoint, loans held for investment grew 12% from September 30, 2017 to September 30, 2018, while assets and deposits were up 5%. Based on the high ROE, stockholders' equity increased to \$44.6 million, or 5.05% of assets, at September 30, 2018, up from \$41.1 million, or 4.90% of assets, at the year-ago date.

### Asset Quality Continues to Improve

As of September 30, 2018, total nonperforming assets were \$1.0 million, or 0.11% of assets, versus \$1.1 million, or 0.13% of assets, at June 30, 2018 and \$2.1 million, or 0.25% of total assets, at September 30, 2017. This level of NPAs remains at a 10+ year low. The allowance for loan losses was \$4.1 million, or 0.57% of total loans, at September 30, 2018, as compared to \$4.4 million, or 0.68% of total loans, at the year-ago date.



### Projections

Based on the mortgage slowdown, we are lowering our 2018 earnings estimate to \$10.1 million, or \$1.73 per diluted share, from our previous estimate of \$11.0 million, or \$1.88 per diluted share. Given that North State derives a large portion of its revenues from the mortgage and SBA operations, actual results may vary significantly from these figures.

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