



FS Bancorp, Inc.

FSBW - NASDAQ

Institutional Equity Research

April 29, 2019

No Rancor With Anchor, Loan Pause Lets Deposits Catch Up

1Q19 is the first quarter following the Anchor deal close and disruption on expenses is to be expected. The deposit retention and seemingly smooth path towards conversion is encouraging. As for operating results in 1Q, the silver lining of a pause on torrid loan growth for the bank is the chance to catch up on the funding side. Improving the deposit franchise and leveraging capital efficiently remain catalysts to this story in our view. We continue to rate the shares at **NEUTRAL**.

- **FSBW reported 1Q19 operating EPS of \$1.22**, \$0.06 below our \$1.28 estimate and \$0.02 below the Street mean estimate of \$1.24. When including \$374K of merger related costs, GAAP EPS was \$1.15. The variance from our model was due to higher than expected core operating costs combined with a higher than expected provision expense.
- **Payoffs eat into loan growth, deposits thrive.** Loans decreased ~9% annualized with increased payoff activity in both construction and warehouse mortgage loans contributing to the runoff. Although the pipeline looks strong, we are lowering our full year 2019 loan growth from 10% to 5.5% with the year starting in reverse. Deposit growth had great success in the quarter, coming in at ~15% annualized. The bank has retained the majority of funding from the Anchor platform with some runoff tied to departures with loan relationships.
- **Core costs increase, should moderate.** Non-interest expenses rose \$1.0M to \$14.8M. Excluding merger costs, employee salary and benefits rose as a result of onboarding from the Anchor acquisition, although this was partially offset by fee income due to greater service charges. We expect core expenses to be ~\$14.5M in 2Q19 (ex merger costs), then moderate in the back half of the year post systems conversion, which is set for late 2Q19.
- **Core margin holds, accretion to slow.** FSBW reported NIM of 4.70% although 15bp was attributed to accretion, resulting in core margin holding steady at 4.55% when comparing to the previous quarter. Yields on average interest earning assets increased 21bp, outpacing funding costs that were up 17bp. We are modeling margin to drift lower as accretion fades over time, but expect core margin to remain stable especially should construction lending pick up steam. Deposit growth could outstrip loan growth this year for the first time in a long time, while the loan to deposit ratio dipped under 100% in 1Q19 (98%).
- **Credit quality hits a speed bump.** NPAs decreased \$1.7M in the quarter to \$3.2M, lowering to 0.19% of total assets, although the decline was loss related. Net charge-offs increased to \$1.3M or 37bp of average loans and were mostly attributed to a legacy business lending relationship. The legacy credit was said to be a one-off loan with no systemic ties and we still view the credit picture as solid. The charge-off was also the root of the increased LLP level in 1Q (\$750k) and we will look for this to normalize around \$450K moving forward.
- **Estimate tweaks.** We are lowering our 2019 EPS estimate from \$5.75 to \$5.60, mostly tied to the negative GAAP variance this quarter. Other adjustments to our model include a lower loan growth assumption, higher NIM expectations and essentially offsetting changes to our fee income and operating forecasts. Our 2020 EPS estimate is unchanged at \$6.00.
- **We rate the shares at NEUTRAL with an increased price target of \$54** (up from \$51), which equals 9.0x our 2020 EPS estimate and 1.3x our current TBV. The lift in our target is driven by further indication the Anchor acquisition integration is progressing well.

FY (Dec)		2018A	2019E	Previous	Cons.	2020E	Previous	Cons.
EPS	Q1 (Mar)	\$1.15	\$1.15A	\$1.28	<i>n.a.</i>	n.a.	NC	<i>n.a.</i>
	Q2 (Jun)	\$1.13	\$1.48E	\$1.45	\$1.43	n.a.	NC	<i>n.a.</i>
	Q3 (Sep)	\$1.07	\$1.53E	\$1.57	\$1.48	n.a.	NC	<i>n.a.</i>
	Q4 (Dec)	\$2.83	\$1.44E	\$1.45	\$1.43	n.a.	NC	<i>n.a.</i>
			\$6.31	\$5.60E	\$5.75	\$5.46	\$6.00E	NC
Price/EPS		8.1x	9.1x			8.5x		
Revenue (\$M)	Q1 (Mar)	\$16.5	\$22.2A	\$21.9	<i>n.a.</i>	n.a.	NC	<i>n.a.</i>
	Q2 (Jun)	\$17.5	\$23.5E	\$23.0	\$23.5	n.a.	NC	<i>n.a.</i>
	Q3 (Sep)	\$17.7	\$24.1E	\$23.9	\$24.0	n.a.	NC	<i>n.a.</i>
	Q4 (Dec)	\$27.2	\$23.8E	\$23.5	\$23.8	n.a.	NC	<i>n.a.</i>
			\$78.9	\$93.7E	\$92.3	\$93.8	\$101.0E	\$100.1

Neutral

Price Target	↑\$54.00
Price (4/26/19)	\$50.87
Industry	FINANCIAL INSTITUTIONS

Valuation & Performance

Return on Assets (MRQ)	13.0%
ROTC (MRQ)	11.9%
Net Interest Margin (MRQ)	4.70%
Efficiency Ratio (MRQ)	66.5%
TBV per Share (3/31/19)	\$40.57
TCE/TA (3/31/19)	11.0%
Dividend	\$0.60 (1.2%)

Trading Data

Shares Outstanding (M)	4.4
Market Capitalization (\$M)	\$222.7
52-week range	\$41.25 - \$66.40
Avg. Volume (3-mth.) (K)	10.3

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Company Description

Mountlake Terrace, WA - FS Bancorp, Inc., a Washington corporation, is the holding company for 1st Security Bank of Washington. The company provides loan and deposit services to customers who are predominantly small and middle-market businesses and individuals in western Washington.

Price Performance

NASDAQ: FSBW



Please refer to pages 3 - 4 of this report for detailed disclosure and certification information.

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Potential Risks

- Significant economic deterioration (i.e. home price deterioration, worsening employment situation, etc.).
- Severe deterioration in credit quality.

Required Disclosures

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Rating Information

D.A. Davidson & Co.'s Institutional Research Rating Scale Definitions (maintained since October 10, 2017); information regarding our previous definitions is available upon request:

BUY: Expected to produce a total return of over 15% on a risk adjusted basis over the next 12-18 months

NEUTRAL: Expected to produce a total return of -15% to +15% on a risk adjusted basis over the next 12-18 months

UNDERPERFORM: Expected to lose value of over 15% on a risk adjusted basis over the next 12-18 months

Rating Distribution (as of 3/31/19)	Coverage Universe Distribution			Investment Banking Distribution		
	IR	WMR	Combined	IR	WMR	Combined
BUY (Buy)	59%	83%	60%	10%	4%	9%
NEUTRAL (Hold)	40%	17%	39%	5%	0%	5%
UNDERPERFORM (Sell)	1%	0%	1%	0%	0%	0%

IR denotes Institutional Research; WMR denotes Wealth Management Research whose rating scale is Buy/Add, Neutral, Sell/Reduce. Investment Banking Distribution denotes companies from whom D.A. Davidson & Co. has received compensation in the last 12 months.



Target prices are our Institutional Research Department's evaluation of price potential over the next 12-month, based upon our assessment of future earnings and cash flow, comparable company valuations, growth prospects and other financial criteria. Certain risks may impede achievement of these price targets including, but not limited to, broader market and macroeconomic fluctuations and unforeseen changes in the subject company's fundamentals or business trends.

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