

FS Bancorp, Inc.  
Form 10-Q  
November 09, 2018  
Table of Contents

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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10 Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2018                      OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from                      to

Commission File Number: 001 35589

FS BANCORP, INC.

(Exact name of registrant as specified in its charter)

Washington

(State or other jurisdiction of incorporation or organization)

45 4585178

(IRS Employer Identification No.)

6920 220th Street SW, Mountlake Terrace, Washington 98043

(Address of principal executive offices; Zip Code)

(425) 771 5299

(Registrant's telephone number, including area code)

None

(Former name, former address and former fiscal year, if changed since last report)

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Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically, every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company, or an emerging growth company. See the definitions of “large accelerated filer,” “accelerated filer,” “smaller reporting company” and “emerging growth company” in Rule 12b-2 of the Exchange Act.

Large accelerated filer  Accelerated filer   
Non-accelerated filer  Smaller reporting company   
Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).  
Yes  No

Indicate the number of shares outstanding of each of the issuer’s classes of common stock, as of the latest practicable date: As of November 2, 2018, there were 3,736,960 outstanding shares of the registrant’s common stock.

Table of Contents

FS Bancorp, Inc.

Form 10 Q

Table of Contents

	Page Number
<b>PART I</b>	<b>FINANCIAL INFORMATION</b>
<u>Item 1.</u>	<u>Financial Statements</u>
	<u>Consolidated Balance Sheets at September 30, 2018 and December 31, 2017 (Unaudited)</u>
	3
	<u>Consolidated Statements of Income for the Three and Nine Months Ended September 30, 2018 and 2017 (Unaudited)</u>
	4
	<u>Consolidated Statements of Comprehensive Income for the Three and Nine Months Ended September 30, 2018 and 2017 (Unaudited)</u>
	5
	<u>Consolidated Statements of Changes in Stockholders' Equity for the Nine Months Ended September 30, 2018 and 2017 (Unaudited)</u>
	6
	<u>Consolidated Statements of Cash Flows for the Nine Months Ended September 30, 2018 and 2017 (Unaudited)</u>
	7 - 8
	<u>Notes to Consolidated Financial Statements</u>
	9 - 42
<u>Item 2.</u>	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>
	43 - 55
<u>Item 3.</u>	<u>Quantitative and Qualitative Disclosures About Market Risk</u>
	55
<u>Item 4.</u>	<u>Controls and Procedures</u>
	55
<b>PART II</b>	<b>OTHER INFORMATION</b>
	56
<u>Item 1.</u>	<u>Legal Proceedings</u>
	56
<u>Item 1A.</u>	<u>Risk Factors</u>
	56
<u>Item 2.</u>	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>
	56
<u>Item 3.</u>	<u>Defaults Upon Senior Securities</u>
	56
<u>Item 4.</u>	<u>Mine Safety Disclosures</u>
	56
<u>Item 5.</u>	<u>Other Information</u>
	56

<u>Item 6.</u>	<u>Exhibits</u>	57 - 58
<u>SIGNATURES</u>		59

As used in this report, the terms “we,” “our,” “us,” “Company” and “FS Bancorp” refer to FS Bancorp, Inc. and its consolidated subsidiary, 1st Security Bank of Washington, unless the context indicates otherwise. When we refer to “Bank” in this report, we are referring to 1st Security Bank of Washington, the wholly owned subsidiary of FS Bancorp.

Table of Contents

## Item 1. Financial Statements

## FS BANCORP, INC. AND SUBSIDIARY

## CONSOLIDATED BALANCE SHEETS

(Dollars in thousands, except share amounts) (Unaudited)

	September 30, 2018	December 31, 2017
<b>ASSETS</b>		
Cash and due from banks	\$ 4,389	\$ 3,043
Interest-bearing deposits at other financial institutions	10,813	15,872
Total cash and cash equivalents	15,202	18,915
Certificates of deposit at other financial institutions	17,362	18,108
Securities available-for-sale, at fair value	97,374	82,480
Loans held for sale, at fair value	54,784	53,463
Loans receivable, net	947,572	761,558
Accrued interest receivable	4,453	3,566
Premises and equipment, net	16,527	15,458
Federal Home Loan Bank ("FHLB") stock, at cost	7,131	2,871
Deferred tax asset, net	120	—
Bank owned life insurance ("BOLI"), net	13,586	10,328
Servicing rights, held at the lower of cost or fair value	9,190	6,795
Goodwill	2,312	2,312
Core deposit intangible, net	1,087	1,317
Other assets	4,631	4,612
<b>TOTAL ASSETS</b>	<b>\$ 1,191,331</b>	<b>\$ 981,783</b>
<b>LIABILITIES</b>		
Deposits:		
Noninterest-bearing accounts	\$ 190,237	\$ 186,890
Interest-bearing accounts	754,300	642,952
Total deposits	944,537	829,842
Borrowings	86,526	7,529
Subordinated note:		
Principal amount	10,000	10,000
Unamortized debt issuance costs	(140)	(155)
Total subordinated note less unamortized debt issuance costs	9,860	9,845
Deferred tax liability, net	—	607
Other liabilities	17,279	11,958
Total liabilities	1,058,202	859,781
<b>COMMITMENTS AND CONTINGENCIES (NOTE 7)</b>		
<b>STOCKHOLDERS' EQUITY</b>		
Preferred stock, \$.01 par value; 5,000,000 shares authorized; none issued or outstanding	—	—
Common stock, \$.01 par value; 45,000,000 shares authorized; 3,716,460 and 3,680,152 shares issued and outstanding at September 30, 2018 and	37	37

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December 31, 2017, respectively

Additional paid-in capital	57,027	55,135
Retained earnings	79,648	68,422
Accumulated other comprehensive loss, net of tax	(2,664)	(475)
Unearned shares – Employee Stock Ownership Plan (“ESOP”)	(919)	(1,117)
Total stockholders’ equity	133,129	122,002
<b>TOTAL LIABILITIES AND STOCKHOLDERS’ EQUITY</b>	<b>\$ 1,191,331</b>	<b>\$ 981,783</b>

See accompanying notes to these consolidated financial statements.

3

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Table of Contents

## FS BANCORP, INC. AND SUBSIDIARY

## CONSOLIDATED STATEMENTS OF INCOME

(Dollars in thousands, except per share amounts) (Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
<b>INTEREST INCOME</b>				
Loans receivable, including fees	\$ 14,624	\$ 11,715	\$ 40,015	\$ 31,488
Interest and dividends on investment securities, cash and cash equivalents, and certificates of deposit at other financial institutions	959	637	2,578	2,034
Total interest and dividend income	15,583	12,352	42,593	33,522
<b>INTEREST EXPENSE</b>				
Deposits	1,850	1,045	4,525	2,793
Borrowings	704	114	1,280	259
Subordinated note	171	171	508	508
Total interest expense	2,725	1,330	6,313	3,560
NET INTEREST INCOME	12,858	11,022	36,280	29,962
PROVISION FOR LOAN LOSSES	450	450	1,250	450
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	12,408	10,572	35,030	29,512
<b>NONINTEREST INCOME</b>				
Service charges and fee income	716	879	2,045	2,743
Gain on sale of loans	3,818	5,025	12,467	13,840
Gain on sale of investment securities	—	143	113	380
Gain on sale of mortgage servicing rights (“MSR”)	—	38	—	996
Earnings on cash surrender value of BOLI	88	68	258	208
Other noninterest income	180	274	557	637
Total noninterest income	4,802	6,427	15,440	18,804
<b>NONINTEREST EXPENSE</b>				
Salaries and benefits	7,039	7,140	21,759	20,174
Operations	1,308	1,577	4,209	4,506
Occupancy	744	650	2,097	1,939
Data processing	625	651	1,944	1,811
Loan costs	850	726	2,183	1,977
Professional and board fees	414	378	1,321	1,261
Federal Deposit Insurance Corporation (“FDIC”) insurance	137	175	268	428
Marketing and advertising	201	192	564	512
Acquisition costs	443	—	443	—
Amortization of core deposit intangible	77	100	230	300
Impairment on servicing rights	—	—	—	1
Total noninterest expense	11,838	11,589	35,018	32,909
INCOME BEFORE PROVISION FOR INCOME TAXES	5,372	5,410	15,452	15,407
PROVISION FOR INCOME TAXES	1,320	1,956	2,822	5,001
NET INCOME	\$ 4,052	\$ 3,454	\$ 12,630	\$ 10,406

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Basic earnings per share	\$ 1.12	\$ 1.13	\$ 3.52	\$ 3.53
Diluted earnings per share	\$ 1.07	\$ 1.07	\$ 3.35	\$ 3.31

See accompanying notes to these consolidated financial statements.

4

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Table of Contents

## FS BANCORP, INC. AND SUBSIDIARY

## CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(In thousands) (Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
Net Income	\$ 4,052	\$ 3,454	\$ 12,630	\$ 10,406
Other comprehensive (loss) income, before tax:				
Securities available-for-sale:				
Unrealized holding (loss) gain during period	(684)	80	(2,675)	1,012
Income tax benefit (provision) related to unrealized holding (loss) gain	147	(28)	575	(357)
Reclassification adjustment for realized gain included in net income	—	(143)	(113)	(380)
Income tax provision related to reclassification for realized gain	—	50	24	133
Other comprehensive (loss) income, net of tax	(537)	(41)	(2,189)	408
COMPREHENSIVE INCOME	\$ 3,515	\$ 3,413	\$ 10,441	\$ 10,814

See accompanying notes to these consolidated financial statements.

Table of Contents

## FS BANCORP, INC. AND SUBSIDIARY

## CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

(Dollars in thousands, except share amounts) (Unaudited)

	Common Stock Shares	Common Stock Amount	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income, Net of Tax	Unearned ESOP Shares	Total Stockholders' Equity
BALANCE, January 1, 2017	3,059,503	\$ 31	\$ 27,334	\$ 55,584	\$ (536)	\$ (1,380)	\$ 81,033
Net income	—	\$ —	—	10,406	—	—	\$ 10,406
Dividends paid (\$0.31 average per share)	—	\$ —	—	(941)	—	—	\$ (941)
Proceeds from public offering, net of expenses	587,234	\$ 6	25,612	—	—	—	\$ 25,618
Share-based compensation	—	\$ —	496	—	—	—	\$ 496
Common stock repurchased	(6,198)	\$ —	(275)	—	—	—	\$ (275)
Stock options exercised	34,363	\$ —	580	—	—	—	\$ 580
Other comprehensive income, net of tax	—	\$ —	—	—	408	—	\$ 408
ESOP shares allocated	—	\$ —	716	—	—	198	\$ 914
BALANCE, September 30, 2017	3,674,902	\$ 37	\$ 54,463	\$ 65,049	\$ (128)	\$ (1,182)	\$ 118,239
BALANCE, January 1, 2018	3,680,152	\$ 37	\$ 55,135	\$ 68,422	\$ (475)	\$ (1,117)	\$ 122,002
Net income	—	\$ —	—	12,630	—	—	\$ 12,630
Dividends paid (\$0.38 average per share)	—	\$ —	—	(1,404)	—	—	\$ (1,404)
Share-based compensation	—	\$ —	492	—	—	—	\$ 492
Common stock repurchased	(4,325)	\$ —	(250)	—	—	—	\$ (250)
Stock options exercised	40,633	\$ —	686	—	—	—	\$ 686
Other comprehensive loss, net of tax	—	\$ —	—	—	(2,189)	—	\$ (2,189)

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ESOP shares allocated	—	\$ —	964	—	—	198	\$ 1,162
BALANCE, September 30, 2018	3,716,460	\$ 37	\$ 57,027	\$ 79,648	\$ (2,664)	\$ (919)	\$ 133,129

See accompanying notes to these consolidated financial statements.

Table of Contents

## FS BANCORP, INC. AND SUBSIDIARY

## CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands) (Unaudited)

	Nine Months Ended September 30,	
	2018	2017
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net income	\$ 12,630	\$ 10,406
Adjustments to reconcile net income to net cash from operating activities		
Provision for loan losses	1,250	450
Depreciation, amortization and accretion	4,535	2,577
Compensation expense related to stock options and restricted stock awards	492	496
ESOP compensation expense for allocated shares	1,162	914
Increase in cash surrender value of BOLI	(258)	(208)
Gain on sale of loans held for sale	(12,275)	(13,840)
Gain on sale of portfolio loans	(192)	—
Gain on sale of investment securities	(113)	(380)
Gain on sale of MSR	—	(996)
Origination of loans held for sale	(485,490)	(520,358)
Proceeds from sale of loans held for sale	492,336	520,091
Impairment of servicing rights	—	1
Changes in operating assets and liabilities		
Accrued interest receivable	(853)	(693)
Other assets	(139)	(79)
Other liabilities	5,314	2,668
Net cash from operating activities	18,399	1,049
<b>CASH FLOWS USED BY INVESTING ACTIVITIES</b>		
Activity in securities available-for-sale:		
Proceeds from sale of investment securities	5,305	39,103
Maturities, prepayments, sales, and calls	6,942	6,531
Purchases	(30,197)	(41,320)
Maturities of certificates of deposit at other financial institutions	744	1,240
Purchase of certificates of deposit at other financial institutions	—	(4,102)
Loan originations and principal collections, net	(176,433)	(129,763)
Purchase of portfolio loans	(22,532)	(32,342)
Proceeds from sale of portfolio loans	10,950	—
Purchase of premises and equipment, net	(2,355)	(623)
Purchase of BOLI	(3,000)	—
FHLB stock, net	(4,260)	(328)
Proceeds from sale of MSR	—	4,827
Net cash used by investing activities	(214,836)	(156,777)
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Net increase in deposits	114,695	127,985

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Proceeds from borrowings	739,740	348,260
Repayments of borrowings	(660,743)	(350,660)
Dividends paid	(1,404)	(941)
Proceeds from stock options exercised	686	580
Common stock repurchased	(250)	(275)
Proceeds from issuance of common stock	—	25,618
Net cash from financing activities	192,724	150,567
NET DECREASE IN CASH AND CASH EQUIVALENTS	(3,713)	(5,161)
CASH AND CASH EQUIVALENTS, beginning of period	18,915	36,456
CASH AND CASH EQUIVALENTS, end of period	\$ 15,202	\$ 31,295

7

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Table of Contents

FS BANCORP, INC. AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)

(In thousands) (Unaudited)

SUPPLEMENTARY DISCLOSURES OF CASH FLOW INFORMATION

Cash paid during the period for:

Interest on deposits and borrowings	\$ 6,021	\$ 3,528
Income taxes	\$ 1,800	\$ 5,800

SUPPLEMENTARY DISCLOSURES OF NONCASH OPERATING, INVESTING AND FINANCING ACTIVITIES

Change in unrealized (loss) gain on investment securities, net	\$ (2,789)	\$ 631
Transfer portfolio loans to loans held for sale	\$ —	\$ 1,886
Retention of gross mortgage servicing rights from loan sales	\$ 3,970	\$ 3,569

See accompanying notes to these consolidated financial statements

Table of Contents

NOTE 1 - BASIS OF PRESENTATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Operations - FS Bancorp, Inc. (the “Company”) was incorporated in September 2011 as the holding company for 1st Security Bank of Washington (the “Bank” or “1st Security Bank”) in connection with the Bank’s conversion from the mutual to stock form of ownership which was completed on July 9, 2012. The Bank is a community-based savings bank with 12 branches, one administrative office that accepts deposits, and seven loan production offices in suburban communities in the greater Puget Sound area within Snohomish, King, Pierce, Jefferson, Kitsap, and Clallam counties, and one loan production office in the market area of the Tri-Cities, Washington. The Bank provides loan and deposit services to customers who are predominantly small- and middle-market businesses and individuals. The Company and its subsidiary are subject to regulation by certain federal and state agencies and undergo periodic examination by these regulatory agencies.

Pursuant to the Plan of Conversion (the “Plan”), the Company’s Board of Directors adopted an employee stock ownership plan (“ESOP”) which purchased 8% of the common stock in the open market or 259,210 shares. As provided for in the Plan, the Bank also established a liquidation account in the amount of retained earnings at December 31, 2011. The liquidation account is maintained for the benefit of eligible savings account holders at June 30, 2007, and supplemental eligible account holders as of March 31, 2012, who maintain deposit accounts at the Bank after the conversion. The conversion was accounted for as a change in corporate form with the historic basis of the Company’s assets, liabilities, and equity unchanged as a result.

Financial Statement Presentation - The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States (“U.S. GAAP”) for interim financial information and in accordance with the instructions to Form 10 Q and Article 10 of Regulation S-X as promulgated by the Securities and Exchange Commission (“SEC”). It is recommended that these unaudited interim consolidated financial statements be read in conjunction with the Company’s Annual Report on Form 10 K with all of the audited information and footnotes required by U.S. GAAP for complete financial statements for the year ended December 31, 2017, as filed with the SEC on March 16, 2018. In the opinion of management, all normal adjustments and recurring accruals considered necessary for a fair presentation of the financial position and results of operations for the periods presented have been included.

The results for the three and nine months ended September 30, 2018 are not necessarily indicative of the results that may be expected for the year ending December 31, 2018, or any other future period. The preparation of financial statements, in conformity with U.S. GAAP, requires management to make estimates and assumptions that affect amounts reported in the financial statements. Actual results could differ from these estimates. Material estimates that are particularly susceptible to significant change relate to the determination of the allowance for loan and lease losses, fair value of financial instruments, the valuation of servicing rights, and the deferred income taxes.

Amounts presented in the consolidated financial statements and footnote tables are rounded and presented in thousands of dollars except per share amounts. In the narrative footnote discussion, amounts are rounded and presented in millions of dollars to one decimal point if the amounts are above \$1.0 million. Amounts below \$1.0 million are rounded and presented in dollars to the nearest thousands. Certain prior year amounts have been reclassified to conform to the 2018 presentation with no change to consolidated net income or stockholders’ equity previously reported.

Principles of Consolidation - The consolidated financial statements include the accounts of FS Bancorp, Inc. and its wholly owned subsidiary, 1st Security Bank of Washington. All material intercompany accounts have been eliminated in consolidation.

Segment Reporting - The Company operates in two business segments through the Bank: commercial and consumer banking and home lending. The Company's business segments are determined based on the products and services provided, as well as the nature of the related business activities, and they reflect the manner in which financial information is regularly reviewed for the purpose of allocating resources and evaluating performance of the Company's businesses. The results for these business segments are based on management's accounting process, which assigns income statement items and assets to each responsible operating segment. This process is dynamic and is based on management's view of the Company's operations. See "Note 13 - Business Segments".



## Table of Contents

Subsequent Events – The Company has evaluated events and transactions subsequent to September 30, 2018 for potential recognition or disclosure.

On July 17, 2018, FS Bancorp, Inc. announced the signing of a definitive merger agreement whereby the Company will acquire Anchor Bancorp (“Anchor”) in a stock and cash transaction valued at approximately \$73.3 million. The transaction is subject to customary closing conditions, including the receipt of regulatory approvals and approval of the agreement by the shareholders of Anchor. See “Note 16 - Proposed Merger”.

## RECENT ACCOUNTING PRONOUNCEMENTS

In February 2016, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2016-02, Leases (Topic 842). ASU No. 2016-02 requires lessees to recognize on the balance sheet the assets and liabilities arising from operating leases. A lessee should recognize a liability to make lease payments and a right-of-use asset representing its right to use the underlying asset for the lease term. A lessee should include payments to be made in an optional period only if the lessee is reasonably certain to exercise an option to extend the lease or not to exercise an option to terminate the lease. For a finance lease, interest payments should be recognized separately from amortization of the right-of-use asset in the statement of comprehensive income. For operating leases, the lease cost should be allocated over the lease term on a generally straight-line basis. The amendments in ASU 2016-02 are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early application of the amendments in the ASU is permitted. In July 2018, the FASB issued ASU No. 2018-10, Codification Improvements to Topic 842, Leases and ASU No. 2018-11, Leases (Topic 842): Targeted Improvements. These ASUs contain clarifications to ASU 2016-02, including providing a new transition method in addition to the existing transition method contained in ASU No. 2016-02 to allow entities to initially apply the new leases standard at the adoption date and recognize a cumulative-effect adjustment to the opening balance of retained earnings in the period of adoption. These amendments have the same effective date as ASU 2016-02. The effect of the adoption of these ASUs will depend on leases at time of adoption. Once adopted, we expect to report higher assets and liabilities as a result of including right-of-use assets and lease liabilities related to certain banking offices and certain equipment under noncancelable operating lease agreements. As of December 31, 2017, we would have reported an increase of approximately \$4.7 million in both assets and liabilities in the Consolidated Balance Sheets based on management’s estimate assuming the early adoption of this ASU.

In June 2016, the FASB issued ASU No. 2016-13, Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments. The ASU is intended to improve financial reporting by requiring timelier recording of credit losses on loans and other financial instruments held by financial institutions and other organizations. The ASU requires the measurement of all current expected credit losses (“CECL”) for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts. Financial institutions and other organizations will now use forward-looking information to better inform their credit loss estimates. Many of the loss estimation techniques applied today will still be permitted, although the inputs to those techniques will change to reflect the full amount of CECL. Organizations will continue to use judgment to determine which loss estimation method is appropriate for their circumstances. The ASU requires enhanced disclosures to help investors and other financial statement users better understand significant estimates and judgments used in estimating credit losses, as well as the credit quality and underwriting standards of an organization’s portfolio. These disclosures include qualitative and quantitative requirements that provide additional information about the amounts recorded in the financial statements. In addition, the ASU amends the accounting for credit losses on available-for-sale debt securities and purchased financial assets with credit deterioration. The ASU is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. Early application will be permitted for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. The Company is currently evaluating the impact of this ASU on the Company’s consolidated financial statements. Once adopted, we anticipate our allowance for loan losses to increase through a one-time adjustment to retained earnings,

however, until our evaluation is complete the magnitude of the increase will be unknown.

In March 2017, the FASB issued ASU No. 2017-08, Receivables - Nonrefundable Fees and Other Costs (Subtopic 310-20): Premium Amortization on Purchased Callable Debt Securities. The ASU shortens the amortization period for certain callable debt securities held at a premium. The ASU will take effect for SEC filers for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. The adoption of ASU No. 2017-08 is not expected to have a material impact on the Company's consolidated financial statements.

Table of Contents

In August 2017, the FASB issued ASU No. 2017-12, Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities. This ASU amends the hedge accounting recognition and presentation requirements in ASC 815 to (1) improve the transparency and understandability of information conveyed to financial statement users about an entity's risk management activities by better aligning the entity's financial reporting for hedging relationships with those risk management activities and (2) reduce the complexity of and simplify the application of hedge accounting by preparers. The amendments in this ASU permit hedge accounting for hedging relationships involving nonfinancial risk and interest rate risk by removing certain limitations in cash flow and fair value hedging relationships. In addition, the ASU requires an entity to present the earnings effect of the hedging instrument in the same income statement line item in which the earnings effect of the hedged item is reported. The amendments in this ASU are effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2018 and early adoption is permitted. The adoption of ASU No. 2017-12 is not expected to have a material impact on the Company's consolidated financial statements.

In March 2018, the FASB issued ASU No. 2018-05, Income Taxes (Topic 740). This ASU was issued to provide guidance on the income tax accounting implications of the Tax Cuts and Jobs Act ("Tax Act") and allows for entities to report provisional amounts for specific income tax effects of the Tax Act for which the accounting under Topic 740 was not yet complete but a reasonable estimate could be determined. A measurement period of one year is allowed to complete the accounting effects under Topic 740 and revise any previous estimates reported. Any provisional amounts or subsequent adjustments included in an entity's financial statements during the measurement period should be included in income from continuing operations as an adjustment to tax expense in the reporting period the amounts are determined. The Company adopted this ASU with the provisional adjustments as reported in the Consolidated Financial Statements on Form 10-K as of December 31, 2017. As of September 30, 2018, the Company did not incur any adjustments to the provisional recognition.

In June 2018, the FASB issued ASU No. 2018-07, Compensation - Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting. This ASU was issued to expand the scope of Topic 718 to include share-based payment transactions for acquiring goods and services from nonemployees. Previously, these awards were recorded at the fair value of consideration received or the fair value of the equity instruments issued and was measured as the earlier of the commitment date or date performance was completed. The amendments in this ASU require the awards to be measured at the grant-date fair value of the equity instrument. ASU No. 2018-07 is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. Early adoption is permitted, but no earlier than an entity's adoption of Topic 606. The adoption of ASU No. 2018-07 is not expected to have a material impact on the Company's future consolidated financial statements.

In August 2018, the FASB issued ASU No. 2018-13, Fair Value Measurement (Topic 820): Disclosure Framework – Changes to the Disclosure Requirements for Fair Value Measurement. This ASU contains some technical adjustments related to the fair value disclosure requirements of public companies. Included in this ASU is the additional disclosure requirement of unrealized gains and losses for the period in recurring level 3 fair value disclosures and the range and weighted average of significant unobservable inputs, among other technical changes. ASU 2018-13 is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. Early adoption is permitted for any removed or modified disclosures. The adoption of ASU 2018-13 is not expected to have a material impact on the Company's consolidated financial statements.

In August 2018, FASB issued Accounting Standards Update (ASU) 2018-15, Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract. The amendments in this ASU broaden the scope of ASC Subtopic 350-40 to include costs incurred to implement a hosting arrangement that is a service contract. The amendments align the requirements for capitalizing implementation costs incurred in a hosting arrangement that is a service contract with the requirements for capitalizing implementation costs incurred to develop or obtain internal-use software (and hosting arrangements that include an internal-use software license). The

costs are capitalized or expensed depending on the nature of the costs and the project stage during which they are incurred, consistent with the accounting for costs for internal-use software. The amendments in this ASU result in consistent capitalization of implementation costs of a hosting arrangement that is a service contract and implementation costs incurred to develop or obtain internal-use software (and hosting arrangements that include an internal-use software license). The accounting for the service element of a hosting arrangement that is a service contract is not affected by the amendments in this ASU. This ASU is effective for fiscal years beginning after December 15, 2019 and interim periods within those fiscal years. The

Table of Contents

amendments in this ASU should be applied either retrospectively to all implementation costs incurred after the date of adoption. Adoption of ASU 2018-15 is not expected to have a material impact on the Company's Consolidated Financial Statements.

Application of New Accounting Guidance Adopted in 2018

On January 1, 2018, the Company adopted FASB issued ASU No. 2014 09, Revenue from Contracts with Customers and all subsequent amendments to the ASU (collectively "ASC 606"), which created Topic 606 and superseded Topic 605, Revenue Recognition. In August 2015, FASB issued ASU No. 2015 14, Revenue from Contracts with Customers (Topic 606), which postponed the effective date of ASU No. 2014 09. The core principle of Topic 606 is that an entity recognizes revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. In general, the new guidance requires companies to use more judgment and make more estimates than under past guidance, including identifying performance obligations in the contract, estimating the amount of variable consideration to include in the transaction price and allocating the transaction price to each separate performance obligation. For financial reporting purposes, the Company utilized the modified retrospective approach, meaning the ASU is applied only to the most current period presented in the financial statements with the cumulative effect of initially applying the standard recognized at the date of initial application. As a bank holding company, key revenue sources, such as interest income on loans, investment securities and deposits, as well as other sources of income including loan fees, security sales, and derivatives have been identified as out of the scope of this new guidance. Management conducted an assessment of the revenue streams that were affected by the new guidance and identified those considered material and in scope to ensure compliance with the new guidance concluding those related to credit and debit card fees, and service charges and fees on deposit accounts. No additional changes to processes or procedures were identified for the recognition of revenues in scope. The adoption of this ASU did not have a material impact on the Company's consolidated financial statements. However, additional disclosures required by the ASU have been included in "Note 15 - Revenue from Contracts with Customers" to the Company's consolidated financial statements.

On January 1, 2018, the FASB issued ASU No. 2016 01, Financial Instruments - Overall (Subtopic 825 10): Recognition and Measurement of Financial Assets and Financial Liabilities. The new guidance improves the recognition and measurement of financial instruments. This ASU requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes and requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (i.e., securities or loans and receivables) on the balance sheet or the accompanying notes to the financial statements. Exit price is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. This ASU also eliminates the requirement to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet. The adoption of ASU No. 2016-01 did not have a material impact on the Company's consolidated financial statements. The disclosures to the Company's consolidated financial statements have been updated appropriately using the exit price notion in "Note 8 - Fair Value of Financial Instruments".

Table of Contents

## NOTE 2 - SECURITIES AVAILABLE-FOR-SALE

The following tables present the amortized costs, unrealized gains, unrealized losses, and estimated fair values of securities available-for-sale at September 30, 2018 and December 31, 2017:

	September 30, 2018			Estimated Fair Values
	Amortized Cost	Unrealized Gains	Unrealized Losses	
<b>SECURITIES AVAILABLE-FOR-SALE</b>				
U.S. agency securities	\$ 16,058	\$ 24	\$ (270)	\$ 15,812
Corporate securities	7,082	4	(179)	6,907
Municipal bonds	13,203	3	(599)	12,607
Mortgage-backed securities	48,726	19	(1,826)	46,919
U.S. Small Business Administration securities	15,699	—	(570)	15,129
Total securities available-for-sale	\$ 100,768	\$ 50	\$ (3,444)	\$ 97,374

	December 31, 2017			Estimated Fair Values
	Amortized Cost	Unrealized Gains	Unrealized Losses	
<b>SECURITIES AVAILABLE-FOR-SALE</b>				
U.S. agency securities	\$ 9,077	\$ 49	\$ (11)	\$ 9,115
Corporate securities	7,113	9	(96)	7,026
Municipal bonds	12,720	148	(82)	12,786
Mortgage-backed securities	40,161	63	(490)	39,734
U.S. Small Business Administration securities	14,014	—	(195)	13,819
Total securities available-for-sale	\$ 83,085	\$ 269	\$ (874)	\$ 82,480

At September 30, 2018, the Bank had pledged seven securities held at the FHLB of Des Moines with a carrying value of \$10.3 million to secure Washington State public deposits of \$7.8 million with a \$3.3 million collateral requirement by the Washington Public Deposit Protection Commission. At December 31, 2017, the Bank pledged nine securities held at the FHLB of Des Moines with a carrying value of \$10.7 million to secure Washington State public deposits of \$7.6 million with a \$3.2 million minimum collateral requirement by the Washington Public Deposit Protection Commission.

Investment securities that were in an unrealized loss position at September 30, 2018 and December 31, 2017 are presented in the following tables, based on the length of time individual securities have been in an unrealized loss position. Management believes that these securities are only temporarily impaired due to changes in market interest rates or the widening of market spreads subsequent to the initial purchase of the securities, and not due to concerns regarding the underlying credit of the issuers or the underlying collateral.

September 30, 2018		
Less than 12 Months	12 Months or Longer	Total

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	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
SECURITIES						
AVAILABLE-FOR-SALE						
U.S. agency securities	\$ 13,787	\$ (270)	\$ —	\$ —	\$ 13,787	\$ (270)
Corporate securities	4,007	(79)	1,897	(100)	5,904	(179)
Municipal bonds	6,077	(165)	5,115	(434)	11,192	(599)
Mortgage-backed securities	23,653	(656)	21,773	(1,170)	45,426	(1,826)
U.S. Small Business Administration securities	6,969	(181)	8,160	(389)	15,129	(570)
Total	\$ 54,493	\$ (1,351)	\$ 36,945	\$ (2,093)	\$ 91,438	\$ (3,444)

Table of Contents

	December 31, 2017				Total Fair Value	Unrealized Losses
	Less than 12 Months Fair Value	Unrealized Losses	12 Months or Longer Fair Value	Unrealized Losses		
<b>SECURITIES</b>						
<b>AVAILABLE-FOR-SALE</b>						
U.S. agency securities	\$ 2,987	\$ (11)	\$ —	\$ —	\$ 2,987	\$ (11)
Corporate securities	4,102	(15)	1,915	(81)	6,017	(96)
Municipal bonds	5,982	(82)	—	—	5,982	(82)
Mortgage-backed securities	7,262	(61)	20,635	(429)	27,897	(490)
U.S. Small Business Administration securities	11,876	(162)	1,943	(33)	13,819	(195)
Total	\$ 32,209	\$ (331)	\$ 24,493	\$ (543)	\$ 56,702	\$ (874)

There were 37 investments with unrealized losses of less than one year, and 29 investments with unrealized losses of more than one year at September 30, 2018. There were 21 investments with unrealized losses of less than one year, and 17 investments with unrealized losses of more than one year at December 31, 2017. The unrealized losses associated with these investments are believed to be caused by changes in market interest rates that are considered to be temporary and the Company does not intend to sell the securities, and it is not likely to be required to sell these securities prior to maturity. Based on the Company's evaluation of these securities, no other-than-temporary impairment was recorded for the nine months ended September 30, 2018, or for the year ended December 31, 2017.

The contractual maturities of securities available-for-sale at September 30, 2018 and December 31, 2017 are listed below. Expected maturities of mortgage-backed securities may differ from contractual maturities because borrowers may have the right to call or prepay the obligations; therefore, these securities are classified separately with no specific maturity date.

	September 30, 2018		December 31, 2017	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
U.S. agency securities				
Due after five years through ten years	\$ 11,060	\$ 10,909	\$ 4,079	\$ 4,124
Due after ten years	4,998	4,903	4,998	4,991
Subtotal	16,058	15,812	9,077	9,115
Corporate securities				
Due after one year through five years	6,086	6,001	5,117	5,111
Due after five years through ten years	996	906	1,996	1,915
Subtotal	7,082	6,907	7,113	7,026
Municipal bonds				
Due after one year through five years	2,659	2,568	2,001	2,026
Due after five years through ten years	1,736	1,702	4,111	4,206
Due after ten years	8,808	8,337	6,608	6,554
Subtotal	13,203	12,607	12,720	12,786
Mortgage-backed securities				
Federal National Mortgage Association ("FNMA")	32,735	31,597	23,310	23,091



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Federal Home Loan Mortgage Corporation (“FHLMC”)	10,737	10,256	10,818	10,629
Government National Mortgage Association (“GNMA”)	5,254	5,066	6,033	6,014
Subtotal	48,726	46,919	40,161	39,734
U.S. Small Business Administration securities				
Due after five years through ten years	13,837	13,354	12,065	11,896
Due after ten years	1,862	1,775	1,949	1,923
Subtotal	15,699	15,129	14,014	13,819
Total	\$ 100,768	\$ 97,374	\$ 83,085	\$ 82,480

Table of Contents

The proceeds and resulting gains and losses, computed using specific identification from sales of securities available-for-sale for the three and nine months ended September 30, 2018 and 2017 were as follows:

	Three Months Ended September 30, 2018			Nine Months Ended September 30, 2018		
	Proceeds	Gross	Gross	Proceeds	Gross	Gross
		Gains	(Losses)		Gains	(Losses)
Securities available-for-sale	\$ —	\$ —	\$ —	\$ 5,305	\$ 113	\$ —

	Three Months Ended September 30, 2017			Nine Months Ended September 30, 2017		
	Proceeds	Gross	Gross	Proceeds	Gross	Gross
		Gains	(Losses)		Gains	(Losses)
Securities available-for-sale	\$ 9,115	\$ 143	\$ —	\$ 39,103	\$ 413	\$ (33)

## NOTE 3 - LOANS RECEIVABLE AND ALLOWANCE FOR LOAN LOSSES

The composition of the loan portfolio was as follows at September 30, 2018 and December 31, 2017:

	September 30, 2018	December 31, 2017
<b>REAL ESTATE LOANS</b>		
Commercial	\$ 68,694	\$ 63,611
Construction and development	191,172	143,068
Home equity	26,085	25,289
One-to-four-family (excludes loans held for sale)	188,333	163,655
Multi-family	48,061	44,451
Total real estate loans	522,345	440,074
<b>CONSUMER LOANS</b>		
Indirect home improvement	155,870	130,176
Solar	42,967	41,049
Marine	56,578	35,397
Other consumer	2,059	2,046
Total consumer loans	257,474	208,668
<b>COMMERCIAL BUSINESS LOANS</b>		
Commercial and industrial	113,786	83,306
Warehouse lending	67,540	41,397
Total commercial business loans	181,326	124,703

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Total loans receivable, gross	961,145	773,445
Allowance for loan losses	(12,045)	(10,756)
Deferred costs and fees, net	(3,195)	(2,708)
Premiums on purchased loans	1,667	1,577
Total loans receivable, net	\$ 947,572	\$ 761,558

Most of the Company's commercial and multi-family real estate, construction, residential, and/or commercial business lending activities are with customers located in the greater Puget Sound area and near our one loan production office located in the Tri-Cities, Washington. The Company originates real estate, consumer, and commercial business loans and has concentrations in these areas, however, indirect home improvement loans are originated through a network of home improvement contractors and dealers located throughout Washington, Oregon, California, Idaho, Colorado, and Arizona. The Company also originates solar loans through contractors and dealers in the state of California. Loans are generally secured by collateral and rights to collateral vary and are legally documented to the extent practicable. Local economic conditions may affect borrowers' ability to meet the stated repayment terms.

## Table of Contents

The Company has defined its loan portfolio into three segments that reflect the structure of the lending function, the Company's strategic plan and the manner in which management monitors performance and credit quality. The three loan portfolio segments are: (a) Real Estate Loans, (b) Consumer Loans, and (c) Commercial Business Loans. Each of these segments is disaggregated into classes based on the risk characteristics of the borrower and/or the collateral type securing the loan. The following is a summary of each of the Company's loan portfolio segments and classes:

### Real Estate Loans

**Commercial Lending.** Loans originated by the Company primarily secured by income producing properties, including retail centers, warehouses, and office buildings located in our market areas.

**Construction and Development Lending.** Loans originated by the Company for the construction of, and secured by, commercial real estate, one-to-four-family, and multi-family residences and tracts of land for development that are not pre-sold. A small portion of the one-to-four-family construction portfolio is custom construction loans to the intended occupant of the residence.

**Home Equity Lending.** Loans originated by the Company secured by second mortgages on one-to-four-family residences, including home equity lines of credit in our market areas.

**One-to-Four-Family Real Estate Lending.** One-to-four-family residential loans include owner occupied properties (including second homes), and non-owner occupied properties with four or less units. These loans originated by the Company are secured by first mortgages on one-to-four-family residences in our market areas that the Company intends to hold (excludes loans held for sale).

**Multi-Family Lending.** Apartment term lending (five or more units) to current banking customers and community reinvestment loans for low to moderate income individuals in the Company's footprint.

### Consumer Loans

**Indirect Home Improvement.** Fixture secured loans for home improvement are originated by the Company through its network of home improvement contractors and dealers and are secured by the personal property installed in, on, or at the borrower's real property, and may be perfected with a UCC 2 financing statement filed in the county of the borrower's residence. These indirect home improvement loans include replacement windows, siding, roofing, pools, and other home fixture installations.

**Solar.** Fixture secured loans for solar related home improvement projects are originated by the Company through its network of contractors and dealers, and are secured by the personal property installed in, on, or at the borrower's real property, and which may be perfected with a UCC 2 financing statement filed in the county of the borrower's residence.

**Marine.** Loans originated by the Company, secured by boats, to borrowers located in the states we originate consumer loans.

**Other Consumer.** Loans originated by the Company to consumers in our retail branch footprint, including automobiles, recreational vehicles, direct home improvement loans, loans on deposits, and other consumer loans, primarily consisting of personal lines of credit.

### Commercial Business Loans

Commercial and Industrial Lending (“C&I”). Loans originated by the Company to local small- and mid-sized businesses in our Puget Sound market area are secured primarily by accounts receivable, inventory, or personal property, plant and equipment. Some of the C&I loans purchased by the Company are outside of the Greater Puget Sound market area. C&I loans are made on the basis of the borrower’s ability to make repayment from the cash flow of the borrower’s business.

Warehouse Lending. Loans originated to non-depository financial institutions and secured by notes originated by the non-depository financial institution. The Company has two distinct warehouse lending divisions: commercial warehouse re-lending secured by notes on construction loans and mortgage warehouse re-lending secured by notes on one-to-four-family

Table of Contents

loans. The Company's commercial construction warehouse lines are secured by notes on construction loans and typically guaranteed by principles with experience in construction lending. Mortgage warehouse lending loans are funded through third-party residential mortgage bankers. Under this program the Company provides short-term funding to the mortgage banking companies for the purpose of originating residential mortgage loans for sale into the secondary market.

The following tables detail activity in the allowance for loan losses by loan categories at or for the three and nine months ended September 30, 2018 and 2017:

	At or For the Three Months Ended September 30, 2018				
	Real Estate	Consumer	Commercial Business	Unallocated	Total
<b>ALLOWANCE FOR LOAN LOSSES</b>					
Beginning balance	\$ 5,125	\$ 3,184	\$ 2,567	\$ 695	\$ 11,571
Provision for loan losses	324	(23)	734	(585)	450
Charge-offs	—	(192)	—	—	(192)
Recoveries	15	201	—	—	216
Net recoveries	15	9	—	—	24
Ending balance	\$ 5,464	\$ 3,170	\$ 3,301	\$ 110	\$ 12,045
Period end amount allocated to:					
Loans individually evaluated for impairment	\$ 21	\$ 156	\$ 700	\$ —	\$ 877
Loans collectively evaluated for impairment	5,443	3,014	2,601	110	11,168
Ending balance	\$ 5,464	\$ 3,170	\$ 3,301	\$ 110	\$ 12,045
<b>LOANS RECEIVABLE</b>					
Loans individually evaluated for impairment	\$ 290	\$ 444	\$ 1,438	\$ —	\$ 2,172
Loans collectively evaluated for impairment	522,055	257,030	179,888	—	958,973
Ending balance	\$ 522,345	\$ 257,474	\$ 181,326	\$ —	\$ 961,145

	At or For the Nine Months Ended September 30, 2018				
	Real Estate	Consumer	Commercial Business	Unallocated	Total
<b>ALLOWANCE FOR LOAN LOSSES</b>					
Beginning balance	\$ 4,770	\$ 2,814	\$ 2,014	\$ 1,158	\$ 10,756
Provision for loan losses	667	348	1,283	(1,048)	1,250
Charge-offs	(4)	(644)	—	—	(648)
Recoveries	31	652	4	—	687
Net recoveries	27	8	4	—	39
Ending balance	\$ 5,464	\$ 3,170	\$ 3,301	\$ 110	\$ 12,045
Period end amount allocated to:					
Loans individually evaluated for impairment	\$ 21	\$ 156	\$ 700	\$ —	\$ 877
	5,443	3,014	2,601	110	11,168

Loans collectively evaluated for impairment					
Ending balance	\$ 5,464	\$ 3,170	\$ 3,301	\$ 110	\$ 12,045
<b>LOANS RECEIVABLE</b>					
Loans individually evaluated for impairment	\$ 290	\$ 444	\$ 1,438	\$ —	\$ 2,172
Loans collectively evaluated for impairment	522,055	257,030	179,888	—	958,973
Ending balance	\$ 522,345	\$ 257,474	\$ 181,326	\$ —	\$ 961,145

Table of Contents

	At or For the Three Months Ended September 30, 2017				
	Real Estate	Consumer	Commercial Business	Unallocated	Total
<b>ALLOWANCE FOR LOAN LOSSES</b>					
Beginning balance	\$ 4,144	\$ 2,669	\$ 2,453	\$ 877	\$ 10,143
Provision for loan losses	481	65	(130)	34	450
Charge-offs	(55)	(152)	(33)	—	(240)
Recoveries	35	208	2	—	245
Net (charge-offs) recoveries	(20)	56	(31)	—	5
Ending balance	\$ 4,605	\$ 2,790	\$ 2,292	\$ 911	\$ 10,598
Period end amount allocated to:					
Loans individually evaluated for impairment	\$ —	\$ —	\$ —	\$ —	\$ —
Loans collectively evaluated for impairment	4,605	2,790	2,292	911	10,598
Ending balance	\$ 4,605	\$ 2,790	\$ 2,292	\$ 911	\$ 10,598
<b>LOANS RECEIVABLE</b>					
Loans individually evaluated for impairment	\$ 210	\$ —	\$ 551	\$ —	\$ 761
Loans collectively evaluated for impairment	429,998	201,674	133,138	—	764,810
Ending balance	\$ 430,208	\$ 201,674	\$ 133,689	\$ —	\$ 765,571

	At or For the Nine Months Ended September 30, 2017				
	Real Estate	Consumer	Commercial Business	Unallocated	Total
<b>ALLOWANCE FOR LOAN LOSSES</b>					
Beginning balance	\$ 3,547	\$ 2,082	\$ 2,675	\$ 1,907	\$ 10,211
Provision for loan losses	1,077	726	(357)	(996)	450
Charge-offs	(55)	(536)	(33)	—	(624)
Recoveries	36	518	7	—	561
Net charge-offs	(19)	(18)	(26)	—	(63)
Ending balance	\$ 4,605	\$ 2,790	\$ 2,292	\$ 911	\$ 10,598
Period end amount allocated to:					
Loans individually evaluated for impairment	\$ —	\$ —	\$ —	\$ —	\$ —
Loans collectively evaluated for impairment	4,605	2,790	2,292	911	10,598
Ending balance	\$ 4,605	\$ 2,790	\$ 2,292	\$ 911	\$ 10,598
<b>LOANS RECEIVABLE</b>					
Loans individually evaluated for impairment	\$ 210	\$ —	\$ 551	\$ —	\$ 761
Loans collectively evaluated for impairment	429,998	201,674	133,138	—	764,810
Ending balance	\$ 430,208	\$ 201,674	\$ 133,689	\$ —	\$ 765,571



Non-accrual and Past Due Loans. Loans are considered past due if the required principal and interest payments have not been received as of the date such payments were due. Loans are automatically placed on non-accrual once the loan is 90 days past due or sooner if, in management's opinion, the borrower may be unable to meet payment obligations as they become due, or as required by regulatory authorities.

18

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Table of Contents

The following tables provide information pertaining to the aging analysis of contractually past due loans and non-accrual loans at September 30, 2018 and December 31, 2017:

	September 30, 2018				Current	Total Loans Receivable	Non- Accrual
	30-59 Days Past Due	60-89 Days Past Due	90 Days or More Past Due	Total Past Due			
<b>REAL ESTATE LOANS</b>							
Commercial	\$ —	\$ —	\$ —	\$ —	\$ 68,694	\$ 68,694	\$ —
Construction and development	—	—	—	—	191,172	191,172	—
Home equity	—	—	46	46	26,039	26,085	149
One-to-four-family	—	—	141	141	188,192	188,333	141
Multi-family	—	—	—	—	48,061	48,061	—
Total real estate loans	—	—	187	187	522,158	522,345	290
<b>CONSUMER LOANS</b>							
Indirect home improvement	347	149	141	637	155,233	155,870	339
Solar	96	62	40	198	42,769	42,967	40
Marine	7	—	50	57	56,521	56,578	63
Other consumer	—	2	—	2	2,057	2,059	2
Total consumer loans	450	213	231	894	256,580	257,474	444
<b>COMMERCIAL BUSINESS LOANS</b>							
Commercial and industrial	—	—	—	—	113,786	113,786	1,438
Warehouse lending	—	—	—	—	67,540	67,540	—
Total commercial business loans	—	—	—	—	181,326	181,326	1,438
Total loans	\$ 450	\$ 213	\$ 418	\$ 1,081	\$ 960,064	\$ 961,145	\$ 2,172

	December 31, 2017				Current	Total Loans Receivable	Non- Accrual
	30-59 Days Past Due	60-89 Days Past Due	90 Days or More Past Due	Total Past Due			
<b>REAL ESTATE LOANS</b>							
Commercial	\$ —	\$ —	\$ —	\$ —	\$ 63,611	\$ 63,611	\$ —
Construction and development	—	—	—	—	143,068	143,068	—
Home equity	122	—	136	258	25,031	25,289	151
One-to-four-family	142	—	—	142	163,513	163,655	142
Multi-family	—	—	—	—	44,451	44,451	—
Total real estate loans	264	—	136	400	439,674	440,074	293
<b>CONSUMER LOANS</b>							
	255	215	99	569	129,607	130,176	195

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Indirect home improvement							
Solar	49	19	—	68	40,981	41,049	—
Marine	—	—	—	—	35,397	35,397	—
Other consumer	—	—	—	—	2,046	2,046	—
Total consumer loans	304	234	99	637	208,031	208,668	195
<b>COMMERCIAL BUSINESS LOANS</b>							
Commercial and industrial	—	551	—	551	82,755	83,306	551
Warehouse lending	—	—	—	—	41,397	41,397	—
Total commercial business loans	—	551	—	551	124,152	124,703	551
Total loans	\$ 568	\$ 785	\$ 235	\$ 1,588	\$ 771,857	\$ 773,445	\$ 1,039

There were no loans 90 days or more past due and still accruing interest at both September 30, 2018 and December 31, 2017.

Table of Contents

The following tables provide additional information about our impaired loans that have been segregated to reflect loans for which an allowance for credit losses has been provided and loans for which no allowance was provided at September 30, 2018 and December 31, 2017:

	September 30, 2018			
	Unpaid Principal Balance	Impairment	Recorded Investment	Related Allowance
<b>WITH NO RELATED ALLOWANCE RECORDED</b>				
Home equity	\$ 149	\$ —	\$ 149	\$ —
<b>WITH RELATED ALLOWANCE RECORDED</b>				
One-to-four-family	141	—	141	21
Consumer loans	444	—	444	156
Commercial business loans	1,438	—	1,438	700
	2,023	—	2,023	877
<b>Total</b>	<b>\$ 2,172</b>	<b>\$ —</b>	<b>\$ 2,172</b>	<b>\$ 877</b>

	December 31, 2017			
	Unpaid Principal Balance	Impairment	Recorded Investment	Related Allowance
<b>WITH NO RELATED ALLOWANCE RECORDED</b>				
Home equity	\$ 151	\$ —	\$ 151	\$ —
One-to-four-family	67	(12)	55	—
Total real estate loans	218	(12)	206	—
Commercial business loans	551	—	551	—
	769	(12)	757	—
<b>WITH RELATED ALLOWANCE RECORDED</b>				
One-to-four-family	142	—	142	21
Consumer loans	195	—	195	68
	337	—	337	89
<b>Total</b>	<b>\$ 1,106</b>	<b>\$ (12)</b>	<b>\$ 1,094</b>	<b>\$ 89</b>

The following table presents the average recorded investment in loans individually evaluated for impairment and the interest income recognized and received for the three and nine months ended September 30, 2018 and 2017:

	At or For the Three Months Ended			
	September 30, 2018		September 30, 2017	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
<b>WITH NO RELATED ALLOWANCE RECORDED</b>				
Home equity	\$ 166	\$ 2	\$ 201	\$ —
One-to-four-family(1)	—	—	56	1

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Total real estate loans	166	2	257	1
WITH RELATED ALLOWANCE RECORDED				
One-to-four-family	141	1	—	—
Consumer loans	357	8	—	—
Commercial business loans	479	38	551	23
	977	47	551	23
Total	\$ 1,143	\$ 49	\$ 808	\$ 24

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(1) Includes loans supported by Federal Housing Administration (“FHA”) guarantees.

20

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Table of Contents

	At or For the Nine Months Ended			
	September 30, 2018		September 30, 2017	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
<b>WITH NO RELATED ALLOWANCE RECORDED</b>				
Home equity	\$ 171	\$ 5	\$ 220	\$ —
One-to-four-family (1)	—	—	56	3
Total real estate loans	171	5	276	3
<b>WITH AN ALLOWANCE RECORDED</b>				
One-to-four-family	196	4	—	—
Consumer loans	303	20	—	—
Commercial business loans	360	38	551	23
	859	62	551	23
Total	\$ 1,030	\$ 67	\$ 827	\$ 26

(1) Includes loans supported by FHA guarantees.

## Credit Quality Indicators

As part of the Company's on-going monitoring of credit quality of the loan portfolio, management tracks certain credit quality indicators including trends related to (i) the risk grading of loans, (ii) the level of classified loans, (iii) net charge-offs, (iv) non-performing loans, and (v) the general economic conditions in the Company's markets.

The Company utilizes a risk grading matrix to assign a risk grade to its real estate and commercial business loans. Loans are graded on a scale of 1 to 10, with loans in risk grades 1 to 6 considered "Pass" and loans in risk grades 7 to 10 are reported as classified loans in the Company's allowance for loan loss analysis.

A description of the 10 risk grades is as follows:

Grades 1 and 2 - These grades include loans to very high quality borrowers with excellent or desirable business credit.

Grade 3 - This grade includes loans to borrowers of good business credit with moderate risk.

Grades 4 and 5 - These grades include "Pass" grade loans to borrowers of average credit quality and risk.

Grade 6 - This grade includes loans on management's "Watch" list and is intended to be utilized on a temporary basis for "Pass" grade borrowers where frequent and thorough monitoring is required due to credit weaknesses and where significant risk-modifying action is anticipated in the near term.

Grade 7 - This grade is for "Other Assets Especially Mentioned" ("OAEM") in accordance with regulatory guidelines and includes borrowers where performance is poor or significantly less than expected.

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Grade 8 - This grade includes “Substandard” loans in accordance with regulatory guidelines which represent an unacceptable business credit where a loss is possible if loan weakness is not corrected.

Grade 9 - This grade includes “Doubtful” loans in accordance with regulatory guidelines where a loss is highly probable.

Grade 10 - This grade includes “Loss” loans in accordance with regulatory guidelines for which total loss is expected and when identified are charged off.

Table of Contents

## Consumer, Home Equity, and One-to-Four-Family Real Estate Loans

Homogeneous loans are risk rated based upon the Federal Financial Institutions Examination Council's Uniform Retail Credit Classification and Account Management Policy. Loans classified under this policy at the Company are consumer loans which include indirect home improvement, solar, marine, other consumer, and one-to-four-family first and second liens. Under the Uniform Retail Credit Classification Policy, loans that are current or less than 90 days past due are graded "Pass" and risk rated "4" or "5" internally. Loans that are past due more than 90 days are classified "Substandard" and risk rated "8" internally until the loan has demonstrated consistent performance, typically six months of contractual payments. Closed-end loans that are 120 days past due and open-end loans that are 180 days past due are charged off based on the value of the collateral less cost to sell.

The following tables summarize risk rated loan balances by category at the dates indicated:

	September 30, 2018						
	Pass (1 - 5)	Watch (6)	Special Mention (7)	Substandard (8)	Doubtful (9)	Loss (10)	Total
<b>REAL ESTATE LOANS</b>							
Commercial	\$ 68,694	\$ —	\$ —	\$ —	\$ —	\$ —	\$ 68,694
Construction and development	191,172	—	—	—	—	—	191,172
Home equity	25,936	—	—	149	—	—	26,085
One-to-four-family	188,192	—	—	141	—	—	188,333
Multi-family	48,061	—	—	—	—	—	48,061
Total real estate loans	522,055	—	—	290	—	—	522,345
<b>CONSUMER LOANS</b>							
Indirect home improvement	155,531	—	—	339	—	—	155,870
Solar	42,927	—	—	40	—	—	42,967
Marine	56,515	—	—	63	—	—	56,578
Other consumer	2,057	—	—	2	—	—	2,059
Total consumer loans	257,030	—	—	444	—	—	257,474
<b>COMMERCIAL BUSINESS LOANS</b>							
Commercial and industrial	99,383	7,729	—	6,674	—	—	113,786
Warehouse lending	67,540	—	—	—	—	—	67,540
Total commercial business loans	166,923	7,729	—	6,674	—	—	181,326
Total loans receivable, gross	\$ 946,008	\$ 7,729	\$ —	\$ 7,408	\$ —	\$ —	\$ 961,145



Table of Contents

	December 31, 2017						
	Pass (1 - 5)	Watch (6)	Special Mention (7)	Substandard (8)	Doubtful (9)	Loss (10)	Total
<b>REAL ESTATE LOANS</b>							
Commercial	\$ 62,057	\$ —	\$ 1,554	\$ —	\$ —	\$ —	\$ 63,611
Construction and development	143,068	—	—	—	—	—	143,068
Home equity	25,138	—	—	151	—	—	25,289
One-to-four-family	163,513	—	—	142	—	—	163,655
Multi-family	44,451	—	—	—	—	—	44,451
Total real estate loans	438,227	—	1,554	293	—	—	440,074
<b>CONSUMER LOANS</b>							
Indirect home improvement	129,981	—	—	195	—	—	130,176
Solar	41,049	—	—	—	—	—	41,049
Marine	35,397	—	—	—	—	—	35,397
Other consumer	1,998	—	—	48	—	—	2,046
Total consumer loans	208,425	—	—	243	—	—	208,668
<b>COMMERCIAL BUSINESS LOANS</b>							
Commercial and industrial	76,942	—	425	5,939	—	—	83,306
Warehouse lending	40,724	673	—	—	—	—	41,397
Total commercial business loans	117,666	673	425	5,939	—	—	124,703
Total loans receivable, gross	\$ 764,318	\$ 673	\$ 1,979	\$ 6,475	\$ —	\$ —	\$ 773,445

**NOTE 4 - SERVICING RIGHTS**

Loans serviced for others are not included on the Consolidated Balance Sheets. The unpaid principal balances of permanent loans serviced for others were \$1.0 billion and \$778.9 million at September 30, 2018 and December 31, 2017, respectively, and are carried at the lower of cost or market.

The following table summarizes servicing rights activity for the three and nine months ended September 30, 2018 and 2017:

	At or For the Three Months Ended September 30,	
	2018	2017
Beginning balance	\$ 8,352	\$ 4,899
Additions	1,451	1,326
Sales	—	—
Servicing rights amortized	(613)	(414)

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Impairment on servicing rights	—	—
Ending balance	\$ 9,190	\$ 5,811

	At or For the Nine Months Ended September 30,	
	2018	2017
Beginning balance	\$ 6,795	\$ 8,459
Additions	3,970	3,569
Sales	—	(4,751)
Servicing rights amortized	(1,575)	(1,465)
Impairment on servicing rights	—	(1)
Ending balance	\$ 9,190	\$ 5,811

Table of Contents

The fair market value of the permanent servicing rights' assets was \$13.5 million and \$8.6 million at September 30, 2018 and December 31, 2017, respectively. Fair value adjustments to servicing rights are mainly due to market-based assumptions associated with discounted cash flows, loan prepayment speeds, and changes in interest rates. A significant change in prepayments of the loans in the servicing portfolio could result in significant changes in the valuation adjustments, thus creating potential volatility in the carrying amount of servicing rights.

The following provides valuation assumptions used in determining the fair value of mortgage servicing rights ("MSR") at the dates indicated:

	At September 30, 2018      2017			
Key assumptions:				
Weighted average discount rate	9.5	%	9.5	%
Conditional prepayment rate ("CPR")	8.8	%	11.3	%
Weighted average life in years	8.1		6.8	

Key economic assumptions and the sensitivity of the current fair value for single family MSR to immediate adverse changes in those assumptions at September 30, 2018 and December 31, 2017 were as follows:

	September 30, 2018		December 31, 2017	
Aggregate portfolio principal balance	\$ 1,043,978		\$ 775,093	
Weighted average rate of note	4.2	%	4.1	%
	0.5% Adverse Rate		1.0% Adverse Rate	
At September 30, 2018	Base	Change	Change	
Conditional prepayment rate	8.8	%	10.3	%
Fair value MSR	\$ 13,489	\$ 12,264	\$ 10,703	
Percentage of MSR	1.3	%	1.2	%
Discount rate	9.7	%	10.2	%
Fair value MSR	\$ 13,489	\$ 13,190	\$ 12,904	
Percentage of MSR	1.3	%	1.3	%
	0.5% Adverse Rate		1.0% Adverse Rate	
At December 31, 2017	Base	Change	Change	
Conditional prepayment rate	10.9	%	17.7	%
Fair value MSR	\$ 8,602	\$ 6,811	\$ 5,614	
Percentage of MSR	1.1	%	0.9	%
Discount rate	9.6	%	10.1	%
Fair value MSR	\$ 8,602	\$ 8,433	\$ 8,271	
Percentage of MSR	1.1	%	1.1	%

The above table shows the sensitivity to market rate changes for the par rate coupon for a conventional one-to-four-family FNMA, FHLMC, GNMA, or FHLB serviced home loan. The above tables reference a 50 basis point and 100 basis point decrease in note rates.

These sensitivities are hypothetical and should be used with caution as the tables above demonstrate the Company's methodology for estimating the fair value of MSR, which is highly sensitive to changes in key assumptions. For example, actual prepayment experience may differ and any difference may have a material effect on MSR fair value. Changes in fair value resulting from changes in assumptions generally cannot be extrapolated because the relationship of the change in the assumption to the change in fair value may not be linear. Also, in these tables, the effects of a variation in a particular assumption on the fair value of the MSR is calculated without changing any other assumption; in reality, changes in one factor may be associated with changes in another (for example, decreases in market interest rates may provide an incentive to refinance, however, this may also indicate a slowing economy and an increase in the unemployment rate, which reduces the number of borrowers who qualify for refinancing), which may magnify or counteract the sensitivities. Thus, any

Table of Contents

measurement of MSR fair value is limited by the conditions existing and assumptions made at a particular point in time. Those assumptions may not be appropriate if they are applied to a different point in time.

The Company recorded \$634,000 and \$430,000 of gross contractually specified servicing fees, late fees, and other ancillary fees resulting from servicing mortgage and commercial loans for the three months ended September 30, 2018 and 2017, respectively, and \$1.7 million and \$1.8 million for the nine months ended September 30, 2018 and 2017, respectively. The income, net of amortization, is reported in noninterest income on the Consolidated Statements of Income.

## NOTE 5 - DERIVATIVES

The Company regularly enters into commitments to originate and sell loans held for sale. The Company has established a hedging strategy to protect itself against the risk of loss associated with interest rate movements on loan commitments. The Company enters into contracts to sell forward To-Be-Announced (“TBA”) mortgage-backed securities. These commitments and contracts are considered derivatives but have not been designated as hedging instruments for reporting purposes under U.S. GAAP. Rather, they are accounted for as free-standing derivatives, or economic hedges, with changes in the fair value of the derivatives reported in noninterest income. The Company recognizes all derivative instruments as either other assets or other liabilities on the Consolidated Balance Sheets and measures those instruments at fair value.

The following tables summarize the Company’s derivative instruments at the dates indicated:

September 30, 2018

	Notional	Fair Value	
		Asset	Liability
Fallout adjusted interest rate lock commitments with customers	\$ 32,553	\$ 538	\$ —
Mandatory and best effort forward commitments with investors	14,597	49	—
Forward TBA mortgage-backed securities	66,500	332	—
TBA mortgage-backed securities forward sales paired off with investors	25,500	13	—

December 31, 2017

	Notional	Fair Value	
		Asset	Liability
Fallout adjusted interest rate lock commitments with customers	\$ 31,951	\$ 726	\$ —
Mandatory and best effort forward commitments with investors	12,505	51	—
Forward TBA mortgage-backed securities	66,500	—	65
TBA mortgage-backed securities forward sales paired off with investors	36,500	53	—

At both September 30, 2018 and December 31, 2017, the Company had \$66.5 million of unsettled TBA trades with counterparties that required margin collateral of \$220,000 and \$75,000, respectively. This collateral is included in interest-bearing deposits at other financial institutions on the Consolidated Balance Sheets.

Changes in the fair value of the derivatives recognized in other noninterest income on the Consolidated Statements of Income and included in gain on sale of loans resulted in net (loss) gain of \$(345,000) and \$374,000 for the three months ended September 30, 2018 and 2017, respectively, and net gain (loss) of \$138,000 and \$(7,000) for the

nine months ended September 30, 2018 and 2017, respectively.

25

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Table of Contents

## NOTE 6 - DEPOSITS

Deposits are summarized as follows at September 30, 2018 and December 31, 2017:

	September 30, 2018(1)	December 31, 2017(1)
Noninterest-bearing checking	\$ 174,712	\$ 177,739
Interest-bearing checking	115,059	119,872
Savings	78,785	72,082
Money market(2)	240,626	228,742
Certificates of deposit less than \$100,000(3)	188,192	111,489
Certificates of deposit of \$100,000 through \$250,000	89,075	77,934
Certificates of deposit of \$250,000 and over(4)	42,563	32,833
Escrow accounts related to mortgages serviced	15,525	9,151
Total	\$ 944,537	\$ 829,842

(1) Includes \$122.4 million of deposits at September 30, 2018 (which is remaining from the purchase of four retail bank branches from Bank of America, National Association on January 22, 2016) and \$134.6 million at December 31, 2017.

(2) Includes \$200,000 of brokered deposits at September 30, 2018 and \$6.5 million at December 31, 2017.

(3) Includes \$123.4 million and \$59.3 million of brokered deposits at September 30, 2018 and December 31, 2017, respectively.

(4) Time deposits that meet or exceed the FDIC insurance limit.

Federal Reserve regulations require that the Bank maintain reserves in the form of cash on hand and deposit balances with the Federal Reserve Bank based on a percentage of deposits. The amounts of such balances at September 30, 2018 and December 31, 2017 were \$18.4 million and \$18.2 million, respectively.

Scheduled maturities of time deposits at September 30, 2018 for future periods ending are as follows:

	At September 30, 2018
Maturing in 2018	\$ 106,729
Maturing in 2019	113,227
Maturing in 2020	56,192
Maturing in 2021	23,298
Maturing in 2022	17,732
Thereafter	2,652
Total	\$ 319,830

Interest expense by deposit category for the three and nine months ended September 30, 2018 and 2017 is as follows:

Three Months Ended September 30,	Nine Months Ended September 30,
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	2018	2017	2018	2017
Interest-bearing checking	\$ 53	\$ 44	\$ 183	\$ 66
Savings and money market	584	356	1,296	937
Certificates of deposit	1,213	645	3,046	1,790
Total	\$ 1,850	\$ 1,045	\$ 4,525	\$ 2,793

NOTE 7 - COMMITMENTS AND CONTINGENCIES

Commitments - The Company is party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit. These

26

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Table of Contents

instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized on the Consolidated Balance Sheets.

The Company's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit is represented by the contractual amount of those instruments. The Company uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments.

The following table provides a summary of the Company's commitments at September 30, 2018 and December 31, 2017:

	September 30, 2018	December 31, 2017
COMMITMENTS TO EXTEND CREDIT		
REAL ESTATE LOANS		
Commercial	\$ 607	\$ 107
Construction and development	85,959	73,321
One-to-four-family (includes locks for salable loans)	36,736	37,336
Home equity	36,121	32,889
Multi-family	584	438
Total real estate loans	160,007	144,091
CONSUMER LOANS	10,312	10,041
COMMERCIAL BUSINESS LOANS		
Commercial and industrial	71,614	52,452
Warehouse lending	43,460	78,303
Total commercial business loans	115,074	130,755
Total commitments to extend credit	\$ 285,393	\$ 284,887

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Since many of the commitments are expected to expire without being drawn upon, the amount of the total commitments do not necessarily represent future cash requirements. The Company evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Company upon an extension of credit, is based on management's credit evaluation of the party. Collateral held varies, but may include accounts receivable, inventory, property and equipment, residential real estate, and income-producing commercial properties.

Unfunded commitments under commercial lines of credit, revolving credit lines, and overdraft protection agreements are commitments for possible future extensions of credit to existing customers. These lines of credit are uncollateralized and usually do not contain a specified maturity date and ultimately may not be drawn upon to the total extent to which the Company is committed. The Company has established reserves for estimated losses from unfunded commitments of \$253,000 at both September 30, 2018 and at December 31, 2017. One-to-four-family commitments included in the table above are accounted for as fair value derivatives and do not carry an associated loss reserve.

The Company also sells one-to-four-family loans to the FHLB of Des Moines that require a limited level of recourse if the loans default and exceed a certain loss exposure. Specific to that recourse, the FHLB of Des Moines established a first loss account ("FLA") related to the loans and required a credit enhancement ("CE") obligation by the Bank to be

utilized after the FLA is used. Based on loans sold through September 30, 2018, the total loans sold to the FHLB of Des Moines were \$61.7 million with the FLA totaling \$693,000 and the CE obligation at \$425,000 or 0.70% of the loans outstanding. The holdback for CE obligations is included in the contingent liabilities detailed below. There were no outstanding delinquencies on the loans sold to the FHLB of Des Moines at both September 30, 2018 and December 31, 2017.

Contingent liabilities for loans held for sale - In the ordinary course of business, loans are sold with limited recourse against the Company and may have to subsequently be repurchased due to defects that occurred during the origination of the loan. The defects are categorized as documentation errors, underwriting errors, early payoff, early payment defaults, breach of representation or warranty, servicing errors, and/or fraud. When a loan sold to an investor without recourse fails to perform according to its contractual terms, the investor will typically review the loan file to determine whether defects in the origination process occurred. If a defect is identified, the Company may be required to either repurchase the loan or

Table of Contents

indemnify the investor for losses sustained. If there are no such defects, the Company has no commitment to repurchase the loan. The Company has recorded a holdback reserve of \$1.0 million to cover loss exposure related to these guarantees for one-to-four-family loans sold into the secondary market at both September 30, 2018 and December 31, 2017, which is included in other liabilities on the Consolidated Balance Sheets.

The Company has entered into a severance agreement with its Chief Executive Officer. The severance agreement, subject to certain requirements, generally includes a lump sum payment to the Chief Executive Officer equal to 24 months of base compensation in the event his employment is involuntarily terminated, other than for cause or the executive terminates his employment with good reason, as defined in the severance agreement.

The Company has entered into change of control agreements with its Chief Financial Officer/Chief Operating Officer, Chief Lending Officer, Chief Credit Officer, Chief Risk Officer, Chief Human Resources Officer, Senior Vice President Compliance Officer, Executive Vice President of Retail Banking and Marketing, and two Executive Vice Presidents of Home Lending. The change of control agreements, subject to certain requirements, generally remain in effect until canceled by either party upon at least 24 months prior written notice. Under the change of control agreements, the executive generally will be entitled to a change of control payment from the Company if the executive is involuntarily terminated within six months preceding or 12 months after a change in control (as defined in the change of control agreements). In such an event, the executives would each be entitled to receive a cash payment in an amount equal to 12 months of their then current salary, subject to certain requirements in the change of control agreements.

The Bank received 7,158 shares of Class B common stock in Visa, Inc. as a result of the Visa initial public offering (“IPO”) in March 2008. These Class B shares of stock held by the Bank could be converted to Class A shares at a conversion rate of 1.6298 when all litigation pending as of the date of the IPO is concluded. However, at September 30, 2018, the date that litigation will be concluded cannot be determined. Until such time, the stock cannot be redeemed or sold by the Bank; therefore, it is not readily marketable and has a current carrying value of \$0. Visa, Inc. Class A stock’s market value at September 30, 2018 and December 31, 2017 was \$150.09 per share and \$114.02 per share, respectively.

As a result of the nature of our activities, the Company is subject to various pending and threatened legal actions, which arise in the ordinary course of business. From time to time, subordination liens may create litigation which requires us to defend our lien rights. In the opinion of management, liabilities arising from these claims, if any, will not have a material effect on our financial position. The Company had no material pending legal actions at September 30, 2018.

**NOTE 8 - FAIR VALUE OF FINANCIAL INSTRUMENTS**

The Company assumes interest rate risk (the risk that general interest rate levels will change) as a result of its normal operations. Consequently, the fair value of the Company’s consolidated financial instruments will change when interest rate levels change and that change may either be favorable or unfavorable to the Company. Management attempts to match maturities of assets and liabilities to the extent believed necessary to minimize interest rate risk. However, borrowers with fixed interest rate obligations are less likely to prepay in a rising interest rate environment and more likely to prepay in a falling interest rate environment. Conversely, depositors who are receiving fixed interest rates are more likely to withdraw funds before maturity in a rising interest rate environment and less likely to do so in a falling interest rate environment. Management monitors interest rates and maturities of assets and liabilities, and attempts to minimize interest rate risk by adjusting terms of new loans and deposits, and by investing in securities with terms that mitigate the Company’s overall interest rate risk.

On January 1, 2018, the Company adopted ASU 2016-01, Financial Instruments - Overall (Subtopic 825 10), Recognition and Measurement of Financial Assets and Financial Liabilities, which requires us to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes.

The Company determines the fair values of its financial instruments based on the requirements established in Accounting Standards Codification (“ASC”) 820, Fair Value Measurements, which provides a framework for measuring fair value in accordance with U.S. GAAP and requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. ASC 820 defines fair values for financial instruments as the exit price, the price that would be received for an asset or paid to transfer a liability, in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date under current market

Table of Contents

conditions. The Company's fair values for financial instruments at September 30, 2018 were determined based on these requirements.

The following definitions describe the levels of inputs that may be used to measure fair value:

Level 1 - Inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets.

Level 2 - Inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.

Level 3 - Inputs to the valuation methodology are unobservable and significant to the fair value measurement.

Determination of Fair Market Values at December 31, 2017:

Securities Available-for-Sale - The fair value of securities available-for-sale are recorded on a recurring basis. The fair value of investments and mortgage-backed securities are provided by a third-party pricing service. These valuations are based on market data using pricing models that vary by asset class and incorporate available current trade, bid, and other market information, and for structured securities, cash flow, and loan performance data. The pricing processes utilize benchmark curves, benchmarking of similar securities, sector groupings, and matrix pricing. Option adjusted spread models are also used to assess the impact of changes in interest rates and to develop prepayment scenarios. Transfers between the fair value hierarchy are determined through the third-party service provider which, from time to time will transfer between levels based on market conditions per the related security. All models and processes used take into account market convention (Level 2).

Mortgage Loans Held for Sale - The fair value of loans held for sale reflects the value of commitments with investors and/or the relative price as delivered into a TBA mortgage-backed security (Level 2).

Derivative Instruments - The fair value of the interest rate lock commitments and forward sales commitments are estimated using quoted or published market prices for similar instruments, adjusted for factors such as pull-through rate assumptions based on historical information, where appropriate. TBA mortgage-backed securities are fair valued on similar contracts in active markets (Level 2) while locks and forwards with customers and investors are fair valued using similar contracts in the market and changes in the market interest rates (Level 2 and 3).

Impaired Loans - Fair value adjustments to impaired collateral dependent loans are recorded to reflect partial write-downs based on the current appraised value of the collateral or internally developed models, which contain management's assumptions. Management will utilize discounted cashflow impairment for TDRs when the change in terms results in a discount to the overall cashflows to be received (Level 3).

The following tables present securities available-for-sale measured at fair value on a recurring basis at the dates indicated:

	Securities Available-for-Sale			
	Level 1	Level 2	Level 3	Total
At September 30, 2018				
U.S. agency securities	\$ —	\$ 15,812	\$ —	\$ 15,812

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Corporate securities	—	6,907	—	6,907
Municipal bonds	—	12,607	—	12,607
Mortgage-backed securities	—	46,919	—	46,919
U.S. Small Business Administration securities	—	15,129	—	15,129
Total	\$ —	\$ 97,374	\$ —	\$ 97,374

Table of Contents

	Securities Available-for-Sale			Total
	Level 1	Level 2	Level 3	
At December 31, 2017				
U.S. agency securities	\$ —	\$ 9,115	\$ —	\$ 9,115
Corporate securities	—	7,026	—	7,026
Municipal bonds	—	12,786	—	12,786
Mortgage-backed securities	—	39,734	—	39,734
U.S. Small Business Administration securities	—	13,819	—	13,819
Total	\$ —	\$ 82,480	\$ —	\$ 82,480

The following table presents mortgage loans held for sale measured at fair value on a recurring basis at the dates indicated:

	Mortgage Loans Held for Sale			
	Level 1	Level 2	Level 3	Total
September 30, 2018	\$ —	\$ 54,784	\$ —	\$ 54,784
December 31, 2017	\$ —	\$ 53,463	\$ —	\$ 53,463

The following tables present the fair value of interest rate lock commitments with customers, individual forward sale commitments with investors, and paired off commitments with investors measured at their fair value on a recurring basis at the dates indicated:

	Interest Rate Lock Commitments with Customers			
	Level 1	Level 2	Level 3	Total
September 30, 2018	\$ —	\$ —	\$ 538	\$ 538
December 31, 2017	\$ —	\$ —	\$ 726	\$ 726

	Individual Forward Sale Commitments with Investors			
	Level 1	Level 2	Level 3	Total
September 30, 2018	\$ —	\$ 332	\$ 49	\$ 381
December 31, 2017	\$ —	\$ (65)	\$ 51	\$ (14)

	Paired Off Commitments with Investors			
	Level 1	Level 2	Level 3	Total
September 30, 2018	\$ —	\$ 13	\$ —	\$ 13
December 31, 2017	\$ —	\$ 53	\$ —	\$ 53

The following table presents impaired loans measured at fair value on a nonrecurring basis for which a nonrecurring change in fair value has been recorded during the reporting periods indicated. The amounts disclosed below represent the fair values at the time the nonrecurring fair value measurements were evaluated.

	Impaired Loans			Total
	Level 1	Level 2	Level 3	
September 30, 2018	\$ —	\$ —	\$ 2,172	\$ 2,172
December 31, 2017	\$ —	\$ —	\$ 1,094	\$ 1,094



Table of Contents

Quantitative Information about Level 3 Fair Value Measurements - Shown in the table below is the fair value of financial instruments measured under a Level 3 unobservable input on a recurring and nonrecurring basis at September 30, 2018:

Level 3 Fair Value Instruments	Valuation Technique	Significant Unobservable Inputs	Range (Weighted Average)	Weighted Average	
RECURRING					
Interest rate lock commitments with customers	Quoted market prices	Pull-through expectations	80% - 99%	94.6	%
Individual forward sale commitments with investors	Quoted market prices	Pull-through expectations	80% - 99%	94.6	%
NONRECURRING					
Impaired loans	Fair value of underlying collateral	Discount applied to the obtained appraisal	0% - 50%	40.4	%

An increase in the pull-through rate utilized in the fair value measurement of the interest rate lock commitments with customers and forward sale commitments with investors will result in positive fair value adjustments (and an increase in the fair value measurement). Conversely, a decrease in the pull-through rate will result in a negative fair value adjustment (and a decrease in the fair value measurement).

The following table provides a reconciliation of assets and liabilities measured at fair value using significant unobservable inputs (Level 3) on a recurring basis during the three and nine months ended September 30, 2018 and 2017:

	Beginning Balance	Purchases and Issuances	Sales and Settlements	Ending Balance	Net change in fair value for gains/ (losses) relating to items held at end of period
Three Months Ended September 30, 2018					
Interest rate lock commitments with customers	\$ 1,138	\$ 2,375	\$ (2,975)	\$ 538	\$ (600)
Individual forward sale commitments with investors	(18)	171	(104)	49	67
2017					

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Interest rate lock commitments with customers	\$ 1,212	\$ 3,891	\$ (3,972)	\$ 1,131	\$ (81)
Individual forward sale commitments with investors	83	40	(119)	4	(79)

	Beginning Balance	Purchases and Issuances	Sales and Settlements	Ending Balance	Net change in fair value for gains/ (losses) relating to items held at end of period
Nine Months Ended September 30, 2018					
Interest rate lock commitments with customers	\$ 726	\$ 7,950	\$ (8,138)	\$ 538	\$ (188)
Individual forward sale commitments with investors	51	827	(829)	49	(2)
Nine Months Ended September 30, 2017					
Interest rate lock commitments with customers	\$ 818	\$ 11,440	\$ (11,127)	\$ 1,131	\$ 313
Individual forward sale commitments with investors	177	(49)	(124)	4	(173)

Gains (losses) on interest rate lock commitments carried at fair value are recorded in other noninterest income. Gains (losses) on forward sale commitments with investors carried at fair value are recorded within other noninterest income.

Table of Contents

Fair Values of Financial Instruments - The following methods and assumptions were used by the Company in estimating the fair values of financial instruments disclosed in the financial statements at December 31, 2017:

Cash, and Cash Equivalents and Certificates of Deposit at Other Financial Institutions - The carrying amounts of cash and short-term instruments approximate their fair value (Level 1).

Federal Home Loan Bank Stock - The par value of FHLB stock approximates its fair value (Level 2).

Bank-owned Life Insurance - The estimated fair value is equal to the cash surrender value of policies, net of surrender charges (Level 1).

Accrued Interest - The carrying amount of accrued interest approximates its fair value (Level 2).

Loans Receivable, Net - For variable rate loans that re-price frequently and have no significant change in credit risk, fair values are based on carrying values. Fair values for fixed rate loans are estimated using discounted cashflow analyses, using interest rates currently being offered for loans with similar terms to borrowers or similar credit quality (Level 3).

Servicing Rights - The fair value of mortgage, commercial, and consumer servicing rights are estimated using net present value of expected cash flows using a third party model that incorporates assumptions used in the industry to value such rights, adjusted for factors such as weighted average prepayments speeds based on historical information where appropriate (Level 3).

Deposits - The fair value of deposits with no stated maturity date is included at the amount payable on demand. Fair values for fixed rate certificates of deposit are estimated using a discounted cashflow calculation on interest rates currently offered on similar certificates (Level 2).

Borrowings - The carrying amounts of advances maturing within 90 days approximate their fair values. The fair values of long-term advances are estimated using discounted cashflow analyses based on the Bank's current incremental borrowing rates for similar types of borrowing arrangements (Level 2).

Subordinated Note - The fair value of the Subordinated Note is based upon the average yield of debt issuances for similarly sized issuances (Level 2).

Off-Balance Sheet Instruments - The fair value of commitments to extend credit are estimated using the fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreement and the present creditworthiness of the customers. The majority of the Company's off-balance sheet instruments consist of non-fee producing, variable-rate commitments, the Company has determined they do not have a distinguishable fair value. The fair value of loan lock commitments with customers and investors reflect an estimate of value based upon the interest rate lock date, the expected pull-through percentage for the commitment, and the interest rate at year end (Level 2 and 3).

Table of Contents

The following table provides estimated fair values of the Company's financial instruments at September 30, 2018 and December 31, 2017, whether or not recognized at fair value in the Consolidated Balance Sheets:

	September 30, 2018		December 31, 2017	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
<b>Financial Assets</b>				
<b>Level 1 inputs:</b>				
Cash and cash equivalents	\$ 15,202	\$ 15,202	\$ 18,915	\$ 18,915
Certificates of deposit at other financial institutions	17,362	17,362	18,108	18,108
<b>Level 2 inputs:</b>				
Securities available-for-sale, at fair value	97,374	97,374	82,480	82,480
Loans held for sale, at fair value	54,784	54,784	53,463	53,463
FHLB stock, at cost	7,131	7,131	2,871	2,871
Accrued interest receivable	4,453	4,453	3,566	3,566
Paired off commitments with investors	13	13	53	53
Individual forward sale commitments with investors	332	332	—	—
<b>Level 3 inputs:</b>				
Loans receivable, gross	961,145	951,178	773,445	780,551
Servicing rights, held at lower of cost or fair value	9,190	13,489	6,795	8,608
Fair value interest rate locks with customers	538	538	726	726
Individual forward sale commitments with investors	49	49	51	51
<b>Financial Liabilities</b>				
<b>Level 2 inputs:</b>				
Deposits	944,537	935,941	829,842	838,087
Borrowings	86,526	86,426	7,529	7,498
Subordinated note	9,860	10,741	9,845	10,741
Accrued interest payable	506	506	214	214
Individual forward sale commitments with investors	—	—	65	65

## NOTE 9 - EMPLOYEE BENEFITS

## Employee Stock Ownership Plan

On January 1, 2012, the Company established an ESOP for eligible employees of the Company and the Bank. Employees of the Company and the Bank are eligible to participate in the ESOP if they have been credited with at least 1,000 hours of service during the employees' first 12 month period and based on the employee's anniversary date will be vested in the ESOP. The employee will be 100% vested in the ESOP after two years of working at least 1,000 hours in each of those two years.

The ESOP borrowed \$2.6 million from FS Bancorp, Inc. and used those funds to acquire 259,210 shares of FS Bancorp, Inc. common stock in the open market at an average price of \$10.17 per share during the second half of

2012. It is anticipated that the Bank will make contributions to the ESOP in amounts necessary to amortize the ESOP loan payable to FS Bancorp, Inc. over a period of 10 years, bearing interest at 2.30%. Intercompany expenses associated with the ESOP are eliminated in consolidation. Shares purchased by the ESOP with the loan proceeds are held in a suspense account and allocated to ESOP participants on a pro rata basis as principal and interest payments are made by the ESOP to FS Bancorp, Inc. The loan is secured by shares purchased with the loan proceeds and will be repaid by the ESOP with funds from the Bank's discretionary contributions to the ESOP and earnings on the ESOP assets. Payments of principal and interest are due annually on December 31, the Company's fiscal year end. On December 31, 2017, the ESOP paid the sixth annual installment of principal in the amount of \$263,000, plus accrued interest of \$32,000 pursuant to the ESOP loan agreement.

As shares are committed to be released from collateral, the Company reports compensation expense equal to the average daily market prices of the shares at September 30, 2018 for the prior 90 days. These shares become outstanding for earnings

Table of Contents

per share computations. The compensation expense is accrued monthly throughout the year. Dividends on allocated ESOP shares are recorded as a reduction of retained earnings; dividends on unallocated ESOP shares are recorded as a reduction of debt and accrued interest.

Compensation expense related to the ESOP for the three months ended September 30, 2018 and 2017 was \$411,000 and \$360,000, respectively, and \$1.2 million and \$914,000 for the nine months ended September 30, 2018 and 2017, respectively. Tax deductions for the ESOP only are applicable on the costs to acquire shares, or \$10.17 per allocated share.

Shares held by the ESOP at September 30, 2018 and 2017 were as follows (shown as actual):

	Balances at September 30, 2018	Balances at September 30, 2017
Allocated shares	153,049	126,589
Committed to be released shares	19,441	19,441
Unallocated shares	84,243	110,164
Total ESOP shares	256,733	256,194
Fair value of unallocated shares (in thousands)	\$ 5,037	\$ 5,180

## NOTE 10 - EARNINGS PER SHARE

Basic earnings per share are computed by dividing income available to common shareholders by the weighted average number of common shares outstanding for the period. Diluted earnings per share reflect the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock or resulted in the issuance of common stock that then shared in the earnings of the entity. For earnings per share calculations, the ESOP shares committed to be released are included as outstanding shares for both basic and diluted earnings per share.

The following table presents a reconciliation of the components used to compute basic and diluted earnings per share for the three and nine months ended September 30, 2018 and 2017:

	At or For the Three Months Ended September 30,		At or For the Nine Months Ended September 30,	
	2018	2017	2018	2017
Numerator:				
Net income (in thousands)	\$ 4,052	\$ 3,454	\$ 12,630	\$ 10,406
Denominator:				
Basic weighted average common shares outstanding	3,610,731	3,051,744	3,590,383	2,949,092
Dilutive shares	169,247	187,584	182,025	192,685
	3,779,978	3,239,328	3,772,408	3,141,777

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Diluted weighted average common shares  
outstanding

Basic earnings per share	\$ 1.12	\$ 1.13	\$ 3.52	\$ 3.53
Diluted earnings per share	\$ 1.07	\$ 1.07	\$ 3.35	\$ 3.31
Potentially dilutive weighted average share options that were not included in the computation of diluted earnings per share because to do so would be anti-dilutive	10,131	—	4,144	—

Potential dilutive shares are excluded from computation of earnings per share if their effect is anti-dilutive. Options to purchase common stock shares were not included in the computation of diluted earnings per share because their exercise price resulted in them being anti-dilutive. At September 30, 2018 and 2017, there were outstanding options to purchase 155,000 shares and 135,000 shares of the Company's common stock, respectively.

Table of Contents

NOTE 11 - STOCK-BASED COMPENSATION

Stock Options and Restricted Stock

On May 17, 2018, the shareholders of FS Bancorp, Inc. approved the 2018 Equity Incentive Plan (the “2018 Plan”) that authorizes 650,000 shares of the Company’s common stock to be awarded. The 2018 Plan provides for the grant of incentive stock options, non-qualified stock options, and up to 163,000 restricted stock awards (“RSAs”) to directors, emeritus directors, officers, employees or advisory directors of the Company. On August 15, 2018, the Company awarded grants of 25,000 RSAs and 100,000 stock options with an exercise price equal to the market price of FS Bancorp’s common stock at the grant date of \$58.60 per share.

In September 2013, the shareholders of FS Bancorp, Inc. approved the FS Bancorp, Inc. 2013 Equity Incentive Plan (the “2013 Plan”). The 2013 Plan provides for the grant of incentive stock options, non-qualified stock options, and RSAs. The 2013 Plan authorizes the grant of stock options totaling 324,013 shares of common stock to Company directors and employees of which 322,000 option share awards were granted with an exercise price equal to the market price of FS Bancorp’s common stock at the grant date of May 8, 2014, of \$16.89 per share. The 2013 Plan authorizes the grant of RSAs totaling 129,605 shares to Company directors, advisory directors, emeritus directors, officers, and employees, and 125,105 shares were granted on May 8, 2014 at a grant date fair value of \$16.89 per share. The remaining 4,500 RSAs were granted January 1, 2016 at a grant date fair value of \$26.00 per share.

Total share-based compensation expense for both plans was \$208,000 and \$492,000 for the three and nine months ended September 30, 2018 respectively, and \$138,000 and \$496,000 for the 2013 Plan during the three and nine months ended September 30, 2017, respectively.

Stock Options

Both plans consist of stock option awards that may be granted as incentive stock options or non-qualified stock options. Options typically vest over a period of five years with 20% vesting on the anniversary date of each grant date as long as the award recipient remains in service to the Company. The options are exercisable after vesting for up to the remaining term of the original grant. The maximum term of the options granted is 10 years. Any unexercised stock options will expire 10 years after the grant date or sooner in the event of the award recipient’s termination of service with the Company or the Bank. At September 30, 2018, there were 6,013 and 387,000 option share awards available to be granted under the 2013 Plan and the 2018 Plan, respectively.

The fair value of each option award is estimated on the grant date using a Black-Scholes Option pricing model that uses the following assumptions. The dividend yield is based on the current quarterly dividend in effect at the time of the grant. Historical employment data is used to estimate the forfeiture rate. The Company elected to use Staff Accounting Bulletin 107, simplified expected term calculation for the “Share-Based Payments” method permitted by the SEC to calculate the expected term. This method uses the vesting term of an option along with the contractual term, setting the expected life at 6.5 years.



Table of Contents

The following table presents a summary of the Company's stock option awards during the nine months ended September 30, 2018 (shown as actual):

	Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term In Years	Aggregate Intrinsic Value
Outstanding at January 1, 2018	256,237	\$ 16.89	6.36	\$ 9,655,010
Granted	100,000	58.60	6.50	—
Less exercised	40,633	\$ 16.89	—	\$ 1,662,233
Forfeited or expired	—	—	—	—
Outstanding at September 30, 2018	315,604	\$ 30.11	6.88	\$ 8,371,903
Expected to vest, assuming a 0.31% annual forfeiture rate (1)	314,601	\$ 30.03	6.88	\$ 8,367,470
Exercisable at September 30, 2018	154,804	\$ 16.89	5.45	\$ 6,011,039

(1) Forfeiture rate has been calculated and estimated to assume a forfeiture of 1/32 over the 10-year contractual life, or 3.1% of the options forfeited over 10 years.

At September 30, 2018, there was \$1.4 million of total unrecognized compensation cost related to nonvested stock options granted under both plans. The cost is expected to be recognized over the remaining weighted-average vesting period of 4.5 years.

#### Restricted Stock Awards

The RSAs' fair value is equal to the value on the grant date. Compensation expense is recognized over the vesting period of the awards based on the fair value of the restricted stock. Shares in the 2013 Plan awarded as restricted stock typically vest ratably over a three-year period for directors and a five-year period for employees, beginning at the grant date, and for the 2018 Plan, shares typically vest ratably over a five-year period for both directors and employees beginning at the grant date. Any unvested RSAs will expire after vesting or sooner in the event of the award recipient's termination of service with the Company or the Bank.

The following table presents a summary of the Company's nonvested awards during the nine months ended September 30, 2018 (shown as actual):

Nonvested Shares	Shares	Weighted-Average Grant-Date Fair Value Per Share
Nonvested at January 1, 2018	36,842	\$ 17.63
Granted	25,000	58.60
Less vested	18,421	\$ 17.63
Forfeited or expired	—	—
Nonvested at September 30, 2018	43,421	\$ 41.22

At September 30, 2018, there was \$1.6 million of total unrecognized compensation costs related to nonvested shares granted as RSAs for both plans. The cost is expected to be recognized over the remaining weighted-average vesting period of 4.4 years.

NOTE 12 - REGULATORY CAPITAL

The Company and the Bank are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company's consolidated

Table of Contents

financial statements. Under capital adequacy guidelines of the regulatory framework for prompt corrective action, the Bank must meet specific capital adequacy guidelines that involve quantitative measures of the Bank's assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The Bank's capital classification is also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the table below) of Tier 1 capital (as defined in the regulations) to total average assets (as defined), and minimum ratios of Tier 1 total capital (as defined) and common equity Tier 1 ("CET 1") capital to risk-weighted assets (as defined).

The Bank must maintain minimum total risk-based, Tier 1 risk-based, Tier 1 leverage, and CET 1 capital ratios as set forth in the table below to be categorized as well capitalized. At September 30, 2018 and December 31, 2017, the Bank was categorized as well capitalized under applicable regulatory requirements. There are no conditions or events since that notification that management believes have changed the Bank's category. Management believes, at September 30 2018, that the Company and the Bank met all capital adequacy requirements.

The following table compares the Bank's actual capital amounts and ratios at September 30, 2018 and December 31, 2017 to their minimum regulatory capital requirements and well capitalized regulatory capital at those dates (dollars in thousands):

Bank Only	Actual Amount	Ratio	For Capital Adequacy Purposes		For Capital Adequacy with Capital Buffer		To be Well Capitalized Under Prompt Corrective Action Provisions	
			Amount	Ratio	Amount	Ratio	Amount	Ratio
At September 30, 2018								
Total risk-based capital (to risk-weighted assets)	\$ 147,950	15.20 %	\$ 77,881	8.00 %	\$ 96,182	9.88 %	\$ 97,351	10.00 %
Tier 1 risk-based capital (to risk-weighted assets)	\$ 135,780	13.95 %	\$ 58,410	6.00 %	\$ 76,712	7.88 %	\$ 77,881	8.00 %
Tier 1 leverage capital (to average assets)	\$ 135,780	11.73 %	\$ 46,305	4.00 %	N/A	N/A	\$ 57,881	5.00 %
CET 1 capital (to risk-weighted assets)	\$ 135,780	13.95 %	\$ 43,808	4.50 %	\$ 74,279	7.63 %	\$ 63,278	6.50 %
At December 31, 2017								
Total risk-based capital								

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(to risk-weighted assets) Tier 1 risk-based capital	\$ 133,967	16.25 %	\$ 65,965	8.00 %	\$ 76,272	9.25 %	\$ 82,456	10.00 %
(to risk-weighted assets) Tier 1 leverage capital	\$ 123,651	15.00 %	\$ 49,474	6.00 %	\$ 59,781	7.25 %	\$ 65,965	8.00 %
(to average assets) CET 1 capital	\$ 123,651	12.61 %	\$ 39,233	4.00 %	N/A	N/A	\$ 49,041	5.00 %
(to risk-weighted assets)	\$ 123,651	15.00 %	\$ 37,105	4.50 %	\$ 47,412	5.75 %	\$ 53,597	6.50 %

In addition to the minimum CET 1, Tier 1, total capital, and leverage ratios, the Bank now has to maintain a capital conservation buffer consisting of additional CET 1 capital above the required minimum levels in order to avoid limitations on paying dividends, engaging in share repurchases, and paying discretionary bonuses based on percentages of eligible

Table of Contents

retained income that could be utilized for such actions. The capital conservation buffer requirement was phased-in on January 1, 2016 when more than 0.625% of risk-weighted assets was required and increases by 0.625% on each subsequent January 1, until fully implemented to an amount more than 2.5% of risk-weighted assets in January 2019. At September 30, 2018, the Bank's CET 1 capital exceeded the required capital conservation buffer of an amount more than 1.875%.

FS Bancorp, Inc. is a bank holding company subject to the capital adequacy requirements of the Federal Reserve under the Bank Holding Company Act of 1956, as amended, and the regulations of the Federal Reserve. For a bank holding company with less than \$1.0 billion in assets (as of June 30th of the preceding year), the capital guidelines apply on a bank only basis and the Federal Reserve expects the holding company's subsidiary bank to be well capitalized under the prompt corrective action regulations. At September 30, 2018, FS Bancorp, Inc. was subject to regulatory guidelines for bank holding companies with \$1.0 billion or more in assets and exceeded all regulatory capital requirements. The regulatory capital ratios calculated for FS Bancorp, Inc. at September 30, 2018 were 11.4% for Tier 1 leverage-based capital, 13.6% for Tier 1 risk-based capital, 14.9% for total risk-based capital, and 13.6% for CET 1 capital ratio.

NOTE 13 - BUSINESS SEGMENTS

The Company's business segments are determined based on the products and services provided, as well as the nature of the related business activities, and they reflect the manner in which financial information is currently evaluated by management. This process is dynamic and is based on management's current view of the Company's operations and is not necessarily comparable with similar information for other financial institutions. We define our business segments by product type and customer segment which we have organized into two lines of business: commercial and consumer banking and home lending.

We use various management accounting methodologies to assign certain income statement items to the responsible operating segment, including:

- a funds transfer pricing ("FTP") system, which allocates interest income credits and funding charges between the segments, assigning to each segment a funding credit for its liabilities, such as deposits, and a charge to fund its assets;

- a cost per loan serviced allocation based on the number of loans being serviced on the balance sheet and the number of loans serviced for third parties;

- an allocation based upon the approximate square footage utilized by the home lending segment in Company owned locations;

- an allocation of charges for services rendered to the segments by centralized functions, such as corporate overhead, which are generally based on the number of full time employees ("FTEs") in each segment; and

- an allocation of the Company's consolidated income taxes which are based on the effective tax rate applied to the segment's pretax income or loss.

The FTP methodology is based on management's estimated cost of originating funds including the cost of overhead for deposit generation.

A description of the Company's business segments and the products and services that they provide is as follows:

Commercial and Consumer Banking Segment

The commercial and consumer banking segment provides diversified financial products and services to our commercial and consumer customers through Bank branches, automated teller machines (“ATM”), online banking platforms, mobile banking apps, and telephone banking. These products and services include deposit products; residential, consumer, business and commercial real estate lending portfolios and cash management services. We originate consumer loans, commercial and multi-family real estate loans, residential and multi-family construction loans, and commercial business loans. At September 30, 2018, our retail deposit branch network consisted of 12 branches and one administrative office that accepts deposits in the Pacific Northwest. At September 30, 2018 and December 31, 2017, our deposits totaled \$944.5

Table of Contents

million and \$829.8 million, respectively. This segment is also responsible for the management of our investment portfolio and other assets of the Bank.

## Home Lending Segment

The home lending segment originates one-to-four-family residential mortgage loans primarily for sale in the secondary markets as well as originating adjustable rate mortgage (“ARM”) loans held for investment. The majority of our mortgage loans are sold to or securitized by FNMA, FHLMC, GNMA, or FHLB, while we retain the right to service these loans. Loans originated under the guidelines of the Federal Housing Administration or FHA, US Department of Veterans Affairs or VA, and United States Department of Agriculture or USDA are generally sold servicing released to a correspondent bank or mortgage company. We have the option to sell loans on a servicing-released or servicing-retained basis to securitizers and correspondent lenders. A small percentage of our loans are brokered to other lenders. On occasion, we may sell a portion of our MSR portfolio and we may sell small pools of loans originated for the portfolio. We manage the loan funding and the interest rate risk associated with the secondary market loan sales and the retained one-to-four-family mortgage servicing rights within this business segment. One-to-four-family loans originated for investment are allocated to the home lending segment with a corresponding provision expense and FTP for cost of funds.

## Segment Financial Results

The tables below summarize the financial results for each segment based primarily on the number of FTEs and assets within each segment for the three and nine months ended September 30, 2018 and 2017:

	At or For the Three Months Ended September 30, 2018		
	Home Lending	Commercial and Consumer Banking	Total
Condensed income statement:			
Net interest income (1)	\$ 946	\$ 11,912	\$ 12,858
Provision for loan losses	(55)	(395)	(450)
Noninterest income	3,606	1,196	4,802
Noninterest expense	(4,113)	(7,725)	(11,838)
Income before provision for income taxes	384	4,988	5,372
Provision for income taxes	(104)	(1,216)	(1,320)
Net income	\$ 280	\$ 3,772	\$ 4,052
Total average assets at period end	\$ 241,164	\$ 920,742	\$ 1,161,906
FTEs	114	231	345

	At or For the Three Months Ended September 30, 2017		
	Home Lending	Commercial and Consumer Banking	Total

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Condensed income statement:

Net interest income (1)	\$ 812	\$ 10,210	\$ 11,022
Provision for loan losses	(127)	(323)	(450)
Noninterest income	5,014	1,413	6,427
Noninterest expense	(4,586)	(7,003)	(11,589)
Income before provision for income taxes	1,113	4,297	5,410
Provision for income taxes	(407)	(1,549)	(1,956)
Net income	\$ 706	\$ 2,748	\$ 3,454
Total average assets at period end	\$ 220,898	\$ 744,820	\$ 965,718
FTEs	119	204	323



Table of Contents

	At or For the Nine Months Ended September 30, 2018		
	Home Lending	Commercial and Consumer Banking	Total
Condensed income statement:			
Net interest income (1)	\$ 2,425	\$ 33,855	\$ 36,280
Provision for loan losses	(200)	(1,050)	(1,250)
Noninterest income	11,819	3,621	15,440
Noninterest expense	(12,677)	(22,341)	(35,018)
Income before provision for income taxes	1,367	14,085	15,452
Provision for income taxes	(250)	(2,572)	(2,822)
Net income	\$ 1,117	\$ 11,513	\$ 12,630
Total average assets at period end	\$ 226,836	\$ 860,858	\$ 1,087,694
FTEs	114	231	345

	At or For the Nine Months Ended September 30, 2017		
	Home Lending	Commercial and Consumer Banking	Total
Condensed income statement:			
Net interest income (1)	\$ 1,857	\$ 28,105	\$ 29,962
Provision for loan losses	(324)	(126)	(450)
Noninterest income	14,863	3,941	18,804
Noninterest expense	(12,985)	(19,924)	(32,909)
Income before provision for income taxes	3,411	11,996	15,407
Provision for income taxes	(1,107)	(3,894)	(5,001)
Net income	\$ 2,304	\$ 8,102	\$ 10,406
Total average assets at period end	\$ 196,765	\$ 706,017	\$ 902,782
FTEs	119	204	323

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(1) Net interest income is the difference between interest earned on assets and the cost of liabilities to fund those assets. Interest earned includes actual interest earned on segment assets and, if the segment has excess liabilities, interest credits for providing funding to the other segment. The cost of liabilities includes interest expense on segment liabilities and, if the segment does not have enough liabilities to fund its assets, a funding charge based on the cost of assigned liabilities to fund segment assets.

## NOTE 14 - GOODWILL AND OTHER INTANGIBLE ASSETS

Goodwill and certain other intangibles generally arise from business combinations accounted for under the purchase method of accounting. Goodwill totaled \$2.3 million at September 30, 2018 and December 31, 2017, and represents the excess of the total acquisition price paid over the fair value of the assets acquired, net of the fair values of liabilities assumed. Goodwill is not amortized but is evaluated for impairment on an annual basis at December 31 of each year or whenever events or changes in circumstances indicate the carrying value may not be recoverable. The Company performed an impairment analysis at December 31, 2017, and determined that no impairment of goodwill existed. No events or circumstances since the December 31, 2017 annual impairment test were noted that would indicate it was more likely than not a goodwill impairment existed at September 30, 2018.

Table of Contents

The following table summarizes the changes in the Company's other intangible assets for the year ended December 31, 2017, and the nine months ended September 30, 2018.

	Other Intangible Assets		
	Gross	Accumulated Amortization	Net
Balance, December 31, 2016	\$ 2,239	\$ (522)	\$ 1,717
Amortization	—	(400)	(400)
Balance, December 31, 2017	2,239	(922)	1,317
Amortization	—	(230)	(230)
Balance, September 30, 2018	\$ 2,239	\$ (1,152)	\$ 1,087

The core deposit intangible represents the fair value of the acquired core deposit base. The core deposit intangible will be amortized on an accelerated basis over approximately nine years. Total amortization expense was \$77,000 and \$230,000 for the three and nine months ended September 30, 2018, and \$100,000 and \$300,000 for the same period in 2017. Amortization expense for core deposit intangible is expected to be as follows at September 30, 2018:

Remainder of 2018	\$ 77
2019	235
2020	181
2021	166
2022	166
Thereafter	262
Total	\$ 1,087

**NOTE 15 - REVENUE FROM CONTRACTS WITH CUSTOMERS**

As noted in Note 1, the Company adopted the provisions of ASU No. 2014-09, Revenue from Contracts with Customers (Topic 606), on January 1, 2018 and all subsequent ASUs that modified Topic 606. Results for reporting periods beginning after December 31, 2017 are presented under Topic 606, while prior period amounts have not been adjusted and continue to be reported in accordance with Topic 605.

**Revenue Recognition**

In accordance with Topic 606, revenues are recognized when control of promised goods or services is transferred to customers in an amount that reflects the consideration the Company expects to be entitled to in exchange for those goods or services. To determine revenue recognition for arrangements that an entity determines are within the scope of Topic 606, the Company performs the following five steps: (i) identify the contract(s) with a customer; (ii) identify the performance obligations in the contract; (iii) determine the transaction price; (iv) allocate the transaction price to the performance obligations in the contract; and (v) recognize revenue when (or as) the Company satisfies a performance obligation. The Company only applies the five-step model to contracts when it is probable that the entity will collect the consideration it is entitled to in exchange for the goods or services it transfers to the customer. At contract inception, once the contract is determined to be within the scope of Topic 606, the Company assesses the goods or

services that are promised within each contract and identifies those that contain performance obligations, and assesses whether each promised good or service is distinct. The Company then recognizes as revenue the amount of the transaction price that is allocated to the respective performance obligation when (or as) the performance obligation is satisfied.

All of the Company's revenue from contracts with customers in scope of ASC 606 is recognized in noninterest income and included in our commercial and consumer banking segment. For the three months ended September 30, 2018, the Company recognized \$569,000 in total deposit fees, which included \$274,000 of debit card interchange fees and \$117,000 of fees from non-sufficient funds, both considered within the scope of ASC 606, and \$4.4 million of noninterest income considered not within the scope of ASC 606. For the nine months ended September 30, 2018, the Company recognized \$1.7 million in total deposit fees, which included \$815,000 of debit card interchange fees and \$354,000 of fees from non-

## Table of Contents

sufficient funds, both considered within the scope of ASC 606, and \$14.3 million of noninterest income considered not within the scope of ASC 606.

### Deposit Fees

The Bank earns fees from its deposit customers for account maintenance, transaction-based and overdraft services. Account maintenance fees consist primarily of account fees and analyzed account fees charged on deposit accounts on a monthly basis. The performance obligation is satisfied and the fees are recognized on a monthly basis as the service period is completed. Transaction-based fees on deposits accounts are charged to deposit customers for specific services provided to the customer, such as non-sufficient funds fees, overdraft fees, and wire fees. The performance obligation is completed as the transaction occurs and the fees are recognized at the time each specific service is provided to the customer.

### Debit Interchange Income

Debit and ATM interchange income represent fees earned when a debit card issued by the Bank is used. The Bank earns interchange fees from debit cardholder transactions through the Visa payment network. Interchange fees from cardholder transactions represent a percentage of the underlying transaction value and are recognized daily, concurrently with the transaction processing services provided to the cardholder. The performance obligation is satisfied and the fees are earned when the cost of the transaction is charged to the cardholders' debit card. Certain expenses directly associated with the debit card are recorded on a net basis with the interchange income.

### NOTE 16 - PROPOSED MERGER

On July 17, 2018, the Company entered into a definitive agreement (the "Agreement") with Anchor Bancorp, headquartered in Lacey, Washington ("Anchor"), pursuant to which Anchor will be merged with and into the Company, and immediately thereafter Anchor's bank subsidiary, Anchor Bank, will be merged with and into 1st Security Bank of Washington (the "Anchor Merger"). Anchor Bank has nine full-service banking offices within Grays Harbor, Thurston, Lewis, and Pierce counties, and one loan production office located in King County, Washington. Under the terms of the Agreement, Anchor shareholders will receive 0.2921 shares of FS Bancorp common stock and \$12.40 in cash for each share of Anchor common stock. FS Bancorp will pay aggregate consideration of 725,585 shares of FS Bancorp common stock and \$30.8 million in cash, or approximately \$73.3 million in aggregate, including the value of outstanding shares of Anchor restricted stock.

In the event the Agreement is terminated under certain specified circumstances in connection with a competing transaction, Anchor will be required to pay the Company a termination fee of \$2.7 million in cash. All of the directors of Anchor have agreed to vote their shares of Anchor common stock in favor of approval of the Agreement. Regulatory approval for the proposed merger has been received. The proposed transaction is subject to customary closing conditions and approval of the Agreement by the shareholders of Anchor, which is scheduled for November 13, 2018. Management anticipates closing the transaction shortly after Anchor's shareholder approval is received.

At September 30, 2018, Anchor reported total assets of \$478.9 million, loans receivable, net of \$369.3 million and total deposits of \$365.7 million.

Table of Contents

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Forward-Looking Statements

This report contains forward-looking statements, which can be identified by the use of words such as “believes,” “expects,” “anticipates,” “estimates,” or similar expressions. Forward-looking statements include, but are not limited to:

- statements of our goals, intentions, and expectations;
- statements regarding our business plans, prospects, growth, and operating strategies;
- statements regarding the quality of our loan and investment portfolios; and
- estimates of our risks and future costs and benefits.

These forward-looking statements are subject to significant risks and uncertainties. Actual results may differ materially from those contemplated by the forward-looking statements due to, among others, the following factors:

- the expected cost savings, synergies and other financial benefits from our pending merger with Anchor Bancorp (“Anchor”) might not be realized within the expected time frames or at all;
- remaining conditions to the closing of the merger may not be satisfied;
- the shareholders of Anchor may fail to approve the consummation of the merger;
- the integration of the combined company, including personnel changes/retention, might not proceed as planned;
- the combined company might not perform as well as expected;
- general economic conditions, either nationally or in our market area, that are worse than expected;
- the credit risks of lending activities, including changes in the level and trend of loan delinquencies, write offs, changes in our allowance for loan losses, and provision for loan losses that may be impacted by deterioration in the housing and commercial real estate markets;
- secondary market conditions and our ability to sell loans in the secondary market;
- fluctuations in the demand for loans, the number of unsold homes, land and other properties, and fluctuations in real estate values in our market area;
- staffing fluctuations in response to product demand or the implementation of corporate strategies that affect our workforce and potential associated charges;
- increases in premiums for deposit insurance;
- the use of estimates in determining fair value of certain of our assets, which estimates may prove to be incorrect and result in significant declines in valuation;
- changes in the interest rate environment that reduce our interest margins or reduce the fair value of financial instruments;
- increased competitive pressures among financial services companies;
- our ability to execute our plans to grow our residential construction lending, our home lending operations, our warehouse lending, and the geographic expansion of our indirect home improvement lending;
- our ability to attract and retain deposits;
- our ability to control operating costs and expenses;
- our ability to retain key members of our senior management team;
- changes in consumer spending, borrowing, and savings habits;
- our ability to successfully manage our growth;
- legislative or regulatory changes that adversely affect our business, including the effect of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, changes in regulation policies and principles, an increase in regulatory capital requirements or change in the interpretation of regulatory capital or other rules, including as a result of Basel III;
- adverse changes in the securities markets;

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- changes in accounting policies and practices, as may be adopted by the bank regulatory agencies, the Public Company Accounting Oversight Board or the Financial Accounting Standards Board;
- costs and effects of litigation, including settlements and judgments;

43

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## Table of Contents

- disruptions, security breaches, or other adverse events, failures, or interruptions in, or attacks on, our information technology systems or on the third-party vendors who perform several of our critical processing functions;
- our ability to implement our branch expansion strategy;
- inability of key third-party vendors to perform their obligations to us; and
- other economic, competitive, governmental, regulatory, and technical factors affecting our operations, pricing, products, and services and other risks described elsewhere in this Form 10 Q and our other reports filed with the U.S. Securities and Exchange Commission, including our Annual Report on Form 10 K for the year ended December 31, 2017.

Any of the forward-looking statements made in this Form 10 Q and in other public statements may turn out to be wrong because of inaccurate assumptions we might make, because of the factors illustrated above or because of other factors that we cannot foresee. Forward-looking statements are based upon management's beliefs and assumptions at the time they are made. The Company undertakes no obligation to update or revise any forward-looking statement included in this report or to update the reasons why actual results could differ from those contained in such statements, whether as a result of new information, future events or otherwise. In light of these risks, uncertainties and assumptions, the forward-looking statements discussed in this report might not occur and you should not put undue reliance on any forward-looking statements.

## Overview

FS Bancorp, Inc. and its subsidiary bank, 1st Security Bank of Washington have been serving the Puget Sound area since 1936. Originally chartered as a credit union, known as Washington's Credit Union, the credit union served various select employment groups. On April 1, 2004, the credit union converted to a Washington state-chartered mutual savings bank. On July 9, 2012, the Bank converted from mutual to stock ownership and became the wholly owned subsidiary of FS Bancorp, Inc.

The Company is relationship-driven, delivering banking and financial services to local families, local and regional businesses and industry niches within distinct Puget Sound area communities, and one loan production office located in the Tri-Cities, Washington. The Company also maintains its long-standing indirect consumer lending platform which operates throughout the western region of the United States. The Company emphasizes long-term relationships with families and businesses within the communities served, working with them to meet their financial needs. The Company is also actively involved in community activities and events within these market areas, which further strengthens our relationships within those markets.

The Company focuses on diversifying revenues, expanding lending channels, and growing the banking franchise. Management remains focused on building diversified revenue streams based upon credit, interest rate, and concentration risks. Our business plan remains as follows:

- Growing and diversifying our loan portfolio;
- Maintaining strong asset quality;
- Emphasizing lower cost core deposits to reduce the costs of funding our loan growth;
- Capturing our customers' full relationship by offering a wide range of products and services by leveraging our well-established involvement in our communities and by selectively emphasizing products and services designed to meet our customers' banking needs; and
- Expanding the Company's markets.

The Company is a diversified lender with a focus on the origination of one-to-four-family loans, commercial real estate mortgage loans, second mortgage or home equity loan products, consumer loans including home improvement ("fixture secured") loans and marine lending, and commercial business loans. As a result of our expanding lending channels, the Company experienced growth in warehouse lending as part of our business plan to diversify revenues. Historically, consumer loans, in particular, fixture secured loans had represented the largest portion of the

Company's loan portfolio and had traditionally been the mainstay of the Company's lending strategy. In recent years, the Company has placed more of an emphasis on real estate lending products, such as one-to-four-family loans, commercial real estate loans, including speculative residential construction loans, as well as commercial business loans, while growing the current size of the consumer loan portfolio.

Table of Contents

Consumer loans, in particular indirect home improvement loans to finance window replacement, gutter replacement, siding replacement, solar panels, pools, and other improvement renovations is a large and regionally expanding segment of the loan portfolio. Stage funded loans for pools had an outstanding balance of \$1.3 million with an original committed balance of \$1.6 million at September 30, 2018. Consumer lending is dependent on the Bank's contractor/dealer network of 157 active dealers located throughout Washington, Oregon, California, Idaho, and within the past twelve months, Colorado and Arizona, with 10 contractor/dealers responsible for 52.9% of the funded loans dollar volume. The Company funded \$38.7 million, or approximately 1,900 loans during the quarter ended September 30, 2018. The following table details total consumer funded loan originations by state for the periods indicated:

State	For the Nine Months Ended September 30, 2018		For the Twelve Months Ended December 31, 2017	
	Amount	Percent	Amount	Percent
Washington	\$ 46,775	42.0 %	\$ 37,748	35.3 %
Oregon	35,435	31.9	43,678	40.9
California	22,652	20.4	20,246	18.9
Idaho	4,361	3.9	5,142	4.8
Colorado	1,864	1.7	108	0.1
Arizona	151	0.1	—	—
Total consumer loans	\$ 111,238	100.0 %	\$ 106,922	100.0 %

The Company originates one-to-four-family residential mortgage loans through referrals from real estate agents, financial planners, builders, and from existing customers. Retail banking customers are also an important source of the Company's loan originations. The Company originated \$555.3 million of one-to-four-family loans which includes loans held for sale, loans held for investment, and fixed seconds in addition to loans brokered to other institutions of \$5.1 million through the home lending segment during the nine months ended September 30, 2018, of which \$490.6 million were sold to investors. Of the loans sold to investors, \$326.4 million were sold to the FNMA, FHLMC, FHLB, and/or GNMA with servicing rights retained for the purpose of further developing these customer relationships. At September 30, 2018, one-to-four-family residential mortgage loans held for investment, which excludes loans held for sale of \$54.8 million, totaled \$188.3 million, or 19.6%, of the total gross loan portfolio.

The Company expanded its residential construction and commercial real estate lending team in 2011 with a focus on vertical, in-city one-to-four-family development in our market area. This team has over 60 years of combined experience and expertise in commercial real estate and multi-family acquisition, development and construction ("ADC") lending in the Puget Sound market area and the related take-out financing as applicable. The Company has implemented this strategy to take advantage of what is believed to be a strong demand for construction and ADC loans to experienced, successful and relationship driven builders in our market area.

The Company originates commercial business loans and lines of credit to local small- and mid-sized businesses in the Puget Sound market area that are secured by accounts receivable, inventory or property, plant and equipment. Consistent with management's objectives to expand commercial business lending, in 2009, the Company commenced a mortgage warehouse lending program through which the Company funds third-party residential mortgage bankers. Under this program the Company provides short-term funding to the mortgage banking companies for the purpose of originating residential mortgage loans for sale into the secondary market. In 2013, the Company expanded this program to include commercial construction warehouse lines along with residential construction lending.

Since 2012, the Company has had an emphasis on diversifying lending products by expanding commercial real estate, commercial business, and residential lending, while maintaining the current volume of production and historical

growth of the consumer loan portfolio. The Company's lending strategies are intended to take advantage of: (1) historical strength in indirect consumer lending, (2) recent market consolidation that has created new lending opportunities and the availability of experienced bankers, and (3) strength in relationship lending. Retail deposits will continue to serve as an important funding source.

Recently, improvements in the economy, employment rates, stronger real estate prices, and a general lack of new housing inventory has resulted in our significantly increasing originations of construction loans for properties located in our market

## Table of Contents

areas. We anticipate that construction and development lending will continue to be a strong element of our total loan portfolio in future periods. We will continue to take a disciplined approach in our construction and development lending by concentrating our efforts on loans to builders and developers in our market areas known to us. These short term loans typically mature in six to twelve months. In addition, the funding is usually not fully disbursed at origination, thereby reducing our net loans receivable in the short term.

The Company is significantly affected by prevailing economic conditions, as well as government policies and regulations concerning, among other things, monetary and fiscal affairs. Deposit flows are influenced by a number of factors, including interest rates paid on time deposits, other investments, account maturities, and the overall level of personal income and savings. Lending activities are influenced by the demand for funds, the number and quality of lenders, and regional economic cycles. Sources of funds for lending activities include primarily deposits, including brokered deposits, borrowings, payments on loans, and income provided from operations.

The Company's earnings are primarily dependent upon net interest income, the difference between interest income and interest expense. Interest income is a function of the balances of loans and investments outstanding during a given period and the yield earned on these loans and investments. Interest expense is a function of the amount of deposits and borrowings outstanding during the same period and interest rates paid on these deposits and borrowings. Another significant influence on the Company's earnings is fee income from mortgage banking activities. The Company's earnings are also affected by the provision for loan losses, service charges and fees, gains from sales of assets, operating expenses and income taxes.

### Critical Accounting Policies and Estimates

Certain of the Company's accounting policies are important to the portrayal of the Company's financial condition, since they require management to make difficult, complex, or subjective judgments, some of which may relate to matters that are inherently uncertain. Estimates associated with these policies are susceptible to material changes as a result of changes in facts and circumstances. Facts and circumstances which could affect these judgments include, but are not limited to, changes in interest rates, changes in the performance of the economy, and changes in the financial condition of borrowers. Management believes that its critical accounting policies include the following:

Allowance for Loan and Lease Losses ("ALLL"). The ALLL is the amount estimated by management as necessary to cover probable losses inherent in the loan portfolio at the balance sheet date. The allowance is established through the provision for loan losses, which is charged to income. A high degree of judgment is necessary when determining the amount of the ALLL. Among the material estimates required to establish the allowance are: loss exposure at default; the amount and timing of future cash flows on impacted loans; value of collateral; and determination of loss factors to be applied to the various elements of the portfolio. All of these estimates are susceptible to significant change. Management reviews the level of the allowance at least quarterly and establishes the provision for loan losses based upon an evaluation of the portfolio, past loss experience, current economic conditions, and other factors related to the collectability of the loan portfolio. Although the Company believes that use of the best information available currently establishes the ALLL, future adjustments to the allowance may be necessary if economic conditions differ substantially from the assumptions used in making the evaluation. As the Company adds new products to the loan portfolio and expands the Company's market area, management intends to enhance and adapt the methodology to keep pace with the size and complexity of the loan portfolio. Changes in any of the above factors could have a significant effect on the calculation of the ALLL in any given period. Management believes that its systematic methodology continues to be appropriate given the Company's increased size and level of complexity.

Servicing Rights. Servicing assets are recognized as separate assets when rights are acquired through the purchase or through the sale of financial assets. Generally, purchased servicing rights are capitalized at the cost to acquire the rights. For sales of mortgage, commercial and consumer loans, a portion of the cost of originating the loan is allocated

to the servicing right based on relative fair value. Fair value is based on market prices for comparable mortgage, commercial, or consumer servicing contracts, when available, or alternatively, is based on a valuation model that calculates the present value of estimated future net servicing income. The valuation model incorporates assumptions that market participants would use in estimating future net servicing income, such as the cost to service, the discount rate, the custodial earnings rate, an inflation rate, ancillary income, prepayment speeds, and default rates and losses. Servicing assets are evaluated quarterly for impairment based upon the fair value of the rights as compared to amortized cost. Impairment is determined

Table of Contents

by stratifying rights into tranches based on predominant characteristics, such as interest rate, loan type, and investor type. Impairment is recognized through a valuation allowance for an individual tranche, to the extent that fair value is less than the capitalized amount for the tranches. If the Company later determines that all or a portion of the impairment no longer exists for a particular tranche, a reduction of the allowance may be recorded as a recovery and an increase to income. Capitalized servicing rights are stated separately on the consolidated balance sheets and are amortized into noninterest income in proportion to, and over the period of, the estimated future net servicing income of the underlying financial assets.

**Derivatives and Hedging Activity.** ASC 815, “Derivatives and Hedging,” requires that derivatives of the Company be recorded in the consolidated financial statements at fair value. Management considers its accounting policy for derivatives to be a critical accounting policy because these instruments have certain interest rate risk characteristics that change in value based upon changes in the capital markets. The Company’s derivatives are primarily the result of its mortgage banking activities in the form of commitments to extend credit, commitments to sell loans, TBA mortgage-backed securities trades and option contracts to mitigate the risk of the commitments to extend credit. Estimates of the percentage of commitments to extend credit on loans to be held for sale that may not fund are based upon historical data and current market trends. The fair value adjustments of the derivatives are recorded in the Consolidated Statements of Income with offsets to other assets or other liabilities on the Consolidated Balance Sheets.

**Income Taxes.** Income taxes are reflected in the Company’s consolidated financial statements to show the tax effects of the operations and transactions reported in the consolidated financial statements and consist of taxes currently payable plus deferred taxes. ASC 740, “Accounting for Income Taxes,” requires the asset and liability approach for financial accounting and reporting for deferred income taxes. Deferred tax assets and liabilities result from differences between the financial statement carrying amounts and the tax bases of assets and liabilities. They are reflected at currently enacted income tax rates applicable to the period in which the deferred tax assets or liabilities are expected to be realized or settled and are determined using the assets and liability method of accounting. The deferred income provision represents the difference between net deferred tax asset/liability at the beginning and end of the reported period. In formulating the deferred tax asset, the Company is required to estimate income and taxes in the jurisdiction in which the Company operates. This process involves estimating the actual current tax exposure for the reported period together with assessing temporary differences resulting from differing treatment of items, such as depreciation and the provision for loan losses, for tax and financial reporting purposes.

Deferred tax assets and liabilities occur when taxable income is larger or smaller than reported income on the income statements due to accounting valuation methods that differ from tax, as well as tax rate estimates and payments made quarterly and adjusted to actual at the end of the year. Deferred tax assets and liabilities are temporary differences payable in future periods. The Company had net deferred tax assets of \$120,000 and net deferred tax liabilities of \$607,000, at September 30, 2018 and December 31, 2017, respectively.

#### Comparison of Financial Condition at September 30, 2018 and December 31, 2017

**Assets.** Total assets increased \$209.5 million, or 21.3%, to \$1.2 billion at September 30, 2018, from \$981.8 million at December 31, 2017, primarily as a result of a \$186.0 million, or 24.4% increase in loans receivable, net, a \$14.9 million, or 18.1% increase in securities available-for-sale, a \$4.3 million, or 148.4% increase in FHLB stock, a \$3.3 million, or 31.5% increase in BOLI, a \$2.4 million increase in servicing rights, a \$1.3 million increase in loans held for sale, and a \$1.0 million increase in premises and equipment, net, partially offset by a \$3.7 million, or 19.6% decrease in total cash and cash equivalents. The increases in total assets were primarily funded by deposit growth and FHLB borrowings.

Loans receivable, net increased \$186.0 million, or 24.4% to \$947.6 million at September 30, 2018, from \$761.6 million at December 31, 2017. Total real estate loans increased \$82.3 million including increases in construction and

development loans of \$48.1 million, one-to-four-family portfolio loans of \$24.7 million, which is net of an \$8.6 million portfolio loan sale, commercial loans of \$5.1 million, and multi-family loans of \$3.6 million. Undisbursed construction and development loan commitments increased \$12.6 million, or 17.2%, to \$86.0 million at September 30, 2018, as compared to \$73.3 million at December 31, 2017. Total commercial business loans increased \$56.6 million, mostly due to an increase in commercial and industrial (“C&I”) lending of \$30.5 million, including purchases of \$12.0 million in shared national credits and \$9.7 million in U.S. Department of Agriculture loans. Total consumer loans increased \$48.8 million, reflecting primarily growth of \$25.7 million in indirect home improvement loans and \$21.2 million in marine loans.



Table of Contents

Loans held for sale, consisting of one-to-four-family loans, increased by \$1.3 million, or 2.5% to \$54.8 million at September 30, 2018, from \$53.5 million at December 31, 2017. The Company continues to build its home lending operations by developing additional lending niches and will continue selling one-to-four-family loans into the secondary market for asset/liability management purposes.

One-to-four-family loan originations, including \$485.5 million of loans originated for sale, \$64.7 million of portfolio loans including first and second liens, and \$5.1 million of loans brokered to other institutions, decreased \$48.1 million, or 8.0% to \$555.3 million during the nine months ended September 30, 2018, compared to \$603.4 million during the nine months ended September 30, 2017. Originations of one-to-four-family loans to purchase a home (purchase production) decreased by \$27.5 million, or 5.9% with \$436.8 million in loan purchase production closing during the nine months ended September 30, 2018, down from \$464.3 million during the nine months ended September 30, 2017. One-to-four-family loan originations for refinance (refinance production) decreased \$20.0 million, or 14.6% with \$116.6 million in refinance production closing during the nine months ended September 30, 2018, down from \$136.6 million during the nine months ended September 30, 2017. During the nine months ended September 30, 2018, the Company sold \$490.6 million of one-to-four-family loans, compared to sales of \$511.8 million for the same period one year ago. In addition, the margin on loans sold decreased to 2.50% for the nine months ended September 30, 2018, compared to 2.53% for the nine months ended September 30, 2017.

The ALLL at September 30, 2018 increased to \$12.0 million, or 1.3% of gross loans receivable, excluding loans held for sale, compared to \$10.8 million, or 1.4% of gross loans receivable, excluding loans held for sale, at December 31, 2017. Substandard loans increased to \$7.4 million at September 30, 2018, compared to \$6.5 million at December 31, 2017, primarily from the addition of one non-performing C&I loan of \$1.4 million. Non-performing loans, consisting solely of non-accruing loans, increased to \$2.2 million at September 30, 2018, from \$1.0 million at December 31, 2017, also impacted by the C&I loan previously mentioned. At September 30, 2018, non-performing loans consisted of the \$1.4 million C&I loan, \$339,000 of indirect home improvement loans, \$149,000 of home equity loans, \$141,000 of one-to-four-family loans, \$63,000 of marine loans, \$40,000 of solar loans, and \$2,000 of other consumer loans. Non-performing loans to total gross loans were 0.23% at September 30, 2018, compared to 0.13% at December 31, 2017. The Company had no OREO at both September 30, 2018, and December 31, 2017.

Liabilities. Total liabilities increased \$198.4 million to \$1.1 billion at September 30, 2018, from \$859.8 million at December 31, 2017, primarily due to growth in deposits and borrowings. Total deposits increased \$114.7 million to \$944.5 million at September 30, 2018, from \$829.8 million at December 31, 2017. Relationship-based transactional accounts (noninterest-bearing checking, interest-bearing checking, and escrow accounts) decreased \$1.5 million to \$305.3 million at September 30, 2018, from \$306.8 million at December 31, 2017. Money market and savings accounts increased \$18.6 million to \$319.4 million at September 30, 2018, from \$300.8 million at December 31, 2017. Time deposits increased \$97.6 million to \$319.8 million at September 30, 2018, from \$222.3 million at December 31, 2017. Non-retail certificates of deposit which includes brokered certificates of deposit, online certificates of deposit, and public funds increased \$57.9 million to \$124.4 million at September 30, 2018, compared to \$66.5 million at December 31, 2017. Management remains focused on growth in lower cost relationship-based deposits to fund long-term asset growth.

Borrowings increased \$79.0 million to \$86.5 million at September 30, 2018, from \$7.5 million at December 31, 2017, primarily due to continued growth in real estate loans funded with FHLB borrowings.

Stockholders' Equity. Total stockholders' equity increased \$11.1 million to \$133.1 million at September 30, 2018, from \$122.0 million at December 31, 2017. The increase in stockholders' equity during the nine months ended September 30, 2018, was primarily due to net income of \$12.6 million, partially offset by an increase in accumulated other comprehensive loss, net of tax of \$2.2 million. Book value per common share was \$37.10 at September 30, 2018, compared to \$34.47 at December 31, 2017.

We calculated book value based on common shares outstanding of 3,716,460 at September 30, 2018, less 43,421 unvested restricted stock shares, and 84,243 unallocated ESOP for the reported common shares outstanding of 3,588,796. Common shares outstanding was calculated using 3,680,152 at December 31, 2017, less 36,842 unvested restricted stock shares, and 103,684 unallocated ESOP shares for the reported common shares outstanding of 3,539,626.

Table of Contents

## Comparison of Results of Operations for the Three Months Ended September 30, 2018 and 2017

General. Net income for the three months ended September 30, 2018, increased \$598,000, or 17.3%, to \$4.1 million, from \$3.5 million for the three months ended September 30, 2017. The primary reason for the increase in net income was a \$1.8 million, or 17.4% increase in net interest income after provision for loan losses, and a \$636,000, or 32.5% decrease in the provision for income taxes partially offset by a \$1.6 million, or 25.3% decrease in noninterest income.

The following table sets forth the average balances of all major categories of interest-earning assets and interest-bearing liabilities to calculate the comparison of results of operations for the three months ended September 30, 2018 and 2017:

Average Balances	For the Three Months Ended			For the Three Months		
	September 30, 2018			September 30, 2017		
	Average Balance	Interest Earned/ Paid	Yield/ Rate	Average Balance	Interest Earned/ Paid	Yield/ Rate
<b>ASSETS</b>						
Loans receivable, net deferred loan fees (1)	\$ 971,061	\$ 14,624	5.97%	\$ 803,399	\$ 11,715	5.79%
Mortgage-backed securities	49,751	297	2.37%	41,559	213	2.03%
Investment securities	50,751	355	2.78%	37,818	236	2.48%
Federal Home Loan Bank stock	8,594	126	5.82%	4,034	30	2.95%
Interest-bearing deposits at other financial institutions	40,261	181	1.78%	42,990	158	1.46%
Total interest-earning assets	1,120,418	15,583	5.52%	929,800	12,352	5.27%
Noninterest-earning assets (2)	41,488			35,868		
Total assets	\$ 1,161,906			\$ 965,668		
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>						
Savings and money market	\$ 295,387	\$ 584	0.78%	\$ 326,929	\$ 356	0.43%
Interest-bearing checking	117,513	53	0.18%	97,751	44	0.18%
Certificates of deposit	283,863	1,213	1.70%	215,309	645	1.19%
Borrowings	125,945	704	2.22%	34,372	114	1.32%
Subordinated note	9,857	171	6.88%	9,837	171	6.90%
Total interest-bearing liabilities	832,565	2,725	1.30%	684,198	1,330	0.77%
Noninterest-bearing accounts	184,187			172,189		
Other noninterest-bearing liabilities	13,322			13,966		
Stockholders' equity	131,832			95,315		
Total liabilities and stockholders' equity	\$ 1,161,906			\$ 965,668		
Net interest income		\$ 12,858			\$ 11,022	
Net interest rate spread			4.22%			4.50%
Net earning assets	\$ 287,853			\$ 245,602		
Net interest margin			4.55%			4.70%
Average interest-earning assets to average interest-bearing liabilities		134.57%			135.90%	

(1) Includes loans held for sale.

(2) Includes fixed assets, BOLI, servicing rights, goodwill, and CDI.

Net Interest Income. Net interest income increased \$1.8 million, or 16.7%, to \$12.9 million for the three months ended September 30, 2018, from \$11.0 million for the three months ended September 30, 2017. The increase in net interest income primarily resulted from a \$2.9 million, or 24.8% increase in loans receivable interest income, due to a \$167.7 million, or 20.9% increase in the average loans receivable, net balance, and an 18 basis point increase in the average loan

Table of Contents

yield. These increases were partially offset by an \$805,000, or 77.0% increase in deposit interest expense driven by continued overall deposit growth at higher current market interest rates, and a \$590,000 increase in interest expense resulting from the use of FHLB borrowings to support loan growth.

The net interest margin (“NIM”) decreased 15 basis points to 4.55% for the three months ended September 30, 2018, from 4.70% for the three months ended September 30, 2017. The decreased NIM was primarily the result of growth in higher cost market rate deposits and increased borrowing costs to fund loan growth. Management remains focused on matching deposit/liability duration with the duration of loans/assets where appropriate.

Interest Income. Interest income for the three months ended September 30, 2018, increased \$3.2 million, or 26.2%, to \$15.6 million, from \$12.4 million for the three months ended September 30, 2017. The increase during the period was primarily attributable to the increase in the average balance of loans receivable to \$971.1 million for the three months ended September 30, 2018, compared to \$803.4 million for the three months ended September 30, 2017, and a 25 basis point increase in the average yield on interest-earning assets to 5.52% for the three months ended September 30, 2018, compared to 5.27% for the three months ended September 30, 2017. The increase in average yield on interest-earning assets compared to the same period a year earlier primarily reflects the growth in the average balance and yield of the loan portfolio and the proportionally larger level of loans in the average interest-earning asset mix.

The following table compares average earning asset balances, associated yields, and resulting changes in interest income for the three months ended September 30, 2018 and 2017:

	Three Months Ended September 30,				Increase in Interest Income
	2018		2017		
(Dollars in thousands)	Average Balance	Yield/ Rate	Average Balance	Yield/ Rate	
Loans receivable, net and loans held for sale	\$ 971,061	5.97 %	\$ 803,399	5.79 %	\$ 2,909
Mortgage-backed securities	49,751	2.37	41,559	2.03	84
Investment securities	50,751	2.78	37,818	2.48	119
FHLB stock	8,594	5.82	4,034	2.95	96
Interest-bearing deposits at other financial institutions	40,261	1.78	42,990	1.46	23
Total interest-earning assets	\$ 1,120,418	5.52 %	\$ 929,800	5.27 %	\$ 3,231

Interest Expense. Interest expense increased \$1.4 million, or 104.9%, to \$2.7 million for the three months ended September 30, 2018, from \$1.3 million for the same prior year period. The increase was attributable to an increase in interest expense on deposits of \$805,000, and borrowings of \$590,000. The average cost of funds increased 53 basis points to 1.30% from 0.77% for the three months ended September 30, 2018 and 2017, respectively, driven by growth in time deposits and an increase in short-term overnight FHLB borrowing rates reflecting increases in the targeted federal funds rate. The average cost of deposits increased 33 basis points to 0.84%, for the three months ended September 30, 2018, compared to 0.51%, for the three months ended September 30, 2017, reflecting rising market interest rates over the last year and increased certificates of deposit, including a \$24.7 million increase in non-retail certificates of deposit.



Table of Contents

The following table details average balances for cost of funds on interest-bearing liabilities and the change in interest expense for the three months ended September 30, 2018 and 2017:

	Three Months Ended September 30,				Increase in Interest Expense
	2018		2017		
	Average Balance		Average Balance		
(Dollars in thousands)	Outstanding	Yield	Outstanding	Yield	
Savings and money market	\$ 295,387	0.78 %	\$ 326,929	0.43 %	\$ 228
Interest-bearing checking	117,513	0.18	97,751	0.18	9
Certificates of deposit	283,863	1.70	215,309	1.19	568
Borrowings	125,945	2.22	34,372	1.32	590
Subordinated note	9,857	6.88	9,837	6.90	—
Total interest-bearing liabilities	\$ 832,565	1.30 %	\$ 684,198	0.77 %	\$ 1,395

Provision for Loan Losses. For the three months ended September 30, 2018 and 2017, the provision for loan losses was \$450,000 due primarily to the increase in the loan portfolio and in nonperforming loans. During the three months ended September 30, 2018, net recoveries totaled \$24,000, compared to \$5,000 during the three months ended September 30, 2017.

Noninterest Income. Noninterest income decreased \$1.6 million, or 25.3%, to \$4.8 million for the three months ended September 30, 2018, from \$6.4 million for the three months ended September 30, 2017. The decrease during the period primarily reflects a \$1.2 million reduction in gain on sale of loans, a \$163,000 reduction in service charges and fee income as a result of the MSR sale in 2017, and a \$143,000 reduction in gain on sale of investment securities as there were no sales during the current quarter.

Noninterest Expense. Noninterest expense increased \$249,000, or 2.1%, to \$11.8 million for the three months ended September 30, 2018, from \$11.6 million for the three months ended September 30, 2017. The increase was primarily due to increases from acquisition costs related to the pending Anchor merger of \$443,000, \$124,000 in loan costs, and \$94,000 in occupancy expense, partially offset by decreases of \$269,000 in operations expense, and \$101,000 in salaries and benefits, which includes a \$956,000 increase in salaries reflecting an increase in full-time employees, partially offset by an \$803,000 decrease in incentives and commissions reflecting lower one-to-four-family originations as a result of the impact of rising interest rates and a reduction of homes available for sale in the Pacific Northwest.

The efficiency ratio, which is noninterest expense as a percentage of net interest income and noninterest income, increased slightly to 67.0% for the three months ended September 30, 2018, compared to 66.4% for the three months ended September 30, 2017, representing a greater increase in interest and noninterest expense as compared to a smaller increase in net interest and noninterest income.

Provision for Income Tax. For the three months ended September 30, 2018, the Company recorded a provision for income tax expense of \$1.3 million on pre-tax income as compared to \$2.0 million for the three months ended September 30, 2017. The effective corporate income tax rates for the three months ended September 30, 2018 and 2017 were 24.6% and 36.2%, respectively, reflecting the reduction of the federal corporate income tax rate effective January 1, 2018 from the Tax Act enacted on December 22, 2017, and the impact of ASU 2016-09.

Comparison of Results of Operations for the Nine Months Ended September 30, 2018 and 2017

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General. Net income for the nine months ended September 30, 2018, increased \$2.2 million, or 21.4%, to \$12.6 million, from \$10.4 million for the nine months ended September 30, 2017. The increase was primarily due to a \$5.5 million, or 18.7% increase in net interest income, after provision for loan losses, and a \$2.2 million, or 43.6% decrease in the provision for income taxes, partially offset by a \$3.4 million, or 17.9% decrease in noninterest income, and a \$2.1 million, or 6.4% increase in noninterest expense.



Table of Contents

The following table sets forth the average balances of all major categories of interest-earning assets and interest-bearing liabilities to calculate the comparison of results of operations for the nine months ended September 30, 2018 and 2017:

	For the Nine Months Ended September 30, 2018			For the Nine Months Ended September 30, 2017		
	Average Balance Outstanding	Interest Earned/ Paid	Yield/ Rate	Average Balance Outstanding	Interest Earned/ Paid	Yield/ Rate
Average Balances						
<b>ASSETS</b>						
Loans receivable, net deferred loan fees (1)	\$ 905,645	\$ 40,015	5.91%	\$ 725,247	\$ 31,488	5.80%
Mortgage-backed securities	47,250	826	2.34%	48,072	764	2.12%
Investment securities	48,753	997	2.73%	42,134	744	2.36%
Federal Home Loan Bank stock	6,275	238	5.07%	3,658	78	2.85%
Interest-bearing deposits at other financial institutions	40,980	517	1.69%	46,153	448	1.30%
Total interest-earning assets	1,048,903	42,593	5.43%	865,264	33,522	5.18%
Noninterest-earning assets (2)	38,791			37,501		
Total assets	\$ 1,087,694			\$ 902,765		
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>						
Savings and money market	\$ 292,074	\$ 1,296	0.59%	\$ 319,719	\$ 937	0.39%
Interest-bearing checking	122,255	184	0.20%	80,128	66	0.11%
Certificates of deposit	260,163	3,045	1.56%	200,872	1,790	1.19%
Borrowings	83,081	1,280	2.06%	27,994	259	1.24%
Subordinated note	9,852	508	6.89%	9,832	508	6.91%
Total interest-bearing liabilities	767,425	6,313	1.10%	638,545	3,560	0.75%
Noninterest-bearing accounts	181,516			164,098		
Other noninterest-bearing liabilities	11,903			13,029		
Stockholders' equity	126,850			87,093		
Total liabilities and stockholders' equity	\$ 1,087,694			\$ 902,765		
Net interest income		\$ 36,280			\$ 29,962	
Net interest rate spread			4.33%			4.43%
Net earning assets	\$ 281,478			\$ 226,719		
Net interest margin			4.62%			4.63%
Average interest-earning assets to average interest-bearing liabilities	136.68%			135.51%		

(1) Includes loans held for sale.

(2) Includes fixed assets, BOLI, servicing rights, goodwill, and CDI.

Net Interest Income. Net interest income increased \$6.3 million, or 21.1%, to \$36.3 million for the nine months ended September 30, 2018, from \$30.0 million for the nine months ended September 30, 2017, driven mostly by an \$8.5 million, or 27.1% increase in loans receivable interest income, and a \$544,000 increase in interest and dividends on investment securities, and cash and cash equivalents, partially offset by a \$1.7 million increase in deposit interest expense and a \$1.0 million increase in borrowing interest expense.

The NIM decreased one basis point to 4.62% for the nine months ended September 30, 2018, from 4.63% for the nine months ended September 30, 2017. The decreased NIM reflects growth in higher cost market rate deposits and increased borrowing costs to fund loan growth.

Table of Contents

Interest Income. Interest income for the nine months ended September 30, 2018, increased \$9.1 million, or 27.1%, to \$42.6 million, from \$33.5 million for the nine months ended September 30, 2017. The increase during the period was primarily due to the increase in the average balance of loans receivable to \$905.6 million for the nine months ended September 30, 2018, compared to \$725.2 million for the nine months ended September 30, 2017. The average yield on interest-earning assets increased 25 basis points to 5.43% for the nine months ended September 30, 2018, compared to 5.18% for the nine months ended September 30, 2017. The increase in average yield on interest-earning assets compared to the same period last year primarily reflects the growth in the loan portfolio and the proportionally larger level of loans in the average interest-earning asset mix.

The following table compares average earning asset balances, associated yields, and resulting changes in interest income for the nine months ended September 30, 2018 and 2017:

	Nine Months Ended September 30,				Increase (Decrease) in Interest Income
	2018		2017		
	Average Balance	Yield/ Rate	Average Balance	Yield/ Rate	
(Dollars in thousands)	Outstanding		Outstanding		
Loans receivable, net and loans held for sale	\$ 905,645	5.91 %	\$ 725,247	5.80 %	\$ 8,527
Mortgage-backed securities	47,250	2.34	48,072	2.12	62
Investment securities	48,753	2.73	42,134	2.36	253
FHLB stock	6,275	5.07	3,658	2.85	160
Interest-bearing deposits at other financial institutions	40,980	1.69	46,153	1.30	69
Total interest-earning assets	\$ 1,048,903	5.43 %	\$ 865,264	5.18 %	\$ 9,071

Interest Expense. Interest expense increased \$2.8 million, or 77.3%, to \$6.3 million for the nine months ended September 30, 2018, from \$3.6 million for the same prior year period. The average cost of funds increased 35 basis points to 1.10% for the nine months ended September 30, 2018, compared to 0.75% for the nine months ended September 30, 2017 reflecting increases in both the average balance and cost of certificates of deposit and borrowings. The average cost of deposits increased 22 basis points to 0.70% for the nine months ended September 30, 2018, compared to 0.48% for the nine months ended September 30, 2017, mostly driven by increases in certificates of deposit.

The following table details average balances for cost of funds on interest-bearing liabilities and the change in interest expense for the nine months ended September 30, 2018 and 2017:

	Nine Months Ended September 30,				Increase in Interest Expense
	2018		2017		
	Average Balance	Yield	Average Balance	Yield	
(Dollars in thousands)	Outstanding		Outstanding		
Savings and money market	\$ 292,074	0.59 %	\$ 319,719	0.39 %	\$ 359
Interest-bearing checking	122,255	0.20	80,128	0.11	118
Certificates of deposit	260,163	1.56	200,872	1.19	1,255
Borrowings	83,081	2.06	27,994	1.24	1,021
Subordinated note	9,852	6.89	9,832	6.91	—
Total interest-bearing liabilities	\$ 767,425	1.10 %	\$ 638,545	0.75 %	\$ 2,753

Provision for Loan Losses. For the nine months ended September 30, 2018, the provision for loan losses was \$1.3 million, primarily due to continued loan growth, compared to \$450,000 for the nine months ended September 30, 2017. Net recoveries totaled \$39,000 during the nine months ended September 30, 2018, compared to net charge-offs of \$63,000 during the nine months ended September 30, 2017.

## Table of Contents

**Noninterest Income.** Noninterest income decreased \$3.4 million, or 17.9%, to \$15.4 million for the nine months ended September 30, 2018, from \$18.8 million for the nine months ended September 30, 2017. The decrease during the period was primarily due to a \$1.4 million reduction in gain on sale of loans, no gain on sale of MSR in 2018 compared to \$996,000 in 2017, a \$698,000 reduction in service charges and fee income as a result of the MSR sale in 2017, and a \$267,000 reduction in gain on sale of investment securities.

**Noninterest Expense.** Noninterest expense increased \$2.1 million, or 6.4%, to \$35.0 million for the nine months ended September 30, 2018, from \$32.9 million for the nine months ended September 30, 2017. The increase was primarily due to increases of \$1.6 million, or 7.9% in salaries and benefits reflecting an increase in full-time employees due to asset growth, but also including a \$422,000 decrease in incentives and commissions for the reasons described above, and acquisition costs related to the pending Anchor merger of \$443,000. Increases of \$206,000 in loan costs, \$158,000 in occupancy expense, and \$133,000 in data processing expense were mostly offset by decreases of \$297,000 in operations expense and \$160,000 in premiums for Federal Deposit Insurance Corporation ("FDIC") insurance.

The efficiency ratio was 67.7% for the nine months ended September 30, 2018, compared to 67.5% for the nine months ended September 30, 2017, representing a greater increase in noninterest expenses as compared to a smaller increase in net interest and noninterest income.

**Provision for Income Tax.** For the nine months ended September 30, 2018, the Company recorded a provision for income tax expense of \$2.8 million on pre-tax income as compared to \$5.0 million for the nine months ended September 30, 2017. The year over year reduction in the tax provision is partially due to the application of ASU 2016-09, Stock Compensation, as discussed above, and a reduction in the effective corporate income tax rates for the nine months ended September 30, 2018 and 2017 to 18.3% and 32.5%, respectively, reflecting the reduction of the federal corporate income tax rate from the Tax Act.

## Liquidity

Management maintains a liquidity position that it believes will adequately provide funding for loan demand and deposit runoff that may occur in the normal course of business. The Company relies on a number of different sources in order to meet potential liquidity demands. The primary sources are increases in deposit accounts, FHLB advances, purchases of federal funds, sale of securities available-for-sale, cash flows from loan payments, sales of one-to-four-family loans held for sale, and maturing securities.

At September 30, 2018, the Bank's total borrowing capacity was \$236.8 million with the FHLB of Des Moines, with unused borrowing capacity of \$149.9 million. The FHLB borrowing limit is based on certain categories of loans, primarily real estate loans that qualify as collateral for FHLB advances. At September 30, 2018, the Bank held approximately \$328.1 million in loans that qualify as collateral for FHLB advances.

In addition to the availability of liquidity from the FHLB of Des Moines, the Bank maintained a short-term borrowing line with the Federal Reserve Bank, with a current limit of \$121.1 million, and a combined credit limit of \$51.0 million in written federal funds lines of credit through correspondent banking relationships at September 30, 2018. The Federal Reserve Bank borrowing limit is based on certain categories of loans, primarily consumer loans that qualify as collateral for Federal Reserve Bank line of credit. At September 30, 2018, the Bank held approximately \$249.2 million in loans that qualify as collateral for the Federal Reserve Bank line of credit.

At September 30, 2018, \$86.5 million in FHLB advances and FHLB borrowings were outstanding, and no advances were outstanding against the Federal Reserve Bank line of credit, or the Fed Funds lines of credit. The Bank's Asset and Liability Management Policy permits management to utilize brokered deposits up to 20% of Bank deposits or

\$190.0 million at September 30, 2018. Total brokered deposits at September 30, 2018 were \$123.6 million. Management utilizes brokered deposits to mitigate interest rate risk and liquidity risk exposure when appropriate.

Liquidity management is both a daily and long-term function of Company management. Excess liquidity is generally invested in short-term investments, such as overnight deposits or the repayment of FHLB borrowings. On a longer term basis, a strategy is maintained of investing in various lending products and investment securities, including U.S. Government obligations and U.S. agency securities. The Company uses sources of funds primarily to meet ongoing commitments, pay maturing deposits, fund withdrawals, and to fund loan commitments. At September 30, 2018, the

## Table of Contents

approved outstanding loan commitments, including unused lines of credit amounted to \$285.4 million. Certificates of deposit scheduled to mature in three months or less at September 30, 2018, totaled \$106.7 million. It is management's policy to offer deposit rates that are competitive with other local financial institutions. Based on this management strategy, the Company believes that a majority of maturing relationship deposits will remain with the Bank.

As a separate legal entity from the Bank, FS Bancorp, Inc. must provide for its own liquidity. Sources of capital and liquidity for FS Bancorp, Inc. include distributions from the Bank and the issuance of debt or equity securities. Dividends and other capital distributions from the Bank are subject to regulatory notice. At September 30, 2018, FS Bancorp, Inc. had \$5.3 million in unrestricted cash to meet liquidity needs.

### Commitments and Off-Balance Sheet Arrangements

The Company is a party to financial instruments with off-balance sheet risk in the normal course of business in order to meet the financing needs of its customers. For information regarding our commitments and off-balance sheet arrangements, see Note 7 of the Notes to Consolidated Financial Statements included in Part I. Item 1 of this report.

### Capital Resources

The Bank is subject to minimum capital requirements imposed by the FDIC. Based on its capital levels at September 30, 2018, the Bank exceeded these requirements as of that date. Consistent with our goals to operate a sound and profitable organization, our policy is for the Bank to maintain a well capitalized status under the capital categories of the FDIC. Based on capital levels at September 30, 2018, the Bank was considered to be well capitalized. At September 30, 2018, the Bank exceeded all regulatory capital requirements with Tier 1 leverage-based capital, Tier 1 risk-based capital, total risk-based capital, and common equity Tier 1 capital ratios of 11.7%, 14.0%, 15.2%, and 14.0%, respectively.

FS Bancorp, Inc. is subject to regulatory guidelines for bank holding companies with \$1.0 billion or more in assets. At September 30, 2018, FS Bancorp, Inc. exceeded all regulatory capital requirements. The regulatory capital ratios calculated for FS Bancorp, Inc. at September 30, 2018 were 11.4% for Tier 1 leverage-based capital, 13.6% for Tier 1 risk-based capital, 14.9% for total risk-based capital, and 13.6% for CET 1 capital ratio. For additional information regarding regulatory capital compliance, see the discussion included in Note 12 to the Notes to Consolidated Financial Statements included in Part I. Item 1 of this report.

### Item 3. Quantitative and Qualitative Disclosures About Market Risk

There have been no material changes in the market risk disclosures contained in FS Bancorp's Annual Report on Form 10-K for the fiscal year ended December 31, 2017.

### Item 4. Controls and Procedures

#### (a) Evaluation of Disclosure Controls and Procedures

An evaluation of the disclosure controls and procedures as defined in Rule 13a-15(e) of the Securities Exchange Act of 1934, as amended (the "Exchange Act") was carried out as of September 30, 2018 under the supervision and with the participation of the Company's Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO") and several other members of the Company's senior management. In designing and evaluating the Company's disclosure controls and procedures, management recognized that disclosure controls and procedures, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the disclosure controls and procedures are met. Additionally, in designing disclosure controls and procedures, management necessarily was

required to apply its judgment in evaluating the cost-benefit relationship of possible disclosure controls and procedures. The design of any disclosure controls and procedures also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions.

The Company's CEO and CFO concluded that based on their evaluation at September 30, 2018, the Company's disclosure controls and procedures were effective in ensuring that information we are required to disclose in the reports we file or submit under the Exchange Act is (1) recorded, processed, summarized, and reported within the time periods specified in



Table of Contents

the SEC's rules and forms, and (2) accumulated and communicated to FS Bancorp management, including its CEO and CFO, as appropriate to allow timely decisions regarding required disclosure, specified in the SEC's rules and forms.

(b) Changes in Internal Controls

There were no significant changes in the Company's internal control over financial reporting that occurred during the three months ended September 30, 2018, that have materially affected or are reasonably likely to materially affect our internal control over financial reporting. The Company does not expect that its disclosure controls and procedures and internal control over financial reporting will prevent all error and all fraud. A control procedure, no matter how well conceived and operated, can provide only reasonable, not absolute assurance that the objectives of the control procedure are met. Because of the inherent limitations in all control procedures, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls may be circumvented by the individual acts of some persons, by collusion of two or more people, or by override of the control. The design of any control procedure is also based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, controls may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control procedure, misstatements due to error or fraud may occur and not be detected.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

In the normal course of business, the Company occasionally becomes involved in various legal proceedings. In the opinion of management, any liability from such proceedings would not have a material adverse effect on the business or financial condition of the Company.

Item 1A. Risk Factors

There have been no material changes to the risk factors set forth in Part I. Item 1A of the Company's Annual Report on Form 10 K for the year ended December 31, 2017.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

- (a) Not applicable
- (b) Not applicable
- (c) Not applicable

Item 3. Defaults Upon Senior Securities

Not applicable.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

Not applicable.

56

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Table of Contents

Item 6. Exhibits

- 2.1 Agreement and Plan of Merger, dated as of July 17, 2018, by and between FS Bancorp, Inc. and Anchor Bancorp (1)
- 3.1 Articles of Incorporation of FS Bancorp, Inc. (2)
- 3.2 Bylaws of FS Bancorp, Inc. (3)
- 4.1 Form of Common Stock Certificate of FS Bancorp, Inc. (2)
- 10.1 Severance Agreement between 1st Security Bank of Washington and Joseph C. Adams (2)
- 10.2 Form of Change of Control Agreement between 1st Security Bank of Washington and Matthew D. Mullet (2)
- 10.3 FS Bancorp, Inc. 2013 Equity Incentive Plan (the “2013 Plan”) (4)
- 10.4 Form of Incentive Stock Option Agreement under the 2013 Plan (4)
- 10.5 Form of Non-Qualified Stock Option Agreement under the 2013 Plan (4)
- 10.6 Form of Restricted Stock Agreement under the 2013 Plan (4)
- 10.7 Purchase and Assumption Agreement between Bank of America, National Association and 1st Security Bank dated September 1, 2015 (5)
- 10.8 Subordinated Loan Agreement dated September 30, 2015 by and among Community Funding CLO, Ltd. and the Company (6)
- 10.9 Form of change of control agreement with Donn C. Costa, Debbie L. Steck, Dennis O’Leary, Rob Fuller, Erin Burr, Victoria Jarman, Kelli Nielsen, and May-Ling Sowell (7)
- 10.10 FS Bancorp, Inc. 2018 Equity Incentive Plan (8)
- 10.11 Form of Incentive Stock Option Award Agreement under the 2018 Equity Incentive Plan (8)
- 10.12 Form of Non-Qualified Stock Option Award Agreement under the 2018 Equity Incentive Plan (8)
- 10.13 Form of Restricted Stock Award Agreement under the 2018 Equity Incentive Plan (8)
- 31.1 Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 31.2 Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 32.1 Certification of Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 32.2 Certification of Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 101 The following materials from the Company’s Quarterly Report on Form 10 Q for the quarter ended September 30, 2018 formatted in Extensible Business Reporting Language (XBRL): (1) Consolidated Balance Sheets; (2) Consolidated Statements of Income; (3) Consolidated Statements of Comprehensive Income; (4) Consolidated Statements of Changes in Stockholders’ Equity; (5) Consolidated Statements of Cash Flows; and (6) Notes to Consolidated Financial Statements.
  - (1) Filed as an exhibit to the Registrant’s Current Report on Form 8-K filed on July 18, 2018 (File No. 001-35589) and incorporated by reference.
  - (2) Filed as an exhibit to the Registrant’s Registration Statement on Form S 1 (333 177125) filed on October 3, 2011, and incorporated by reference.
  - (3) Filed as an exhibit to the Registrant’s Current Report on Form 8 K filed on July 10, 2013 (File No. 001 35589) and incorporated by reference.
  - (4) Filed as an exhibit to the Registrant’s Registration Statement on Form S 8 (333 192990) filed on December 20, 2013, and incorporated by reference.
  - (5) Filed as an exhibit to the Registrant’s Current Report on Form 8 K filed on September 2, 2015 (File No. 001 35589) and incorporated by reference.
  - (6) Filed as an exhibit to the Registrant’s Current Report on Form 8 K filed on October 19, 2015 (File No. 001 35589) and incorporated by reference.
  - (7) Filed as an exhibit to the Registrant’s Current Report on Form 8 K filed on February 1, 2016 (File No. 001 35589) and incorporated by reference.
  - (8)

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Filed as an exhibit to the Registrant's Registration Statement on Form S-8 (333-225135) filed on May 23, 2018.

Table of Contents

Exhibit Index

Exhibit No.	Description
10.10	<u>FS Bancorp, Inc. 2018 Equity Incentive Plan</u>
31.1	<u>Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002</u>
31.2	<u>Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002</u>
32.1	<u>Certification of Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002</u>
32.2	<u>Certification of Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002</u>
101	The following materials from the Company's Quarterly Report on Form 10 Q for the quarter ended September 30, 2018 formatted in Extensible Business Reporting Language (XBRL): (1) Consolidated Balance Sheets; (2) Consolidated Statements of Income; (3) Consolidated Statements of Comprehensive Income; (4) Consolidated Statements of Changes in Stockholders' Equity; (5) Consolidated Statements of Cash Flows; and (6) Notes to Consolidated Financial Statements.

Table of Contents

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

FS BANCORP, INC.

Date: November 9, 2018 By: /s/Joseph C. Adams  
Joseph C. Adams,  
Chief Executive Officer  
(Duly Authorized Officer)

Date: November 9, 2018 By: /s/Matthew D. Mullet  
Matthew D. Mullet  
Secretary, Treasurer and  
Chief Financial Officer  
(Principal Financial and Accounting Officer)