FS Bancorp, Inc.

Ratings

FS Bancorp, Inc.	
Action: **Assigned**	1/29/21
Senior Unsecured Debt	BBB
Subordinated Debt	BBB-
Short-Term Debt	K3

1st Security Bank of Washington	
Action: **Assigned**	1/29/21
Deposit	BBB+
Senior Unsecured Debt	BBB+
Subordinated Debt	BBB
Short-Term Deposit	K2
Short-Term Debt	K2

KBRA Bank & Bank Holding Company Global Rating Methodology dated October 16, 2019.

Outlook/Watch

FS Bancorp, Inc.	
Long-Term Ratings	Stable

1st Security Bank of Washington	
Long-Term Ratings	Stable

Financial Snapshot

FSBW (%)	YE20*	YE19
Total Assets ($B)	2.1	1.5
ROAA	2.02	1.41
NIM	4.02	4.57
NCO Ratio	0.01	0.15
NPA Ratio	0.46	0.23
TCE Ratio	10.6	11.5
Leverage Ratio	11.1	11.3
Loans/Core Dep	N/A	122

*GAAP data sourced from FSBW 4Q20 earnings release.

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Company Profile

- FS Bancorp, Inc. (NASDAQ: FSBW) ("the company") is a $2 billion bank holding company for 1st Security Bank of Washington ("the bank"), largely serving the Seattle MSA and other markets throughout the western counties of Washington through its 22 branch and 11 mortgage LPOs. The bank was originally established as a credit union in 1936, converting to a mutual savings bank in 2004, and going public in 2012.
- Stemming from its credit union heritage, FSBW has a consumer lending tilt with residential mortgages and other consumer lending, representing over 50% of total loans. The consumer book, (approximately 21% of total loans at 3Q20), was largely comprised of small dollar indirect home improvement loans (66% of consumer loans), as well as marine loans (23%) and solar loans (10%). While residential mortgage loans HFI comprised roughly 20% of total loans, following the re-engagement of the division in 2011, mortgage banking has become a key revenue contributor.
- The commercial portfolio is a diverse mix of C&I lending (20% of loans including owner occupied CRE), investor CRE (13% including multifamily) and C&D (11%) – which is focused on infill speculative lending.
- The company has grown materially in recent years, owing to considerable organic growth as well as the 2018 acquisition of Anchor Bank. The acquisition expanded FSBW's presence southwest of Washington while improving its core funding base. Having not been a particularly active acquirer, any future M&A should be expected to be of similar nature, expanding its markets through the addition of strong deposit franchises.

Key Credit Considerations

- The ratings are supported by the company's strong earnings performance in recent years, benefitting from its above-average margins and noninterest income contribution. With a meaningful boost from higher-yielding consumer loans, FSBW's average loan yields (5.14% for 4Q20, and over 6% for 2019) have trended well above peer averages, largely offsetting the company's comparatively higher funding costs.
- While high average loan yields portend a potentially higher risk loan portfolio, FSBW has reflected a favorable asset quality history and manageable credit costs, demonstrating capable underwriting (particularly on a risk adjusted basis). Nonetheless, with loans comprising over 85% of AEA and the noted +20% of consumer, KBRA considers the potential risk associated with FSBW's balance sheet to be greater than that of higher rated peers. Positively, the company has historically maintained solid core capital levels – +10% TCE and +12% CET1 – which remains an important element of a stable creditor profile.
- Having operated as a credit union for the bulk of its history, FSBW's funding includes an elevated level of higher cost time deposits (30% of total balances at 4Q20), resulting in above average deposit costs (estimated 0.78% for 2020, down from 1.21% in 2019).
- Noninterest income has historically represented firmly more than 20% of company core revenues, having increased to over 40% in 2020, because of a very favorable mortgage banking environment. Outside of large but variable gain on sale revenues, net MSR and service fees remain modest.

Rating Sensitivities

A rating upgrade is not currently expected over the near-to-intermediate term; however, further improvement in core funding profile – both cost and mix – would be viewed favorably.	+
Any material, unexpected deterioration of asset quality, resulting in credit costs impacting the profitability; or outsized growth, negatively impacting the core capital position materially; or some weakening of the core funding profile, could have negative ratings ramifications.	–

ESG Considerations

KBRA's ratings incorporate all material credit factors including those that relate to Environmental, Social and Governance (ESG) factors. While ESG factors may influence ratings, it is important to underscore that KBRA's ratings do not incorporate value-based judgments. Throughout our analysis, KBRA captures the impact of ESG factors in the same manner as all other credit-relevant factors. More information on ESG Considerations for the Financial Institutions sector can be found **here**. The company's sound risk management practices have a material impact on this rating analysis. For supplementary information on FSBW's risk management and other relevant governance considerations, please reference the qualitative rating determinants section beginning on page 8.

Additional ESG information is presented in Appendix A at the end of this report. This information is not material to the rating, unless otherwise noted, but was uncovered during KBRA's due diligence process. Though not necessarily material now, the ESG factors listed in the additional information section may become more relevant to credit over time.

Financial Metrics

Summary Financial Highlights
1ST SECURITY BANK OF WASHINGTON

	4Q20*	3Q20	2Q20	1Q20	4Q19	2019	2018	2017	2016	2015
Balance Sheet ($ millions)										
Loans (HFI)	1,545	1,516	1,466	1,410	1,350	1,350	1,325	772	604	510
Average Earning Assets	1,980	1,913	1,830	1,627	1,595	1,544	1,173	896	764	553
Total Assets	2,113	2,054	2,008	1,847	1,713	1,713	1,621	981	828	678
Core Deposits	N/A	1,386	1,335	1,232	1,166	1,166	1,090	740	692	461
Total Deposits	1,674	1,635	1,618	1,461	1,405	1,405	1,288	839	719	494
Total Equity	230	217	214	204	205	205	183	127	88	79
Tangible Common Equity	223	210	207	196	197	197	174	124	85	79
Income Statement ($ millions)										
Net Interest Income	19.9	19.2	18.3	17.7	17.2	70.6	51.5	40.6	33.2	27.4
Noninterest Income	14.8	16.7	12.5	7.9	5.2	20.2	25.3	22.5	22.6	16.6
Noninterest Expense	18.6	16.5	13.4	15.2	15.0	58.9	46.0	41.3	36.6	28.1
Provision for Loan Losses	1.6	3.1	4.6	3.7	0.6	2.9	1.5	0.8	2.4	2.3
Net Income	11.4	12.9	10.2	5.3	6.1	23.4	25.0	14.6	11.0	8.9
Performance Measures (%)										
Return on Average Assets	2.18%	2.57%	2.11%	1.23%	1.43%	1.41%	2.03%	1.59%	1.38%	1.53%
Return on Average Equity	20.48%	23.89%	19.50%	10.47%	12.03%	12.02%	17.44%	14.29%	13.08%	14.21%
Net Interest Margin	3.99%	4.02%	4.00%	4.35%	4.32%	4.57%	4.39%	4.53%	4.34%	4.96%
Efficiency Ratio	53.7%	45.5%	42.9%	58.7%	65.9%	65.0%	59.9%	65.5%	65.6%	63.8%
Noninterest Income / Op. Revenue	42.7%	46.5%	40.5%	30.9%	23.2%	22.2%	32.9%	35.6%	40.5%	37.7%
Average Loans / Average Earning Assets	86%	86%	84%	87%	87%	88%	88%	85%	81%	88%
Cost of Interest-bearing Deposits	0.72%	0.84%	0.86%	1.12%	1.22%	1.27%	0.93%	0.55%	0.23%	0.31%
Average Loan Yield	5.14%	5.12%	5.40%	5.87%	5.96%	6.17%	5.57%	5.51%	5.52%	6.05%
Asset Quality (%)										
NPA / Loans + OREO	0.46%	0.42%	0.50%	0.21%	0.23%	0.23%	0.35%	0.11%	0.11%	0.18%
LLR / Loans (HFI)	1.66%	1.64%	1.47%	1.20%	0.98%	0.98%	0.93%	1.39%	1.69%	1.53%
LLR / NPL	337%	341%	273%	529%	436%	436%	297%	1199%	1416%	765%
NCO / Average Loans	0.05%	-0.04%	0.00%	0.01%	0.05%	0.15%	-0.01%	0.03%	0.00%	0.11%
Provision / NCO (x)	7.0	-17.8	-1,162.3	85.7	3.5	1.4	-29.1	3.7	-92.3	4.1
NPA Change Rate	3%	-8%	143%	3%	35%	-34%	441%	24%	-29%	135%
Capital (%)										
TCE Ratio	10.6%	10.3%	10.3%	10.7%	11.5%	11.5%	10.8%	12.7%	10.3%	11.6%
Leverage Ratio	11.1%	10.7%	10.8%	11.3%	11.6%	11.6%	10.7%	12.6%	10.3%	12.1%
CET 1 ratio	N/A	N/A	N/A	N/A	13.7%	13.7%	12.6%	15.0%	12.6%	14.3%
Tier 1 Ratio	N/A	N/A	N/A	N/A	13.7%	13.7%	12.6%	15.0%	12.6%	14.3%
Total Capital Ratio	N/A	N/A	N/A	N/A	14.6%	14.6%	13.5%	16.2%	13.9%	15.5%
Leverage & Funding (%)										
Loans / Deposits	106%	106%	99%	104%	101%	101%	107%	98%	91%	112%
Loans / Core Deposits	125%	125%	120%	124%	122%	122%	126%	112%	95%	120%
Core Deposits / Total Funding	77%	77%	75%	76%	78%	78%	76%	87%	95%	78%
Risk Weighted Density	N/A	N/A	N/A	N/A	84%	84%	86%	84%	81%	81%

*GAAP data sourced from FSBW 4Q20 earnings release.
Note: as a CBLR bank, as of 1Q20, 1st Security Bank of Washington does not report risk-based capital measures, or its risk weighted assets.

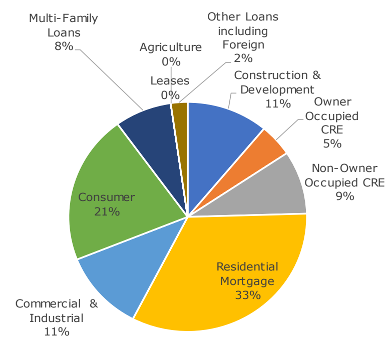
FS Bancorp, Inc. Financial Summary									
	4Q20	**3Q20**	**2Q20**	**1Q20**	**4Q19**	**2020**	**2019**	**2018**	**2017**
Performance Measures									
Return on Average Assets	2.18%	2.51%	2.08%	1.20%	1.38%	2.02%	1.38%	2.07%	1.53%
PTPP Return on Average Assets	3.10%	3.83%	3.59%	2.35%	1.70%	3.24%	1.88%	2.56%	2.31%
Return on Average Equity	20.48%	24.04%	19.77%	10.23%	11.89%	18.74%	11.92%	18.15%	14.80%
Net Interest Margin	4.61%	3.92%	3.91%	4.30%	4.29%	4.02%	4.53%	4.61%	4.65%
Efficiency Ratio	53.7%	47.1%	45.7%	61.4%	68.4%	51.4%	66.8%	61.9%	67.4%
Non-Interest Income / Op. Revenue	43%	48%	44%	34%	25%	43%	25%	34%	37%
Capital									
TCE Ratio	10.6%	10.4%	10.1%	10.5%	11.3%	10.6%	11.3%	10.6%	12.1%
CET1 Ratio	N/A	N/A	N/A	N/A	N/A	N/A	13.4%	12.4%	14.5%
Leverage Ratio	11.1%	10.8%	10.5%	11.1%	11.3%	11.1%	11.3%	12.1%	12.1%
Tier 1 Ratio	N/A	N/A	N/A	N/A	N/A	N/A	13.4%	12.1%	14.5%
Total Capital Ratio	N/A	N/A	N/A	N/A	N/A	N/A	14.3%	13.3%	15.7%

Source: FSBW GAAP reported data from filed 10-K and quarterly earnings press releases

Loan Composition

($ millions)	3Q20	2019	2018	2017	2016
Construction & Development	192	180	247	143	95
Owner Occupied CRE	79	63	86	32	29
Non-Owner Occupied CRE	155	150	127	34	32
Residential Mortgage	573	389	358	258	210
Commercial & Industrial	197	117	112	66	79
Consumer	365	326	275	209	175
Multi-Family Loans	134	135	106	44	38
Leases	0	0	0	0	0
Agriculture	0	0	0	0	0
Other Loans including Foreign	40	61	66	41	0
Total Loans and Leases	1,731	1,419	1,376	826	656
Loans Held for Sale (HFS)	215	70	51	53	53
Loans Held for Investment (HFI)	1,516	1,350	1,325	772	604
Annual Loan Growth	23%	3%	67%	26%	18%
Investor CRE / Total Loans	29%	36%	35%	31%	29%
C&D / Risk-Based Capital	N/A	86%	131%	107%	102%
Non-Owner Occupied CRE / RBC	N/A	245%	255%	190%	203%

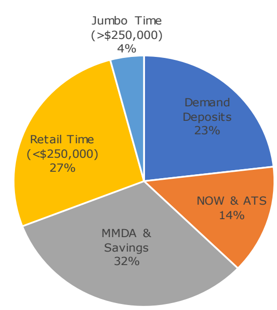
Loan Composition



Deposit Composition

($ millions)	3Q20	2019	2018	2017	2016
Domestic Deposits					
Demand Deposits	379	32	246	196	161
NOW & ATS	230	49	154	120	64
MMDA & Savings	522	773	405	301	298
Time Deposits					
Retail Time (<$250,000)	436	459	402	189	169
Jumbo Time (>$250,000)	68	92	81	33	27
Foreign Deposits	0	0	0	0	0
Total Deposits	1,635	1,405	1,288	839	719
Total Core Deposits	1,386	1,166	1,090	740	692
Total Non-interest Bearing	379	32	246	196	161
Annual Core Deposit Growth	18%	7%	47%	7%	50%

Deposit Composition



Comparative Statistics

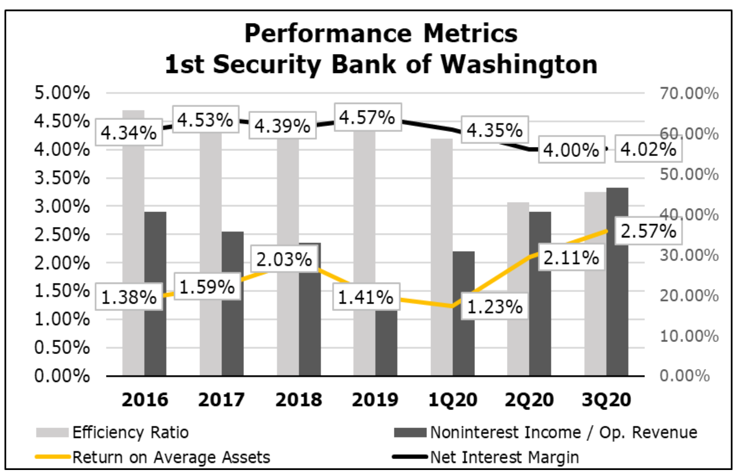
Peer Comparison Trends									
	1ST SECURITY BANK OF WASHINGTON	Benchmark $1-$10BN	KBRA Peers BBB+	1ST SECURITY BANK OF WASHINGTON	Benchmark $1-$10BN	KBRA Peers BBB+	1ST SECURITY BANK OF WASHINGTON	Benchmark $1-$10BN	KBRA Peers BBB+
Time Period	**3Q20**	**3Q20**	**3Q20**	**2019**	**2019**	**2019**	**3Q19**	**3Q19**	**3Q19**
Balance Sheet									
Total Assets	2,053,751	2,641,387	5,012,896	1,712,897	2,657,639	4,213,304	1,693,877	2,585,328	4,153,178
Total Risk Weighted Assets	*1653543	1,898,720	3,578,344	1,431,270	2,012,641	3,415,424	1,404,699	1,962,190	3,371,576
Risk Weighted Density	81%	68%	73%	84%	76%	81%	83%	76%	81%
Loans (HFI)	1,516,350	1,800,369	3,743,787	1,349,588	1,864,373	3,241,290	1,324,070	1,818,025	3,205,884
Total Deposits	1,635,138	2,155,180	3,963,902	1,405,275	2,136,952	3,340,564	1,398,541	2,077,219	3,286,463
Loans / Deposits	106%	87%	95%	101%	88%	98%	100%	89%	98%
Loans / Core Deposits	114%	102%	107%	124%	103%	113%	127%	104%	115%
Average Loans / Average Earning Assets	86%	80%	88%	90%	79%	86%	89%	79%	87%
Performance Measures									
ROAA	2.57%	1.28%	1.06%	1.41%	1.31%	1.15%	1.77%	1.38%	1.19%
ROAE	23.89%	11.85%	10.23%	11.88%	11.07%	9.55%	14.85%	11.75%	10.08%
Return on Risk Weighted Assets	3.19%	2.20%	1.50%	1.68%	2.15%	1.42%	2.13%	2.14%	1.46%
Cost of Interest Bearing Dep.	0.84%	0.59%	0.57%	1.27%	1.11%	1.35%	1.27%	1.17%	1.41%
Noninterest Bearing / Total Dep.	23%	26%	27%	2%	22%	21%	3%	22%	21%
Average Loan Yield	5.09%	4.54%	4.33%	6.05%	5.12%	4.96%	6.21%	5.32%	5.14%
NIM	4.02%	3.29%	3.35%	4.43%	3.73%	3.61%	4.64%	3.75%	3.60%
Noninterest Inc. / Total Rev.	46%	24%	22%	22%	20%	16%	24%	21%	17.00%
Efficiency	45.5%	60.4%	57.3%	64.1%	61.9%	59.6%	57.2%	60.4%	1.19%
Asset Quality									
NCO / Average Loans	-0.04%	0.13%	0.10%	0.14%	0.18%	0.12%	0.04%	0.18%	0.16%
NPA / Loans + OREO	0.43%	0.84%	0.71%	0.23%	0.75%	0.63%	0.17%	0.81%	0.58%
LLR / NPL	328%	719%	512%	436%	689%	371%	582%	1069%	461%
LLR / Loans(HFI)	1.64%	1.32%	1.30%	0.98%	1.10%	0.00%	0.96%	1.12%	0.90%
Capital									
TCE	10.3%	10.1%	9.5%	11.5%	11.0%	10.5%	11.4%	11.0%	10.5%
CET1	12.5%	14.7%	12.8%	13.7%	15.7%	12.8%	13.6%	15.5%	12.7%
Tier 1 Leverage	10.7%	8.8%	9.3%	11.6%	11.1%	10.7%	11.6%	11.1%	10.6%
Loan Portfolio									
C&I Loans/Total Loans	11%	22%	22%	8%	15%	17%	8%	15%	17%
ICRE Loans/Total Loans	29%	31%	37%	36%	34%	41%	37%	33%	40%
C&D Loans / Total Loans	11%	7%	8%	13%	8%	8%	14%	8%	8%

*Estimated risk-weighted assets

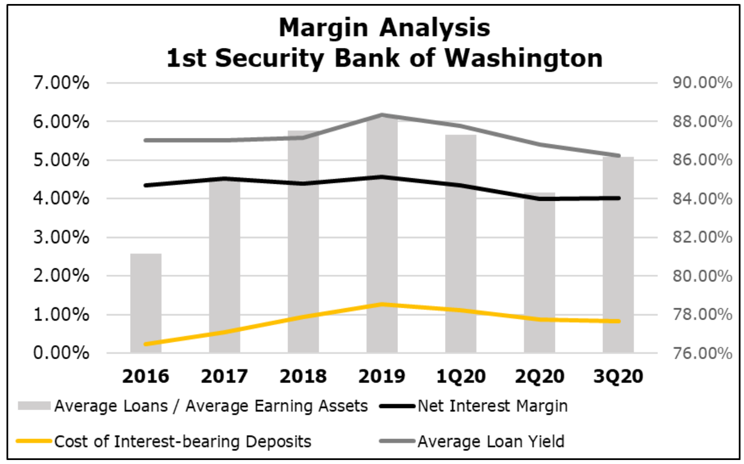
Key Quantitative Rating Determinants

The quantitative financial fundamentals of the bank are derived from the analysis of the bank's intrinsic financial strength and potential adjustments due to KBRA's stress testing as well as an analysis of current and historical financial metrics.

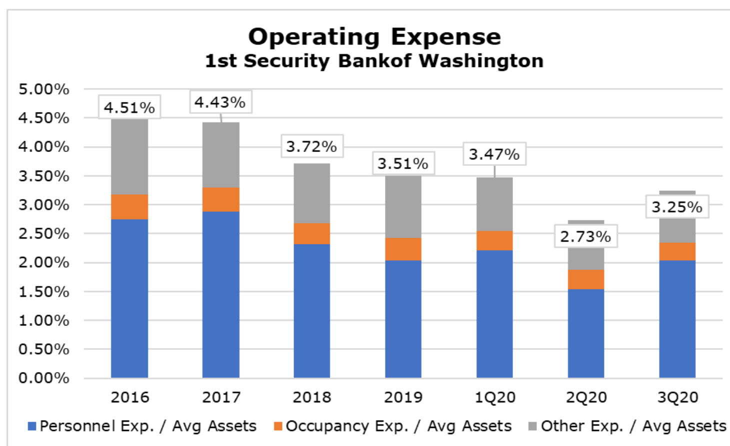
Performance



FSBW has reported strong earnings results in recent years, supported by robust margins and above-average, though somewhat volatile, noninterest income. KBRA recognizes FSBW's higher risk-adjusted balance sheet with loans generally comprising 85% - 90% of earning assets, consistently above benchmark peers. Yet, when adjusting for the company's higher mix of loans, earnings still track at or above peer averages. Noninterest revenues are concentrated in mortgage banking income, which after a down year in 2019, has driven significant growth in earnings in 2020. Despite compressed margins, FSBW has seen its ROA increase to 2.02% for YE20, largely due to the booming mortgage banking environment. Originations more than doubled in 2020, with gain on sale margins up over 50 bps, thus increasing revenues from its mortgage banking sector more than $16 million through 9M20 over YE19, expanding to roughly 38% of total revenues. However, the company has limited other fee income, largely comprised of account service fees which has historically represented 4% - 7% of total revenues (with service fees down and mortgage banking income up significantly, this number was less than 2% for 9M20). While a continued strong mortgage banking environment may carry into early 2021, revenues for the company from this sector should become more normalized over time. Thus, earnings may dip in 2021, though remain at, or above peer levels. KBRA notes the sound performance for the company outside of the mortgage banking sector, reporting an ROA of 0.97% through 9M20. Similar to most of its peers within the banking industry, FSBW has experienced margin pressure with the reported NIM falling 58 bps to 4.03% through 9M20, as compared to 9M19. However, with most of the loan book having already repriced, slowing the drop in average loan yields, margins should stabilize over the near to medium term with a targeted NIM ranging from 3.90% - 4.05%. Moreover, despite the decrease in recent periods, NIM has remained well above peer averages, largely due to an average loan yield sustained above 5%, despite the elevated level of low-yielding loans-for-sale held and cash equivalent assets on the balance sheet throughout 2020. As such, NIM should benefit from the deployment of the excess cash out into higher yielding loan products over time.



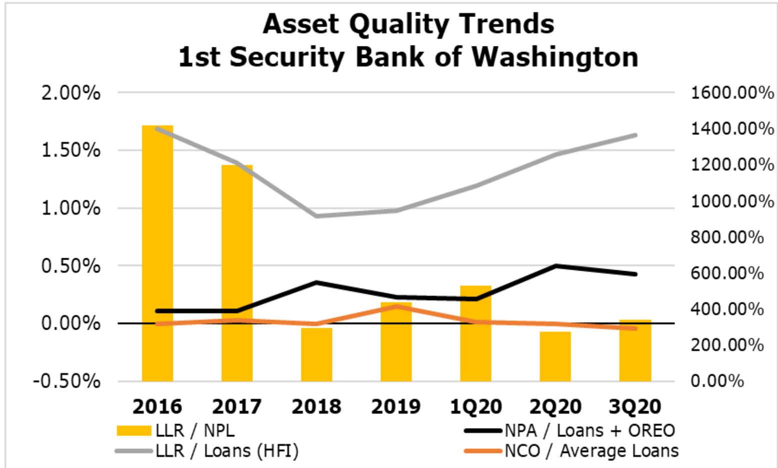
The company's higher loan yields have primarily been driven by its consumer loan portfolio which comprised over 20% of loans with average loan yields near 7%. Additionally, the residential mortgage portfolio has had a more modest drag on company yields, in part due to the inclusion of some higher-rate prime mortgage loans that has kept average yields for the portfolio in the mid-4% range. Somewhat offsetting the higher average loan yields has been the company's elevated funding costs. Having originated as a credit union, then transitioning to a mutual savings bank before its current operating model, FSBW continues to have an above-average reliance on noncore funding with brokered deposits and FHLB borrowings comprising 19% of its funding mix. As such, the cost of total interest-bearing liabilities were 1.15% for 9M20. Moreover, deposit costs have tracked above peers, despite a considerable portion in noninterest bearing accounts (23% at 3Q20), largely due to an outsized portion in time deposits (31%). Altogether, FSBW reported a total cost of deposits of 0.85% for 9M20, a 36 bp reduction from the prior year 9M. Further reductions in costs could be made as the company continues to remake its deposit mix, though may not be of material impact of the near term.



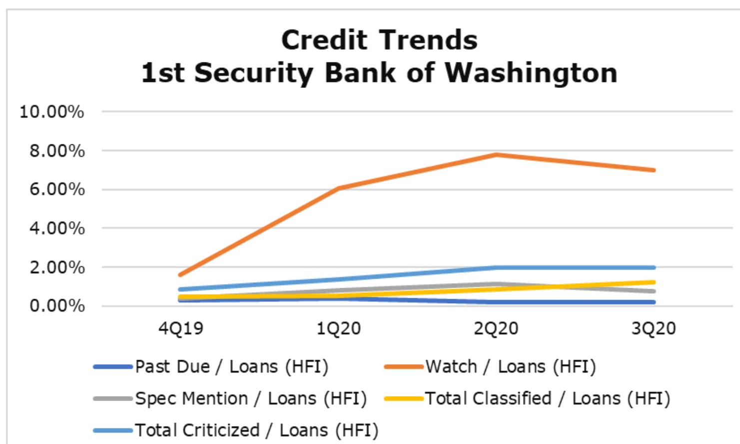
FSBW's operating model, which includes 22 branch offices and 11 mortgage loan production offices, tends to carry an elevated expense base. The company's comparatively high expenses (3.17% of average assets for 9M20) are largely driven by its high employee headcount. FSBW had average assets of approximately $4 million per employee, well below peer averages, driving up the company's personnel expense (1.91% of average assets). However, FSBW's historically above-average noninterest income has given the company roughly peer average efficiencies. In 2020, this has been greatly enhanced with the robust growth in noninterest income from the mortgage banking sector. The company is not aggressive in cutting expenses, looking to gain efficiencies, instead, through revenue growth. The company expects to continue to expand its employee base, in order to serve its growth needs. While not a highly active acquirer, this approach holds true with its M&A strategy, seeking to expand and enhance the franchise as opposed to cost saves. With regards to credit costs, FSBW has historically maintained above average levels of reserves, despite a low loss history. As such, provision expenses have trended slightly above peer averages in the 0.10% - 0.25% of average assets in recent years. In 2020, FSBW significantly strengthened its reserves balances in response to the ongoing pandemic, thus, increasing provision expenses to 0.80% of average assets. FSBW's loan book has shown limited credit stress throughout 2020, therefore, with strong reserves in place, the company is expected to have more normalized credit costs over the near term.

Asset Quality

Stable credit quality has been a key tenet of the company in recent years. FSBW has sustained an NCO ratio below 15 bps dating back to 2015. Moreover, despite a lower trend over this time, reserves have been maintained above peer averages. More recently, while credit losses have been negligible through YE20, the company took a conservative approach and materially increased its reserve balances in response to the pandemic, with loan loss reserves at 1.66% of loans (HFI) at 4Q20. Higher reserve balances are, in part, due to the company's somewhat elevated risk within the loan portfolio, particularly its sizable consumer (21% of total loans) and C&D (11%) books. Following the global financial crisis, FSBW shifted its focus to more higher quality credit within the consumer portfolio, increasing its concentration in high prime clients. High prime borrowers (defined as FICO scores over 720) comprised near-80% of the consumer loan portfolio at 3Q20, as compared to 60% at YE09, while low-prime borrowers (FICO scores between 620-680) have decreased from roughly 17% to less than 5%. Additionally, the consumer portfolio had an average DTI ratio of 29% at 3Q20. More importantly, charge-offs have fallen to the point where recoveries have largely offset losses in recent years (gross charge-offs have tracked between 0.20% - 0.25% in recent periods). The majority of the consumer portfolio is small dollar – short duration – indirect home improvement lending (66% of consumer loans) that are sourced through various dealers primarily on the west coast. The rest of the consumer portfolio is comprised of marine loans (24% of consumer loans) with an average loan size near $60,000, and solar loans.

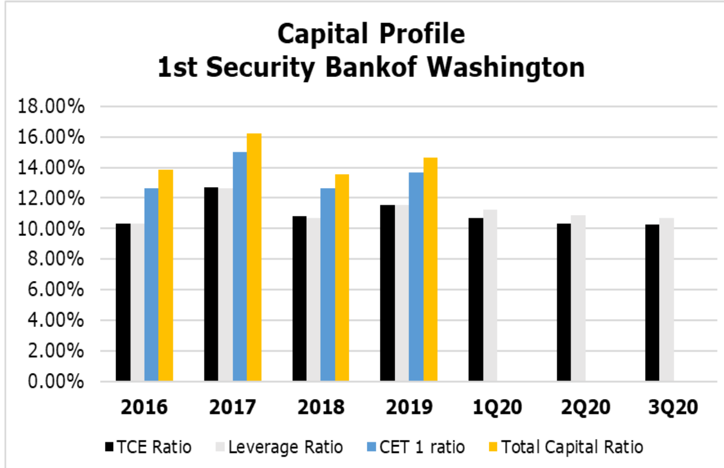


The C&D portfolio largely comprised infill speculative lending within the Seattle MSA and includes construction for owner-occupied and manufactured homes. Following its acquisition of Anchor Bank in 2018, FSBW shrunk the C&D portfolio and only recently began to grow the portfolio again. As previously stated, the company had some higher yielding residential mortgage loans that primarily consisted of prime consumers with limited, though stable income history. However, the majority of the residential mortgage portfolio (33% of total loans) were prime jumbo mortgages. The commercial portfolio was a mix of C&I lending (20% of loans including owner occupied CRE) and investor CRE (13% including multifamily), with limited concentrations in any industry. The company had modest exposure to COVID sensitive industries with just $44 million, or 3% of loans, in hospitality and less than $3 million in retail CRE. FSBW had total deferrals of $94 million, roughly 5% of loans, with $45 million remaining in deferral status. The company had downgraded all high-risk industry loans as well as any credits needing a second deferral ($26 million). FSBW experienced moderate credit migration through the first half of 2020, with metrics flattening in 3Q20. Total criticized loans were a manageable 1.98% of total loans at 3Q20, as compared to 0.88% at YE19, while watch credits were 6.98% of loans as compared to 1.63%. In addition, delinquencies have largely held steady between 0.20% - 0.40% of total loans. Altogether, despite the riskier nature of the portfolio, FSBW's loan book has performed well thus far through the economic downturn with no signs of material deterioration imminent.



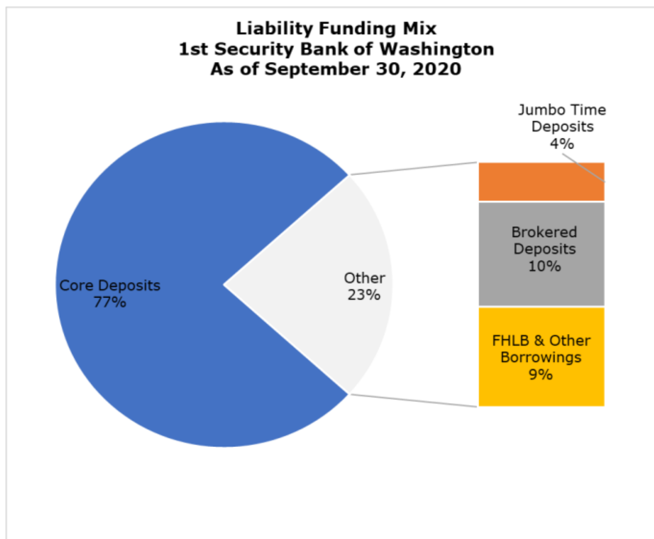
Capital

The company's core capital measures reflect consistent and sound capital management practices, with its TCE and leverage ratios tracking above 10% in recent years. In addition, risk-based capital has remained near rated peer averages, with a CET 1 of 12.7% at 3Q20. The company primarily utilizes capital as a tool for organic growth, though remains open to both whole bank and branch acquisitions. Strong earnings have perpetuated the company's sound capital position, thus, despite its rapid growth in recent years, FSBW has sustained capital ratios well above targeted levels, which includes a leverage ratio above 9%. Furthermore, KBRA recognizes FSBW's above average reserve levels with allowances to loan losses at 1.66% of loans (HFI). Overall, when taking into account the company's somewhat elevated risk profile, KBRA views FSBW's capital position as adequate. KBRA notes FSBW's willingness and ability to access capital markets as demonstrated in 2017 with its common stock offering that had been upsized totaling $25.7 million. The company's capital stack included $10 million in subordinated debt that became callable and was retired in January of 2021.



Funding & Liquidity

While the company remains focused on enhancing its funding profile through improved organic core deposit growth along with potential opportunities in the M&A space, FSBW continues to have an elevated concentration in higher cost time deposits (31% of total deposits at 3Q20), though the company has increased its noninterest bearing accounts to be closer to peer averages (23%). The company's branch footprint includes some higher density, urban markets in the Seattle MSA, though many are located in more rural parts of western Washington. FSBW's market share within the larger counties of western Washington is somewhat weak outside of a top 10 ranking in Snohomish County. However, the company believes considerable growth opportunities within its markets, though growth may include new markets over time. Total deposit costs have certainly benefitted from the lower rate environment, decreasing 61 bps compared to the year ago period, yet remained comparatively elevated at 0.65% for 3Q20. Moreover, FSBW's noncore funding usage has generally tracked above 20%, primarily consisted of brokered deposits along with FHLB borrowings. However, FSBW's higher usage of noncore funding should be expected due to the company's operating model, which includes a large mortgage banking operation and moderately sized commercial portfolio. Thus, funding costs are likely to remain somewhat elevated comparatively over the near-to-medium term.



Historically, FSBW has managed its on-balance sheet liquidity at adequate levels, targeting 12%-15% of total assets. However, buoyed by the effects of the pandemic, on-balance sheet liquidity has strengthened, with significantly higher amounts of cash, securities and loans (HFS) on the balance sheet. At 11/30/20, FSBW had roughly 20% in on-balance sheet liquidity. As cash assets increased during the year, the company looked to move some of its cash into higher yielding assets. The company increased its loans (HFS) and its investment portfolio. Loans (HFS) totaled $215 million at 3Q20, with roughly $98 million aged less than 45 days. The $179 million investment portfolio was largely comprised of MBS (35% of securities) and muni bonds (31% of securities), with the bulk of the entirety of the muni portfolio from within the state of Washington. The investment portfolio also included considerable portions in SBA securities (8%) and corporate debt (12%).

Key Qualitative Rating Determinants

The qualitative aspects of FS Bancorp, Inc. were assessed using a scorecard that focuses on four key factors: market strategy, risk management, liquidity management, and the operating environment. For the most part, the bank scored average for qualitative factors. For qualitative aspects, KBRA relies principally on discussions with management supplemented by publicly available data, regulatory filings and KBRA's view of the economic and regulatory environment. The following describes KBRA's qualitative assessment for FSBW:

Market Strategy

The bank was originally established in 1936 as a credit union in Mountlake Terrace, Washington. In 2004, the bank converted to a state chartered mutual bank and went public as a stock savings bank in 2012 when the holding company was created. The company now offers a variety of consumer and commercial financial services, operating 22 branch offices and 11 mortgage LPOs within the western part of Washington state, including the Seattle MSA. Its mortgage banking division is a revenue contributor, with just over 20% of total revenues in 2018/2019, though ballooning to 38% through 9M20. The company is focused on in-house originations with the bulk sold into the secondary market (FSBW had approximately $1.4 billion in originations through 9M20 with over 90% originated for sale). Additionally, FSBW is primarily a purchase lender, generally originating loans with a 70/30 split between purchase and refinance loans. However, with the dramatic reduction in interest rates, refinance loans comprised nearly 60% of originations through 9M20. While conventional 1-4 family loans make up a piece of the residential mortgage portfolio, the bulk comes from jumbo mortgage loans along with some non-agency prime mortgage loans and home equity loans. Altogether, residential mortgage loans comprised approximately 33% of total loans at 3Q20 (22% excluding loans HFS). The loan portfolio also includes a considerable portion in consumer loans (21% of total loans), primarily comprised of small dollar indirect home improvement loans, as well as marine loans and solar loans. While the largest segment of the consumer portfolio is originated in the state of Washington (44%), the portfolio also includes exposure in Oregon (27%) and California (17%) with small amounts in other western states. The commercial portfolio is a mix of C&I lending (20% of total loans including owner-occupied CRE) which generally targets businesses with revenues ranging from $10 million to $30 million, non-owner occupied CRE (5%), multifamily (8%) and a small portion in warehouse lending (2%). The company also maintains a notable C&D portfolio (11% of total loans) that is primarily comprised of infill speculative lending within the state of Washington. Future loan growth is expected to come from each of the different lending segments, with the company looking to maintain its relatively diverse loan mix.

FSBW has an experienced and diverse mix of leaders within its executive team. The company's CEO, Joseph C. Adams, had a legal and accounting background prior to joining FSBW in 2003, becoming its CEO in 2004. Most of the executive team has a long history within the industry, including its Chief Credit Officer, who has over 30 years in the industry, much of it in commercial lending, as well as the Chief Risk Officer, who prior to joining FSBW in 2009 was a financial examiner for the state of Washington. The company's growth strategy is primarily focused on organic tactics, though is open to acquisition opportunities that could expand its market outside of the Seattle MSA, including outside the state of Washington. As previously stated, any acquisition would need to be additive to the company either through product enhancements or market expansion, and not a transaction to gain cost saves. More importantly, FSBW is highly focused on maintaining its culture, thus the company's intent to grow largely through organic means. This includes the addition of new commercial lenders that add to its culture.

Risk Management

FSBW has risk management practices and infrastructure in place which are suitable of an institution of its size and structure. Within the risk framework key drivers are split into two categories, business drivers and regulatory and rating agency drivers, that cover the following risks: concentration risk, compliance/regulatory risk, interest rate risk, liquidity risk, operational risk, transaction risk, credit risk, reputation risk, strategic risk. The company employs board and committee oversight and reporting, with the CRO and senior executive compliance officers reporting directly to the audit committee. FSBW utilizes an independent internal audit department that conducts an annual review. The company uses top-tier third party providers for its critical customer-facing systems while maintaining its own critical infrastructure and systems in-house. FSBW has a disciplined underwriting approach with generally standard LTV and DSC coverage requirements with firm concentration limits and designated focused lending channels. Loans greater than $5 million are reported to the Asset Quality Committee, while loans between $15 million and $25 million require approval from the Senior Loan Committee. The CRE and C&D portfolios are stressed on a quarterly basis with a third-party review of the commercial portfolio conducted on an annual basis. The company has made modest changes with its underwriting standards due to the pandemic, primarily within its consumer lending while also temporarily not active in multifamily or non-owner occupied CRE lending. Within the consumer space, higher FICO scores were required for certain loans. FSBW has an approval rate near 60% with roughly 40% of approvals decisioned automatically. Altogether, FSBW has demonstrated an ability and willingness to adjust its credit standards to changing market conditions, with its sound principles as its primary guidelines, suggesting a disciplined credit approach.

Liquidity Management

FSBW manages its liquidity targeting generally 12%-15% in on-balance sheet liquidity with both primary and contingent liquidity source limits. The company's primary liquidity sources include FHLB borrowing at less than 75% of capacity, brokered deposits at 20% of total deposits, QwickRate deposits at 15% of deposits as well as other line of credit facilities. Liquidity is stressed over a 12-month period with cash inflows and outflows of deposits, loans and investments. At 3Q20, the company had over $700 million in availability from these sources, representing nearly 35% of total assets. FSBW regularly measures interest rate risk, which has trended slightly asset sensitive, with margin impact measured over a 3-year scope while EVE is measured over a 12-month time horizon.

Operating Environment

Overall, the U.S. banking system has a strong regulatory framework. Since the 2008 financial crisis, banking institutions have adjusted to additional rules and regulations resulting from the Dodd-Frank Wall Street Reform and Consumer Protection Act and Basel III standards. Despite some easing of regulatory burden, particularly for small to mid-sized banks in recent years, regulatory standards and oversight remain strong for the U.S. banking system. The latest research on this and other topics can be found **here**.

External Support

Pursuant to the 2010 Dodd-Frank Act, U.S. regulators created a resolution regime with the goal of preventing a systemic crisis if a systemically important bank fails. For non-systemically important depositories such as the bank, KBRA believes that uninsured depositors could benefit from some degree of extraordinary systemic support. However, KBRA does not foresee any regulatory support being extended to creditors or investors at the bank or its BHC. As the bank operates in the U.S. market, a well-developed economy with a AAA sovereign rating, there were no adjustments for country risk. In addition, the company is publicly traded and the rating assumes no external support related to its ownership structure.

Rating Approach

KBRA's ratings supported by the following factors: i) a quantitative view of the bank's financial fundamentals, including stress testing, ii) a qualitative assessment of the bank's management and market strategy, and iii) the incorporation of potential external systemic support. KBRA's ratings for the bank holding company reflect the overall credit profile of the organization and the potential structural subordination of its liabilities to the liabilities of its subsidiary in an event of default or regulatory intervention. KBRA's short-term ratings are derived from senior long-term bank ratings. Consistent with KBRA's typical notching practices, subordinated debt is rated one notch below senior unsecured debt.

Appendix A: ESG Additional Information	
Environmental-Related	**Description and Other Information**
Board oversight of climate-related issues and process for identifying, assessing and responding to risks/opportunities	The Board instructed management to focus on products and services that would assist homeowners in saving on energy costs as well as cut down on their carbon footprint. Over the past seven years the bank has worked with our various public utility districts on energy efficiency initiatives. The bank has undertaken eight projects with energy savings ranging from 25%-92%. The bank has two more of these projects lined up for 2021.
Influence of climate-related risks and opportunities on strategy/financial planning	None noted.
Process for identifying, assessing, and responding to climate-related risks and opportunities	Management performs a SWOT analysis periodically. Based on this analysis, management takes the necessary steps to evaluate and mitigate the risks identified to the bank.
Any inherent climate-related risks with the potential to have a substantive financial or strategic impact on the business	None noted.
Calculation of CO2 emissions in current year	Although this is not calculated, the bank identified employees traveled 114,781 miles in 2020 with 64 tons of CO2 vs 291,511 miles in 2019 with 165 tons of CO2. A savings of 101 tons year over year.
Aspects of loan portfolio directed to renewable energy projects or lending opportunities in the area of energy efficiency	Since 2013, the bank has provided consumer loans to almost 4,000 borrowers totaling $135MM. These borrowers have switched their primary energy source from electric to solar and thus a renewable energy source. Since 2011, the bank has provided residential construction financing to a number of builders that are focused on building energy efficient homes. The bank has financed approximately $500MM in construction loans (almost 1,000 individual units) in the City of Seattle that were Built Green certification with a 4 star or 5 star (5 star being the highest possible standard).
Portion of loan portfolio to energy and other carbon-intensive industries	None noted.
Any facilities that are environmentally oriented, either LEED certified or enhanced	The Montesano branch is a Green certified building. The bank's data center has many sustainability initiatives including: o LEED Gold Certification o Energy Star Certification o Green Lease Leaders
Social-Related	
Number and amount of loans outstanding, past due, and non-accruing associated with programs designed to promote small business and community development	Due to COVID, the bank has a nominal amount of small business loans that have requested to defer their loan payments in the interim.
Any bank deposit or lending products geared toward low income customers as well as low-income housing, etc.	The bank participates in loan programs and committees that focus on low income housing needs, such as the Washington Community Reinvestment Association, Housing Consortium of Everett and Snohomish County, Washington State Housing Finance Commission, and the Federal Home Loan Bank.
Number of no-cost retail checking accounts provided to previously unbanked or underbanked customers	None noted.
Number of participants in financial literacy initiatives for unbanked, underbanked, or underserved customers	The bank offers financial literacy programs in conjunction with local nonprofits in the communities we serve.

Governance-Related	
Number of data breaches, percentage involving personally identifiable information (PII), and number of account holders affected	None noted.
Description of whistleblower policies and procedures	The bank has Board approved Whistleblower Policy and procedures.
Description of approach to identifying and addressing data security risks	The bank has Board approved Information Security related policies and procedures.
Total amount of monetary losses as a result of legal proceedings associated with fraud, insider trading, anti-trust, anti-competitive behavior, market manipulation, malpractice, or other related financial industry laws or regulations	None noted.

Source: Company Reports and Management Presentations/Data