TRANSCRIPT

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# Enterprise Financial Services Corp

## Second Quarter 2024 Earnings

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## CORPORATE SPEAKERS:

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*Enterprise Financial Services Corp; President, Chief Executive Officer*
**Scott Goodman**
*Enterprise Financial Services Corp; President of Enterprise Bank & Trust*
**Keene Turner**
*Enterprise Financial Services Corp; Chief Financial Officer, Chief Operating Officer*
**Douglas Bauche**
*Enterprise Financial Services Corp; Chief Credit Officer of Enterprise Bank & Trust*

## PARTICIPANTS:

**Jeff Rulis**
*D.A. Davidson; Analyst*
**Andrew Liesch**
*Piper Sandler; Analyst*
**Damon Del Monte**
*KBW; Analyst*
**Brian Martin**
*Janney Montgomery Scott; Analyst*

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## PRESENTATION:

Operator^ Hello. And thank you for standing by. At this time I would like to welcome you to the Enterprise Financial Services Corp Second Quarter '24 Earnings Conference Call. (Operator Instructions)

I would now like to turn the conference over to Jim Lally, President and CEO.

Please go ahead.

James Lally^ Well thank you, [Jericho]. And thank you all very much for joining us this morning. And welcome to our 2024 second quarter earnings call.

Joining me, this morning is Keene Turner, EFSC's Chief Financial Officer and Chief Operating Officer; Scott Goodman, President of Enterprise Bank & Trust; and Douglas Bauche, Chief Credit Officer of Enterprise Bank & Trust.

# Enterprise Financial Services Corp

## Second Quarter 2024 Earnings

Before we begin, I would like to remind everybody on the call that a copy of the release and accompanying presentation can be found on our website. The presentation and earnings release were furnished on SEC Form 8-K yesterday. Please refer to Slide 2 of the presentation entitled Forward-Looking Statements in our most recent 10-K and 10-Q for reasons why actual results may vary from any forward-looking statements that we make today.

I'm very pleased with our second quarter results. Our business model, associate base and management team has been constructed to perform well in any economic environment, and the results in the second quarter are a product of the great work that has been done for the last several years. In the quarter, we were able to expand margin, grow net interest income, experienced positive operating leverage and continue to significantly compound tangible book value per share.

Like we've stated during previous earnings calls and investor meetings over the last several years, we have worked diligently to diversify our business model such that we do not have to depend on any one business, market, or asset class to produce high-quality and predictable earnings. Our second quarter financial performance is a result of this strategy, and I'm confident that we can continue to perform at this level or better for the remainder of 2024.

Our financial scorecard begins on Slide 3.

For the quarter, we earned net income of $45.4 million or $1.19 per diluted share, and we produced an adjusted return on assets of 1.27% and a pre-provision return on assets of 1.74%. These results improved over a fundamentally sound first quarter.

Our net interest income increased $2.8 million to $140.5 million. Looking back over the last six quarters, we've been able to hold this number at or around $140 million despite challenging competitive and interest rate conditions. This reflects the strength of the franchise we've built, and we remain positioned to produce high-quality earnings that consistently improve shareholder value through deep-rooted client relationships.

Our stable net interest income was aided by the defense and growth of our net interest margin to 4.19%. This is a direct result of our appropriately priced, stable deposit base in our ability to originate commensurate to the needs of our clients but priced well amid the current interest rate environment. Keene will provide much more detail on these results in his comments.

As we thought what happened, loan growth moderated in the quarter, largely due to lower line usage, higher paydown and payoffs in the quarter and the planned rundown of the agricultural portfolio.

Our second quarter saw strong loan origination activity, as you will hear from Scott, and I'm confident that we will see our normal second half strength in loan originations. Deposit growth continues to be a bright spot for our company. After experiencing our typical first quarter seasonal outflows, the second quarter saw us grow client deposits by $192 million.

Our confidence in the continued growth in our national deposit verticals allows us to be disciplined with respect to the deposit pricing in our geographic markets. This is evidenced by the fact that our overall cost of deposits increased only 3 basis points to 2.16% in the quarter.

At quarter end, our loan-to-deposit ratio remained at 90%, while our DDA level improved to 32% of total deposits. With the overall business generation strong, I remain optimistic that our high single-digit balance sheet growth is achievable.

We are starting backlog grow in our life insurance premium finance business, our geographic markets have seen recent discussions intensify for new C&I and CRE opportunities, but timing on actual fundings will likely be mid- to late fourth quarter, with some of this leaking into 2025. The bottom line is that we will have opportunities to deploy deposit growth in either loans or securities, both of which we view as favorable long-term value and profit drivers.

Scott will provide much more detail on our markets and businesses in his comments.

Our balance sheet remains well positioned and provides for great flexibility with respect to capital planning. Capital levels at quarter end remained stable and strong, with our tangible common equity ratio at 9.18% and an adjusted return on average tangible common equity of 14.06%.

Tangible book value per common share was $35.02, a 10% annualized increase for the quarter. Given the strength of our earnings and our confidence in our continued execution, we increased the dividend by $0.01 per share in the third quarter of 2024 to $0.27 per share, and we returned an additional $8.5 million to shareholders during the quarter through common stock repurchases.

Before discussing our areas of focus for the remainder of the year, I would like to provide an update on credit.

I'm pleased with the progress that we continue to make.

As expected, asset quality continued to improve as classified assets decreased by 8% or $15 million.

NPAs were well managed and net charge-offs were nominal at less than $1 million.

We did receive the results of the third-party loan review of our agricultural portfolio. This report did not surface any abnormalities that we had not already identified by our internal review. That said, the overall sector is showing some signs of weakness in our efforts to reduce our exposure as well as our allowance build represents our posture towards the industry.

We're making good progress in reducing our exposure as the portfolio reduced by just under $40 million during the quarter and stood at about $194 million at quarter end, with further reductions expected throughout the remainder of the year.

Slide 5 shows where we are focused for the foreseeable future. Our focus remains in taking care of the great clients that we have accumulated over our 36-year history while adding those family-owned businesses to cherish high-touch consultative relationships. Doing this day in and day out will lead to several more quarters of really strong performance and continued building of franchise value. We will not alter our credit discipline to chase growth and we'll be cognizant of the current market pricing trends to make sure we continue to protect and grow our client base.

In addition to this, by our next earnings call, we will have converted to our new core system. To date, we are on time and on plan with respect to this conversion and look forward to the benefits that this will bring to the company for many years to come. The fruits of our recruiting efforts, especially in our higher growth markets and higher profit specialized businesses, are beginning to pay off. We've onboarded several new RMs in our Western markets, and we'll continue to capitalize on the disruption caused by M&A in these markets.

Similarly, we are being very strategic with our adds to our specialized lending teams and our national deposit verticals, focusing on those areas that provide the greatest shareholder value combined with the businesses that have been most disrupted due to M&A where banks have decided to disinvest or disregard the business in total. We will aggressively pursue more of these opportunities throughout '24 and '25.

Before handing the call to Scott, I would like to provide a little perspective on how our clients are seeing the world. The challenges related to loan growth are a product of the sentiment of many of our clients. When speaking to several of our C&I business owners, their posture on increasing leverage ahead of Fed cuts and the fall election was quite conservative. Unless there is a specific need for capital, like a new equipment line for newly awarded business or to close on a new acquisition, they are likely to stay on the sidelines and operate conservatively.

On a somewhat positive note, supply chain issues, for the most part, are behind them and the wage pressure that plagued many of these businesses just a few years ago has largely dissipated. These same clients remain very well capitalized in the either grow their businesses when we have better visibility to economic and political climate ahead. Last quarter, I talked about the Fed’s easing of rates as the psychological impetus for CRE projects to go from the drawing board to reality. With the likelihood of this rather imminent, we have seen the number of meetings in our higher growth CRE markets increase significantly. With that said, I'm confident we'll see these discussions turning to closings late in 2024 and into 2025.

We enjoy a great reputation and corresponding market share of middle market businesses in our mature geographies and specialized lending businesses. As such, I'm confident that we will continue to get more than our fair share of corresponding opportunities. Our newer markets in higher growth areas will provide similar levels of opportunities while we continue to build our

reputation in these markets. This blend is what gives me high confidence that we will continue to grow and earn at a predictable rate while continuing to compound tangible value at a higher level than our peers over the foreseeable future.

With that, I would like to turn the call over to Scott Goodman.

Scott?

Scott Goodman^ Thank you, Jim. And good morning, everyone. Turning to loans, which begins on Slide 6. With a modest reduction of $28 million in the quarter, year-over-year loan growth is $487 million or roughly 5%. Jim outlined the primary factors leading to the softened net growth this quarter, but breaking this down a bit further, there were certainly numerous positive factors which position us well and provide optimism moving forward. Foremost among these is that overall production is sound, with originations of new credit commitments up roughly $100 million from Q1 levels.

The loan details on Slide 7 provide a helpful picture of where we are seeing near-term reductions versus growth for the quarter. The largest reductions were in the C&I categories, with roughly half of this change attributable to lower balances on revolving lines of credit. As the impact of higher short-term borrowing costs took hold, businesses tended to lean a bit more on cash to fund working capital and other short-term needs. Other reductions in the C&I category include the planned runoff of several agricultural loan relationships associated with our planned exit from this business line, as well as some expected payoffs and paydowns from commercial clients relating to the sale of assets and operating businesses.

Commercial real estate posted net growth for the quarter, bolstered by some larger property acquisitions, refinancing and facilities expansion in Dallas, Arizona, Orange County, and Las Vegas. Activity seems to be ramping back up in this category, particularly in higher growth markets as owners and developers are adjusting expectations and re-penciling deal structures around the current rate environment. Existing projects also continue to move forward, driving additional growth in construction and development loan balances, which were up $65 million in the quarter.

We view our capacity for growth in these segments as a competitive advantage, as our overall commercial real estate, construction and development levels remain well within regulatory limits and provide ample runway for additional opportunities. Loans by region are broken out on Slide 8, showing net growth in specialty lending, Southwest and Western markets, with the quarterly decline attributable to our Midwestern markets.

Within the specialty lending business lines, life insurance premium finance posted a seasonally soft growth quarter with lower originations offset by some paydowns being driven by policy restructuring around higher interest rates. We're also seeing some heightened rate competition from a few select national and regional players that tend to ebb and flow in the space based on overall loan demand.

In general, though, our pipeline of new opportunities is solid including deals referred from several newer adviser relationships and the growth outlook in this vertical is sound.

SBA production remained steady in the quarter and generally in line with expectations. Growth in this business has been pressured for a while now by higher payoffs, prompted by the higher rate environment, although this is trending down in 2024 versus the prior year.

Application activity is increasing as borrowers become more comfortable with the current rate environment, and ultimately, a reduction in rates would have a positive impact on payoffs. The tax credit portfolio continues to perform well and grew by $20 million in the quarter as existing affordable housing projects move through the construction phase. The sponsor finance book was essentially level in the quarter with healthy origination activity offset by payoffs stemming from the sale of portfolio companies by our private equity clients.

New deal activity in this business continues to steadily ramp up in what is typically a busier second half of the year. Within the geographic regions, St. Louis and Kansas City markets, which contain our largest base of general C&I businesses were heavily impacted by the reduction in revolving line of credit balances. However, new origination activity was up in both markets over Q1, with significant fundings on acquisitions by existing clients new relationships in the nonprofit and medical services industries, and improved activity in commercial real estate lending.

The Southwest region posted 11% annualized growth in the quarter and loan balances were up $234 million or 16.5% year-over-year. This strong growth is representative of the higher levels of new development and generally more robust economic activity in these major metro markets, which include Dallas, Phoenix and Las Vegas. Key drivers this quarter included fundings on development loans in process, as well as stronger new loan origination versus the prior quarter. Notable deals include new relationships in Las Vegas with an auto dealership and a metal fabricator, as well as owner-occupied commercial real estate expansion with an existing financial services client in Phoenix.

In our West region of Southern California, loan balances were up modestly for the quarter at 5.8% year-over-year. This region was also impacted somewhat by lower usage on lines of credit, however, this was more than offset by several larger new loans in commercial development and hospitality as well as continued onboarding of new C&I relationships. Talent that we've added in this market over the past 18 months or so has continued to gain some traction. With over 20 new commercial relationships added so far year-to-date.

Moving to deposits on Slide 9.

We posted strong core growth with balances up $192 million in the quarter, and $1.1 billion or 9.9% year-over-year. Balances were up in all of the key categories, but most prominently in noninterest-bearing DDA, relating to a strong quarter in the property management deposit

vertical, as well as our focus on new C&I operating accounts. In addition to growth, these strategies are helping to maintain our overall current cost of deposits, which Keene will expand upon, and positions us well moving forward.

The breakout by region on Slide 10 further illustrates this growth profile, with the increase for the quarter attributable to the deposit vertical and the Southwestern markets.

The same behaviors by operating businesses, which prompted reductions in revolving lines, also resulted in lower deposit balances in our Midwestern and Southern California portfolios. At present, these companies are opting to use excess cash for working capital and short-term needs rather than borrow. However, as cash builds heading into the second half of the year, and if companies become more confident that rates will come down in the future, we do expect this behavior to normalize.

The deposit verticals are further broken out on Slide 11, which shows the overall portfolio well-balanced between the three major lines of business. Growth in Q2 was particularly strong in the property management segment as we continue to add new accounts to our existing management company relationships. We're also seeing traction related to the Florida branch, which was opened in 2023, allowing us to bring on new accounts located in that state. These are coming both from our existing relationships, as well as new management companies, which are now able to access our products and our expertise.

Funding mix is profiled on Slide 12, which highlights the strong DDA component of our major client channels. In addition to our growth for Q2 being weighted in low-cost account types, we continue to see moderation in both pricing and remixing to the higher interest rate products. Furthermore, we are producing higher average balances and accounts opened versus those closed across all channels, and we are having success in protecting and expanding our best relationships.

Now I'd like to turn the call over to Keene Turner for the financial highlights. Keene?

Keene Turner^ Thanks, Scott. My comments begin on Slide 13, where we reported earnings per share of $1.19 in the second quarter. Reported earnings included the impact of core conversion-related expenses of $1.3 million. Excluding this item, adjusted EPS was $1.21 per share, a $0.14 increase over the first quarter.

Operating revenue expanded nicely in the second quarter with both net interest income and noninterest income showing improvement. An expanded earning asset base and a 6 basis point improvement in the net interest margin drove the net interest income increase, while a rebound in tax credit income also benefited operating revenue. The improvement in margin this quarter was driven by strong client deposit growth that allowed us to decrease usage of brokered CDs.

Also, the provision for credit losses decreased from the prior quarter as total loans declined and net charge-offs remained low. Noninterest expense was incrementally higher than the current

quarter, but lower than we had originally expected and the increase was mainly due to deposit costs.

Turning to Slide 14. Net interest income was $140.5 million in the second quarter, an increase of $2.8 million compared to the linked quarter.

Interest income increased $3.9 million in the quarter as a result of growth in average earning assets and improvement in yields. Loan income grew $2.6 million from the linked period with higher balances and improved yields, adding $1.9 million and an additional $0.7 million coming from favorable movement in amortization of purchase accounting marks. The average loan origination rate in the second quarter was 8.07% and continues to add to the overall loan yield of 6.9% for the quarter.

Earnings on securities grew $0.4 million on improved yields as the portfolio continues to benefit from higher rates on cash flow reinvestment and from a growing portfolio balance. The average tax equivalent yield on purchases in the quarter was 5.43%. An increase in average cash balances generated an additional $0.8 million in the period. More details follow on Slide 15.

Interest expense grew $1.1 million in the quarter and was well managed due to lower wholesale borrowing and a $48 million increase in average noninterest-bearing demand accounts. Deposit expense increased $1.9 million as a result of higher average balances and an increase in rate, mainly in time deposits.

The overall cost of interest-bearing deposits rose 5 basis points from the linked period while the total cost of deposits increased by 3 basis points.

Interest on other borrowed funds decreased $1 million in the quarter as customer repo balances declined from seasonal highs in the first quarter, and deposit growth reduced our reliance on other short-term FHLB borrowings. The resulting net interest margin for the quarter was 4.19%, an increase of 6 basis points from the linked quarter.

Earning asset yields rose by 8 basis points, aided by higher loan origination rates, as well as the positive change in purchase accounting.

Our cost of liabilities increased by 4 basis points compared to the linked period as funding shifted towards lower cost core DDA and interest-bearing deposits and away from high-cost brokered and wholesale funds.

Our expectation is that while interest rates remain at current levels, asset yields will continue to improve as a result of the additive loan origination and renewal rates, along with the opportunity to improve yields in the investment portfolio through cash flow reinvestment.

On the funding side, we experienced an easing of rate pressure on deposits in the second quarter and expect interest-bearing deposit costs to continue to rise at a moderate pace. Loan growth

funded with core deposits should allow us to add to net interest income dollars. When rate cuts begin, we anticipate initially each 25-point reduction in Fed funds will generally result in five to 10 basis points of margin loss or $2 million to $3 million of quarterly net interest income.

We expect deposit rates to be somewhat sticky at first and we may need to ease into rate reductions for the initial one or two Fed movements. With additional Fed cuts, we will be more deliberate in moving deposit rates just as we were when rates were increasing.

We expect this will result in less net interest margin compression than the initial one or two cuts. And while not a component of net interest income, reductions in interest rates would positively impact deposit-related noninterest expense as more than half of the underlying balances there are indexed to the Fed funds rate.

Each 25 basis point of Fed fund moved equates to approximately $1 million of quarterly expense. So net, we expect pretax income to decline by $1 million to $2 million for every 25 basis points of Fed fund changes on a quarterly basis for the initial cuts with the impact moderating if further cuts follow.

At that level, we estimate that mid- to high single-digit growth will replace lost earnings from interest rate reductions.

Moving on to Slide 16, we show our credit trends. Credit trends remain unchanged and are a reflection of strong performance on our loan portfolio. Net charge-offs were less than $1 million or 2 basis points of average loans for the quarter. Nonperforming assets were 33 basis points of total assets compared to 30 basis points at the end of March.

Asset quality trends continue to be favorable with classified assets declining by more than 8% in the period, along with a reduction in past due accounts. These trends, along with loan growth and qualitative adjustments, resulted in a provision for credit losses of $4.8 million, a decline of $1 million from the first quarter.

On Slide 17, we demonstrate the allowance. The allowance for credit losses represents 1.27% of total loans or 1.38% when adjusting for government guaranteed loans. The allowance totaled $140 million, which is up $4 million from the first quarter.

The allowance build reflects a more pessimistic view of the economic forecast and additions to specific reserves, offset by the decline in the loan portfolio during the quarter.

We continue to use a weighted economic forecast that leans more toward a downside scenario that we continue to believe is appropriate for the environment.

Moving on to Slide 18.

Second quarter fee income of $15 million was a $3 million increase from the first quarter and driven primarily in the tax credit line item, which was higher on increased activity during the quarter. Turning to Slide 19. Noninterest expense of $94 million was up from the first quarter, but expense levels reflected some improvement from what we planned essentially across the board.

Additionally, included in the quarter was $1.3 million of core conversion-related expenses compared to $400,000 in the first quarter. Deposit servicing expenses were higher compared to the linked quarter due to growth in average balances on certain specialized deposits as well as the impact of allowances that expired unused during the first quarter. With growth in property management deposits in the quarter, we were pleased with the sequential performance of this line item.

The second quarter's core efficiency ratio was 58% compared to 60% for the first quarter, with improvement primarily related to the increase in operating revenue and better-than-anticipated expense growth.

Moving on to our capital metrics on Slide 20.

With the strength of our balance sheet and capital position, we repurchased 225,000 shares at an average price of $38.07 for approximately $9 million.

Our strong earnings drove tangible common equity ratio to 9.18%, up 17 basis points from the first quarter.

On a per share basis, tangible book value increased to $35.02, a 10% annualized increase from the first quarter.

We announced another $0.01 increase to our quarterly dividend, which will now be $0.27 per share.

We continue to have a manageable dividend payout ratio that's less than 23% for the first half of 2024.

Regarding potential share repurchases, we have approximately 1.7 million shares remaining under our approved repurchase plan and we expect to continue to manage our capital levels through share repurchases.

This second quarter was another fundamentally sound quarter. Client deposit generation was strong, asset repricing continued to improve, deposit pricing pressure has abated and expenses remain well managed. Credit conditions have also stabilized, and we continue to make investments in the business through technology with our core conversion later this year, and also through new hires of loan and deposit-generating associates in our high-growth markets and verticals.

Additionally, we continue to generate better than peer profitability results with an adjusted return on tangible common equity of over 14% and a 1.3% adjusted return on average assets.

Our pre-provision earnings topped $63 million in the quarter or 1.7% of average assets. These results are indicative of what we expect our company to deliver on an ongoing basis due to the strength of the business platform that has been strategically built over the last several years.

I appreciate your attention today, and we'll now open the line for analyst questions.

## QUESTION & ANSWER:

Operator^ (Operator Instructions)

Your first question comes from the line of Jeff Rulis with D.A. Davidson.

Jeff Rulis^ First question is related to the credit side, sort of the nonperformers kind of trying to moderate a little bit here.

I had thought over the course of the quarter that maybe there were potential for some movement of some of your larger credits, particularly maybe the St. Louis office loan. Any update on some of the larger non-accruals that may be in the bucket and any progress on those?

James Lally^ Sure, Jeff. Let me bring on Doug here and he can address that.

Douglas Bauche^ As previously noted, the St. Louis office CRE building is under contract.

It's passed all of the due diligence period, and we expect to close on the sale of that asset here in the third quarter.

I guess I would just also note Jeff, nonperformers at the end of Q2 were two agriculture relationships, one relationship totaling $2.5 million, which has subsequently been paid off in full and another credit relationship of about $6 million that saw a 20% principal curtailment.

So I think we're proud of the credit results at the end of the second quarter, I think it's very stable, and I think we're carrying some pretty good momentum into the back half of the year.

Jeff Rulis^ And Doug, so on the ag, those two credits. One was the new one, the other one was the one that came on in the fourth quarter?

Yes. One was a downgrade here in the second quarter, Jeff, of about a $6 million relationship. That's the one that we just got a $1.2 million principal curtailment on in exchange for the execution of a forbearance agreement and another one of $2.5 million that was paid in full.

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Jeff Rulis^ Okay. And are they related? It's just -- I mean other than just in the broader category? --

Douglas Bauche^ No relationship. Both of them just in the agriculture industry.

Jeff Rulis^ And Keene, on the margin then, I think kind of coming into the second quarter, I think you framed it up as maybe some first half pressures, and we're talking excluding rate moves, if you will, but I think the idea was that some of the core pressures ease in the second half and -- and I think we kind of framed up maybe margin drifting back towards 4%. I get the rate cut guidance or impact -- can you help us on the margin now that it seems like a little bit higher base. Outside of the rate cut impact, it sounds like the core has some maybe some tailwinds. Is that fair to say on margin?

Keene Turner^ Yes. Maybe, Jeff, I would say not so much tailwinds, but the headwinds have subsided. I think we didn't necessarily plan for such strong DDA growth in the second quarter. And therefore, the abatement of repricing pressure happened a quarter earlier. And so while we were expecting it to be down, it improved. I think the asset repricing, we certainly expect that to continue with rates where they are, I do think that as we look at deposit growth, we expect good core deposit growth in the second half. I don't know that we are so confident or exuberant that we think it's going to be all DDA driven, so I do think that as we get some interest-bearing growth as part of the overall deposit growth, that makes net interest margin maybe a little bit slightly down from where we are but certainly, we think it's a reset of the base at 4.19% here. It's hard for me to guide less than 5 basis points but as I look at margin performance over the next four quarters with rates where they are, I mean I think you're less than 5 basis points of compression per quarter with what we're planning and expecting. So I think that 4% at the end of the year, we're going to be, I think, pretty significantly better than that, probably 10 or so more basis points as we see it. Some of that's just going to depend on the timing of if we get deposit growth in advance of asset growth or if you get any deposit pressure and have to rely on wholesale funding.

But right now, that doesn't seem to be the case, we seem to really have good deposit generation and momentum. And I think that gives us comfort that margin is stable-ish, maybe drifts a little bit, but overall, I think the sentiment has improved and largely because the pricing has stabilized and deposit generation, I'd say, feels normal again.

And I'll stop there for any follow-ups.

Jeff Rulis^ No. That was really thorough. Thanks. Just talk one last thing on the core conversion. The timeline of those costs that you had -- I think you had close to a couple of million this quarter or I guess it's $1.3 million -- should we assume a few more in the third quarter, but then we're kind of done with that? Or any discussion of the conversion timing and costs?

Keene Turner^ Yes. Happy to say, Jeff, I think our third quarter will include a similar level, call it $1.5 million of conversion-related expenses, and then there's probably going to be a little bit again in the fourth quarter to get to the total $4 million to $5 million that we expect to see. So I think we had expected it to maybe happen a little bit later in the year in terms of when the expenses came through, but I think it just shows that we're ahead, we're well prepared and the costs are getting incurred early so I think that's a positive sign.

Operator^ Our next question comes from the line of Andrew Liesch with Piper Sandler.

Andrew Liesch^ Good morning, guys. Question on the loan growth or the pay downs this last quarter. How much of the decline in the payoffs was expected? And do you think that's going to continue here into the third quarter? Just trying to get a sense of where payoffs could trend here before a little more demand with lower rates?

Scott Goodman^ Yes. Andrew, this is Scott. I can handle that. I guess, look at it at a high level, I put payoffs into the three categories, self-managed, right? The ag book, there was a sale of assets related to some classified credits that we kind of pushed and took advantage of. Expected payoffs, the life insurance premium issues that I talked about with kind of rebalancing some of the coverage levels to a higher rate environment, some of the larger competitors, which we kind of see ebb and flow, and then the Kansas City clients that kind of cycle out and then back in with their real estate projects. And then lastly, just normal course of business. So -- the way I would look at payoffs is it's not a long-term headwind. Many of them are happening for reasons that we fully expected. Certainly the ag book was something that is self-managed, and we feel really good about production and the ability for production to outpace those payoffs going forward.

Andrew Liesch^ Got it. So it sounds like just given where the pipeline is standing on the commentary, you'll get back to growth during this third quarter, but really, it sounds like fourth quarter based on Jim's commentary earlier that that's really when you'll see growth accelerate with good momentum into '25. Is that a good way to think about it?

James Lally^ Andrew, this is Jim. I think that's exactly how I look at it. Our origination and production is right where we want it to be. I think too, like I said, our customers are waiting for all clear sign. And so that will come later -- here with some Fed cuts as well as, I think, results of the election. And our focus really is just bringing in great relationships, people who -- companies that fit well with our culture, and who we know over the long haul, will invest in their businesses and the loan growth will emanate from that. So overall balance sheet growth, we're confident that's going to grow mid- to high single digits and then loan growth will come from that because we're on the right clients.

Andrew Liesch^ Great. You’ve covered all of my other questions. I’ll step back.

James Lally^ Thanks, Andrew.

Operator^ Our next question comes from the line of Damon DelMonte with KBW.

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Damon Del Monte^ Hey good morning everyone, hope you're all doing well and thanks for taking my questions here. I just wanted to follow up on the expenses and then kind of the outlook here in the back half of the year. Keene, it was a pretty solid quarter, came in below guidance. Could you give a little bit more color and perspective for the back half of the year?

Keene Turner^ Yes, absolutely. I think similar to net interest income and margin, I think we reset the second half year with a little bit more favorable run rate so we're pleased with that. There's an additional working day in the third quarter and we have made some additional investments in people, as you've heard from Jim and Scott's comments. That's going to drive a little bit higher on the comp and benefits line. We do expect deposit verticals to continue to grow - that's going to drive a little bit there. So sequentially, we're thinking from 2Q to 3Q, we're up $2 million to $3 million between those line items. And then obviously you get improved day count on the NII side so pretty comparable and I think generally paid for.

Damon Del Monte^ That's helpful. And then on the fee income side of things, as you guys noted, the tax credit income swung to a positive this quarter. Do you still kind of have that roughly $10 million annual level based on what you're seeing with deals that are scheduled to close?

Keene Turner^ We do. And I think with the second quarter results, it may even prove to be a little bit better but we don't control the fair value and rate impact there, but we were able to overcome an adverse rate move with the activity in the quarter so we feel pretty good about where we're set up there for both the third and the fourth quarter.

Damon Del Monte^ Got it. Okay. And then just lastly, just to clarify on the margin commentary to Jeff's question. So I think you had said that originally, you're kind of looking at a 4% level by the end of the year but could be upwards of 10 basis points better than that. Was that commentary including a 25 basis point rate cut? Or was the commentary around rate cut, the additional impact should that occur?

Keene Turner^ Yes. That was not including a rate impact. With a rate cut, margin will decline a little bit, but you'll get that offset in noninterest expense. And then to the extent you get multiple rate cuts, I think the margin compression isn't as significant in, call it, the third and fourth cut as it is in the first and second.

Damon Del Monte^ Got it, okay. That's helpful. Thank you very much.

Keene Turner^ Thank you.

Operator^ Our next question comes from the line of Brian Martin from Janney. Please, go ahead.

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Brian Martin^   Jim or whomever, maybe Scott, just on the loan side, that runoff on the ag portfolio, how are you thinking that progresses here in the back half of the year, just in the next year, kind of timing as far as when you fully exit that business?

Scott Goodman^   Yes. I can take that one, Brian. We've had some good success early on, and there's probably maybe $40 million to $50 million that could run off in the next couple of quarters, there's going to be a portion of that portfolio, though, that may take a little bit longer. I mean, we're not going to just kick performing companies to the curb. But in the same light, they're going to go find a new home with a company that's probably in that business over time. But I would say that maybe is a little bit longer runway.

Brian Martin^   Got you. Okay. helpful. And then, Keene, just on the fee income line, kind of those volatile lines, if you will, kind of the CDE and the -- I think there's one other -- some other ones in there. This quarter, it seemed like you didn't really have a lot of noise in there in terms of unusual items -- so on that other line item kind of per se, is this kind of a clean quarter and then there's still going to be some bouncing around on those other more volatile line items, if you will?

Keene Turner^   Yes. I would say this is a pretty clean quarter in terms of the baseline items were as expected, and you had a modest contribution from the tax credit business and with good deposit generation and a little bit lower loan growth, we elected to retain SBA loans, which obviously helped the origination rate and the margin expansion. I think if you could draw it up this way for the nonseasonal quarters I think it's a pretty good quarter for the fee income space.

Brian Martin^   Yes. Got you. Okay. And then maybe just one on the credit side, just as far as the overall health of the -- had a couple of questions of late about the C&I portfolio at some of the banks and just how the performance has been there? Just are you seeing any stress within that portfolio? I don't know if you can just give any commentary on that. It seems like credit is very healthy from some of the commentary here, but anything you're seeing on the C&I side or any concerns out there within that portfolio?

Douglas Bauche^   Yes, Brian, it's Doug. I'll try to address that. We saw in the second quarter a migration of about eight or 10 relationships from pass rating into special mention. No real commonalities there, though. We saw companies that range from commercial roofing contractors to health care service providers to importers of apparel, but no real common trends and no real concerns about really the overall health of the portfolio. These were migrations in risk ratings due to the collection of the fiscal year-end '23 numbers and first quarter 2024 numbers, where there's just some impairment and cash flow, temporarily or liquidity, but I think appropriate plans are in place to see these improve in the quarters to come.

Brian Martin^   Okay. That's helpful. And then just the last one, Keene, maybe I missed what you said on the outlook for the expenses. Was it just a couple of $2 million to $3 million a quarter is kind of what you're thinking the increase may look like with the deposit expense in there?

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Keene Turner^   Yes. That's correct. That's correct, Brian. And then eventually, once we're post core conversion, you'll have that $1.5 million coming back in our favor.

Brian Martin^   Okay. And if I remember right, Keene, the impact of the rate cuts- did it broaden out a little bit? The $5 million to $10 million, I mean it seems a little bit bigger than maybe what you had talked about in the past, but maybe that's more with earlier rate cuts versus later rate cuts, but just the size of that impact on a potential cut? It sounds like it could be at the lower end of that range or even lower on the out cuts, if you will.

Keene Turner^   Yes. I would say on the out cuts, we've had the passage of time and we've added to the investment portfolio, which has helped us to stabilize and further improve the net interest income stream. I think with -- we've put some hedges and collars in place, and I think just some of what's happening on the origination side, we're getting a little bit less variable, a little bit more fixed in this current environment so all of those I think are contributing to better than we had initially thought out rate guidance. And I also don't think that we had really talked much about that previously. We've stayed back from that, I think just because we were still seeing so much deposit pricing trickle through. And now that, that's slowed and we're kind of back to what feels more like a normal deposit environment I think that gives us comfort with the initial cuts still being very similar but not as dramatic on third, fourth, et cetera.

Brian Martin^   Yes. Okay. That's super helpful. And just the last one was on the reserve coverage. It's kind of picked up a bit here, but credit still sounds pretty healthy. I guess, is the current level of the reserve or kind of reserve coverage does it feel like it's sustainable at this level and really no further rise from here? Or I guess how are you feeling about that?

Keene Turner^   Yes. I mean obviously a big portion of that, Brian, is what happens with the underlying forecast. The forecast got better in the second quarter compared to the first but we qualitatively weighted more heavily to be pessimistic. Even with cuts looming, it still feels like higher for longer and I think we want to make sure that we're just well covered given the profitability, and given the capital levels for any of those credits that randomly might experience stress just because of higher rates for such an extended period of time. I think we're trying to be prudent. I think it's sustainable to the extent that we don't have material changes in any portion of the portfolio, and we'll continue to evaluate the weightings and whether we want to get more pessimistic than we are.

Brian Martin^   Got you. Okay. Yes. It just seems like with rate cuts potentially coming that going to be a positive for the borrowers, but I guess so -- but for now the level seems fine. I appreciate you guys taking my questions. Thank you.

Keene Turner^   Thanks, Brian.

Operator^   It seems that there are no further questions so I'll now turn the call back over to Jim Lally.

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## Second Quarter 2024 Earnings

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James Lally^   Thank you, Jericho. And thank you all for joining us today and for your interest in our company. Have a great day, and we'll talk to you later this year at the end of the third quarter. Take care now.

Operator^   The meeting is now concluded. You may now disconnect.