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Enterprise Financial Services Corp

Third Quarter 2023 Earnings

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CORPORATE SPEAKERS:

James Lally

Enterprise Financial Services Corp; President and Chief Executive Officer

Scott Goodman

Enterprise Financial Services Corp; President of Enterprise Bank & Trust

Keene Turner

Enterprise Financial Services Corp; Chief Financial Officer and Chief Operating Officer

PARTICIPANTS:

Jeff Rulis

D.A. Davidson; Managing Director, Senior Research Analyst

Andrew Liesch

Piper Sandler; Managing Director and Senior Research Analyst

Damon DelMonte

Keefe, Bruyette & Woods; Managing Director

Brian Martin

Janney Montgomery Scott; Director, Banks & Thrifts

PRESENTATION:

Operator^ Thank you for standing by. At this time, I would like to welcome everyone to the Enterprise Financial Services Corp Third Quarter 2023 Earnings Conference Call. (Operator Instructions) Jim Lally, President and CEO of Enterprise Financial Corp, you may begin your conference.

James Lally^ Well, thank you. And thank you all very much for joining us this morning. And welcome to our 2023 third quarter earnings call. Joining me this morning is Keene Turner, EFSC's Chief Financial Officer and Chief Operating Officer; and Scott Goodman, President of Enterprise Bank & Trust.

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.

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So please refer to Slide Two of the presentation titled forward-looking statements and our most recent 10-K and 10-Q for reasons why actual results may vary from any forward-looking statements that we make today. The third quarter represents a strong performance during a series of rapid changes affecting the economic, and therefore, banking landscape.

Our business model, associate base and management team has been constructed to perform during times of challenge. Our teams are adept at navigating difficult circumstances and using them to differentiate our strength as a banking partner.

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 third quarter financial results and momentum that we displayed on both sides of the balance sheet during all of 2023 are the results of this focused strategy. The business model delivered well again in the third quarter of 2023. Our financial scorecard begins on Slide Three.

Our strong financial performance continued during the third quarter. We earned net income of \$44.7 million or \$1.17 per diluted share, and we produced an ROAA of 1.26% and a PPNR [ROA] of 1.84%. These results reflect a robust earnings profile that easily allowed us to absorb some deterioration in credit during the third quarter.

Combined with our already strong reserves and balance sheet, we remain positioned to operate from a position of strength. This means both delivering returns to shareholders, while also supporting the needs of existing and new clients. The ability to continue to fulfill the loan needs of these clients and prospects have opened up channels of deposit growth as well.

Our net interest income increased over \$900,000 in the quarter, a trend that has continued each quarter since the beginning of 2022. This result, despite challenging competitive and interest rate conditions reflects the strength of the franchise we have

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built. We remain positioned to produce high-quality earnings stream that consistently improves shareholder value through deep-rooted client relationships.

Growth of net interest income was aided by the defense and resilience of our net interest margin at 4.33%. This is a direct result of our appropriately priced stable deposit base and our ability to originate commensurate to the needs of our clients, but priced well amid the current interest rate environment.

As we thought would happen, loans moderated in the quarter largely through lower line utilization and a focus on higher-[valued] segments. This resulted in loan growth during the quarter of \$104 million and total outstanding loans at the end of the quarter of \$10.6 billion.

We also committed to funding our second half growth [with] client deposits, an area where we made significant progress in the current period. For the quarter, we grew net deposits \$290 million. Netting out the reduction in brokered CDs, client deposits grew by \$488 million in the quarter.

Equally impressive is the fact that the DDA as a percentage of total deposits remained strong at 32% and our loan-to-deposit ratio at quarter end was 89%. Scott will give much more color on the markets and businesses where we saw continued success, but we are encouraged that we have a significant amount of runway to continue growing throughout the remainder of 2023 and into 2024. Our balance sheet remains strong and positioned for continued growth.

Capital levels at quarter end remained stable and strong, with our TCE/TA ratio of 8.51%. Tangible book value per common share was \$31.06, an increase of over 8% this year due to our strong earnings that has more than offset the impact of securities portfolio in AOCI.

During the quarter, we did see credit begin to normalize. However, the results I noted both on the income statement and the balance sheet reflect that we both anticipated and are positioned well to deal with these changes.

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I did want to provide a little color around one commercial office loan that moved into OREO during the quarter. This was a St. Louis based borrower that had a single tenant, Midtown office building where the tenant defaulted on its lease.

After pay downs related to the personal guarantees and lease termination penalties, we charged off approximately \$4.7 million of an approximately \$16 million loan balance. This loan represented our only single-tenant office CRE loan in our portfolio

.Additionally, we saw nonperforming loans edge up in the quarter. It's important to reiterate that the strength of our earnings profile generates pre-provision earnings that have averaged nearly \$70 million a quarter this year. This provides a significant buffer to absorb credit issues before ever touching our loan loss reserves or capital. There are also very strong levels, particularly when considering the short duration of our loan portfolio.

Slide Five shows where we are focused for the foreseeable future. Just like we've done -- just as we've done so far this year, in the second half of 2023, we will continue to be focused on funding future loan growth with client deposits. Additionally, I'm confident that we can continue to improve shareholder value through the execution of our strategy.

Our focus combined with modest improvement in certain business lines and markets, along with continued steadfast expense management should consistently produce strong earnings amid the current economic and rate environment that we are in. My optimism for our prospects stems from both my confidence in our existing performance, but also my conversations I'm having with our clients.

Our manufacturing and distribution clients continue to have good backlogs and consistent sales volumes. Margins are compressing slightly due to increased labor and interest expense, causing overall profitability to decline, but not to a point where debt service has been compromised. Advising and helping clients navigate through times like these is the specialty of our teams.

Past turbulent times have shown that these conversations will solidify the relationships that we currently have and invite several more companies to come our way. Our CRE

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clients predict a much lower 2024. Current projects will be completed, but new opportunities [would] be challenged with higher costs, particularly interest expense.

I believe that higher demand asset classes such as industrial and housing will find return equilibrium such that we will see projects and corresponding loan demand come to life late in 2024. I do believe that this is -- this bit of optimism will manifest itself in our higher-growth markets like Phoenix, Dallas and Southern California.

With all that said, I feel strongly that our multiple business lines and geographies will be robust enough to produce loan volumes in the mid-single-digit range over the next several quarters, funded by our continued success in generating well-priced relationship-oriented client deposits.

Before turning the call over to Scott, another piece of good news I would like to share is that we were recently awarded a \$60 million new market tax credit allocation by the Community Development Financial Institutions Fund, or the CDFI, a bureau within the United States Department of the Treasury. This will serve us well over the next 12 to 18 months to attract new clients and projects that qualify for these credits. With that, I would like to turn the call over to Scott Goodman. Scott?

Scott Goodman^ Thank you, Jim. And good morning, everyone. As you heard from Jim and as we show on Slide Six, loans grew by \$104 million in the quarter and results in year-over-year growth of 13.5%.

Components of the growth for the last 12 months are broken out on Slide Seven and reflect the prior comments regarding balance and diversification with increases across all major categories and proportionate between our metro markets and the specialized lines of business.

For the quarter, shown on Slide number Eight, we saw the most lift in the owner-occupied commercial real estate, tax credit and construction categories. It's also worth noting that revolving line of credit usage declined in the quarter as operating companies manage their working capital more efficiently in response to higher rates and a more risk-off approach to their businesses.

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Outstanding balances on lines declined by \$100 million in the quarter. So while the C&I loan portfolio was down by \$9 million, net [of line] reductions, this book actually grew \$91 million.

This C&I lift as well as the owner-occupied commercial real estate growth reflects continued success in attracting new operating company relationships and expanding business with our existing clients. The Construction category rose in conjunction with improved momentum of projects following the code and supply chain induced construction lags that we saw last year and earlier this year.

And while we are certainly seeing new development loan requests slow significantly, the existing projects closed over the past 12 to 18 months are continuing to move forward. This portfolio overall is well-diversified with the majority of the book fairly well-balanced within the multifamily, residential, industrial and mixed-use projects.

Investor-owned CRE office represents less than 5% of this total construction book. Within the specialized business units, tax credit lending had a strong quarter, reflecting continued momentum in the funding of existing affordable housing projects on the books. Jim also mentioned our recent award of \$60 million in new market tax credit allocation by the U.S. Treasury Department.

As we have with prior awards, these credits will serve as a catalyst to facilitate much needed projects within underinvested areas in our metro markets. But these credits will also allow our bankers to bring a differentiated solution to the table to attract new banking relationships and can provide a source of fee income, which is typically 7% to 8% of the allocation earned over seven years.

Life insurance premium finance grew modestly this quarter, with some seasonally slower premium fundings on existing policies but has grown nearly 19% year-over-year and continues to build a solid pipeline of new opportunities.

Sponsor Finance also had a modest growth quarter, reflecting some seasonal softness on origination volume, but also an uptick in pay downs related to the sale of portfolio companies by our private equity sponsor companies.

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The SBA portfolio declined by \$19 million in Q3, mainly due to the sale of \$33 million in 7(a) loans. Payoffs continue to be somewhat of a headwind from certain borrowers that are now bank qualified, while origination volumes were stable and in line with expectations.

We also remain focused on improving returns opportunistically within specialties or in loan categories where the supply-demand dynamics have shifted. Generally, in these cases and depending upon the loan type, we're targeting some combination of higher loan spreads or requiring associated compensating deposit balances.

A regional breakdown of the loan trends are shown on Slide Nine. Growth of the specialized businesses continues on a solid and steady pace, up 15% annualized for the quarter and 19% year-over-year.

In addition to my prior comments on these specialized businesses, our practice finance unit also performed well in 2023, growing by roughly \$70 million year-to-date, including \$23 million of growth in Q3. This team, which has a long history and deep expertise in this niche focuses mainly on banking, dental and veterinary practices, which are generally viewed as stable and high credit quality business types.

Within the Midwest region, reduction in revolving lines were a primary headwind to growth this quarter, offsetting some of the otherwise solid origination activity. New relationships were opened in Kansas City and St. Louis for reputable long-standing companies in these markets with businesses such as electrical contracting, hospitality, entertainment and medical services.

The Southwest region of Arizona, New Mexico, Las Vegas and Texas grew by \$50 million in the quarter, posting year-over-year loan growth of 26% and reflecting our team's successes in leveraging the above-average economic growth profile in these markets.

Significant wins in Q3 included several new owner-operator and C&I deals with a large local not-for-profit and automotive services business, a regional storage operator and a commercial design company. In addition, these markets benefited from the elevated fundings under existing construction lines.

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In Southern California, which is our West region, we continue to show positive momentum, posting another quarter of growth.

Year-over-year, this portfolio is up 9.3%, following an intentional shift during 2022 to move away from higher-risk, large, fix-and-flip Resi Real Estate lending and focus the legacy platform on a more balanced relationship-based CRE and C&I strategy, which is consistent with our other markets.

New loans during Q3 included moderate to midsized seven figure relationships with an apparel manufacturer, a hospitality business, transportation company and specialty printing business. We've also continued to expand our talent base in this region, adding a new market leader in San Diego as well as two experienced relationship managers and a treasury management officer in the L.A. Orange County market during the quarter.

Moving now to deposits, which are broken out on Slides number 10 and 11. Total balances grew by \$290 million in the quarter after a reduction in higher-cost brokered deposits of \$198 million. So net of brokered funds, client deposit balances are up \$488 million or 18% annualized in the quarter.

The regional market client deposits rose \$185 million, reflecting success in our sales plan to recapture excess funds from existing relationships that had moved to nonbank alternatives earlier in the year as well as our ongoing focus on deposit-heavy new relationships.

Specialized deposits rose by \$303 million. This breakdown is highlighted on Slide 12. Within the geographies, we grew client deposits net of brokered balances in each of our major markets, with the exception of New Mexico. This growth generally mirrors the concentration of our C&I client base and was most evident in the Midwest where client balances were up \$125 million.

In California, representing our West region, client deposits rose by roughly \$46 million in the quarter. I think this is a particularly positive sign just given the sensitivity to stress banks in that market, and also another indicator of our success in landing balanced new relationships there.

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The specialized deposit portfolio, which is broken out on Slide 13, also continued its growth trajectory in Q3, now representing 27% of total deposits.

There's good balance amongst the lines of business within this book, with property management and third-party escrow driving most of the growth this quarter. Property management continues to be a consolidating industry, which provides opportunity to expand the account base as our clients are generally the larger acquirers.

Slide 14 shows some additional detail on our core funding mix and account activity for the quarter. Deposits are generally balanced among our 4 main channels and anchored to client relationships that have an assigned team or a key point of contact within our company.

These deposits are also well diversified by industry, by household and by geographic market. The underlying account activity also continues to trend favorably with new accounts open, exceeding closed accounts and average balances stable to increasing across all channels. Now I'd like to turn the call over to Keene Turner for his comments. Keene?

Keene Turner^ Thanks, Scott, and good morning, everyone. My comments begin on Slide 15, where we reported earnings per share of \$1.17 in the third quarter on net income of \$45 million. Net interest income expanded from the linked quarter as we have continued to focus on growing and defended net interest income.

Our disciplined pricing on loans and deposits, combined with improved customer funding benefited our results. A decline in fee income offset the growth in net interest income during the quarter, and we had a few moving parts in this area that I'll touch on in a few minutes.

The provision for credit losses increased for the quarter, driven by net charge-offs, an increase in nonperforming loans and loan growth.

Finally, noninterest expense was higher in the current quarter with continued growth in deposit costs to support our expanding specialized deposit business. Overall,

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pre-provision net revenue of \$65 million for the quarter shows the strength of our earnings profile and our ability to generate capital to support balance sheet growth.

Turning to Slide 16. Net interest income for the third quarter of 2023 was \$141.6 million, an increase of nearly \$1 million compared to the linked quarter. We're pleased with the growth of net interest income in the quarter as it reflects balance sheet growth amid improving the proportion of the balance sheet that has been customer funded since the last quarter.

Interest income increased \$13 million during the third quarter of 2023, driven equally by continued loan growth and higher rates on the loan portfolio. Additionally, our success in generating customer funding, improved cash levels due to the timing of maturing brokered CDs and added roughly \$2 million to interest income.

With that said, our lending pricing and the structure of the loan portfolio continues to shine. Loan yields increased 16 basis points, while average balances were up over \$230 million.

The average interest rate of new loan originations in the third quarter of 2023 was 7.89% and the most recent month yield is just under 7% overall. More details on this are on Slide 17. Interest income in the quarter was more than sufficient to absorb the \$12 million increase we experienced in interest expense. We were able to grow customer deposits nearly \$500 million during the quarter, which allowed for the previously mentioned decrease in broker funding.

The balance growth was coupled with a 38 basis point increase in the cost of deposits, principally driven by commercial accounts. With that said, total cost of deposits was 1.84% in the third quarter and is approximately 2% in the most recent months.

The deposit pricing performance is aided overall by DDA percentage at 33%, while our asset yield and balance sheet growth more than paid for the increase in the cost of our liabilities in the third quarter. The resulting net interest margin was 4.33% in the third quarter of 2023, decreasing 16 basis points sequentially.

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Most notably, we believe that we are seeing stabilization in net interest margin, at least that's been accurate for the last couple of months. When I say that, I mean notably that deposit pricing is becoming more predictable.

We are expecting continued net interest margin drift rather than contraction in the fourth quarter of 2023 and early quarters of 2024. We're encouraged by both deposit generation and the overall performance of net interest income and margin, and we're growing optimistic that with modest growth in net interest income and some slowing in net interest margin compression, that we'll have the opportunity to further expand net interest income growth in the upcoming quarters.

It's worth noting that excluding PPP, we have grown net interest income dollars for the last 12 quarters and expanded it by roughly 2.5x during that period. Slide 18 reflects our credit trends. Annualized net charge-offs were 26 basis points of average loans in the period.

On a year-to-date basis, net charge-offs were 13 basis points, which continues to be below our historical average. The credit relationship, Jim mentioned, moving into ORE made up the majority of net charge-off balance for the quarter.

It's worth reiterating that this loan represented the only material loan in the investor-owned office portfolio that was supported by a single tenant. Nonperforming assets were 40 basis points of total assets compared to 12 basis points at the end of June. The increase primarily relates to the single credit totaling \$6 million in foreclosed assets from the investor owned office property that we charged down in the quarter, and an approximately \$30 million increase in commercial real estate loans made up of 3 relationships.

While we did experience some deterioration in our credit metrics this quarter, we continue to have relatively low levels of [problem] loans. The provision for credit losses was \$8 million during the third quarter and largely reflects the impact of the net charge-offs, nonperforming loans and loan growth.

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Slide 19 represents the allowance for credit losses. The allowance for credit losses increased \$1 million in the quarter and is 1.34% of total loans or 1.47% when adjusting for guarantees.

On Slide 20, third quarter fee income of \$12 million was a decrease of \$2 million from the second quarter. Income from community development investments decreased, as was anticipated, which was mostly offset by recognized gains from the sale of roughly \$33 million of SBA loans, which occurred in the third quarter. Tax credit income was the largest driver of the sequential decline in fee income as a 70 basis point increase in the 10-year SOFR rate in the quarter negatively impacted the credits that are carried at fair value and masked the strong transaction volumes in the period.

As a reminder, tax credit income has been -- has some seasonal volatility and is typically strongest at the end of each year, and thus, we expect fourth quarter fee income to be roughly \$15 million to \$17 million.

Turning to Slide 21. Third quarter noninterest expense was \$89 million, an increase of \$3 million compared to the second quarter. Deposit service expenses were higher which was partially mitigated by a sequential decline in employee compensation and benefits as well as other expenses.

Deposit servicing expenses grew roughly \$4 million in the quarter due to both rate and volume on certain specialized deposits.

We expect this line item to continue to expand with both continued growth in balances as well as higher rates, but at a decreasing rate, at least as it relates to increased pricing. We do expect specialized deposits to continue to outpace overall deposit growth, which we will continue to drive this expense line item.

Comp and benefits was lower in the quarter-over-quarter due to favorable medical plan performance combined with hiring discipline. Other expenses were lower sequentially, primarily from the non-recurrence of the operational event in the second quarter as well as certain other expenses. Overall, we expect noninterest expense to increase to roughly \$90 million to \$92 million in the fourth quarter, reflecting an increase in deposit service expense.

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The third quarter's core efficiency was 56.2%, an increase of 220 basis points compared to the second quarter and was driven primarily by the rise in both interest and noninterest expenses, while the decrease in fee income impacted revenues. With some moderation of our net interest margin and net interest income expectations, we do expect core efficiency to move up slightly in the coming quarters.

However, this is a function of our expectation for expanding our market share in the specialized deposit business. For all other expense categories, we expect to prudently maintain cost controls, which are part of our daily discipline.

Our capital metrics are demonstrated on Slide 22. Our tangible common equity ratio was 8.5% at the end of the third quarter, down from 0.6% in the linked quarter. The decline is due to the increase in longer-term interest rates and the related impact on the fair value of securities and derivatives that are reflected in comprehensive income.

Our regulatory capital ratios continue to be above well-capitalized minimums when including the impact of unrealized losses on available for sale and held to maturity securities. Our strong earnings and manageable dividend level allows us to quickly build capital that we can use to support our growth.

And overall, this was a strong quarter, and we've been pleased with the performance so far this year. Return on assets has been 1.47% and return on tangible common equity is nearly 17%. With that, I'll conclude my remarks and open the line for analyst questions.

Operator^ (Operator Instructions) Your first question is from Jeff Rulis of D.A. Davidson.

Jeff Rulis^ Just a couple of follow-up questions on the deposit base that's impacted by the variable deposit costs. I just want to try to get a sense for, is that the entire specialty loan or specialty deposit balance, or is it a portion of that?

Keene Turner^ If you look at Slide 13, it's really going to be community property and third-party. So it's roughly \$2.5 billion that the \$21 million in the quarter is attributable to. The other is really more part of what's assigned based on specialized lending verticals. So that's how that's delineated.

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Jeff Rulis^ So just want to kind of walk down the strategy again. Just -- these are maybe accretive to net interest margin. But on the expense side, certainly there's been a source of cost increase. Could you just sort of lay out the strategy of that? Overall, it's a more efficient deposit, franchise is stickier. Just want to kind of get a sense for the cost and the value of that relative to traditional deposits?

James Lally^ Yes. Let me tackle that and then Scott and Keene can certainly join in. So I look at it this way, it blends well with our overall deposit base. If you think about how we built the business and the franchise carefully with commercial and business banking and consumer and the specialized blends in nicely. It's very stable deposit base.

Largely an insured deposit base, and it does come in with some nice chunks and we've done some great work relative to the areas, especially in the property management in the last year to pick up great clients that were somewhat orphaned by those who are no longer around. And so we feel as we go forward, it blends well with everything, and certainly too much of a good thing is too much of a good thing. But as we see it, it's allowed us to reduce reliance on brokered CDs and yet maintain a very healthy return profile.

Jeff Rulis^ Is there a limit that you -- too much of a good thing? Do you say, hi. We want to cap this at a certain percent right now with an elevated broker and running it off? And it [seems] appropriate?

James Lally^ So we look at it this way. So we look at -- carefully, we look at our growth for '24 and beyond. And you know us too. We're not a [spigot] on [spigot] off business, right? We're going to support a particular segment well, but we're not going to do it to a point that it's harmful to the company.

And so I look at it this way that if they're -- behind that deposit is an entity that is a long-lived client in any great environment, we're going to support that. And we're just going to have to figure out ways with respect to that blended into our overall deposit base to make a great return.

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And so we look at the overall growth for '24 and '25. And to the extent that we could fund all of that confidently without leaning into specialized deposits, likely we would, but we're not going to be able to -- So it's going to be an important part of our overall growth going forward. But at this point in time, I'm not willing to put a cap on what that's going to be.

Jeff Rulis^ And Keene, kind of baked into that expense guidance you're alluding to, continue to expand deposit costs there, but it may be at a diminishing level. And you can give us overall deposit -- excuse me, overall noninterest expense? Anything to guide us on how to model that ahead? Is there a percent of those deposits? Or -- I guess that's variable, but any thoughts on how to model it?

Keene Turner^ Yes. Let me just -- let me give you a couple of pieces of information that I sort of think about high level and maybe this is helpful and you can either follow up or tell me it's not helpful. So in the second quarter, the \$17 million on roughly \$2.2 billion of deposits was like a 3% relative cost. In the current quarter, you're at like [\$3.35 billion] with \$21 million on \$2.5 billion.

So when you look at \$4 million sequentially, we estimate that roughly half was due to rate and pricing and competitive pressures and us really trying to drive down the brokered, and then the other half was really due to growth in the underlying balances of a few hundred million.

So I think, obviously, you've got some blending in there in the quarter, but if you took [\$3.50 billion] and said that's your kind of current earnings credit -- and we're, I think viewing it as absent more activity by the Fed that -- the competition in that space should come down with some of what we're seeing in the industry.

We've been very fair to those customers, and we really think that -- moving forward, that the majority of the expense is going to be driven by volumes. So I think from my perspective that will be a way to kind of think about how we're at least thinking about the fourth quarter and maybe the first quarter.

And then I think you made some comments earlier to Jim and in terms of the efficiency of the business -- and we look at this, if you stack it up versus peers, our margins near

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the top of the stack and efficiency sort of in the top third, as it's reported today. But if you re-class these deposit costs, margin would maybe be in the sort of top 10% or 15%, but efficiency would go right to the top of the chart at roughly 50% in the quarter and lower than that, and then the 40% year-to-date.

So to Jim's point on returns, I mean, I think if we look at it that way and you just sort of do some with and without, it helps you really characterize how efficient we are truly being in the business and where we stack up. Obviously, we wouldn't -- we don't necessarily publish those results because it belongs in noninterest expense, but just a way for us to gauge what it would be if that was just truly a commercial deposit and we were paying an interest rate on it.

Jeff Rulis^ Yes, second guessing, just trying to get a better handle on it. So I appreciate the detail. Maybe just one other topic. Just on the loan front, and Jim, I think you mentioned it's kind of mid-single digit. I just wanted to make sure that's sort of net of -- well, one, I don't -- to be embedded in that as -- do you anticipate more SBA loan sales? And would that mid-single-digit include -- is that net of expected sales? Or what?

James Lally^ Yes. That would be net of that. That's what we're predicting. And part of it is not having a whole lot of faith that the CRE market is going to be significant in the first half of '24. That's why we moderate back to that. So we feel good about that number and being able to do it in a very responsible manner with some high yield there, too.

Operator^ Your next question is from Andrew Liesch of Piper Sandler.

Andrew Liesch^ Some clarification on the nonperformers here. How long have they been on your radar screen and then look out into the future? And what are you seeing with trends in 30 to 89-day [past dues]?

Scott Goodman^ Yes. I can take that one. I mean, I think generally, the credit that impacted this quarter represented historically weaker operating companies that had been in the system, in our process for a while.

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And I think the amount of movement you saw this quarter kind of reflects the intentionally proactive workout strategy that we're trying to take, get to the table early when there's cash to get a pay down, liquidity to get guarantor payments, to get additional collateral, which also pushes them through our process faster.

I'm happy to provide more color because I think really, the movement, at least in nonperformers, is just related to three credits this quarter. There was a \$19 million commercial real estate developer leasing company in SoCal, a 19-year -- or a 13-year client of that legacy bank.

\$16 million of our exposure is actually secured -- adequately secured by margin multifamily collateral. There's really just this smaller unsecured piece which is driving most of the rating, and we're in the process of securing.

There's an \$8 million Kansas City-based truck dealership. They deal in specially modified commercial box and delivery trucks. And I think we're in the process of exiting that through either a refi or a liquidation, which does include hard assets, owner-occupied commercial real estate.

And then \$5.5 million Ag credit, which is a hog producer, and they're actually under contract to sell prior to year-end and pay us off. So I think by just pushing those fairly quickly and getting to the table, we've got decent strategies.

I think the other question is what do we see? As we try to read the tea leaves, I think the major comment is we're not seeing signs that this is part of a bigger wave at this point. Total criticized loans, if you take classifieds plus the next level of special mention, we're actually down \$60 million this quarter versus last quarter. So we've exited some of those credits. We've upgraded others. Other trends that we look at, past dues are actually down versus the prior quarter.

And we're not seeing abnormally high activity on things like covenant breaks or additional downgrades. So you just look at classifieds and nonperformers at the levels they're at today, it's really similar to what we saw pre-pandemic 2019 and prior. So hopefully, that provides a little bit of color.

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Andrew Liesch^ Yes, absolutely. And obviously, we saw the increase, but I mean, still at a very low level here. And actually looking at -- you touched on pretty much some of the other questions. So I'm in good shape. I'll step back here.

Operator^ Your next question is from Damon DelMonte of KBW.

Damon DelMonte^ Just wanted to start off with a question on the outlook for fee income regarding the tax credit line item. Can you break down how much of the \$2.7 million loss was rate related versus realized gains during the quarter?

James Lally^ Yes. I would say that, Damon, based on the net, the rate-related loss was like 300% of what was posted. So there was good activity in the quarter, as I noted, but with what's carried at fair value, and how much SOFR move, we just weren't able to really withstand that. I think we expect some rebound here in the fourth quarter as sort of noted by my total guide. And then, look, if rates are -- don't continue to tick up sort of as hard as they have the last couple of years.

The passage of time as well as the business activity will drive better opportunity for next year and maybe that tax credit line item will be able to get to, call it, seven or eight figures again for 2024 with just some stability returning.

Damon DelMonte^ So that seven or eight figure number for '24, the cadence of that, is it kind of more realizations in the first and fourth quarters and the second and third, or usually seasonally weak. Is that right?

James Lally^ Yes. I mean, some of it is probably going to be a little bit dependent on what happens with rate. I would still expect it to be driven largely in the fourth quarter just by nature of how the business occurs, with some of the turbulence and some of the business climate issues.

I mean, we've been trying to circulate some of those credits and bulk sale them, and that may somewhat affect timing, but I would still expect it to be maybe a little bit here in the first quarter if rates don't [mess] with us and then back-end loaded for the fourth quarter of '24.

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Damon DelMonte^ And then with regards to the margin outlook, and I think you commented that you expect somewhat continued drift here from this quarter's level. Can you kind of put some bookends around that? I mean, do you think maybe like 5 to 10 basis points of drift over the next couple of quarters is reasonable before bottoming?

James Lally^ Yes. And I would just say I don't -- I think -- we think that we can get to largely level net interest income in the quarter here. I mean, I think there was some inefficiency and there probably will still be some inefficiency in the balance sheet composition because we use brokered CDs to really fund a lot of the growth in the first and second quarter. So my comments are sort of notwithstanding balance sheet composition, just similar level at [\$9.30 billion], but yes. I mean, I think we've got, call it, 3 or 5 basis points of drifts.

And as I say that -- it sounds ridiculous that in this environment, I'm guiding 3 to 5 basis points, but -- in each of the next couple of quarters is what we're thinking. And then we start to have day count in our favor going from 1Q to 2Q and maybe there's a chance that we can start to grow net interest income again.

But we are definitely seeing some stabilization and the last couple of months have been much more stable than they were. And in fact, September was a little bit higher than August, but 1 month isn't a trend, and there's a lot of pieces that drive that. But we're definitely feeling better about it, and we're seeing slowing in cumulative [betas] even though we expect some continued degradation in the next couple of quarters at the minimum.

Damon DelMonte^ And then kind of on the flip side with rates here, if the Fed does cut in the back half of '24 -- I know you guys are pretty asset sensitive. So how do you kind of envision the margin reaction if there is some cuts that happen again in the back half of 2024?

James Lally^ Yes. I mean -- when you say rate cuts, I mean, I think of that as 25. I mean, I think our view is generally that we expect higher for longer to mean just really stable Fed funds and what we'll be fighting is largely compression. But down 100, we're about 4% asset-sensitive. So 25 basis point cut is 1% on an annualized basis, and that will

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come pretty immediately. I don't worry as much we -- Jeff had pushed on the deposit -- specialized deposit costs.

We think that those can move very much in line with any Fed funds cuts. I think what we're maybe the most concerned about is if variable rate proceed or predict on a short-term basis the Fed funds cut because that's where we get the most compression. But just sort of assuming everything is kind of normally timed, we're sort of down roughly 1% on a cut, and we think that, that's generally an area where we can on a longer-term basis outgrow that as long as we don't have rapid 25 basis points cuts quarter-after-quarter.

Operator^ Your next question is from Brian Martin of Janney.

Brian Martin^ Keene, just one last one on the margin. So it sounds like the margin maybe bottoms next quarter or first quarter is kind of -- I heard the comments on NII, flat and then maybe down a little bit with the day count, but on the margin percentage, the drift is -- the next couple of quarters if we're kind of stable from a Fed environment?

Keene Turner^ Yes. I will just say this, I mean, we're really thinking about it on a net interest income dollars basis because we've got a weighted average life of eight months on the broker portfolio, and we're trying to make it a priority to really get that largely paid down.

So you could get 2, 3, 4, 5 basis points just from an efficient balance sheet, lower risk but inefficient. And I don't want to just be too firm on that. But we generally feel like margin is getting firmer, but still drifting and call it, sometime in the first half of next year, we're starting to feel better about it.

And I think if we're able to get good decent loan growth in that period, I think we're optimistic that we can stabilize profitability and then start to grow in the back half.

But yes. I think, call it -- you get some weird day count stuff going on. So you could kind of see first quarter margin better than fourth quarter depending on what happens, but then it deteriorates in the second quarter just with some of that [33, 63, 65] stuff on the portfolio.

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Brian Martin^ And then how about just on the -- I think -- I don't know if maybe someone answered that, but the -- on the SBA gains this quarter with the sales, do you guys expect to do more of that? Or is that -- you haven't done it up until now. So just kind of wondering how to think about that with your commentary on fee income?

Keene Turner^ Yes. I would say, Brian, the reason we did it this quarter is we -- with the strong growth we had in the second quarter, we started looking at how to fund everything and what we thought was important to investors, and we thought kind of growing net customer funding relative to loan growth was important. It's a highly saleable class of assets, and we have the opportunity to clear some headway there and sell some of the recent production. With fourth quarter being what we would expect to be seasonally strong, I wouldn't expect fourth quarter SBA sales.

But I would say that depending on how growth looks in the early part of next year and how the fee line items look, we -- and overall funding and costs are shaping up, we view that as a play option. And we may do it. But we'd likely be sensitive to when we get some of the other periodic impacts from private equity, CDE, tax credit and those types of businesses.

Brian Martin^ So just kind of helps smooth out some of the volatility within the quarters.

Keene Turner^ Yes. Potentially. Now look. If we're growing deposits well and there's no pressure really on the funding growth, I mean, I think the best strategy versus cash is to keep those loans on the balance sheet with their profile.

But if you're trading off high -- other high-yield loans that you're maybe not doing because you're -- you want to make sure that you're hitting the right funding profile, then I think that, that becomes a much more viable option. So we'll continue to advise you on that, but it's certainly more on the forefront and something that I'd say is equally weighted 50-50 versus maybe not coming into this year.

Brian Martin^ And just last two on the expense side, Keene, you talked about the deposit cost. Just in general, what do you -- those sound like they're up a bit more 4Q

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and then maybe they begin to kind of -- the pace of increase lessens. But just as far as the other -- if that's right? And then the other -- how are you thinking about increases elsewhere, just inflationary, as we look into next year for kind of the comp line, just collectively the other lines?

Keene Turner^ Yes. I would say, Brian, that we're trying to be very, very thoughtful about managing both the short and the intermediate term. So we don't want to do things that impair the business. I think you heard from Scott, we hired a new President in our San Diego region and some of those things. And so we're going to continue to make the right long-term move.

We're going to continue to invest in our associates and technology and training. But we're mindful of the -- sort of the operating leverage that we've lost here along the last couple of quarters. And we're trying to manage it the best we can.

So we're going to apply the normal discipline. I mean, I think you can see it here from first to second to third quarter that we're being fairly tight on spending. And I think there's some opportunities to pay for what [we'll] call compensation and raises and things like that next year with some discipline on other types of expenses.

But we're going to be mindful that we're in a position where even with the provision this quarter we're still earning well and we don't want to just try to hit a number that then ultimately becomes a lower number in future periods because we're not able to grow or we're not able to restart businesses or things like that.

So I think you heard that from Jim, but I think it bears out on expenses. That's our mantra, and we're really trying to be as disciplined as we can. And maybe that's less adding than we would have in prior periods, but I don't -- we're not -- you're not going to hear from us any big initiatives very likely or anything like that, just continued discipline across the board as much as we can.

Brian Martin^ And in your comments about the efficiency and kind of adjusting for the deposits, I mean, the [56%] we're at today, that feels like a sustainable level now given kind of what you expect on those deposit cost trends. I mean, I know it's gone up, but when you adjust them, it's obviously much better relative to the peer and industry, but

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just kind of the efficiency in general, that level we're at, is interest higher from here or is it stable-ish?

Keene Turner^ I think it's slightly higher. It's kind of increasing, but at a decreasing rate, just like we expect that line item to behave. I think the rate -- sort of pricing impact on the -- that line of kind of earnings credit rate, I think we don't expect to move as much.

And so again, I think it's trended underlying balances and collective balances and things like that, that continues to have that grow over time. And I think part of it is just how quickly can we get margin to sort of -- or net interest income -- I guess, say, trying to direct away from margin, net interest income to sort of stabilize and build off that base.

And I think that obviously is a big driver for what happened. I mean I think we would have had -- we would have really loved to have that tax credit line item be 0 or slightly positive. The quarter would have looked a lot different on a pre-provision and on an operating revenue basis. But that's life, and that'll come back to us over time.

Brian Martin^ And last one, if I could sneak it, and maybe just for Scott. The utilization in the quarter was down a lot. I guess, do you expect that to continue to trend a bit lower? Does that feel like we're kind of getting to a bottom? Just wondering what you think on the utilization side relative to your comments on -- Jim's comments on loan growth, kind of still feeling comfortable pretty healthy loan growth?

Scott Goodman^ Yes. I agree. I think it's more of just how existing clients are opting to use their existing cash. I don't think it's going to be an ongoing pressure point. I think if you just look historically, it's kind of up and down, but within a pretty narrow range of 2% or 3%. So I think it's just a function of what happened this quarter. I don't think it's going to impair the business long term.

Operator^ There are no further questions at this time. I will now turn the call over to Jim Lally for closing remarks.

James Lally^ Well, thank you. And thank you everybody, for joining us this morning. And thank you for your interest in our company. And we look forward to speaking to you again, [likely] will be first part of 2025. Have a great day.

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Operator^ This concludes today's conference call. Thank you for your participation. You may now disconnect.