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Enterprise Financial Services Corp

Fourth Quarter 2023 Earnings

TOTAL PAGES: 17

CORPORATE SPEAKERS:

Enterprise Financial Services Corp

Fourth Quarter 2023 Earnings

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PRESENTATION:

Operator^ Thank you for standing by. And welcome to the Enterprise Financial Services Corp. fourth quarter 2023 Earnings Conference Call.

I would now like to welcome Jim Lally, President and CEO, to begin the call.

Jim, over to you.

Jim Lally^ Well, thank you, Mandeep. And thank you all very much for joining us this morning.

And welcome to our 2023 fourth quarter earnings call. Today is January 23, 2024.

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

Enterprise Financial Services Corp

Fourth Quarter 2023 Earnings

Please refer to Slide 2 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 fourth quarter once again showed the strong earnings power of our company despite the manifestation of a few credit challenges that we experienced.

Diluted earnings per share for the quarter was \$1.16 and versus \$1.17 in the third quarter and \$1.58 in the fourth quarter of 2022.

Before I get into some of the highlights of a very strong quarter and year, I would like to briefly address the elevated level of charge-offs that we experienced during the quarter. Two relationships that we charged off during the quarter could be described as extraordinary and uncharacteristic. The first such credit was an agricultural loan, which we believe was an isolated incident that was not directly related to our credit underwriting. There were irregularities in the financial information provided by the borrower that masked the challenges it was facing and ultimately covered up a \$13 million collateral shortfall. In the fourth quarter, we placed a full \$16 million relationship on nonperforming status and correspondingly charged off a \$13 million shortfall.

Additionally, we are taking the appropriate actions and utilizing all available resources to recover what we can for the remaining \$3 million outstanding.

We have stopped originating new credit relationships in the agricultural space, and will wind down this approximately \$200 million portfolio over the next few years. We have our team engaged and we are actively conducting thorough reviews of each relationship including physical farm inspections and even more extensive collateral field audits to reinforce our confidence in the balance of the portfolio.

We'll be engaging a third party to validate these findings to ensure that we do not have any other similar situations to this one. Our initial review provides comfort with respect to the health of the remainder of the portfolio.

The other major loss that we experienced in the quarter was related to a \$10 million unsecured credit exposure that was part of a First Choice legacy relationship to a Southern California commercial real estate investor. After several unsuccessful attempts to find suitable collateral to shore up this credit and the borrowers' inability to keep payments current, we took this unfortunate but appropriate action to charge off this credit. \$3 million of this was identified in reserve for in the third quarter, with the remaining \$7 million reserved in the fourth quarter. We ultimately charged off the full \$10 million unsecured portion. We will continue to pursue all remedies for any sort of recovery.

The remainder of our loan portfolio has performed as we anticipated. Overall, classified loans remained stable in the quarter and NPLs declined over 10% to \$43 million while classified loans

Enterprise Financial Services Corp

Fourth Quarter 2023 Earnings

to capital held steady at 10% at year-end. Delinquencies were well controlled at year-end at only 15 basis points.

Entering 2024, I'm confident in our ability to deliver asset quality results that are in line with our historically strong performance. Despite this unusual level of charge-offs, an appropriate increase to our provision expense, our company delivered very strong financial results for both the fourth quarter and the entirety of 2023. The summary of this begins on Slide 3.

Keene will provide much more detail on our quarterly and full year financial performance in his comments, but ahead of these, I would like to provide a few highlights. Our strong financial performance continued during the fourth quarter. We earned net income of \$44.5 million or \$1.16 per diluted share and we produced an ROAA of 1.28% and a PPNR ROA of 2.10%. ROATCE too improved when compared to the third quarter increasing to 14.98% compared to 14.49%.

These results reflect a robust earnings profile that allowed us to absorb some deterioration in credit during the quarter. Combined with our strong reserves and balance sheet, we remain positioned to operate as we have in the past. This means both delivering returns to shareholders while also supporting the needs of existing and new clients. The ability to continue to fulfill the low needs of these clients and prospects continues to open up channels of deposit growth as well.

Like in years past, we experienced our typical fourth quarter strength in loan growth. For the quarter, loans increased \$267 million or 10% annualized. As important, we, again were able to fund this growth with our client deposits, which increased by \$479 million in the quarter after netting out the reduction in brokered CDs. We finished the year with a loan-to-deposit ratio of 89.4% and our ratio of DDA to total deposits came in at 32.5%.

A couple of things worth mentioning regarding these results. First, we are seeing all markets and businesses contributing to these numbers. Unlike in years past, we're not relying on any one or two markets or businesses to achieve. This diversification, both in terms of geography and revenue has been intentional and the fruits of these investments continue to manifest themselves in our financial results. Secondly, post the [March] banking crisis, we set a goal to fund our second half loan growth with client deposits.

Not only did we do this, but we just about funded the entire year's loan growth with our second half success.

We also set a goal to keep the percentage of DDA to total deposits north of 30%, and we accomplished this too.

Finally, we believe that we have relatively stabilized NII, which means that our daily net interest income has remained stable the last several months. Scott will give much more color on the markets and the businesses where we saw continued success, but I'm encouraged that we'll be able to fund our mid-single-digit loan growth in 2024 with well-priced relationship-oriented client deposits.

Enterprise Financial Services Corp

Fourth Quarter 2023 Earnings

Moving on to capital. Our balance sheet remains strong and positioned for continued growth. Capital levels at quarter end remained stable and strong, with our TCE to TA ratio at 8.96%. Tangible book value per common share at year-end was \$33.85. This is an increase of 18% in 2023 and is due to our strong earnings and return profile.

Before I move on to where we will be focused in 2024, I want to reiterate that the strength of our earnings profile generates pre-provision earnings that have averaged over \$70 million per quarter this year. This provides a significant buffer to absorb credit issues before ever touching our loan loss reserves or capital that are also at very strong levels, particularly when considering the short duration of our loan portfolio. Slide 5 shows where we are focused for the foreseeable future.

Just like we've done 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. We will stay focused on continually improving our performance in all our business lines and markets. This, combined with improved credit performance and 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 both from my confidence in our business model, a careful review of our loan portfolio and the optimism that I continue to hear from our clients.

One final note. Throughout 2024, we'll be working on a core system conversion after 35 years on the same system, this upgrade will further improve our efficiency in many areas while also improving the quality and accessibility of our data. 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, Q4 loan and deposit growth was strong, pushing us to double-digit annual growth for both categories in 2023. These results are significant, not just based on the magnitude of the growth, but also when considering that they're fully organic and highly diversified across geographic markets and specialty business lines. Loans, which are highlighted on Slides eight and nine were up \$1.15 billion or 12% for the year with most major categories of the portfolio contributing materially to this growth.

For the quarter, broken out on Slide 9. Loans rose \$267 million, contributing 23% of our growth for the year and up 157% from the prior quarter displaying the traditional seasonal lift, which is characteristic of our portfolio.

C&I was a standout this quarter, benefiting from several significant new client relationships and elevated usage on revolving lines of credit. Specialized loan growth was helped by strong seasonal performance in the life insurance premium finance and tax credit lines of business.

In Premium Finance, we continue to originate steady closings on new policy loans from our referral network and experienced the typical Q4 uptick in premium payments due for the existing

Enterprise Financial Services Corp

Fourth Quarter 2023 Earnings

policies. Advances on affordable housing projects and process accounted for the majority of the increase in the tax credit portfolio.

For Q4, SBA came in somewhat below expectations, down \$27 million due mainly to slower execution of the pipeline and elevated prepayments. Prepayments continue to be stressed by the higher rate environment, and we remain committed to our high credit standards and focus on owner-occupied real estate secured loans. Much of the lag to pipeline is expected to push into Q1 and gross production remains relatively consistent, but paydowns continue to be a headwind.

The Sponsor Finance book posted a modest decline in the quarter as actively slowed in general in the space -- activity slowed in general in the space during Q4. Following robust activity in the first half of the year, private equity and slowed their pace of acquisition to digest this activity and to consider the impact and direction of the interest rate environment on their pipeline opportunities.

We're also taking a disciplined approach to sponsors and to credit structures in this segment, and we would expect these factors to moderate the growth rate in the coming year.

Moving to Slide 10. Loan portfolios posted growth across all major regions for the year and in the current quarter. Specialty lending was up modestly for the quarter related to the aforementioned niche business lines as well as continued growth in the practice finance vertical, which was up \$12 million in Q4 and \$81 million for the full year of 2023.

In the Midwest, St. Louis and Kansas City portfolios were up \$78 million or nearly 10% annualized, showing balanced growth between increased line usage, fundings on construction in process and new loan originations. Notable deals this quarter include a new relationship with a middle market construction materials provider and two new loan facilities with long-time relationships in the hospitality and business finance industries.

In the Southwest, the combined markets grew \$102 million in Q4 and 26% for the full year of 2023. Results for the quarter were bolstered by elevated new originations as well as additional fundings on existing construction projects in process. Significant new loans include new relationships with a premier middle market electric contractor, and a specialty precision parts manufacturer in Phoenix as well as large, well-established general contractor in Las Vegas.

In our Western region of Southern California, loan balances were up by \$58 million in Q4 to round out a year in which we grew this portfolio by 9.5%. The increase this quarter is primarily related to success by our recent talent additions onboarding a number of new relationships, including companies in the specialty food production business, financial services and manufacturing spaces.

We also continue to expand legacy relationships in this book with new loans to top-tier clients in the franchise and commercial real estate sectors.

Enterprise Financial Services Corp

Fourth Quarter 2023 Earnings

Moving now to deposits on Slides 11 and 12. Total deposit balances were up \$266 million for the quarter and \$1.3 billion or 12.4% year-over-year. Breaking this down, noninterest-bearing DDA accounts were down year-over-year by \$684 million, with interest-bearing DDA accounts up by a similar amount due mainly to the remixing behavior of depositors precipitated by accelerated rate increases throughout 2023.

In the quarter, however noninterest-bearing DDA balances grew by \$107 million relating to success of onboarding new C&I commercial banking relationships, increased property management and third-party escrow accounts as well as some seasonal cash build.

Deposit growth by region is broken out on Slide 13. We grew client balances net of specialty deposits and brokered CDs in the quarter by \$394 million with growth being spread throughout the geographic footprint and across all regions. Higher growth was experienced in the Midwest, mainly relating to the larger C&I books in our Kansas City and St. Louis markets, but highlighted as well by several large new C&I deposit relationships.

In the West and Southwest regions, higher balances reflect the impacts of new relationships as well as a focused effort to attract new funds through the consolidation of balances from our existing clients.

Specialty deposits grew \$85 million in the quarter and are broken out in more detail on Slide 14. The increases this quarter were mainly within the property management and third-party escrow segments as we continue to expand these lines of business with new accounts and new relationships.

Q4 is typically a seasonally softer growth quarter in the Community Association line as expenses are paid and new accounts begin to be opened, which will then fund up as assessments are collected during Q1. Additional detail on the core funding mix and the account activity is shown on Slide 15.

A majority of our growth this quarter has been with the commercial account base, which generally represents relationship-based balances, 80% of which are treasury management clients. And while we have seen the aforementioned mix shift from DDA into interest-bearing options, the pace of this activity has slowed. 37% of our total balances still reside in noninterest-bearing accounts. The underlying account activity also continues to trend favorably and reflect our intentional and elevated efforts toward emphasizing core deposits, with new accounts open exceeding closed accounts and net balance increases when comparing new accounts to closed accounts 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 be on Slide 16, where we reported earnings per share of \$1.16 in the fourth quarter on net income of \$45 million. Excluding the impact of the FDIC special assessment, EPS was \$1.21 per share, an increase from

Enterprise Financial Services Corp

Fourth Quarter 2023 Earnings

the third quarter. Net interest income in the quarter was relatively stable earning asset growth and disciplined pricing on loans and deposits, mostly offset the increase in interest expense in the quarter due to the deposit remixing and rate changes.

Fee income was seasonally higher, which is typical in the fourth quarter and was the primary driver of the increase in operating revenue. The provision for credit losses increased for the quarter, as Jim discussed, driven by net charge-offs and loan growth. And noninterest expense was higher in the current quarter mostly due to the FDIC special assessment.

Overall, pre-provision net revenue of \$76 million for the quarter increased \$11 million or 16% from the third quarter. For the full year, preprovision net revenue was \$285 million, an increase of 10% from 2022. Pre-provision net revenue was up 12% in 2023 and when you consider that pre-provision net revenue in 2022 included \$5 million of PPP income that did not repeat this year. This continues to reflect the strength of our earnings profile and our ability to generate capital to support balance sheet growth.

Turning to Slide 17. Net interest income for the fourth quarter of 2023 was \$141 million, which was a decrease of less than \$1 million compared to the linked quarter. Interest income increased \$6.2 million in the fourth quarter, driven mainly by continued loan growth and higher rates on portfolio loans. Cash levels also increased modestly as a result of strong customer funding and added \$1 million to interest income.

Loan yields increased 7 basis points while average balances were higher by more than \$160 million. The average interest rate on new loan originations in the fourth quarter of 2023 was 7.95% and the most recent month loan yield is just under 7% overall. More details follow on Slide 18.

Interest expense growth slightly outpaced growth in interest income in the quarter. Customer deposit balances increased nearly \$480 million in the quarter. This additional funding allowed us to reduce broker deposits by \$213 million. The balance growth was coupled with a 19 basis point increase in the cost of deposits, which was half the increase we observed in the previous quarter.

With that said, the total cost of deposits was 2.03% in the fourth quarter and only slightly higher at 2.07% in the most recent month. The deposit pricing performance is aided by overall DDA percentage remaining at approximately 33%.

The resulting net interest margin was 4.23% in the fourth quarter of 2023, a decrease of 10 basis points from the linked quarter and represents the 5 basis point drift from where net interest margin was in the month of September.

We're encouraged by recent results that demonstrate deposit pricing has begin to further stabilize and margin pressure while still present, continues to level off.

Enterprise Financial Services Corp

Fourth Quarter 2023 Earnings

Looking forward, while interest rates remain at current levels or higher for longer, we expect that overall funding costs will continue to move slightly higher over the next couple of quarters, and we will see margin drift of around 5 basis points per quarter on the existing balance sheet.

Current asset growth at current spreads should allow us to defend net interest income dollars albeit somewhat with lower margin overall. With the prospect of rate cuts on the table, we anticipate each [25-point] reduction in the Fed funds rate equates to an additional six to 8 basis points of margin loss initially or \$2 million to \$2.5 million of quarterly net interest income.

Our expectation is that deposit rates will be more stable initially and in order to remain competitive, we may need to be cautious in reducing those rates. With additional Fed cuts, we will be more methodical in moving deposit rates down, just as we were when we were increasing them.

And while not a component of net interest income, reduction in interest rates would positively impact deposit-related noninterest expense trends as more than half of the underlying balances are indexed to the Fed funds rate. Each 25 basis points in Fed funds equates to approximately \$4 million of annual expense on this line item.

With that, we'll move on to our Credit Trends on Slide 19. Net charge-offs were \$28 million for the quarter and \$38 million for the year, representing 37 basis points of average loans in 2023. The majority of the charge-offs in the quarter relate to the two relationships that Jim discussed, the real estate developer in California and the agricultural loan that arose unexpectedly late in the fourth quarter. These charge-offs coupled with the charge-off on the investor-owned office loan that moved into other real estate in the third quarter, make up the majority for the year.

Nonperforming assets were 34 basis points of total assets compared to 40 basis points at the end of September. There were \$32 million of loans that moved into nonperforming status in the fourth quarter, of which \$24 million were charged off. An additional \$4 million of nonperforming loans were charged off that were outstanding at the end of September. Between gross charge-offs, recoveries and pay downs, nonperforming assets decreased \$6.4 million from the third quarter. We proactively worked through a number of problem credits over the last two quarters so that these issues were not carried forward into the current year.

The provision for credit losses of \$18 million during the fourth quarter largely reflects the impact of net charge-offs and loan growth, partially offset by modest improvement in the economic forecast. Included in the provision for credit losses is \$3.2 million benefit from the reduction of the reserve for unfunded commitments. This benefit primarily relates to a reduction in commitments on nonperforming loans and a general reduction in commitments due to the higher advance rate at the end of the quarter.

Slide 20 represents the allowance for credit losses. The allowance for credit losses represents 1.24% of total loans or 1.35% when adjusting for government guaranteed loans.

Enterprise Financial Services Corp

Fourth Quarter 2023 Earnings

On Slide 21, fourth quarter fee income of \$25 million was an increase of \$13 million from the third quarter driven primarily by tax credit income, which is typically strongest in the fourth quarter. In addition to the seasonality, an 80 basis point decrease in the 10-year SOFR rate in the quarter, positively impact credits carried at fair value, driving approximately half of the quarterly profit.

Linked quarter increases related to community development, private equity distributions and BOLI helped to offset the gain on SBA loan sales from the third quarter.

As a reminder along with the seasonal tax credit income, community development and private equity distributions will fluctuate from period to period.

Turning to Slide 22. Fourth quarter noninterest expense was \$93 million, an increase of \$4 million compared to the third quarter. Included in the current quarter was the FDIC special assessment of \$2.4 million. Deposit service expenses were higher compared to the linked quarter, primarily due to growth in average balances, as Scott mentioned.

We do expect specialized deposits to continue to be a significant contributor to overall growth, which will continue to drive this expense line item higher. Other expenses increased from the linked quarter, but were partially offset by lower compensation and benefits expense related to lower performance-based incentive accruals and a reduction in accrued paid time off.

The fourth quarter's core efficiency was 53.1%, a decrease of 312 basis points compared to the third quarter driven primarily by the increase in fee income. With some moderation of our net interest margin and net interest income expectations, in addition to the seasonally strong fee income, we do expect core efficiency to move up in the coming quarters. For all other expense categories, we expect to prudently maintain cost controls.

Our capital metrics are shown on Slide 23, and our tangible common equity ratio was 9% at the end of the third quarter, up from 8.5% in the linked quarter. The strength of our earnings profile and a rebound in the fair value of securities and derivatives drove the expansion in the quarter.

On a per share basis, tangible book value increased to \$33.85, which is a 9% increase over the third quarter. For the full year, tangible book value per share increased \$5.18 or 18%. And looking back over a longer timeframe, we have successfully compounded tangible book value per share by 10% annually over the last five years.

With our capital, balance sheet and liquidity and strong positions we're operating with a strong foundation as we look into 2024. And while there was significant turmoil industry to start the year, we had great success in expanding our client base and generating returns. We delivered a 16% return on average tangible common equity with average tangible common equity for the year at 8.7% and delivered a 1.4% return on average assets. With that, I'll conclude my comments, and I appreciate your attention. We're going to open the line for questions.

Enterprise Financial Services Corp

Fourth Quarter 2023 Earnings

QUESTION & ANSWER:

Operator^ (Operator Instructions) Our first question comes from the line of Jeff Rulis with D.A. Davidson. Please go ahead.

Jeff Rulis^ Thanks. Good morning.

Jim Lally^ Morning, Jeff.

Jeff Rulis^ On the credit side, some pretty good detail on the charge-offs. I guess maybe a follow-on is classified assets linked quarter were flat despite those larger charge-offs. I guess what segments kind of filled in or rotated into kind of -- into the classified balance to keep it flat from rather than improving with the charge-offs?

Jim Lally^ I think -- Jeff, this is Jim. I think relative to the stabilization of the classifieds and those maintained that were there is the rapidity in which these loans that rolled through and charged off didn't necessarily sit long enough in those areas such that it cleaned it out.

Jeff Rulis^ Okay. So maybe put another way where you saw a rotation into classifieds. Is there some -- other than the credits that you identified where there's some increases that you could point to segment-wise or fairly granular?

Jim Lally^ I think it's very granular -- looking at the list, and I studied it, it's widespread through the various markets and types. So there's no fees, if you will, relative to what's in that list. And I think the other good news is it's relatively small dollars per credit as well.

Jeff Rulis^ Okay. Just the last one on credit. I guess the criticized balances last quarter, I think they were down a decent amount. I think they were down maybe \$60 million linked quarter. What were those balances in the fourth quarter relative to the third quarter?

Jim Lally^ Why don't I have Doug Bauche comment on that, Doug?

Douglas Bauche^ Yes. Thanks, Jeff. Really two relationships that were downgraded from a monitor six to a special mention rating one that would be related to the mortgage industry, a company that has performed well, but in a down cycle right now is experiencing just some compressed cash flows, so the risk rating on that relationship was downgraded special mention.

The other one would be a diverse mix of commercial real estate, largely 1- to 4-family real estate loans in the California market, again performing well under the current interest rate environment, but looking forward at some of the repricing risk on that portfolio a downgrade to special mention was taken there as well. Good long-term relationship and the borrower has taken appropriate actions to monetize a few of the properties curtail the debt and we feel confident in their ability to continue to perform.

Jeff Rulis^ Got it. So overall criticized balances lifted linked quarter. Is that?

Enterprise Financial Services Corp

Fourth Quarter 2023 Earnings

Douglas Bauche^ Correct.

Jeff Rulis^ Okay. And any range of size, if you were down \$60 million in the prior quarter, what did you increase this quarter?

Douglas Bauche^ Yes, similar back up, probably, Jeff, we're probably back up the [\$60] million that we saw a reduction in the prior quarter.

Jeff Rulis^ Fair enough. Okay. Just hopping over to the -- real quick on the margin discussion sounds, I think Keene said 5 basis points drift per quarter as we sit here. And then maybe accelerate a bit with rate cuts. Any thoughts on the trajectory of NII and I guess that would loop in kind of your expectations for loan growth as well.

But if you could kind of -- are we approaching a bottom on NII, even given that margin backdrop?

Keene Turner^ Yes, Jeff, I think we're generally expecting a mid-single-digit growth rate for both sides of the balance sheet. The 5 basis points is really static. And then I think dollars of growth depending on how it occurs, will be helpful to that.

I think in the first quarter, it's going to be difficult to overcome the day count from 4Q to 1Q even with the extra day this year. But it looks as though somewhere in the middle of the year, we'll start to see a pickup with dollars of net interest income. And some of that could be ruined depending if we get cuts on the back half, it -- that may be a little bit challenging, and we may be treading water a little bit more than we would have otherwise.

But absent rate changes, I still think we feel pretty good about increasing net interest income dollars on the back half, albeit with some continued drift of net interest margin.

Jeff Rulis^ Got it. Thank you. I'll step back.

Keene Turner^ Thanks, Jeff.

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

Damon DelMonte^ Hey, good morning, guys. Hope everybody is doing well. Thanks for taking my question. Just wanted to ask on the expense front here. I think you mentioned you're working on a systems upgrade during the course of this year. How should we think about kind of a quarterly cadence for operating expenses outside of the specialty deposit cost line that could be related to the system upgrade?

Keene Turner^ Hey, Damon, this is Keene. I don't anticipate that you'll have -- I mean there's going to be some payroll and other things for staffing up, but I think we can absorb that

Enterprise Financial Services Corp

Fourth Quarter 2023 Earnings

generally. I think there's some expenses for the implementation that may come through during the year and we'll point those out, that could be up to \$4 million or \$5 million depending on what's capitalized versus what needs to come through the P&L. And I would say that those are going to occur sort of mid to late in the year generally.

So we'll continue to point those out. But I think the run rate from here for the first quarter is obviously going to step up, probably 93% to 95% is what we're expecting. Comp and benefits was a little bit better in the fourth quarter, and then you've got the seasonality to it in the first quarter.

So that's what we're thinking, and that's also just inclusive of specialty deposits. And then again maybe later in the year, we get some of those core related expenses, and we'll have a better sense for what those numbers are in the upcoming quarters.

Damon DelMonte[^] Got you. Okay. And then did you say that for a 25 basis point cut in rates, that's about a \$4 million positive impact on the specialty deposit expenses?

Keene Turner[^] Yes. That's correct. And I think the proportions there are roughly half of the compression you get on a quarterly basis in net interest income would be offset in that noninterest expense line item. Some of that may be subject to timing, but once you run that out and flush it through, that's generally what we're expecting.

Damon DelMonte[^] Okay. Got it. Great. And then just other question on the ag portfolio. I think Jim, you said it's about a \$200 million portfolio, and you're going to look to wind that down.

Given what happened with this one particular credit, are there any early signs that you could see other areas of stress within that portfolio as you go through your review? Or is it still too early to tell?

Jim Lally[^] So Damon, our cursory review on top, and we focused -- and this was -- the problem we have was in the livestock area. So we focused initially in this area -- and the course review at the outset shows that we feel very good about where we stand. That being said, there's more work to do on it, not only by us, but we'll also bring in a third party just to validate what we've seen. As it relates to the rest of the portfolio, Doug, maybe you can talk about what we see because this only -- live stock only represent a third of the portfolio, correct?

Douglas Bauche[^] Yes. Damon, it's Doug. So you're right, \$200 million portfolio spread across 40 or so relationships consisting of a pretty well-balanced mix of agricultural real estate, real crop and livestock collateral to farm operations really throughout the Midwest here. Many of these have been long-term strong performing clients of our team.

And listen. I want to make sure we reiterate, right? This is a credit to that we were monitoring. We had good historical financial information. We were receiving regular collateral and financial information and reports, it's just the irregularities as it relates to the information that was

Enterprise Financial Services Corp

Fourth Quarter 2023 Earnings

revealed and disclosed in information that we received in early December to cause the problem here.

So what we're doing now is simply just reaffirming our risk in the portfolio and intensifying the inspections and the collateral audits that we have historically done.

Damon DelMonte^ Got it. Okay. And then just lastly, on the tax credit line item, Keene. Obviously very strong fourth quarter. As you kind of look at the full year of '24, do you kind of have a targeted range of what we could expect, knowing that the fourth quarter tends to be the strongest of them?

Keene Turner^ Yes. Just a reminder, I think we were negative until year-to-date until we got here. So fourth quarter was maybe even a little bit more robust. But I think net-net, we're expecting roughly \$10 million through that line item for next year. And I think we'll -- with what we're expecting on CDE and private equity will get almost back to the level of income, maybe slightly weaker through that line item, if we don't sell SBA loans and then an opportunity to get back there or exceeded if we decide to execute on any SBA loan sales like we did last year.

Damon DelMonte^ Got it. Okay That's all I had for now. Thank you.

Keene Turner^ Thanks, Damon.

Operator^ (Operator Instructions) Our next question comes from the line of Brian Martin with Janney. Please go ahead.

Brian Martin^ Hey guys, good morning. Hey, Keene, just on that last question on the fee income line outside of the tax credit. I think the -- were you referring to the other line as far as what you said -- you were trying -- just misunderstood what you're saying there as far as getting back to even or how you're thinking about that?

Keene Turner^ Yes. I think in total, Brian, we're thinking about getting back to even, I guess if you stripped out the SBA loan sales and you have \$10 million of tax credit and the numbers on both CDE and PE going through other that I mentioned a couple of million each. I think that basically gets you back to comparable levels for 2023. And then if you sold SBA loans, again that would get you back to the full year level or exceed?

Brian Martin^ Okay. You're talking total fee income, not just that total other line, just to be clear.

Keene Turner^ So yes, I'm talking -- yes, both. Correct.

Brian Martin^ Okay. Got you. Okay. And just one question. The tax rate, I think you guys mentioned it was a bit lower this quarter.

I guess going forward, revert back to kind of low [20] -- I guess the [22%] range. Is that fair?

Enterprise Financial Services Corp

Fourth Quarter 2023 Earnings

Keene Turner^ We're actually right around that 21% effective tax rate for '24. That with some state planning and some other things that have worked through. There's a point lower for the upcoming year that we think will continue. So 21% is a good number for the year.

Brian Martin^ Okay. And then just back to the margin for just one minute, Keene, just your comments, I think I heard what you talked about on the asset sensitivity side with the rate cuts what it does to the loan side. Can you just walk back through what you said on the deposit side, what the offset is if rates are going lower?

Keene Turner^ Yes, on that deposit service charge line item and 25 basis points obviously affects the earnings credit rate and that's about \$4 million annually or \$1 million a quarter for every quarter point cut. So I think that proportion is roughly half of the compression on net interest income. So it doesn't totally mute it, but it makes it more manageable and gives us the opportunity to grow through it.

Brian Martin^ Yes. Okay. And your commentary was that the -- I guess you think you can grow through that or stabilize it absent rate cuts, otherwise, maybe it's a bit lower depending on the timing of the rate cuts or how many rate cuts?

Keene Turner^ Correct. I think the view is that -- I mean we have continued status quo on deposit pricing in my comments of 5 basis points of drift. And that rate of deposit repricing has been improving. So it continues to reprice higher, but at a lower rate.

I would say two factors in the first quarter are we're going to probably have some unfavorable DDA remixing just with seasonal trends at the fourth quarter, and then the day count.

So like I said, sometime midyear, although we've got margin drift and depending on how growth shapes up, there's a chance that we'll be able to start stacking positive net interest income dollars on top of that, -- it's just a matter of how those factors interplay but we've been pretty good with our ability to forecast net interest income even as early as after the first quarter events of last year and we hit stable net interest income per dollars. I think we're still stable from here. It's just without -- with the day count disadvantage at this point, Q4 to Q1, you're going to reset a little bit lower and then we'll get back to more improvement.

Brian Martin^ Got you. And the monthly margin in December, did you give what that was?

Keene Turner^ I didn't give -- I might have given what it was, but it was -- it was 121 -- or sorry 421. So it's only a few basis points lower than where we were in the quarter. And November and December were right on top of each other. So from that perspective, we were in pretty good shape.

And margin in the fourth quarter was a little bit more diluted because of the deposit experience we had with the inability to time out the brokered CDs or pay those down just in time. So I think

Enterprise Financial Services Corp

Fourth Quarter 2023 Earnings

margin in and of itself in the quarter was maybe a little bit more muted than we thought it would be and maybe that will shift a little bit with positive mix here in the first quarter.

Brian Martin^ Got you. Okay. And then last one for me is just on the capital levels and kind of the optionality you have there, just how you're thinking about the capital utilization in 2024 as far as I think from a buyback perspective, M&A, just in general, organic growth, kind of how you're thinking about that?

Jim Lally^ Yes. This is Jim.

I would say this -- that it primarily it's going to be for growth. Right now, we've got a lot on our plate relative to continue growing our business. We've got the core conversion, what have you. So M&A certainly, we're talking -- we'll always talk but certainly, M&A is further down the list.

And I'm not sure the buybacks come into play or not this year. But really, it's about focusing on our -- utilizing for our growth going forward.

Brian Martin^ Got you. Okay. Perfect. Thank you for taking the questions.

Jim Lally^ You bet. Thanks, Brian.

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

Andrew Liesch^ Hi, guys. Good morning. Just a question on the growth in the specialty deposits. I guess what's the outlook for that business? I know you guys have been spending a lot of money in investing in that. And just -- is the growth going to be lumpy? Are there wins in one quarter or the next, is there any seasonality there?

Just curious how we should be looking at how those balances trend?

Scott Goodman^ Hey, Andrew, it's Scott. Good morning. I think the overall comment is, yes, we do expect those to continue to grow, I think steady. The seasonality that exists amongst really the three main business lines, right, the property management, third-party escrow and community associations, mainly in the community associations where those accounts generally fund up early in the year and then they're depleted throughout the year as expenses are paid, and then reopened again in the fourth quarter.

So that's the main seasonality. But I think if you look at that business over time, you'll see that it's also growing. So I think we view those very favorably from a cost and a relationship perspective, and we'll continue to invest and grow.

Andrew Liesch^ Got it. You've covered all my other questions. I'll step back. Thanks.

Operator^ I would now like to turn the call over to Jim Lally for closing remarks.

Enterprise Financial Services Corp

Fourth Quarter 2023 Earnings

Jim Lally^ Well, thank you very much. And thank you all for joining us this morning and for your interest in our company, and we look forward to speaking to you again after the first quarter.

Have a great day.

Operator^ This concludes today's call.

You may now disconnect.