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Enterprise Financial Services Corp

First Quarter 2024 Earnings

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CORPORATE SPEAKERS:

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

PARTICIPANTS:

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

PRESENTATION:

Operator^ Thank you for standing by. (Operator Instructions) At this time I would like to welcome everyone to the Enterprise Financial Services Corp. First Quarter 2024 Earnings Conference Call. (Operator Instructions)

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

Please go ahead.

James Lally^ Thank you, Cath. And good morning, everyone. And thank you very much for joining us this morning. And welcome to our 2024 first quarter earnings call.

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

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Before we begin, I would like to remind everybody on the call that a copy of the release and accompanying presentation can be found on our website. The presentation and earnings release were furnished on SEC Form 8-K yesterday. Please refer to Slide 2 of the presentation 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 first quarter represents fundamentally sound performance amid a higher for longer economic and interest rate environment. Our business model, associate base and management team has been constructed to perform during all economic environments. However, the current pivot in the interest rate policy from year-end will further assist us in stabilizing our margins and, therefore, our profitability in the upcoming quarters.

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

Our financial scorecard begins on Slide 3.

For the quarter, we earned net income of $40.4 million or $1.05 per diluted share, and we produced an adjusted ROAA of 1.14% and a PPNR ROAA of 1.58%. These results are representative of our typical first quarter trends and bode well for delivering upon our expectations and goals for 2024. Keene will provide much more detail on this in his comments.

Our net interest income was essentially flat compared to the linked quarter when considering day count at just under $140 million. Looking back over the last five quarters, we've been able to hold this number at or around $140 million despite challenging competitive and interest rate conditions. This reflects the strength of the franchise we've built and we remain positioned to produce high-quality earnings that consistently improves shareholder value through deep rooted client relationships.

Our stable net interest income was aided by the defense and resilience of our net interest margin at 4.13%. 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, loan growth moderated in the quarter largely due to lower demand in investor-owned CRE and a few of our specialty lending businesses. However, we remained on pace to deliver mid-single loan growth for the year, growing loans by $144 million to $11 billion, led by growth in C&I, LIPF, and construction lending. Scott will provide much more detail on our markets and businesses in his comments.

Like we did in 2023, we are committed to funding our full year's loan growth with our client deposits. During the first quarter, we experienced our typical seasonal deposit outflow as our business clients used their cash for bonus payments and tax distributions. We buffered this with a slight increase in brokered CDs resulting in total deposits remaining flat compared to the linked quarter at $12.3 billion. Our loan-to-deposit ratio increased slightly to 90%, while our DDA level remained in excess of 30% of total deposits.

Our balance sheet remains well positioned for our planned growth. Capital levels at quarter end remained stable and strong, with our TCE/TA ratio of 9.01% and adjusted return on average tangible common equity of 12.53%. Tangible book value per common share was $34.21, an annualized increase of 4%. Given the strength of our earnings and our confidence in our continued execution, we increased the dividend by $0.01 per share in the second quarter of 2024 and have begun modest common stock repurchases to manage growth of excess capital.

Before discussing areas of focus in 2024, I would like to provide an update on credit. Last quarter, I characterized our charge-off levels as extraordinary and uncharacteristic. Asset quality stabilized as expected in quarter one as classified loan levels were flat, NPAs declined 11%, and charge-offs netted out to roughly 5 basis points in the quarter. It's also worth mentioning that the large majority of the amounts charged off during this quarter were residual loan amounts from two relationships that were charged down in the fourth quarter of 2023. Both of these relationships have now been fully charged off. Finally, we did complete our internal review of the agricultural portfolio, inclusive of site visits and found no surprises and feel that the portfolio is in sound condition. We've engaged a third party to validate our findings, and we'll have this report delivered in the next few weeks. We are seeing some of these clients refinance their debt with other institutions, and we'll likely see this $200 million portfolio reduced by at least 50% between now and year-end.

Slide 5 shows where we are focused for the foreseeable future.

Just like we did for all of 2023, we will continue to be focused on funding future loan growth with client deposits. This will be accomplished by sticking to our relationship oriented sales approach and capitalizing on our continued success in our Community Associations, Property Management and Third-Party Escrow and Trust Services deposit businesses. Additionally, I'm confident that we can continue to improve shareholder value through the execution of our strategy. Our focus combined with continued improvement in all business lines, markets and credit, along with steadfast expense management should consistently produce strong earnings amid the current economic and rate environment that we are in.

Our clients remain largely optimistic too. For the most part, the operating companies with whom we partner produced very good results for 2023 and are budgeting for 2024 to be flat to slightly down from these results. Cash conversion cycles continue to elongate requiring higher use of lines of credit and capital expenditures will be lower than previous years as companies curb spending to defend sales levels or to increase production for known increase to sales.

Supply chains have improved, the war on talent has not worsened and the impact of higher rates on debt service has been absorbed in their monthly cash flow. The impact of onshoring is beginning to show residual opportunities in the trades and corresponding suppliers that support this. In my opinion, this will only improve the economic prospects of a portion of our client base.

Our CRE clients are seeing opportunities in most asset classes, but the elevated interest rates are keeping many of these projects on the drawing board for now. I really believe that a slight decrease in short-term interest rates will be the psychological impetus for some of these projects to move to the next level, even though the return related to 25 or 50 basis point decrease is largely negligible.

We enjoy great reputation and corresponding market share of middle market businesses in our mature geographies and specialized lending businesses. As such, I am confident that we will continue to get more than our fair share of corresponding opportunities. Our newer markets and higher-growth areas will provide similar levels of opportunities while we continue to build our reputation in these markets. This blend is what gives me high confidence that we will continue to grow and earn at a predictable rate while continuing to compound tangible book value at a higher level than our peers over the foreseeable future. With that, I would like to turn the call over to Scott Goodman.

Scott?

Scott Goodman^ Thank you, Jim. And good morning everyone.

If you'd like to turn to Slide 6. Loan growth of $144 million in the quarter pushed us past the $11 billion mark and represents just over 10% growth year-over-year. To illustrate Jim's comments on diversification, the breakdown of this year-over-year growth by sector on Slide 7 shows that 25% roughly is within the general C&I category, represents a diverse list of business types throughout our geographic markets, with the remainder well balanced across the other major segments of our business.

For the quarter, loan growth was recognized most prominently in the C&I and owner-occupied real estate space as well as life insurance premium finance and construction/development categories. Within our commercial banking and metro markets, we continue to have success attracting and onboarding new relationships, while existing client operating businesses are generally doing well and despite higher rates, remain willing to actively support growth. Borrowing here represents a variety of capital investment activities by these businesses and increased working capital facilities with revolving line usage up roughly 5.5% in the quarter.

Construction projects in process continue to move forward, providing an increase in related loan balances for the quarter. And while new construction requests have slowed overall, we did originate new project loans for a few current clients for the expansion and renovation of existing properties. Investor CRE origination has slowed, somewhat, impacted more heavily by the

higher rate environment and reacting with more caution, particularly in sectors such as multifamily, office, and retail.

Within the specialized banking sectors, life insurance premium finance posted solid growth with strong new origination volumes and a seasonal uptick from premium advances on existing policy loans. Tax credit loans moved slightly lower in the quarter, but consistent with the typical Q1 seasonal paydown that we see on project loans from the proceeds of the sale of 2023 tax credits.

SBA results were generally in line with expectations, as originations kept pace with recent quarters. Prepayments, which have stressed the portfolio due to rising rates, did continue to trend positively, moving lower during the quarter. However, net growth for the period was impacted by our decision to generate liquidity and income through the sale of a $23 million pool of guaranteed loans in March, which Keene will touch on further in his comments.

Sponsor Finance origination activity continued to moderate in Q1, consistent with a more restrained and patient posture by private equity sponsors. Payoffs associated with the sale of portfolio companies have begun to move toward a more normalized level, following a pause in this activity for most of 2023. While we do expect growth in this sector for the year, our approach will remain disciplined as it relates to credit structure, and originations will be focused primarily on well-known and top-tier sponsor relationships.

Regionally, we did experience growth across our commercial banking footprint in all major regions as displayed on Slide 8. In the Midwest markets of St. Louis and Kansas City, loans rose $74 million or 8.9% annualized. Significant new originations include equipment loans for a civil general contractor, a new relationship with a long-standing automotive dealership and recapitalization of a construction supply company. These markets, which have deeper C&I portfolios, also experienced increases related to heavier working capital line usage.

Our Southwest region loan portfolio rose $40 million in the quarter and is up 21% year-over-year. Larger new loans included an ESOP conversion for a long-standing food services client in Arizona, construction of a medical facility for a New Mexico client, as well as new relationships with a metal fabricator and a specialty contractor with an owner-occupied construction project in Las Vegas.

In our Western region of Southern California, loans rose by $20 million in the quarter and 10.2% year-over-year. We successfully onboarded several new private lender finance relationships as well as a variety of smaller C&I loans to new relationships in the lighting, medical services and specialty stainless steel equipment manufacturing industries. Overall, growth was somewhat moderated this quarter by timing issues related to larger paydowns on revolving lines with a few of our finance and private lending clients.

Moving on to deposits on Slide 9, total deposit balances were up $78 million for the quarter and $1.1 billion or roughly 9% year-over-year.

Breaking this down, noninterest-bearing DDA accounts were down by $387 million, attributable to the remixing of idle balances in interest-bearing alternatives. While lower yielding savings accounts also declined for similar reasons. In aggregate, however, we've been able to successfully grow client deposits by $810 million or 7.5% over the past 12 months. For the quarter, similar activity continued, but growth was slowed by the typical seasonal first quarter outflows related to distributions, bonuses, and tax payments.

Regionally, year-over-year, growth has been fairly well balanced between the specialty deposit verticals and other geographic markets and lending businesses, as shown on Slide 10. For the quarter, client balances were down $98 million or less than 1%, with the seasonal outflows most heavily impacting the St. Louis and California markets. On a combined basis, year-over-year, non-specialty customer deposits within our geographic regions are up $340 million or over 4%. This has been the result of focused development of sales campaigns and product enhancements directed at client outreach, expansion of existing relationships, and targeting of specific business types and competitors.

Specialty deposit businesses were up $123 million for the quarter and have grown year-over-year at 19.3%. These business lines are highlighted in more detail on Slide 11. Community Association balances rose by $69 million and typically experience seasonal increases in Q1 as HOA assessments are billed and paid. The Property Management segment also grew in the quarter, $119 million, as we continue to fund and open new accounts for our best relationships. Third-Party Escrow balances are down slightly, but mainly relate to some planned larger 1031 and class action account disbursements. Overall, key relationships are intact, and we continue to expand these deposit-focused lines of business with new accounts and new relationships.

Additional detail on the core funding mix and account activity is shown on Slide 12. Diversification of these balances by channel remains fairly consistent with the prior period. With, as you heard from Jim, roughly 31% of total deposits being noninterest-bearing. The pace and magnitude of the aforementioned remixing continues to slow, and we remain focused on building and retaining stable relationship-based funding.

The underlying account activity also continues to trend favorably and reflect our intentional efforts toward emphasizing a granular and diversified core deposit base, with new accounts opened exceeding closed accounts, and net balance increases when comparing new accounts to closed accounts across all channels.

With that, I'd like to turn the call over to Keene Turner for his comments. Keene?

Keene Turner^ Thanks, Scott. And good morning, everyone.

Turning to Slide 13, we reported earnings per share of $1.05 in the first quarter on net income of $40 million. Reported earnings included the impact of an additional FDIC special assessment and expenses related to our core conversion project. Excluding these items, EPS was $1.07 per share.

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Net interest income declined $3 million from the linked quarter, mainly due to day count and higher purchase accounting premium amortization. Earning asset growth and improved yields were enough to offset the increase in interest expense in the quarter caused by marginally higher deposit costs and seasonal changes in funding mix.

Fee income declined from the fourth quarter, mainly due to tax credit income that's typically highest at the end of each year.

The provision for credit losses decreased from prior quarters as nonperforming loans have stabilized and is largely reflective of net charge-offs, loan growth, and adjustments to qualitative factors.
Non-interest expense was higher in the current quarter, primarily due to a seasonal increase in compensation and benefits partially offset by a decrease in deposit servicing costs.

Turning to Slide 14, Net interest income for the first quarter of 2024 was $138 million, which was a decrease of $3 million compared to the linked quarter.

Interest income increased $0.7 million during the first quarter of 2024, driven mainly by higher earning asset balances and improved rates on the loan and investment portfolios. Loan income grew $1.7 million from the linked period as higher balances and yields resulted in a $3.5 million increase in interest income which was partially offset by a $1.1 million decline in purchase accounting amortization and $0.7 million of reduced net loan fees. The average loan origination rate in the first quarter was 7.84%, which is accretive to the overall portfolio yield of 6.87% in the quarter. Income from the investment portfolio grew by nearly $1 million as the portfolio continues to benefit from higher rates on cash flow reinvestment with an average yield of 5.21% on purchases within the quarter. Average cash levels declined in the first quarter as we redeployed funds into other earning assets, reducing interest income by nearly $2.1 million. More details follow on Slide 15.

Interest expense grew $3.6 million in the quarter due to a higher cost of funds from expected unfavorable changes in our funding mix. Interest paid on interest-bearing deposits, excluding brokered CDs, was $2.8 million higher as a result of balanced growth and higher rates. Interest on borrowed funds increased $1.5 million in the quarter due to seasonally higher customer repo balances and elevated levels of FHLB advances. This was partially offset by lower expense on brokered time deposits.

The resulting net interest margin for the first quarter was 4.13%, a decrease of 10 basis points from the linked quarter. I would note that the negative change in loan purchase accounting, combined with a $62 million improvement in unrealized losses on the investment portfolio reduced margin by 5 basis points in the quarter. The remaining change in net interest margin was generally in line with our expectations.

Our outlook on margin remains unchanged. While interest rates remain at current levels, higher for longer, we expect that overall funding cost 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. Asset growth funded with core deposits at reasonable spreads should allow us to defend or even add to net interest income dollars over the next couple of quarters, albeit at a somewhat lower marginal cost overall. Without rate cuts, we would see margin level out somewhere around 4% by year-end.

When we do begin to see rate cuts, we anticipate each quarter point reduction in Fed funds equates to an additional 6 - 8 basis points of margin loss, initially, or $2 million - $2.5 million of quarterly net interest income. Our expectation is that deposit rates will be more resistant to repricing initially in order to remain competitive. With additional Fed funds cuts, we will be more deliberate in moving deposit rates just as we were when rates were increasing.

And while not a component of net interest income, reductions in interest rates would positively impact deposit-related noninterest expense trends as more than half of the underlying balances are indexed to the federal funds rate. Each 25 basis points in Fed funds equates to approximately $1 million in quarterly expense.

So net, we expect pretax income to decline by $1 million to $1.5 million for every 25 basis points of Fed funds each quarter. At that level, we estimate that mid- to high single-digit loan growth will replace lost earnings from interest rate cuts, as long as they are limited to 25 basis points at a time.

Slide 16 shows our credit trends. Credit trends are stable or improving from last quarter. Net charge-offs were $5.9 million for the quarter or 22 basis points of average loans. The majority of charge-offs in the quarter were related to loans that went into nonperforming status in the fourth quarter. This included a charge-off of the remaining balance of the agricultural loan that was previously disclosed.

Nonperforming assets were 30 basis points of total assets compared to 34 basis points at the end of December. The provision for credit losses was $5.8 million during the first quarter and reflects the impact of net charge-offs, loan growth, improvement in economic forecast, and additional qualitative reserve builds on our agricultural and office CRE portfolios.

Slide 17 presents the allowance for credit losses. The allowance for credit losses represents 1.23% of loans or 1.34% when adjusting for government guaranteed loans. Our reserve reflects the weighted economic forecast that leans more toward a downside scenario that we believe is appropriate in this environment.

On Slide 18, first quarter fee income of $12 million was a decrease of $13 million from the fourth quarter and primarily in the tax credit income line item which is seasonally strongest in the fourth quarter. In addition to the seasonality, credits that are carried at fair value were

impacted by movements in 10-year SOFR rate, which increased roughly 35 basis points in the quarter.

Linked quarter decreases related to community development, private equity distributions, BOLI, and servicing fees were partially mitigated by a gain on sale of $23 million in SBA loans. As a reminder, community development and private equity distributions will fluctuate from period to period.

Turning to Slide 19, first quarter noninterest expense was $94 million, an increase of $1 million compared to the fourth quarter. Included in the current quarter was $0.6 million of additional FDIC special assessment expense related to updated loss estimates in the deposit insurance fund and $0.4 million of core conversion-related expenses.

Compensation and benefits were higher compared to the linked quarter, primarily due to annual reset of payroll tax limits, accrued PTO, in addition to a month's worth of annual merit increase. Deposit service expenses were lower compared to the linked quarter despite growth in average balances as certain allowances expired unused in the first quarter. We would expect this line item to grow off of the fourth quarter as we expect continued specialized deposit growth to be a significant contributor to overall growth as planned. Other expenses decreased in the quarter due to a combination of lower OREO and loan workout expenses and evidence of prudent cost controls affecting travel and entertainment expenses.

The first quarter's core efficiency ratio was 60.2% compared to 53.1% for the linked quarter, with the decrease being primarily attributable to the decline in fee income. We expect core expenses to expand sequentially due to normalization of deposit service targets.

Our capital metrics are shown on Slide 20. Our tangible common equity ratio was 9% at the end of the first quarter, up slightly from the end of the year. Our strong earnings profile and our manageable dividend payout continues to build capital and offset the impact of AOCI. AOCI losses increased in the quarter and reduced our tangible common equity ratio by 81 basis points at quarter end.

On a per share basis, tangible book value increased to $34.21 per share, a 4% annualized increase over the fourth quarter. With the strength of our earnings and our current capital position, we have put a repurchase plan in place to acquire shares at a price that's attractive based on the value of our company in addition to the previously announced $0.01 per common share increase to the quarterly dividend.

The first quarter was a solid start to the year for us and was generally in line with our expectations. We had an adjusted return on average tangible common equity of 12.5% and a 1.14% adjusted return on average assets. We feel good about our growth prospects on both loans and deposits, and we believe we'll continue to grow both tangible book value and shareholder value in the coming quarters.

I appreciate your attention today and we're now going to open the line for analyst questions.

QUESTION & ANSWER:

Operator^ (Operator Instructions) And your first question comes from the line of Jeff Rulis with D.A. Davidson.

Jeff Rulis^ A couple of questions on the loan growth front. Jim, I think you mentioned -- I would just want to confirm that the mid-single-digit loan growth guidance. Does that include the anticipated runoff out of the ag portfolio?

James Lally^ It does, Jeff. Yes. We're working on with growth in other areas.

Jeff Rulis^ Okay. And I think that balance was in the $200 million range. So you got about $100 million runoff for a headwind.

Is that --

James Lally^ That's right.

We expect between now and year-end, about $100 million would run off.

Jeff Rulis^ Appreciate it. And maybe for Scott, just kind of seeing that uptick in line utilization.

I may have missed it.

Is there any commonality or is there any timing to that? Or could you read into that maybe an improvement in what you've seen?

Scott Goodman^ Yes, Jeff, I think, again I think we see our companies use cash in the first quarter with some of the outflow.

I think you also see some of that on the lines.

But I think it also reflects, as I said, I think companies are basically optimistic about their business and they're willing to draw down working capital, whether it's hiring good people if they can find them or just opportunistically investing in the business.

So I think it's a combination of those two things.

Jeff Rulis^ Do you -- I know that kind of higher for longer the general story has been more sidelines, sitting and waiting. The longer we go with higher for longer, is there any -- do you see any expectation that borrowers say look, this could take a while, I'm ready to get back into the

pool? Or are you getting any indication that, that may be playing out that higher for longer is the reality and it's time to move on with projects?

Scott Goodman^ Yes. I think that's a good observation.

I think what I would say is I'm encouraged by the activity in the pipeline on the loan side overall.

But I think what we've seen now for some time that the pace of those things move very slowly. And I think there has been a little bit of a wait and see, particularly when the expectations were maybe for lower rates earlier this year.

But I think now with maybe the conclusion that it's going to be higher for longer, I think you may see some of this stuff start to move a little quicker because those decisions have been made.

It's just a matter of when not if.

Jeff Rulis^ Got it. And Scott, while I have you, I just -- I wanted to touch on the -- it looks like deposit runoff in the West was a particular -- that was a bigger driver or more there. Was there anything specific to that outflow? Or do you have a greater percentage of tax and bonus type activity that occurred out West for any reason?

Scott Goodman^ Yes.

I think the reasons are similar, but I think that the dollar amounts were a little larger. And I think if you dial into it, it's a group of our top-tier clients out there that are also some of our largest depositors and borrowers.

So I think it is just a function of the same behavior that we've seen in other markets with taxes, distributions, dividends and those relationships, for the most part, are all still intact and continues to be strong.

Jeff Rulis^ Great. And the last one, I think you all communicated the capital side, TCE now above 9%, when you get the little dividend bump here.

But also just wanted to see, is that-- you touched on the buyback authorization? Are those two exclusive of one another? Or do you feel like you could pull off a dividend increase and be nimble with the buyback as well?

James Lally^ Yes, Jeff, this is Jim.

I would say this that we can certainly dribble with both hands in this regard and do both.

We've announced the dividend increase and we'll be opportunistic relative to the buyback.

Jeff Rulis^ Okay. And at this point, Jim, M&A, is that anywhere on the radar?

James Lally^ Not really.

I think we just continue to create relationships.

But given where the stock price is today and where we're focused, it just doesn't make sense at this point in time.

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

Andrew Liesch^ Keene, just on the margin, at least in the near term, I hear the 5 basis points, but you also had, in this last quarter, 5 basis points of maybe not one-time items, but like not necessarily recurring items.

So, do you think maybe that 5 basis points off this last quarter's 4.13% may not be as drastic as 5?

Keene Turner^ Yes, Andrew, I guess when I think about going to 4%-ish by the end of the year with no rate cuts. I do think that the first or the second quarter in terms of margin compression is probably more similar to 4Q to 1Q trends. So, the 5 with maybe some worseness and then we see more firming up. The reason would be, I think we expect continued seasonal pressure on deposits. I don't think we expect to see as much growth until the second half, similar to last year.

And then with the agricultural headwind, we expect that to maybe be a little bit more near term than in the latter parts of the year. And also, I think we expect loan growth is typically stronger for us, in particular, in the fourth quarter.

So I think those things make me a little bit less optimistic of 1Q to 2Q than maybe it would seem. And those pieces aren't lost, I appreciate you pointing those out, where we've got a fairly significant premium still on SBA loans because of the weighted average life, it's roughly $24 million in total.

So that prepayment activity there has been fairly robust and that can cause net interest income and margin to move around quite a bit on a quarterly basis.

I don't know that we have done a good job of shining a light on that, but you get some payoffs in that activity and that can push the forecast around.

But I think we think dollars are reasonably stable with some growth 1Q to 2Q, maybe a little bit of growth there and then some growth in the second half on dollars.

Andrew Liesch^ Got it. All right. That's really helpful there. And then just on the expense front, pretty big increase in the seasonal bonus accruals, payroll taxes, what have you -- how much of that did you expect to fall out of the run rate here in the second quarter?

Keene Turner^ Yes.

I think there's a little bit of a trade-off here because the deposit costs in the quarter normalized are roughly 22.5. The 20.2 had a reversal of 2.5 in there. And I think those essentially trade off some of the expenses that were in the run rate.

So with a little bit of an additional uptick in core related expenses, I think for the second quarter, we think it's more like $94 million to $96 million of expenses, the higher end being with a little bit heavier core and sort of in the middle with a little bit of abatement of payroll tax and some of the seasonal items.

But the specialized deposit costs are going to snap back to the run rate. And then if we expect that there'll be some growth in those balances.

So with the ECR running just over 3% in terms of the accrual rate, that's going to be a sequential increase and push what is otherwise we think expense controls into that range of 94 to 96.

Andrew Liesch^ Got it. Great. Helpful there. And then on the core conversion, any update or that's still early stages to provide any sort of financials around that?

Keene Turner^ Yes.

I guess what I would say Andrew, is that we continue to make progress in making sure that dollars going out the door for those related expenses are well managed.

I think some of it just depends on where it is in terms of what's coming through the P&L.

But I still think $4 million to $5 million in the year is likely to occur.

We're getting a few more of those dollars here, first quarter, second quarter, I thought they'd be maybe more third quarter, fourth quarter heavy, but we're getting some that are trickling through and to the extent that we get any more updates there, we'll let you know.

But things are going well and as planned, and those dollars, I think our money is well spent to make sure that both we have a smooth transition, and we also have access to the information when we wake up on Monday and go to work.

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

Damon Del Monte^ So first question on the tax credit income line, Keene.

I can understand, I appreciate the impact on the -- with the move in rates. Of that loss that was reported this quarter, how much does the rate movement impact that?

Keene Turner^ Yes. Damon, it's essentially all rate-related impact.

It's maybe -- there are some credits that offset that a little bit, but 10 basis points is roughly $1 million and SOFR was up 35.

So it's largely driven by the -- that negative in terms of what the rate movement was.

Damon Del Monte^ Okay.

So if you -- is there any -- it's such a big variable to the bottom line there with the swings.

But I mean do you -- absent any material move in rates here in the second quarter, do you think that you go back to like a $1 million to $2 million level? Or is it just impossible to gauge that?

Keene Turner^ No. I think we do think that at least here in the second quarter, there's going to be some activity. And I think overall, we expect to overcome the negative on rate.

So still like a plus $10 million for the year for 2024 as long as rates don't hurt us too much.

So I think the fundamentals of that business and the activity there are still good.

It's just a little bit tough to outrun some of those larger swings in the quarter.

Damon Del Monte^ Got it.

Okay. And then as far as like the provision goes, the reserves at [$123 million], you cleaned up a couple of credits here this quarter. How should we kind of think about the provision level over the upcoming quarters?

Keene Turner^ Yes.

I think that we think that with maybe some of the ag portfolio going away we put some extra there.

We're optimistic that we won't necessarily need that. And it's tough to say what's going to happen with the economic data.

I mean my expectation is that the rate forecast will probably put some negatives into the longer end economic data.

But that net-net, the economic assumptions underlying that will be unchanged. And some of it will just depend on how much we're a little bit more weighted toward the negative just in terms of how the model works out, how much the revisions downward weigh on that.

I think our goal is that we want investors and everyone to feel secure about that we've got sufficient reserves, and we're going to continue to be maybe a little bit more on the conservative end.

But I think without really degradation of credit or material growth, I think there is some opportunity for the provision level, particularly here in the next quarter to move in our favor a little bit.

Damon Del Monte^ Got it.

Okay. And then just lastly, if you look at the average earning asset yield, I think it was flat at 6.20% quarter-over-quarter. Are you surprised by that? Or would you expect there to be some expansion still?

Keene Turner^ I think the purchase accounting weighed on that just a hair.

So, I think that fundamentally, as we look out, new loan originations are still helping us, reinvestment is helping us. And I don't expect that we're going to really have the remixing that was negative in terms of the proportion of cash balances, I think we're – we'll be similar cash balances.

So, I would expect earning yield to be more positively trending in the upcoming quarter here as long as some of those variables in terms of premium amortization and some of those things are generally in line or cooperate.

But I think we kind of had a few factors going against us.

But the fundamentals of loan yield and investment yield and those things remain favorable.

So I mean despite that we were a little off in terms of how we guided margin forecast, I feel like the pieces that we missed weren't really on recurring fundamental things that materially affect the run rate for 2Q, 3Q, et cetera.

Operator^ And your next question comes from the line of Brian Martin with Janney.

Brian Martin^ Keene, maybe just one on just the margin. Just -- I guess I appreciate the commentary and just the outlook, if rates, if we do see some rate cuts, then that kind of 4% threshold or maybe target you're thinking about is lower depending on when we get those rate cuts.

If we get some later this year, then that number, it drifts a bit lower bit based on your commentary about the impact of cuts fair?

Keene Turner^ Yes, Brian, I think if we start seeing some cuts, I mean I think we're starting to head south of 4%.

If you get one, call it, early to mid second quarter -- I'm sorry, third quarter. And then depending on how much you get by the end of the year when they occur, you'll have some more of that impact in the fourth quarter, but really it will start to impact first quarter of '25.

But yes, I think when I look at two or three rate cuts, we start heading just south of 4% on margin.

Brian Martin^ Yes.

Okay. Understood. And then just remind me, are there -- I guess the -- as far as -- in terms of the fixed assets that we price for fixed rate loans at reprice mean is that a meaningful number, I mean in terms of what you guys have? Or is that not a big number there as what might be repricing over the balance of the year?

Or next 12 months, however you think about it?

Keene Turner^ I mean it's a fairly decent amount.

I mean if you think about the weighted average life of the loan portfolio sort of SBA is three to four years. And then you look at the proportion, I mean you get $500 million, $600 million of fixed rate loan repricing in the next 12 months.

So it's significant and it's helpful, and I think that's part of the new loan origination yield that I indicated, I think was a good fundamental.

We had maybe a little bit more in the first quarter here in terms of some of the tax credit stuff that repriced with a little bit of a headwind. So origination yield wasn't quite as good.

But moving forward, ex that, the seasonality in those fundings occur first half as well.

I think we're optimistic about fixed rate repricing continuing to improve yields and just overall loan origination improving yields.

Brian Martin^ Yes.

In the pickup, I mean if it's half $500 million to $600 million over the next 12 months, is that -- what kind of yield is that coming off at versus what you mentioned as far as what the new

origination yields are? Is it kind of in the 4.5 range? Or I guess- to get an idea of how much pickup you get on that?

Keene Turner^ Yes.

I mean we've been originating roughly 6.5% on fixed rate loans and we're probably picking up 200 basis points on that, just sort of depending on when it was originated.

So it's a fairly decent trade and then variable rate pricing is closer to 8.5% or 9%, that helps drive up that overall origination rate.

Brian Martin^ Got you.

Okay.

I appreciate it. And how about just jump into credit for a moment. Just on the classifieds, it looks like they were down a touch in the quarter.

Just any commentary on just kind of criticized or just kind of the special mention loans, how they're trending here in the quarter?

Douglas Bauche^ Yes, Brian, it's Doug. You're right. Classifieds were flat, but criticized loans were also flat in the quarter.

So really, the combination criticized classifieds represent just about 4% of total loans and really as we expected, just kind of returned to a more stabilized level here in the first quarter.

Brian Martin^ Got you.

Okay. And then -- just on the -- maybe just one more on credit.

Can you talk about the provision, but just the higher for longer, does that impact maybe thinking about just the incremental impact on credit that, that could have that maybe you take the reserve up a bit.

Is that more kind of your commentary about being more cautious here?

I guess just trying to understand how you're thinking about that?

Keene Turner^ Yes.

I guess what I would say is in the quarter, it's probably a little bit of our -- we reflected it in the qualitative factors. And then my comments were just trying to get at the fact that I think we use

Moody's as our data source there, and we think that they'll contemplate that in some of the information.

So I think what we've seen happening is the short-term information in the model looks better, but the longer-term information with rates higher for longer, probably degrades a little bit. And so I think we're positioned to deal with that transition from a Q factor to the underlying data.

I don't know how much we'll lean on it or take a position one way or the other unless we see that affecting our own data, but we do rely on the forecast, and we'll sort of be in the same boat as everyone else.

Brian Martin^ Yes.

Okay. And then the last one for me was just on the -- you guys recognize some SBA gains in the quarter. Just kind of wondering how you're thinking about that? And then just maybe kind of that -- the fee income line, maybe kind of absent your commentary about the tax credit being somewhat volatile, seems, I guess in terms of how we think about that here in the coming quarters?

Keene Turner^ Yes.

I'll say on SBA gains, it's really a function of deposit growth and loan opportunities.

I think you heard from Jim, we've got strong demand and Scott in a variety of areas. And so the SBA portfolio provides a nice relief valve for customers that don't typically bring material funding to the bank.

So when we look at selling a loan in SBA and then our ability to originate an additional one somewhere else, I think it's a good trade and I think you'll see us continue to at least make that trade to the extent that we have sufficient origination activity that drives good yields in the upcoming quarters or at least 2Q and then we'll keep evaluating it.

So I think it's a part of the balance sheet management and also a tool we can use to help mitigate pressure from some of the deposit repricing. And then I think we had the loss of $2 million going through the tax credit line item with what, $3 million of negative fair value. And I think my comment is we expect, as long as we don't get rates moving around or against us too much. The activity in that business for the remainder of the year should sort of get us to the level that we saw net-net in total last year was just under $10 million. And I do think that some of that can occur here in the second quarter.

But we also expect most of it will be fourth quarter weighted.

Brian Martin^ Okay. Yes. And I guess I was asking more about just the kind of the impact.

If you think about fee income ex the tax credit, if you continue to pick up some more gains here on SBA, just kind of relative to how you were thinking about fee income last quarter versus going forward? If you have more gains, does that maybe boost your outlook on fee income ex tax credit? Or is it more just an offset to maybe some other areas being a little bit less or what not as we go forward?

Keene Turner^ Yes.

I mean I think all else being equal, last year, we had unfortunately, a BOLI death benefit included in the gains.

But otherwise, I think we expect private equity, CDE, some of those things to be episodic and contribute similarly along with SBA gains.

So the SBA to your question, would be additive to our overall expectations.

Operator^ (Operator Instructions) And there are no questions at this time.

I will now turn the conference back to Jim Lally for closing remarks.

James Lally^ Okay. Thank you. And thank you all for joining us this morning and for your interest in our company. And we certainly look forward to speaking to you again at the end of the second quarter.

Have a great day.

Operator^ Ladies and gentlemen, that concludes today's call. Thank you all for joining.

You may now disconnect.