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Market Intelligence

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Earnings Call

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CALL PARTICIPANTS	2
PRESENTATION	3
QUESTION AND ANSWER	9

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Presentation

Operator

Thank you for standing by. My name is Carly, and I will be your conference operator today. At this time, I would like to welcome everyone to the Enterprise Financial Services Corp Third Quarter 2025 Earnings Conference Call. [Operator Instructions] I will now turn the call over to Jim Lally, President and CEO. Please go ahead.

James Brian Lally

President, CEO & Director

Good morning, and thank you all very much for joining us for our 2025 third quarter earnings call. Joining me this morning is Keene Turner, our company's Chief Financial Officer and Chief Operating Officer; and Doug Bauche, our company's Chief Banking Officer.

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 third quarter was another very solid quarter for our company. As we expected, we saw loan growth return to an annualized level of 6% while deposit growth continued well above this level. This was a continuation of our intentional strategy to lean into our diversified geography and national businesses that allows for our team to focus on the business that fits us the best versus settling for transactional business that achieves certain growth targets. In addition to this, we spent considerable time on the recent closing and systems conversion for the acquisition of 10 branches in Arizona and 2 in the Kansas City area. As a reminder, this acquisition garnered us approximately \$650 million of well-priced deposits and \$300 million in loans but more importantly, enhances an already strong presence in two strong markets for us.

We did experience an increase in provision for loan losses in the quarter primarily due to a \$22 million increase in nonperforming assets and net charge-offs. Doug will provide much more detail in his comments but I feel good about our ability to work through these issues and expect our NPAs to return to historical levels over the next few quarters.

The recapture of transferable solar tax credits in the quarter caused some noise in our income statement. This investment was a component of our income tax mitigation strategy and is not related to our tax credit loan and fee businesses. Keene will provide details on this and walk you through the accounting treatment in his comments. But I want to reiterate that this project is covered by insurance.

With that said, we earned \$1.19 per diluted share in the quarter compared to \$1.36 in the linked quarter and \$1.32 in the third quarter of 2024. This level of performance produced a return on average assets of 1.11% in the current quarter and a pre-provision ROAA of 1.61%. Net interest income and net interest margin both saw expansion in the quarter. Net interest income improved by \$5.5 million when compared to the previous quarter, and net interest margin improved by 2 basis points to 4.23%. This was the sixth consecutive quarter that we saw net interest income growth. These results reflect our continued focus on pricing discipline on both sides of the balance sheet, combined with overall steady growth.

We continue to improve on striking the correct balance of providing a strategic consultative experience for our clients with appropriate growth. I'm confident that this model will continue to provide for our ability to grow NII for the foreseeable future.

On an annualized basis, loan growth in the quarter was 6% or \$174 million net of \$22 million of guaranteed loans that were sold during the quarter, resulting in a gain of \$1.1 million. We continue to see really good progress in our Southwest markets with high-quality growth coming from newer markets like Dallas and Las Vegas. Overall, we originated loans in the quarter at a rate of 6.98%, which continues to be accretive to the overall portfolio yield.

Deposit growth in the quarter was exceptional. Net of brokered CDs, we were able to grow deposits by \$240 million as impressive as the fact that DDA remained at 32%. While our national verticals provided for much of this growth in the quarter, we have experienced deposit growth from all of our regions year-over-year and would expect to see our typical fourth quarter swell from these markets to finish the year strong. Our ability to continue to grow deposits gives us plenty of liquidity to fund future loan growth while keeping our loan-to-deposit ratio at an appropriate level for our company.

Our well-positioned balance sheet continues to be a strength for our company. Capital levels at quarter end remained stable and strong, with our tangible common equity to tangible assets ratio of 9.60%, yielding a return on tangible common equity of 11.56%. This return profile and the continued expansion of our tangible book value per common share, which increased over 15% on an annualized quarterly basis. This level of compounding of tangible book value per share far exceeds our 10-year CAGR of just over 10%. Given the strength of our earnings and our confidence in our ability to continue to perform at a high level, we increased the dividend by \$0.01 per share for the fourth quarter of 2025 to \$0.32 per share.

Our asset quality statistics moved slightly higher in the quarter when compared to the linked quarter. Nonperforming assets increased by \$22 million, with the largest component of this being a \$12 million life insurance premium loan that is adequately collateralized and just needs to work through the collection process to be resolved. I do not expect any loss of principal on this loan. When accounting for this and the previously disclosed 7 commercial real estate loans in Southern California, these two issues, both of which have high certainty of collection account for nearly 60% of our NPAs. This is why I'm confident that we will see the ratio of NPAs to total assets return to more historical levels in the quarters to come.

I want to be clear that we have never had any exposure to the private lending business identified in regulatory filings by two other regional lenders and articles in various publications. As stated in our October 16 8-K and previously discussed in our first quarter earnings call, the 7 real estate loans in Southern California totaling \$68.4 million that are directly secured by priority first mortgages on the real properties owned by the single-purpose entity borrowers. We have commenced foreclosure proceedings with respect to the real property and expect to collect the full balance on these loans.

We will spend the remainder of the year focused on the cultural integration of our new associates who recently joined through our branch acquisition, along with our new clients acquired in the same deal. Additionally, we'll be focused on continuing the strong momentum we have in our regions and specialty verticals, making sure that we enter 2026 with a great deal of confidence and momentum.

Before turning the call over to Doug, I want to briefly comment on what we are hearing from our clients. Last quarter, I mentioned that the impetus for our clients' confidence was the passing of the One Big Beautiful Bill, the downward trajectory of short-term interest rates and further clarity of U.S. trade policy. With the September rate cut behind us and several more on the horizon, we are seeing our clients move forward with more confidence than what we had seen in several previous quarters despite continued uncertainty with some larger trading partners. With that said, I can see our onboarding of new clients and loan production maintaining its current level or possibly accelerating slightly from here.

We operate in very good markets, many of which continue to have disruption due to M&A. We've invested in many new associates who are embracing our value-added solutions-based approach, and our balance sheet and deposit generating capability has us positioned well to profitably fund the opportunities that will be presented. I'm excited for how 2025 will end and the momentum that we will carry into the new year. With that, I would like to turn the call over to Doug Bauche. Doug?

Douglas N. Bauche
Senior EVP & Chief Banking Officer

Thank you, Jim, and good morning, everyone. Over the past couple of months, I've spent considerable time in our major geographic markets, and I continue to be encouraged by both the quality and volume of new relationship opportunities we are seeing. Our brand continues to gain traction in our newer markets of North Texas and Southern Nevada, led by our bankers that are well entrenched and connected to those communities, and we continue to capitalize on the strong economic growth throughout our Southwest region.

As Jim mentioned, the September rate reduction and further forecasted easing has seemed to spur some cautious optimism among business owners and real estate investors. Discussions with architects, contractors and developers indicate that their new project pipelines are beginning to build momentum heading into 2026. While volatility continues around trade tariffs with China, our C&I clients have largely navigated this challenging period successfully by adjusting supply chains and pricing to maintain operating margins.

On the lending side, loans increased in the quarter, \$174 million, net of \$22 million in SBA loan sales. We continue to prioritize full relationship wins with disciplined structure and pricing. Sector growth in the quarter is broken down on Slide 5 and was well balanced between investor-owned CRE of \$79 million, C&I of \$31 million, including SBA owner-occupied commercial real estate and sponsor finance and \$73 million in our tax credit lending niche. Growth in the tax credit sector was largely related to scheduled fundings on existing affordable housing tax credit bridge loans.

New C&I originations were solid and consistent with the linked quarter as we provided senior debt to both existing and new operating companies across our business lines. However, strong originations were somewhat muted by the exit of a quick service food franchise client in our Midwest region, \$22 million in SBA loan sales and a reduction in commercial line of credit usage between the end of June and September. As it appears, our clients are working through some of the excess inventory purchases they made in prior periods when tariff and supply chain concerns were more pronounced.

Within the specialty lending business lines, SBA production was stable with the prior quarter and in line with expectations. Sponsor Finance originations slowed in the quarter as we continue our fewer but better approach, while we remain disciplined and committed to this space. Originations in this segment were equally offset by payoffs resulting from sponsors exiting portfolio company investments.

LIPF originations were seasonally modest with a strong pipeline of activity heading into the historically strong final quarter of the year. This sector continues to perform well on a risk-adjusted basis and has experienced a 12% year-over-year growth rate.

Moving to the geographic markets shown on Slide 6. We posted growth in our Midwest and Southwest regions, while we continue to hold serve in our California markets. Growth in our major geographies came from the funding of a market-leading employee-owned electrical contractor, a privately held distributor of high-voltage electrical components, a manufacturer of high-precision metal parts and several new commercial real estate loans with established developers for the acquisition or refinance of industrial and multifamily projects.

Turning to deposits on Slide 7. Excluding the addition of \$10 million of brokered CDs, client deposit balances grew by \$241 million in the linked quarter, and are up \$822 million or roughly 7% year-over-year. Noninterest-bearing accounts increased \$65 million in the quarter and represent just over 32% of total deposits.

Within the geographic markets shown on Slide 8, we are posting solid customer deposit growth on a year-over-year basis across all regions. Growth has continued to come from our holistic approach to new business development, which rewards full banking relationships rather than transactional lending or high-cost idle cash balances. Our specialty deposit verticals posted strong results, up \$189 million for the quarter and \$681 million or 22% year-over-year. Our specialty deposits consisting of property management, community associations and legal industry escrow and trust services are broken out on Slide 9.

Deposits in the community association and property management specialties totaled roughly \$1.5 billion each, while deposits residing within the escrow division, reached \$844 million. These businesses provide a diverse, growing and overall favorable cost adjusted source of funding that continues to complement our geographic base.

Turning to Slide 10. You'll see that our deposit base is intentionally well balanced across our core commercial, business and consumer banking and specialty deposit channels at 37%, 33% and 30% of total customer deposits, respectively. With deposit clients deeply rooted in treasury management and

lending relationships, we're encouraged by our ability to rationally adjust pricing in the current rate environment, while continuing to grow balances across the channels.

I'd also like to provide some commentary on asset quality. As Jim noted earlier, nonperforming assets increased \$22 million to 83 basis points from 71 basis points in the linked quarter. The increase in the quarter is largely centered around a \$12 million life insurance premium finance loan that is 100% principal secured by cash value life insurance. We are in the process of liquidating the policy with the life insurance carrier, and we expect full principal collection.

Other notable additions to nonaccrual in the quarter included a \$6.2 million sponsor finance credit which was charged down by \$3.75 million in the quarter with the remaining \$2.5 million book balance expected to be satisfied via the sale of business assets. A \$2 million single-family residential real estate loan in Santa Monica and two smaller commercial real estate secured loans totaling \$2.5 million in aggregate.

On October 16, we filed a Form 8-K, reiterating our position relative to the previously reported 7 commercial real estate secured nonperforming loans totaling \$68.4 million in the aggregate to 7 special-purpose entities in Southern California. Our recent foreclosure attempt on October 15 was temporarily stalled due to a second bankruptcy filing. However, we remain confident in our security position and ability to collect the balance of these loans in full. With the satisfaction of the \$12 million life insurance premium finance loan and \$68 million in aforementioned 7 commercial real estate loans, we expect our nonperforming assets to return to our favorable historical norms in the coming quarter. Now I'll turn the call over to Keene Turner for his comments.

Keene S. Turner
Senior EVP, CFO & COO

Thanks, Doug, and good morning, everyone. Turning to Slide 11. We reported earnings per share of \$1.19 in the third quarter on net income of \$45 million. Excluding acquisition costs, EPS on an adjusted basis was \$1.20. As Jim noted, we had a recapture of \$24 million on solar credits that were purchased as part of our tax planning strategies. Solar tax credits, like many other tax credit programs are subject to recapture from the IRS when certain events occur. Unfortunately, the seller of the tax credits went bankrupt and transferred the solar assets in a bankruptcy sale that triggered the recapture in the quarter. When we acquired the solar credits, we also purchased a tax credit insurance policy to mitigate the risk of loss.

The recognition of the tax credit recapture and the anticipated recovery from the insurance policy has created some noise in our financial statements. The recapture is recorded in tax expense, while the insurance recovery is included in noninterest income. When you account for the recapture plus the taxes on the anticipated insurance recovery, the gross up in noninterest income and income tax expense is \$30.1 million during the quarter. Since there is no impact on net income for the third quarter, we have excluded these items from the earnings per share bridge on Slide 11.

Net interest income and margin both showed strong expansion again in the quarter, benefiting from the increase in both loans and securities. In anticipation of the liquidity from branch acquisition that closed in early October, we had increased our security purchases over the past 2 quarters. Excluding the anticipated insurance recovery, noninterest income decreased due to lower tax credit and community development income. The provision for credit losses increased from the linked quarter, primarily due to net charge-offs and an increase in nonperforming loans, along with loan growth. Noninterest expense was higher in the quarter due to an increase in deposit costs from continued growth in the deposit verticals and higher legal and other expenses associated with the increase in and level of problem loans.

Turning to Slide 12 with more details to follow on 13. Third quarter net interest income was \$158 million, an increase of \$5.5 million from the prior period, reflecting the trend of solid asset growth supported by a growing deposit base and disciplined pricing. Loan interest increased by \$3.6 million on higher average balances and level yields. Average balances grew \$96 million compared to the linked period and a 6.98% rate on loans booked in the quarter supported the overall portfolio yield. Interest on investments was \$2.7 million higher compared to the linked period with average balances increasing more than \$200 million and the portfolio yield was higher by 7 basis points. The average tax equivalent purchase yield in the third quarter was 4.99%.

Interest expense increased only \$0.9 million compared to the linked quarter. Deposit expense increased by \$1.6 million due to higher average balances, partially offset by lower rates on interest-bearing accounts. Interest expense on borrowings decreased \$0.7 million, mainly due to lower Federal Home Loan Bank advances and customer repo balances, along with lower rates on both. Interest expense also reflected the redemption of our subordinated debt in September that was replaced with a new senior note at a 3% lower interest rate.

Our resulting net interest margin for the third quarter was 4.23%, an increase of 2 basis points over the linked period. The earning asset yield declined by 1 basis point, mainly due to the change in the overall asset mix from growth in the investment portfolio. Our cost of funds declined by 4 basis points, driven by lower deposit rates and lower cost of Federal Home Loan Bank advances and repo balances, partially offset by an increase in average brokered deposits.

We have focused for several quarters on creating an earnings profile that is less susceptible to changing interest rates, and we believe we have made significant strides. We are well positioned for the current rate environment to add profitable growth to enhance earnings. However, we are slightly asset sensitive, and we expect a 0.25 point reduction in the federal funds rate to reduce net interest margin by 3 to 5 basis points. That being said, we anticipate that most of the recent rate cut will largely be mitigated in the fourth quarter as the branch acquisition is expected to be 5 basis points accretive to our overall net interest margin.

And one last comment on margin. Despite the Fed reducing interest rates by over 100 basis points in the last year, we have managed to grow net interest margin over the last 4 quarters from 4.17% in the third quarter of 2024 to 4.23% in the most recent period. This speaks not only to a more favorable operating and interest rate environment, but also to the quality of our business model and the discipline in pricing and structure we have employed while achieving nearly 10% asset growth.

Slide 14 reflects our credit trends. We had net charge-offs of \$4.1 million compared to \$1 million in the linked quarter. But importantly, net charge-offs of 4 basis points for the first 9 months of this year continue to trend below our historical average. The provision for credit losses was \$8.4 million in the period compared to \$3.5 million in the linked quarter. The increase was mainly due to the increase in net charge-offs, a higher level of nonperforming loans and loan growth. Nonperforming assets increased \$22 million to 83 basis points of total assets compared to 71 basis points in the linked quarter. Doug provided a lot of details on the movement within our nonperforming assets, but it's worth reiterating that the largest part of our nonperforming assets continues to be made up of two commercial banking relationships where we expect to be made whole. We reaffirmed this expectation in the Form 8-K that we filed a little over a week ago, stating that we expect to collect the balance of these loans because of our senior secured position.

Slide 15 shows the allowance for credit losses. We continue to be well reserved with an allowance of 1.29% of total loans or 1.4% when adjusting for government guaranteed loans.

On Slide 16, third quarter noninterest income of \$47 million includes the previously mentioned \$30 million of accrued insurance proceeds related to the recaptured tax credits. Excluding this, noninterest income decreased \$4.1 million from the linked quarter to \$17 million, primarily due to lower tax credit and community development income in addition to the nonreoccurrence of a BOLI policy payout received in the second quarter. We sold \$22 million of SBA guaranteed loans that generated a gain of approximately \$1.1 million in the current quarter. Depending on levels of planned growth and activity in the SBA space, we may take the opportunity to continue to sell SBA loans in the coming quarters.

Turning to Slide 17. Third quarter noninterest expense of \$109.8 million increased \$4.1 million from the second quarter. Deposit costs increased roughly \$2.4 million from the linked quarter, primarily due to continued growth in the deposit vertical balances. Legal and professional expenses increased as well. Legal and loan expenses grew slightly and remain at elevated levels as we work through certain nonperforming asset relationships. The resulting core efficiency was 61% for the quarter.

Our capital metrics are shown on Slide 18. We grew tangible book value by 4% in the quarter and 12% in the past year. Our tangible common equity ratio was 9.6%, up from 9.4% in the linked quarter, while

our strong CET1 ratio of 12% is at the highest level in our history. The strength of our capital position supported the branch acquisition that closed earlier this month and also allowed for the redemption of our subordinated debt that was included in total risk-based capital. We also increased our quarterly dividend by \$0.01 to \$0.32 per share for the fourth quarter of 2025.

This is another strong quarter of solid financial performance and we expect to close out the year from a position of strength. The strategic branch acquisition that closed this month will help drive this performance as we expand our footprint in important markets. I appreciate your attention today and we will now open the line for questions.

Question and Answer

Operator

[Operator Instructions] Your first question comes from Jeff Rulis with D.A. Davidson.

Jeffrey Allen Rulis

D.A. Davidson & Co., Research Division

Question on -- I guess, to get a little more specific on these credit relationships, just the workout process. I understand you try to give visibility on the Southern California credits. But the resolution that the life insurance loan and these, could you narrow that into -- I thought I heard a resolution in the coming quarter and quarters there was sort of some mixed terms there. Could you just sort of outline that again, how do you expect those to be resolved time line-wise?

Douglas N. Bauche

Senior EVP & Chief Banking Officer

Yes. Jeff, it's Doug. First of all, in relationship to the Southern California real estate loan, certainly, with the secondary bankruptcy filing that has been made, the timing of that is a little bit difficult to ascertain. We do feel comfortable that we're going to get some fairly quick remediation from the bankruptcy courts on this. But as we maybe indicated in prior periods, we started down the path of both the nonjudicial and judicial foreclosure process in California in anticipation of a potential block like this. So we're moving down the path as quickly as we can. But I wouldn't necessarily say it's going to be in the fourth quarter. I think it's more in the coming quarters that we'll get resolution on the real estate loans.

As it relates to the life insurance premium finance loan, I'd just reiterate, we've got a stellar 20-year track record lending in this space without principal loss. This is unfortunate timing, but a co-trustee of the \$12 million life insurance policy filed suit against the insurance carrier. And the insurance carrier is simply delaying their recognition of our demand to honor the obligations to surrender the policy and send us proceeds to pay the loan off. So again, this looks like this may be heading through some litigation. And with that said, I think precise timing of the resolution of that case is a bit uncertain. But what is certain is full coverage of cash surrender value covering our principal balance and collectibility.

Jeffrey Allen Rulis

D.A. Davidson & Co., Research Division

Appreciate it. And Doug, do you have NDFI exposure in the portfolio, just a figure of percent of loans overall?

Douglas N. Bauche

Senior EVP & Chief Banking Officer

Yes. Let me say this, Jeff. So as it relates to NBFIs, it's a very broad classification that includes credit exposure to bank holding companies, mortgage warehouse originators, capital call lines for private equity funds and a lot of different types of businesses, including those engaged in our state and new market tax credit lending programs. But I think specifically what you might be referring to is more exposure to private lenders. And I would say this, we have, for years, maintained some very favorable relationship with private lending entities where we take assignments of their notes, security instruments, and that's our primary collateral. Today, that portfolio consists of approximately \$260 million or \$270 million in balances across, I'll call it, 8 to -- 18 to 20 different relationships. So these private lenders specifically are largely engaged in providing first mortgage secured loans to investors in 1 to 4 family residential real estate. So our process here, Jeff, like everything else, right, these are deep relationships. They're highly experienced and quality leaders. We know them well, and we're very disciplined in our credit underwriting and monitoring process. So hopefully, that captures what you're looking for there in terms of exposures to the private lenders.

Jeffrey Allen Rulis

D.A. Davidson & Co., Research Division

Sure. That helps, Doug. Keene, on the margin. Sounds like you're largely going to offset this most recent rate cut. And then if we carry forward that 3 to 5 basis points pressure per 25 basis point cut, then you detailed the history of the last year plus of really defending margin when you screen asset sensitive, but the reality is you've done much better than that. Is that still the case if we think about a flat margin into the fourth quarter with those cut versus the branch accretion? And then the go forward, is it -- would you say that the net of that is still some modest pressure, I hope to do better than the 3% to 5%? Any commentary on go-forward? .

Keene S. Turner

Senior EVP, CFO & COO

Yes. Maybe just as I always think about it, when we talk about asset sensitivity, we're also talking about parallel shifts. And I don't think anybody is expecting a parallel shift. I think we're thinking the short end of the curve comes down. And in that case, that's been good for us, and we've been able to defend that fairly well. I think your comments are appropriate. I think that our view, once we get the branches on here, we're pretty neutral. And when I start looking at both net interest margin and pretax income at risk, if we execute on our mid-single-digit loan and deposit growth for next year, we're growing pretax income and essentially defending or growing net interest income because of the branch deal. So I think when you look at last year's year-to-date period, returns are roughly 125 basis points. We're on top of that in the current period with a little bit worse provision. And I think that our view is that -- if we assume that we rotate out of taking gains on SBA loans, that profile sort of remains the same and with the bigger balance sheet, you're growing earnings per share. So I think we generally expect to defend net interest margin. It might drift a little bit, but you're still flirting with a 4.20-ish margin for most of '26 at least as we see it right now. And we've got -- we're using Moody's baseline, so that has Fed funds going to 3% in the third quarter of '26 and 50 basis points here in the fourth quarter. So I feel like that environment or that forecast also doesn't assume that we get better-than-expected loan growth, which I do think will occur if we start to get rates down to that degree.

Operator

Your next question comes from Damon DelMonte with KBW.

Damon Paul DelMonte

Keefe, Bruyette, & Woods, Inc., Research Division

Keene, just a question for you on the expense outlook kind of here in the fourth quarter and how we think about going into '26. Can you give a little bit of guidance on the expectation from the branch deal and the integration of that?

Keene S. Turner

Senior EVP, CFO & COO

Yes. So total reported expenses here in the quarter were \$110 million. There's some run rate adjustment in there. So let's call the run rate here in the third quarter normalized without onetimers \$107 million. And then I think in the fourth quarter, you're going to get roughly \$4.5 million of expenses related to run rate on the branch acquisition. And then there's probably 2.5 of onetimers in there. And then I think when you think about full year branch acquisition expenses on a run rate basis, it's just under \$18 million. So I think when you normalize through all of that and you take the historical enterprise base and you annualize the branch base, I think we think expenses year-to-year will be up roughly 3.5%. That's kind of what we're thinking. And that's got that Moody's interest rate reduction in that plan where the deposit costs essentially are level kind of year-to-year.

Damon Paul DelMonte

Keefe, Bruyette, & Woods, Inc., Research Division

Got it. Okay. All right. That's helpful. And then on the fee income, obviously, some volatility in the tax credit income line this quarter. Fourth quarter typically is the strongest point of the year. So how do we

kind of think about the rebound off of the modest loss this quarter? I mean maybe look at it on a full year basis?

Keene S. Turner

Senior EVP, CFO & COO

Yes. I think that we kind of went from the maybe the best case scenario of fee income in the second quarter to, -- I don't want to say worst-case scenario, but certainly a baseline here in the third quarter. And I think the fourth quarter comes somewhere in between it. I will say that there is a -- with the shutdown that's occurred right now, the SBA sale is maybe off the table as a lever here in the fourth quarter, but we do expect the CDE to have a little bit better quarter. Private equity should be in there. And if the tax credit delivers any kind of profitability. I think the fourth quarter should be somewhere between where the second and third quarter were. And you will get a little bit of impact from the branch acquisitions. There's roughly \$2 million annually of fees that come in. Now we give some fee income holidays around acquisitions. So you'd only maybe have like a month of that, but that will also provide some benefit there.

Damon Paul DelMonte

Keefe, Bruyette, & Woods, Inc., Research Division

Okay. So the -- somewhere in between the second and the third quarter, that's on a total noninterest expense basis, not...

Keene S. Turner

Senior EVP, CFO & COO

I think so. And I think that that's -- we're expecting 50 basis points of rate reductions that should help the tax credit line item in addition to activity. I just -- I don't know if there's going to be an opportunity to sell SBA loans, I think we're going to have -- we would have otherwise had a strong quarter. I'm just not sure if those can get funded and sold and all that stuff.

Operator

Your next question comes from Nathan Race with Piper Sandler.

Nathan James Race

Piper Sandler & Co., Research Division

Keene, just going back to your previous comments around noninterest expenses. Can you just remind us what your deposit beta assumptions are just in terms of the ECR costs running through expenses?

Keene S. Turner

Senior EVP, CFO & COO

Yes, it's 40%, and that's been pretty consistent. So 25 is 10. And that's roughly \$1 million quarterly for every 25 basis points.

Nathan James Race

Piper Sandler & Co., Research Division

Okay. Great. And then just turning to capital, and I would be curious to maybe get Jim's updated thoughts on management priorities. Obviously, you guys are in a good capital position, and that should continue to build absent any material deployment. So Jim, just curious to hear what you're thinking on the M&A front these days? And just what the appetite for share repurchases as well.

James Brian Lally

President, CEO & Director

Yes, sure. Thanks, Nate. Our priority capital really is to continue to funding our growth and focused on the organic growth, given our markets and what have you. From an M&A perspective, as I talked about in my comments, it's about integration at this time. Systems are working great now. It's a cultural and

client integration that we're focused on with our new markets and expansion of our markets in Arizona and Kansas. Relative to other M&A, certainly, like a lot of businesses, we talk to a lot of companies and what have you, but we're looking for the fit, if you will, that allows us to continue to improve the right side of our balance sheet, and certainly stay close to the markets that we're in. And to the extent that doesn't come to fruition, certainly, buybacks are on the table for sure.

Nathan James Race

Piper Sandler & Co., Research Division

Okay. Great. And maybe one last housekeeping question. I don't believe you guys disclosed kind of the core deposit intangible goodwill impact from the branch acquisition. Wondering if you could just update us on what we could be expecting there as we think about pro forma tangible book in the fourth quarter?

Keene S. Turner

Senior EVP, CFO & COO

Yes. I would just say, high level, the dilution is 5%, Nate, and we expect that maybe that depending on how mark's work moves around a little bit, from where we estimated it, it's going to be roughly \$70 million of intangibles.

Nathan James Race

Piper Sandler & Co., Research Division

Okay. Great. And that 5% dilution doesn't include kind of the retained earnings impact in the fourth quarter, I presume?

Keene S. Turner

Senior EVP, CFO & COO

No, that's just sort of a hard line deal math. I think we'll obviously make some profitability. And depending on what happens with securities fair value may not even see a diminution of tangible book value in the fourth quarter.

Operator

[Operator Instructions] Your next question comes from Brian Martin with Janney.

Brian Joseph Martin

Janney Montgomery Scott LLC, Research Division

Just Keene, one clarification on the expenses. I think if the -- is your suggestion on expenses, at least kind of a run rate to think about for fourth quarter around 112-ish, is that -- I missed the part about -- you said something about a nonrecurring piece. I know you said it was -- the baseline might be 107 and then you had about 4.5 of pickup from the branches, the kind of that 112-ish level is how we think about where you start for 4Q? Or did I miss something there?

Keene S. Turner

Senior EVP, CFO & COO

No, that's about right. I mean, I think you got sort of 2.5 the 114 minus 2.5 of integration. So you're in that ballpark, like 111 and 113 is kind of where we're thinking.

Brian Joseph Martin

Janney Montgomery Scott LLC, Research Division

Got you. Okay. That's helpful. And then just in general, if we think about the fee income line, Keene, I guess I don't know that the tax line is one item, but just in terms of fee income, kind of where you think -- if we just think bigger picture because there's a lot of moving parts and there are some variable pieces, if we think about it as a percentage of revenue, how you think about where that shakes out as you get into maybe next year on an annual basis? Is it kind of current level, is that how we should think about it? Or

I guess is there a better way to think about it, given all the moving parts in there that swing around in a given quarter, but just bigger picture annually, the best way to think about it?

Keene S. Turner

Senior EVP, CFO & COO

Yes. I think -- I'm not sure I think about it relative to percent of revenue necessarily, just -- it's 10%, 11%, but we're going to expect to grow net interest income and maybe falling on my sword a little bit, we're going to outstrip fee income growth because that's kind of a mid-single-digit grower. I think when I look year-to-year at fee income levels, I think we expect generally that if you stripped out gain on sale of SBA loans, the level is consistent and maybe growth just slightly between 2025 and 2026, and then there's an opportunity to sell SBA loans, call it, from \$2.5 million to \$5 million depending on what production is to solve for some greater profitability. So I think that's more likely. If I look out and say we're going to get Fed funds down to 3%, I think commercial loan growth is going to pick up. And I think SBA production is going to pick up. We've been on our heels a little bit there. We've been being disciplined on credit, and other factors in all spaces, but especially SBA. And I think with rates down, that will improve pricing on gain on sale as well as just the approval rate for borrowers. And so that will give us a greater opportunity, both for production and for sale. So that's an opportunity, but we're not factoring that into what we're thinking, and it's not reflected in my comments about stable ROA and ROATCE from '24 to '25 to '26.

Brian Joseph Martin

Janney Montgomery Scott LLC, Research Division

Got it. Okay. And just big picture on the fees, would you expect fourth quarter to be a relatively -- typically, it's an outsized quarter on the tax credit activity mean not getting into the dollars, but still an outsized quarter in 4Q. Did you say that if you...

Keene S. Turner

Senior EVP, CFO & COO

I didn't say that. Your comment is right. Typically, it's outsized. I think the tax credit line item with rates moving around and also with how we've repositioned that business to be more of a loan business than a fee business. It's gotten a little bit more volatile and a little bit less aggressive. So look, we could come back and have \$5 million or \$6 million in that line item. That's not what we're planning. We're hoping we get \$1.5 million to \$2 million. And so my comments, I think, earlier to Damon were that I thought the fourth quarter total fee income would be somewhere between where the second was, which was a high watermark and in the third quarter, which was sort of the baseline kind of clean quarter minimum from my perspective. So somewhere in the middle of that, I think it's a reasonable expectation for 4Q fee income.

Brian Joseph Martin

Janney Montgomery Scott LLC, Research Division

Got you. Okay. Sorry about that. I missed that comment to Damon. So -- and then just one last one, maybe just for Jim, I guess, -- did I hear it right, Jim, in terms of -- it sounded as though on the capital front that the M&A might be more of an interest than the buyback in the short term depending on that? And if that was the case, let me ask that, and I can ask a follow-up if I can, Jim, but did I miss that or is that your priority?

James Brian Lally

President, CEO & Director

Yes. I'd say this, that to me, the prioritization is growth, as I said, then we would look at buybacks. And if M&A came about. It was a good opportunity for us to improve the right side of the sheet, we'd certainly look at it. But we're certainly not chasing in that space right now.

Brian Joseph Martin

Janney Montgomery Scott LLC, Research Division

Okay. So it's more organic and buyback rather than M&A. And if M&A is there, it seems like less of a priority in the short term. Okay. Got you. And then just the last thing for me, was just the strong growth that you guys have put up in the specialty deposits. Can you just give a sense of what's driving that? And just in terms of where that cost -- where those deposit costs typically are? It sounds like they're maybe on the lower side. But kind of how do those costs shake out relative to the total cost of funds? And just if you expect rapid growth to continue?

James Brian Lally

President, CEO & Director

So the answer to that, Brian, is yes, we do. I think it's one of the things we've invested in people. We invested in systems, expertise and all three of those verticals is keeps driving it. So we look at it that it's a variable cost model for us, very profitable, but yet we're garnering share from others just by virtue of being in the market like we are in our other businesses and being present and being problem solvers. And we'll continue investing in that space with good producers.

Operator

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

James Brian Lally

President, CEO & Director

Carly, thank you, and thank you all very much for joining us this morning and your interest in our company. And we look forward to speaking with you again in early 2026. Have a great day.

Operator

Ladies and gentlemen, that concludes today's call. Thank you all for joining. You may now disconnect.

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