

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549**

FORM 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2021

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____ to _____.
Commission File Number: 001-37886

CAPSTAR FINANCIAL HOLDINGS, INC.

(Exact name of registrant as specified in its charter)

Tennessee
(State or other jurisdiction of
incorporation or organization)

1201 Demonbreun Street, Suite 700
Nashville, Tennessee
(Address of principal executive offices)

81-1527911
(IRS Employer
Identification No.)

37203
(zip code)

(615) 732-6400

(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Trading Symbol(s)	Name of each exchange on which registered
Common Stock, \$1.00 par value per share	CSTR	Nasdaq Global Select Market

Securities registered pursuant to Section 12(g) of the Act:

None

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company" and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large Accelerated Filer	<input type="checkbox"/>	Accelerated Filer	<input checked="" type="checkbox"/>
Non-Accelerated Filer	<input type="checkbox"/>	Smaller Reporting Company	<input checked="" type="checkbox"/>
		Emerging Growth Company	<input checked="" type="checkbox"/>

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date.

Shares outstanding as of November 2, 2021

Common Stock, par value \$1.00 per share

22,166,963

CAPSTAR FINANCIAL HOLDINGS, INC.
QUARTERLY REPORT ON FORM 10-Q
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TERMINOLOGY

The terms “we,” “our,” “us,” “CapStar,” “the Company,” “CSTR” and “CapStar Financial” that appear in this Quarterly Report on Form 10-Q (this “Report”) refer to CapStar Financial Holdings, Inc. and its wholly-owned subsidiary, CapStar Bank, which we sometimes refer to as “CapStar Bank,” “our bank subsidiary,” “the Bank” and “our Bank”.

CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

This Report contains “forward-looking statements” within the meaning of Section 27A of the Securities Act of 1933, as amended (the “Securities Act”), and Section 21E of the Securities Exchange Act of 1934, as amended (the “Exchange Act”). These forward-looking statements reflect our current views with respect to, among other things, statements relating to the Company’s assets, business, cash flows, condition (financial or otherwise), credit quality, financial performance, liquidity, short and long-term performance goals, prospects, results of operations, strategic initiatives, the benefits, cost and synergies of completed acquisitions or dispositions, and the timing, benefits, costs and synergies of future acquisitions, disposition and other growth opportunities. These statements are often, but not always, made through the use of words or phrases such as “may,” “should,” “could,” “predict,” “potential,” “believe,” “will likely result,” “expect,” “continue,” “will,” “anticipate,” “seek,” “aspire,” “estimate,” “intend,” “plan,” “project,” “projection,” “forecast,” “roadmap,” “goal,” “target,” “would,” and “outlook,” or the negative version of those words or other comparable words of a future or forward-looking nature. These forward-looking statements are not historical facts, and are based upon current expectations, estimates and projections about our industry, management’s beliefs and certain assumptions made by management, many of which, by their nature, are inherently uncertain and beyond our control. The inclusion of these forward-looking statements should not be regarded as a representation by us or any other person that such expectations, estimates and projections will be achieved. Accordingly, we caution you that any such forward-looking statements are not guarantees of future performance and are subject to risks, assumptions and uncertainties that are difficult to predict and that are beyond our control. Although we believe that the expectations reflected in these forward-looking statements are reasonable as of the date of this Report, actual results may prove to be materially different from the results expressed or implied by the forward-looking statements. There are or will be important factors that could cause our actual results to differ materially from those indicated in these forward-looking statements, including, but not limited to, the following:

- the continuing effects of the COVID-19 (and variants of that virus) pandemic upon us, our customers, employees, and third-party service providers, and the ultimate extent of the impacts of the pandemic on our business, including on our credit quality, business operations and liquidity, as well as its impact on general economic and financial market conditions;
- deterioration in general business and economic conditions, or turbulence in domestic or global financial markets, which could adversely affect CapStar’s revenues and the values of our assets and liabilities, reduce the availability of funding, affect credit quality, and increase stock price volatility;
- the inability to capitalize on opportunities to enhance market share in certain markets and the risk that the Company’s services may not be generally accepted in new markets;
- the ability of the Company to meet expectations regarding the benefits, costs, synergies and financial and operational impact of the FCB Corporation (“FCB”) and the Bank of Waynesboro (“BOW”) acquisitions;
- the possibility that any of the anticipated benefits, costs, synergies and financial and operational improvements of the FCB and BOW acquisitions will not be realized or will not be realized as expected;
- economic conditions (including interest rate environment, government economic and monetary policies, the strength of global financial markets and inflation and deflation) that impact the financial services industry as a whole and/or our business;
- the concentration of our business in our target markets and the effect of changes in the economic, political and environmental conditions on this market;
- increased competition in the financial services industry, locally, regionally or nationally, which may adversely affect pricing and the other terms offered to our clients;
- an increase in the cost of deposits, loss of deposits or a change in the deposit mix, which could increase our cost of funding; an increase in the costs of capital, which could negatively affect our ability to borrow funds, successfully raise additional capital or participate in strategic acquisition opportunities;
- our dependence on our management team and board of directors and changes in our management and board composition;
- our reputation in the community; our ability to execute our strategy to achieve our loan, return on average assets and

- efficiency ratio goals, hire seasoned bankers, and achieve deposit growth through organic growth and strategic acquisitions;
- credit risks related to the size of our borrowers and our ability to adequately identify, assess and limit our credit risk;
 - our concentration of large loans to a small number of borrowers as well as to borrowers located within our target market;
 - the significant portion of our loan portfolio that originated during the past two years and therefore may less reliably predict future collectability than older loans;
 - the adequacy of reserves (including our allowance for loan losses) and the appropriateness of our methodology for calculating such reserves;
 - non-performing loans, leases and other non-performing assets;
 - charge-offs, non-accruals, troubled debt restructurings, impairments and other credit-related issues;
 - adverse trends in the healthcare service industry, which is an integral component of our target market's economy and which could adversely affect the business operations of certain of our key borrowers;
 - our management of risks inherent in our commercial real estate loan portfolio, and the risk of a prolonged downturn in the real estate market, which could impair the value of our collateral and our ability to sell collateral upon any foreclosure;
 - changes in secondary market conditions for underwriting or repurchase of secondary mortgages;
 - continued compliance and adherence to underwriting and servicing of Government Guaranteed Loans;
 - our inability to realize operating efficiencies and tax savings from the implementation of our strategic plan;
 - our ability to comply with existing and changing governmental legislation and regulation, including Basel guidelines, capital requirements, accounting regulation or standards and other applicable laws and regulations;
 - the loss of large depositor relationships, which could force us to fund our business through more expensive and less stable sources;
 - operational and liquidity risks associated with our business, including liquidity risks inherent in correspondent banking;
 - volatility in interest rates and our overall management of interest rate risk, including managing the sensitivity of our interest-earning assets and interest-bearing liabilities to interest rates, and the impact to our earnings from a change in interest rates;
 - the potential for our Bank's regulatory lending limits and other factors related to our size to restrict our growth and prevent us from effectively implementing our business strategy;
 - our ability to identify and thereafter consummate strategic acquisitions that may be necessary in order to achieve our goals;
 - the sufficiency of our capital, including sources of capital and the extent to which we may be required to raise additional capital to meet our goals;
 - fluctuations in the fair value of our investment securities that are beyond our control;
 - deterioration in the fiscal position of the U.S. government and downgrades in Treasury and federal agency securities;
 - potential exposure to fraud, negligence, computer theft and cyber-crime;
 - the adequacy of our risk management framework;
 - our dependence on our information technology and telecommunications systems and the potential for any systems failures or interruptions;
 - threats to and breaches of our information technology systems and data security, including cyber-attacks; our dependence upon outside third parties for the processing and handling of our records and data;
 - our ability to adapt to technological change;
 - the financial soundness of other financial institutions;
 - our exposure to environmental liability risk associated with our lending activities;

- our engagement in derivative transactions;
- our involvement from time to time in legal proceedings and examinations and remedial actions by regulators;
- our involvement from time to time in litigation or other proceedings instituted by or against shareholders, customers, employees or third parties and the cost of legal fees associated with such litigation or proceedings;
- the susceptibility of our market to natural disasters and acts of God; and
- the effectiveness of our internal controls over financial reporting and our ability to remediate any future material weakness in our internal controls over financial reporting.

The foregoing factors should not be construed as exhaustive and should be read in conjunction with the section entitled “Risk Factors” included in our Annual Report on Form 10-K for the year ended December 31, 2020 (the “2020 Form 10-K”) and in future reports that we file with the Securities and Exchange Commission. If one or more events related to these or other risks or uncertainties materialize, or if our underlying assumptions prove to be incorrect, actual results may differ materially from our forward-looking statements. Accordingly, you should not place undue reliance on any such forward-looking statements. Any forward-looking statement speaks only as of the date of this Report, and we do not undertake any obligation to publicly update or review any forward-looking statement, whether as a result of new information, future developments or otherwise, except as required by law. New risks and uncertainties may emerge from time to time, and it is not possible for us to predict their occurrence or how they will affect us.

PART I. FINANCIAL INFORMATION
Item 1. Financial Statements

CAPSTAR FINANCIAL HOLDINGS, INC. & SUBSIDIARY
Consolidated Balance Sheets
(In thousands, except share data)

	September 30, 2021 (unaudited)	December 31, 2020
Assets		
Cash and due from banks	\$ 51,929	\$ 40,191
Interest-bearing deposits in financial institutions	287,438	237,248
Federal funds sold	19,900	—
Total cash and cash equivalents	<u>359,267</u>	<u>277,439</u>
Securities available-for-sale, at fair value	483,778	486,215
Securities held-to-maturity, fair value of \$1,847 and \$2,504 at September 30, 2021 and December 31, 2020, respectively	1,788	2,407
Loans held for sale, includes \$79,842 and \$97,303 measured at fair value at September 30, 2021 and December 31, 2020, respectively	176,488	186,998
Loans held for investment	1,894,249	1,883,690
Less allowance for loan losses	(22,533)	(23,245)
Loans, net	<u>1,871,716</u>	<u>1,860,445</u>
Premises and equipment, net	25,886	26,689
Restricted equity securities	14,443	15,562
Accrued interest receivable	7,606	8,771
Goodwill	41,068	41,068
Core deposit intangible, net	7,152	8,630
Other real estate owned, net	349	523
Other assets	122,586	72,259
Total assets	<u>\$ 3,112,127</u>	<u>\$ 2,987,006</u>
Liabilities and Shareholders' Equity		
Deposits:		
Noninterest-bearing	\$ 718,299	\$ 662,934
Interest-bearing	963,460	844,101
Savings and money market accounts	601,359	591,438
Time	391,274	469,528
Total deposits	<u>2,674,392</u>	<u>2,568,001</u>
Federal Home Loan Bank advances	—	10,000
Subordinated notes	29,499	29,423
Other liabilities	37,908	36,096
Total liabilities	<u>2,741,799</u>	<u>2,643,520</u>
Shareholders' equity:		
Common stock, voting, \$1 par value; 25,000,000 shares authorized; 22,165,760 and 21,988,803 shares issued and outstanding at September 30, 2021 and December 31, 2020, respectively	22,166	21,989
Additional paid-in capital	248,322	246,890
Retained earnings	99,341	66,879
Accumulated other comprehensive income, net of tax	499	7,728
Total shareholders' equity	<u>370,328</u>	<u>343,486</u>
Total liabilities and shareholders' equity	<u>\$ 3,112,127</u>	<u>\$ 2,987,006</u>

See accompanying notes to consolidated financial statements (unaudited).

CAPSTAR FINANCIAL HOLDINGS, INC. & SUBSIDIARY
Consolidated Statements of Income (Unaudited)
(In thousands, except share and per share data)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2021	2020	2021	2020
Interest income:				
Loans, including fees	\$ 22,350	\$ 22,796	\$ 66,936	\$ 61,620
Securities:				
Taxable	1,655	1,193	4,900	3,465
Tax-exempt	344	343	1,065	975
Federal funds sold	9	—	12	—
Restricted equity securities	161	139	482	421
Interest-bearing deposits in financial institutions	171	171	405	640
Total interest income	24,690	24,642	73,800	67,121
Interest expense:				
Interest-bearing deposits	390	640	1,216	3,371
Savings and money market accounts	288	2,537	896	4,819
Time deposits	654	1,299	2,317	4,197
Federal Home Loan Bank advances	—	116	12	348
Subordinated notes	394	394	1,181	394
Total interest expense	1,726	4,986	5,622	13,129
Net interest income	22,964	19,656	68,178	53,992
Provision for loan losses	—	2,119	(415)	11,295
Net interest income after provision for loan losses	22,964	17,537	68,593	42,697
Noninterest income:				
Deposit service charges	1,187	1,064	3,398	2,531
Interchange and debit card transaction fees	1,236	936	3,555	2,389
Mortgage banking	4,693	9,686	13,318	19,063
Tri-Net	1,939	668	4,618	2,528
Wealth management	481	382	1,412	1,162
SBA lending	911	476	1,781	525
Net gain on sale of securities	7	34	20	74
Other noninterest income	1,197	1,558	3,446	3,228
Total noninterest income	11,651	14,804	31,548	31,500
Noninterest expense:				
Salaries and employee benefits	10,980	12,949	31,210	33,256
Data processing and software	2,632	2,353	8,530	6,317
Occupancy	1,028	999	3,193	2,615
Equipment	760	864	2,640	2,295
Professional services	469	638	1,634	1,854
Regulatory fees	279	397	746	893
Acquisition related expenses	—	2,548	323	3,286
Amortization of intangibles	477	539	1,478	1,300
Other operating	1,741	1,452	5,105	4,067
Total noninterest expense	18,366	22,739	54,859	55,883
Income before income taxes	16,249	9,602	45,282	18,314
Income tax expense	3,147	2,115	9,075	3,299
Net income	\$ 13,102	\$ 7,487	\$ 36,207	\$ 15,015
Per share information:				
Basic net income per share of common stock	\$ 0.59	\$ 0.34	\$ 1.64	\$ 0.77
Diluted net income per share of common stock	\$ 0.59	\$ 0.34	\$ 1.63	\$ 0.77
Weighted average shares outstanding:				
Basic	22,164,278	21,948,579	22,114,948	19,558,281
Diluted	22,218,402	21,960,490	22,165,130	19,583,448

See accompanying notes to consolidated financial statements (unaudited).

CAPSTAR FINANCIAL HOLDINGS, INC. & SUBSIDIARY
Consolidated Statements of Comprehensive Income (Unaudited)
(In thousands)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2021	2020	2021	2020
Net income	\$ 13,102	\$ 7,487	\$ 36,207	\$ 15,015
Other comprehensive income (loss):				
Unrealized gains (losses) on securities available-for-sale:				
Unrealized gains (losses) arising during the period	(2,123)	(440)	(9,748)	3,902
Reclassification adjustment for (gains) included in net income	(7)	(34)	(20)	(74)
Tax effect	548	(40)	2,539	(1,086)
Net of tax	(1,582)	(514)	(7,229)	2,742
Unrealized losses on cash flow hedges:				
Reclassification adjustment for losses included in net income	—	2,167	—	2,679
Tax effect	—	—	—	—
Net of tax	—	2,167	—	2,679
Other comprehensive income (loss)	(1,582)	1,653	(7,229)	5,421
Comprehensive income	\$ 11,520	\$ 9,140	\$ 28,978	\$ 20,436

See accompanying notes to consolidated financial statements (unaudited).

CAPSTAR FINANCIAL HOLDINGS, INC. & SUBSIDIARY
Consolidated Statements of Changes in Shareholders' Equity (Unaudited)
(In thousands, except share and per share data)

	Common Stock, voting		Additional paid-in capital	Retained earnings	Accumulated other comprehensive income (loss)	Total shareholders' equity
	Shares	Amount				
Balance December 31, 2019	18,361,922	\$18,362	\$207,083	\$46,218	\$1,383	\$273,046
Net issuance (redemption) of restricted common stock	73,098	73	(196)	—	—	(123)
Stock-based compensation expense	—	—	360	—	—	360
Net exercise of common stock options	20,582	21	85	—	—	106
Repurchase of common stock	(147,800)	(148)	(1,289)	—	—	(1,437)
Common stock dividends declared (\$0.05 per share)	—	—	—	(916)	—	(916)
Net income	—	—	—	1,346	—	1,346
Other comprehensive income	—	—	—	—	3,408	3,408
Balance March 31, 2020	18,307,802	18,308	206,043	46,648	4,791	275,790
Net issuance (redemption) of restricted common stock	(5,614)	(6)	7	—	—	1
Stock-based compensation expense	—	—	541	—	—	541
Common stock dividends declared (\$0.05 per share)	—	—	—	(923)	—	(923)
Net income	—	—	—	6,181	—	6,181
Other comprehensive income	—	—	—	—	360	360
Balance June 30, 2020	18,302,188	18,302	206,591	51,906	5,151	281,950
Net issuance (redemption) of restricted common stock	13,899	14	(27)	—	—	(13)
Stock-based compensation expense	—	—	330	—	—	330
Issuance of common stock in conjunction with acquisitions	3,631,718	3,632	39,953	—	—	43,585
Common stock dividends declared (\$0.05 per share)	—	—	—	(1,097)	—	(1,097)
Net income	—	—	—	7,487	—	7,487
Other comprehensive income	—	—	—	—	1,653	1,653
Balance September 30, 2020	21,947,805	\$21,948	\$246,847	\$58,296	\$6,804	\$333,895
Balance December 31, 2020	21,988,803	\$21,989	\$246,890	\$66,879	\$7,728	\$343,486
Net issuance (redemption) of restricted common stock	117,962	118	(216)	—	—	(98)
Stock-based compensation expense	—	—	349	—	—	349
Net exercise of common stock options	1,039	1	(1)	—	—	—
Repurchase of common stock	(27,260)	(27)	(435)	—	—	(462)
Common stock dividends declared (\$0.05 per share)	—	—	—	(1,093)	—	(1,093)
Net income	—	—	—	11,030	—	11,030
Other comprehensive income	—	—	—	—	(9,425)	(9,425)
Balance March 31, 2021	22,080,544	22,081	246,587	76,816	(1,697)	343,787
Net redemption of restricted common stock	(2,926)	(3)	(27)	—	—	(30)
Stock-based compensation expense	—	—	447	—	—	447
Net exercise of common stock options	87,929	88	938	—	—	1,026
Common stock dividends declared (\$0.06 per share)	—	—	—	(1,332)	—	(1,332)
Net income	—	—	—	12,076	—	12,076
Other comprehensive loss	—	—	—	—	3,778	3,778
Balance June 30, 2021	22,165,547	22,166	247,945	87,560	2,081	359,752
Net redemption of restricted common stock	(5,702)	(6)	(42)	—	—	(48)
Stock-based compensation expense	—	—	373	—	—	373
Net exercise of common stock options	5,915	6	46	—	—	52
Common stock dividends declared (\$0.06 per share)	—	—	—	(1,321)	—	(1,321)
Net income	—	—	—	13,102	—	13,102
Other comprehensive loss	—	—	—	—	(1,582)	(1,582)
Balance September 30, 2021	22,165,760	\$22,166	\$248,322	\$99,341	\$499	\$370,328

See accompanying notes to consolidated financial statements (unaudited).

CAPSTAR FINANCIAL HOLDINGS, INC. & SUBSIDIARY
Consolidated Statements of Cash Flows (Unaudited)
(In thousands)

	Nine Months Ended September 30,	
	2021	2020
Cash flows from operating activities:		
Net income	\$ 36,207	\$ 15,015
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Provision for loan losses	(415)	11,295
Accretion of discounts on acquired loans and deferred fees	(5,412)	(3,446)
Depreciation and amortization	2,615	2,261
Net amortization of premiums on investment securities	1,823	994
Net gain on sale of securities	(20)	(74)
Mortgage banking	(13,318)	(19,063)
Tri-Net	(4,618)	(2,528)
SBA lending	(1,781)	(525)
Net gain on disposal of premises and equipment	(21)	(303)
Net gain on sale of other real estate owned	(29)	(108)
Stock-based compensation	1,169	1,231
Deferred income tax expense	1,283	1,788
Origination of loans held for sale	(896,950)	(845,982)
Proceeds from loans held for sale	925,397	834,392
Cash payments arising from operating leases	(1,568)	(1,402)
Amortization of debt issuance expense	76	31
Net increase in accrued interest receivable and other assets	(15,373)	(6,406)
Net increase in accrued interest payable and other liabilities	1,812	4,186
Net cash provided by (used in) operating activities	<u>30,877</u>	<u>(8,644)</u>
Cash flows from investing activities:		
Activities in securities available-for-sale:		
Purchases	(83,420)	(134,935)
Sales	—	77,338
Maturities, prepayments and calls	74,305	64,009
Activities in securities held-to-maturity:		
Maturities, prepayments and calls	600	880
Net redemption of restricted equity securities	1,119	1,154
Net increase in loans	(5,685)	(185,614)
Purchase of premises and equipment	(278)	(417)
Proceeds from the sale of premises and equipment	—	2,660
Purchases of bank owned life insurance	(31,000)	—
Proceeds from sale of other real estate	2,225	1,665
Cash paid for acquisitions	—	(27,278)
Cash received from acquisitions	—	90,760
Net cash used in investing activities	<u>(42,134)</u>	<u>(109,778)</u>
Cash flows from financing activities:		
Net increase in deposits	106,391	445,414
Proceeds from Federal Home Loan Bank advances	—	680,000
Payments on Federal Home Loan Bank advances	(10,000)	(680,000)
Issuance of subordinated debt	—	29,387
Repurchase of common stock	(462)	(1,437)
Exercise of common stock options and warrants, net of repurchase of restricted shares	902	(29)
Common stock dividends paid	(3,746)	(2,936)
Termination of interest rate swap agreements and related reclassification adjustment for unrealized losses included in income	—	2,679
Net cash provided by financing activities	<u>93,085</u>	<u>473,078</u>
Net increase in cash and cash equivalents	81,828	354,656
Cash and cash equivalents at beginning of period	277,439	101,269
Cash and cash equivalents at end of period	<u>\$ 359,267</u>	<u>\$ 455,925</u>
Supplemental disclosures of cash paid:		
Interest paid	\$ 5,279	\$ 12,525
Income taxes paid	13,395	5,620
Supplemental disclosures of noncash transactions:		
Transfer of loans to other real estate	\$ 2,022	\$ 113
Loans charged off to the allowance for loan losses	407	1,014
Lease liabilities arising from obtaining right-of-use assets	—	668
Unrealized (losses) gains on securities available for sale	(7,229)	2,742
Loans transferred from held for sale to held for investment	—	2,800
Assets acquired, net of cash	—	423,983
Liabilities assumed	—	447,412
Goodwill	—	3,558

See accompanying notes to consolidated financial statements (unaudited).

CAPSTAR FINANCIAL HOLDINGS, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The accompanying unaudited consolidated financial statements as of and for the period ended September 30, 2021 include CapStar Financial Holdings, Inc. and its wholly owned subsidiary, CapStar Bank (the “Bank”, together referred to as the “Company”). Significant intercompany transactions and accounts are eliminated in consolidation.

The accompanying unaudited consolidated financial statements have been prepared in accordance with instructions to Form 10-Q and do not include all information and notes required by U.S. generally accepted accounting principles (“U.S. GAAP”) for complete financial statements. All adjustments consisting of normally recurring accruals that, in the opinion of management, are necessary for a fair presentation of the financial position and results of operations for the periods presented have been included. These unaudited consolidated financial statements should be read in conjunction with the Company’s consolidated financial statements and related notes appearing in the 2020 Form 10-K.

Business Combinations

The Company accounts for business combinations using the acquisition method of accounting. The accounts of an acquired entity are included as of the date of acquisition, and any excess of purchase price over the fair value of the net assets acquired is capitalized as goodwill. Under this method, all identifiable assets acquired, including purchased loans, and liabilities assumed are recorded at fair value.

The Company typically issues common stock and/or pays cash for an acquisition, depending on the terms of the acquisition agreement. The value of shares of common stock issued is determined based upon the market price of the stock as of the closing of the acquisition.

Reclassifications

Certain amounts, previously reported, have been reclassified to state all periods on a comparable basis and had no effect on shareholders' equity or net income.

Use of Estimates

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change relate to the determination of the allowance for loan losses, determination of impairment of intangible assets, including goodwill, the valuation of our investment portfolio, deferred tax assets and estimated liabilities. There have been no significant changes to the Company’s critical accounting policies as disclosed in the 2020 Form 10-K.

Subsequent Events

Accounting Standards Codification (“ASC”) 855, Subsequent Events, establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued. The Company evaluated all significant events or transactions that occurred after September 30, 2021 through the date of filing this Quarterly Report on Form 10-Q and determined that there were no events that required disclosure.

NOTE 2 – ACQUISITIONS

FCB Acquisition

Effective July 1, 2020, pursuant to the Agreement and Plan of Acquisition dated as of January 23, 2020 (the “FCB Acquisition Agreement”), by and between the Company and FCB Corporation, a Tennessee corporation (“FCB”), FCB was acquired by CapStar, with CapStar continuing as the surviving entity (the “FCB Acquisition”). Immediately following the FCB Acquisition, The First National Bank of Manchester, a national banking association and a wholly owned subsidiary of FCB, was acquired by CapStar Bank, a Tennessee chartered bank and a wholly owned subsidiary of CapStar (the “FNBM Merger”), with CapStar Bank continuing as the surviving entity in the FNBM Acquisition.

Subject to the terms and conditions set forth in the FCB Acquisition Agreement, at the effective time of the FCB Acquisition, shares of common stock, par value \$10.00 per share, of FCB (“FCB Common Stock”) issued and outstanding immediately prior to the completion

of the FCB Acquisition (other than shares of FCB Common Stock owned or held by FCB, CapStar and their subsidiaries (in each case, other than shares of FCB Common Stock held in a fiduciary or agency capacity or in satisfaction of debts previously contracted) were collectively converted into the right to receive in the aggregate 2,966,918 shares of common stock, par value \$1.00 per share, of CapStar (“CapStar Common Stock”), with cash (without interest) in lieu of fractional shares, and \$22.2 million in cash, without interest.

BOW Acquisition

Effective July 1, 2020, following the FCB Acquisition, pursuant to the Plan of Bank Acquisition, dated as of January 23, 2020 (the “BOW Acquisition Agreement,” and together with the FCB Acquisition Agreement, the “Acquisition Agreements”), by and among CapStar, CapStar Bank and The Bank of Waynesboro, a Tennessee chartered bank (“BOW”), BOW was acquired by CapStar Bank, with CapStar Bank continuing as the surviving entity (the “BOW Acquisition,” and together with the FCB Acquisition, the “Acquisitions”).

On the terms and subject to the conditions set forth in the BOW Acquisition Agreement, at the effective time of the BOW Acquisition, shares of common stock, par value \$10.00 per share, of BOW (“BOW Common Stock”) issued and outstanding immediately prior to the completion of the BOW Acquisition (other than shares of BOW Common Stock owned or held by CapStar, CapStar Bank, BOW and their subsidiaries (in each case, other than shares of BOW Common Stock held in a fiduciary or agency capacity or in satisfaction of debts previously contracted)) were collectively converted into the right to receive in the aggregate 664,800 shares of CapStar Common Stock, with cash (without interest) in lieu of fractional shares, and \$5.1 million in cash, without interest.

Total acquisition consideration resulting from the Acquisitions amounted to approximately \$70.9 million.

With the acquisitions, the Company further expanded its franchise in the Middle Tennessee market. FCB’s and BOW’s results of operations were included in the Company’s results beginning July 1, 2020. Acquisition related costs of \$2.5 million and \$3.3 million are included in the Company’s consolidated statements of income for the three and nine months ended September 30, 2020, respectively. The fair value of the common shares issued as part of the consideration paid for the Acquisitions was determined by the closing price of the Company’s common shares immediately preceding the acquisition date.

Goodwill of \$3.6 million associated with the acquisitions is not amortizable for book or tax purposes. The following table summarizes the consideration paid for the acquisitions and the amounts of the assets acquired and liabilities assumed recognized at the acquisition date (in thousands):

	As recorded by FCB Corporation	Initial fair value adjustments	Measurement period adjustments	As recorded by CapStar Financial Holdings
Assets:				
Cash and cash equivalents	\$ 90,760	\$ —	\$ —	\$ 90,760
Securities	98,536	159 (a)	—	98,695
Loans, gross	296,992	(2,318) (b)	—	294,674
Allowance for loan losses	(4,544)	4,544 (c)	—	—
Premises and equipment, net	9,907	1,540 (d)	—	11,447
Core deposit intangible	—	3,570 (e)	—	3,570
Other	16,514	(917) (f)	—	15,597
Total	<u>\$ 508,165</u>	<u>\$ 6,578</u>	<u>\$ —</u>	<u>\$ 514,743</u>
Liabilities:				
Deposits	\$ 440,025	\$ 2,652 (g)	\$ —	\$ 442,677
Other	4,735	—	—	4,735
Total	<u>\$ 444,760</u>	<u>\$ 2,652</u>	<u>\$ —</u>	<u>\$ 447,412</u>
Net identifiable assets acquired				\$ 67,331
Total cost of acquisition:				
Value of stock issued				\$ 43,611
Cash consideration paid				27,278
Total cost of acquisition				<u>\$ 70,889</u>
Goodwill recorded related to acquisition				<u>\$ 3,558</u>

- (a) The amount represents the fair value adjustment of acquired securities that were subsequently sold.
- (b) The amount represents the adjustment of the net book value of acquired loans to their estimated fair value based on interest rates and expected cash flows at the date of acquisition.
- (c) The amount represents the removal of FCB's and BOW's existing allowance for loan losses.
- (d) The amount represents the adjustment of the net book value of acquired premises and equipment to their estimated fair value.
- (e) The amount represents the adjustment of recording the fair value of the core deposit intangible representing the intangible value of the deposit base acquired and the fair value of the customer relationship.
- (f) The amount represents the net adjustment of the deferred tax asset recognized on the fair value adjustments on acquired assets and assumed liabilities.
- (g) The amount represents the adjustment necessary because the weighted average interest rate of acquired time deposits exceeded the cost of similar funding at the time of acquisition. The fair value adjustment will be amortized to reduce future interest expense over the life of the portfolio.

NOTE 3 – SECURITIES

The amortized cost and fair value of securities available-for-sale and held-to-maturity at September 30, 2021 and December 31, 2020 are summarized as follows (in thousands):

	September 30, 2021				December 31, 2020			
	Amortized Cost	Gross unrealized gains	Gross unrealized (losses)	Estimated fair value	Amortized Cost	Gross unrealized gains	Gross unrealized (losses)	Estimated fair value
Securities available-for-sale:								
U. S. government agency securities	\$ 11,588	\$ 101	\$ (79)	\$ 11,610	\$ 16,158	\$ 258	\$ (25)	\$ 16,391
State and municipal securities	82,471	1,996	(780)	83,687	89,081	2,928	(81)	91,928
Mortgage-backed securities	324,862	2,814	(7,176)	320,500	332,014	4,892	(543)	336,363
Asset-backed securities	3,325	19	—	3,344	3,325	—	(132)	3,193
Other debt securities	63,271	1,592	(226)	64,637	37,608	819	(87)	38,340
Total	<u>\$ 485,517</u>	<u>\$ 6,522</u>	<u>\$ (8,261)</u>	<u>\$ 483,778</u>	<u>\$ 478,186</u>	<u>\$ 8,897</u>	<u>\$ (868)</u>	<u>\$ 486,215</u>
Securities held-to-maturity:								
State and municipal securities	\$ 1,788	\$ 59	\$ —	\$ 1,847	\$ 2,407	\$ 97	\$ —	\$ 2,504
Total	<u>\$ 1,788</u>	<u>\$ 59</u>	<u>\$ —</u>	<u>\$ 1,847</u>	<u>\$ 2,407</u>	<u>\$ 97</u>	<u>\$ —</u>	<u>\$ 2,504</u>

Security fair values are established by an independent pricing service as of the dates indicated. The difference between amortized cost and fair value reflects current interest rates and represents the potential gain (loss) had the portfolio been liquidated on those dates. Security gains (losses) are realized only in the event of dispositions prior to maturity or other-than-temporary impairment. Securities with unrealized losses as of September 30, 2021 and December 31, 2020, and the length of time they were in continuous loss positions as of such dates are as follows (in thousands):

	Less than 12 months		12 months or more		Total	
	Estimated fair value	Gross unrealized losses	Estimated fair value	Gross unrealized losses	Estimated fair value	Gross unrealized losses
September 30, 2021						
U. S. government agency securities	\$ 2,931	\$ (40)	\$ 1,964	\$ (39)	\$ 4,895	\$ (79)
State and municipal securities	34,046	(546)	5,479	(234)	39,525	(780)
Mortgage-backed securities	197,864	(5,773)	41,195	(1,403)	239,059	(7,176)
Asset-backed securities	—	—	—	—	—	—
Other debt securities	23,238	(226)	—	—	23,238	(226)
Total temporarily impaired securities	<u>\$ 258,079</u>	<u>\$ (6,585)</u>	<u>\$ 48,638</u>	<u>\$ (1,676)</u>	<u>\$ 306,717</u>	<u>\$ (8,261)</u>
December 31, 2020						
U. S. government agency securities	\$ 1,989	\$ (25)	\$ —	\$ —	\$ 1,989	\$ (25)
State and municipal securities	10,463	(81)	—	—	10,463	(81)
Mortgage-backed securities	100,291	(479)	1,449	(64)	101,740	(543)
Asset-backed securities	—	—	3,193	(132)	3,193	(132)
Other debt securities	6,103	(87)	—	—	6,103	(87)
Total temporarily impaired securities	<u>\$ 118,846</u>	<u>\$ (672)</u>	<u>\$ 4,642</u>	<u>\$ (196)</u>	<u>\$ 123,488</u>	<u>\$ (868)</u>

As noted in the table above, as of September 30, 2021, the Company had gross unrealized losses of \$8.3 million in its investment securities portfolio. The unrealized losses associated with these investment securities are driven by changes in interest rates and are recorded as a component of equity. These investment securities will continue to be monitored as a part of our ongoing impairment analysis. Management evaluates the financial performance of the issuers on a quarterly basis to determine if it is probable that the issuers can make all contractual principal and interest payments. If an expected shortfall in future cash flows is identified, a credit loss will be deemed to have occurred and will be recognized as a charge to earnings and a new cost basis for the security will be established.

Since the Company currently does not intend to sell any investment securities that have an unrealized loss at September 30, 2021, and it is not likely that we will be required to sell these investment securities before recovery of their amortized cost bases, which may be at maturity, we do not consider these securities to be other-than-temporarily impaired at September 30, 2021.

Securities with a market value of \$201.5 million at September 30, 2021 were pledged to collateralize public deposits, derivative positions and Federal Home Loan Bank advances.

Results from sales, maturities, prepayments and calls of securities available for sale were as follows (in thousands):

	Nine Months Ended September 30, 2021	Nine Months Ended September 30, 2020
Proceeds	\$ 74,305	\$ 141,347
Gross gains	44	83
Gross losses	(24)	(9)

The amortized cost and fair value of securities at September 30, 2021, by contractual maturity, are shown below (in thousands). Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. Securities not due at a single maturity date are shown separately.

	Available-for-sale		Held-to-maturity	
	Amortized cost	Estimated fair value	Amortized cost	Estimated fair value
Due in less than one year	\$ 17,820	\$ 17,905	\$ —	\$ —
Due one to five years	73,699	75,446	1,788	1,847
Due five to ten years	55,125	56,249	—	—
Due beyond ten years	10,686	10,334	—	—
Mortgage-backed securities	324,862	320,500	—	—
Asset-backed securities	3,325	3,344	—	—
Total	<u>\$ 485,517</u>	<u>\$ 483,778</u>	<u>\$ 1,788</u>	<u>\$ 1,847</u>

NOTE 4 – LOANS AND ALLOWANCE FOR LOAN LOSSES

A summary of the loans held for investment portfolio as of September 30, 2021 and December 31, 2020 follows (in thousands):

	September 30, 2021	December 31, 2020
Commercial real estate	\$ 772,996	\$ 643,832
Consumer real estate	328,262	343,791
Construction and land development	210,516	174,859
Commercial and industrial	478,279	623,446
Consumer	45,669	44,279
Other	58,527	53,483
Total	<u>1,894,249</u>	<u>1,883,690</u>
Allowance for loan losses	<u>(22,533)</u>	<u>(23,245)</u>
Total loans, net	<u>\$ 1,871,716</u>	<u>\$ 1,860,445</u>

Payroll Protection Program Loans

In 2020, the CARES Act created a new guaranteed, unsecured loan program under the SBA called the Payroll Protection Program (“PPP”), which the Company participates in, to fund operational costs of eligible businesses, organizations and self-employed persons during the pandemic period. The SBA has guaranteed 100% of the amounts loaned under the PPP by lenders to eligible small businesses. One of the notable features of the PPP is that borrowers are eligible for loan forgiveness if certain conditions are met related to retaining staff and if loan amounts are used to cover eligible expenses, such as payroll, mortgage interest, rents and utilities payments. These loans have a two to five year term and will earn interest at a rate of 1%. As of September 30, 2021, the outstanding balance of loans originated under the PPP totaled \$64.2 million compared with \$185.5 million as of December 31, 2020 and was included in commercial and industrial loans.

Additionally, PPP borrowers are not required to pay any fees to the government or the lender and the loans may be repaid by the borrower at any time. The SBA, however, will pay lenders a processing fee based on the size of the PPP loan, ranging from 1% to 5% of the loan. Unamortized fees associated with PPP loans included in total loans were \$2.2 million as of September 30, 2021. These fees are deferred and amortized over the life of the loan. PPP fees recognized as income totaled \$1.7 million and \$5.6 million, respectively, for the three and nine months ended September 30, 2021, compared to \$1.0 million and \$1.9 million for the same periods in 2020.

Allowance for Loan Losses

The adequacy of the allowance for loan losses (“ALL”) is assessed at the end of each quarter. The ALL includes a specific component related to loans that are individually evaluated for impairment and a general component related to loans that are segregated into homogenous pools and collectively evaluated for impairment. The ALL factors applied to these pools are an estimate of probable incurred losses based on management’s evaluation of historical net losses from loans with similar characteristics, which are adjusted by management to reflect current events, trends, and conditions. The adjustments include consideration of the following: changes in lending policies and procedures, economic conditions, nature and volume of the portfolio, experience of lending management, volume and severity of past due loans, quality of the loan review system, value of underlying collateral for collateral dependent loans, concentrations, and other external factors. The Company’s evaluation of other external factors included consideration of continuing developments regarding the novel coronavirus (“COVID-19”) global pandemic (including the effects of COVID-19 variants) and the resulting impact on the Company’s loan portfolio as of September 30, 2021, which is largely uncertain due to rapidly evolving conditions.

The Company categorizes loans into risk categories based on relevant information about the ability of borrowers to service their debt such as: current financial information, historical payment experience, credit documentation, public information, and current economic trends, among other factors. The Company analyzes all commercial loans, and consumer relationships with an outstanding balance greater than \$500,000, individually and assigns each loan a risk rating. This analysis is performed on a continual basis by the relationship managers and credit department personnel. On at least an annual basis, an independent party performs a formal credit risk review of a sample of the loan portfolio. Among other things, this review assesses the appropriateness of the loan’s risk rating. The Company uses the following definitions for risk ratings:

Special Mention – A special mention asset possesses deficiencies or potential weaknesses deserving of management’s attention. If uncorrected, such weaknesses or deficiencies may expose the Company to an increased risk of loss in the future.

Substandard – A substandard asset is inadequately protected by the current sound net worth and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the Company will sustain some loss if deficiencies are not corrected. Loss potential, while existing in the aggregate amount of substandard assets, does not have to exist in individual assets classified substandard.

Doubtful – A doubtful asset has all weaknesses inherent in one classified substandard, with the added characteristic that weaknesses make collection or liquidation in full, on the basis of existing facts, conditions, and values, highly questionable and improbable. The probability of loss is extremely high, but certain important and reasonable specific pending factors which may work to the advantage and strengthening of the asset exist, therefore, its classification as an estimated loss is deferred until a more exact status may be determined. Pending factors include proposed merger, acquisition or liquidation procedures, capital injection, perfecting liens on additional collateral, and refinancing plans.

Loans not falling into the criteria above are considered to be pass-rated loans. The Company utilizes six loan grades within the pass risk rating.

The following tables provides the risk category of loans by applicable class of loans as of September 30, 2021 and December 31, 2020 (in thousands):

September 30, 2021	Pass	Special Mention	Substandard	Doubtful	Total Impaired Loans	Total
Commercial real estate	\$ 748,967	\$ 13,755	\$ 4,960	\$ —	\$ 1,154	\$ 768,836
Consumer real estate	312,991	482	855	—	884	315,212
Construction and land development	207,617	2,844	11	—	—	210,472
Commercial and industrial	451,180	10,194	14,382	26	63	475,845
Consumer	44,344	—	53	28	2	44,427
Other	58,107	—	79	—	—	58,186
Purchased credit impaired	17,060	—	3,931	280	—	21,271
Total	\$ 1,840,266	\$ 27,275	\$ 24,271	\$ 334	\$ 2,103	\$ 1,894,249

December 31, 2020						
Commercial real estate	\$ 601,133	\$ 33,046	\$ 2,933	\$ —	\$ 1,179	\$ 638,291
Consumer real estate	323,072	1,375	1,122	—	1,707	327,276
Construction and land development	169,315	5,153	19	—	102	174,589
Commercial and industrial	568,767	25,855	25,666	—	168	620,456
Consumer	41,640	4	18	2	7	41,671
Other	52,949	—	66	—	—	53,015
Purchased credit impaired	23,899	—	4,412	81	—	28,392
Total	\$ 1,780,775	\$ 65,433	\$ 34,236	\$ 83	\$ 3,163	\$ 1,883,690

The following table details the changes in the ALL for the three and nine month periods ended September 30, 2021 and 2020 (in thousands):

	Commercial real estate	Consumer real estate	Construction and land development	Commercial and industrial	Consumer	Other	Total
Three Months Ended September 30, 2021							
Balance, beginning of period	\$ 7,915	\$ 1,730	\$ 3,871	\$ 8,401	\$ 356	\$ 481	\$ 22,754
Charged-off loans	—	—	—	(125)	(62)	(80)	(267)
Recoveries	—	17	—	1	17	11	46
Provision for loan losses	(521)	596	239	(664)	124	226	—
Balance, end of period	<u>\$ 7,394</u>	<u>\$ 2,343</u>	<u>\$ 4,110</u>	<u>\$ 7,613</u>	<u>\$ 435</u>	<u>\$ 638</u>	<u>\$ 22,533</u>
Three Months Ended September 30, 2020							
Balance, beginning of period	\$ 5,139	\$ 1,398	\$ 2,387	\$ 11,514	\$ 234	\$ 363	\$ 21,035
Charged-off loans	—	—	—	—	(30)	(22)	(52)
Recoveries	13	1	—	3	16	32	65
Provision for loan losses	677	418	795	183	(20)	66	2,119
Balance, end of period	<u>\$ 5,829</u>	<u>\$ 1,817</u>	<u>\$ 3,182</u>	<u>\$ 11,700</u>	<u>\$ 200</u>	<u>\$ 439</u>	<u>\$ 23,167</u>

	Commercial real estate	Consumer real estate	Construction and land development	Commercial and industrial	Consumer	Other	Total
Nine Months Ended September 30, 2021							
Balance, beginning of period	\$ 7,349	\$ 1,831	\$ 3,476	\$ 9,708	\$ 305	\$ 576	\$ 23,245
Charged-off loans	(10)	(1)	—	(132)	(106)	(158)	(407)
Recoveries	—	22	—	2	63	23	110
Provision for loan losses	55	491	634	(1,965)	173	197	(415)
Balance, end of period	<u>\$ 7,394</u>	<u>\$ 2,343</u>	<u>\$ 4,110</u>	<u>\$ 7,613</u>	<u>\$ 435</u>	<u>\$ 638</u>	<u>\$ 22,533</u>
Nine Months Ended September 30, 2020							
Balance, beginning of period	\$ 3,599	\$ 1,231	\$ 2,058	\$ 5,074	\$ 222	\$ 420	\$ 12,604
Charged-off loans	(3)	(43)	—	(710)	(83)	(175)	(1,014)
Recoveries	10	4	—	162	58	48	282
Provision for loan losses	2,223	625	1,124	7,174	3	146	11,295
Balance, end of period	<u>\$ 5,829</u>	<u>\$ 1,817</u>	<u>\$ 3,182</u>	<u>\$ 11,700</u>	<u>\$ 200</u>	<u>\$ 439</u>	<u>\$ 23,167</u>

A breakdown of the ALL and the loan portfolio by loan category at September 30, 2021 and December 31, 2020 follows (in thousands):

	Commercial real estate	Consumer real estate	Construction and land development	Commercial and industrial	Consumer	Other	Total
September 30, 2021							
Allowance for Loan Losses:							
Collectively evaluated for impairment	\$ 7,394	\$ 2,343	\$ 4,110	\$ 7,613	\$ 435	\$ 638	\$ 22,533
Individually evaluated for impairment	—	—	—	—	—	—	—
Purchased credit impaired	—	—	—	—	—	—	—
Balances, end of period	<u>\$ 7,394</u>	<u>\$ 2,343</u>	<u>\$ 4,110</u>	<u>\$ 7,613</u>	<u>\$ 435</u>	<u>\$ 638</u>	<u>\$ 22,533</u>
Loans:							
Collectively evaluated for impairment	\$ 767,682	\$ 314,328	\$ 210,472	\$ 475,782	\$ 44,425	\$ 58,186	\$ 1,870,875
Individually evaluated for impairment	1,154	884	—	63	2	—	2,103
Purchased credit impaired	4,160	13,050	44	2,434	1,242	341	21,271
Balances, end of period	<u>\$ 772,996</u>	<u>\$ 328,262</u>	<u>\$ 210,516</u>	<u>\$ 478,279</u>	<u>\$ 45,669</u>	<u>\$ 58,527</u>	<u>\$ 1,894,249</u>
December 31, 2020							
Allowance for Loan Losses:							
Collectively evaluated for impairment	\$ 7,349	1,831	3,410	9,708	305	576	\$ 23,179
Individually evaluated for impairment	—	—	66	—	—	—	66
Purchased credit impaired	—	—	—	—	—	—	—
Balances, end of period	<u>\$ 7,349</u>	<u>\$ 1,831</u>	<u>\$ 3,476</u>	<u>\$ 9,708</u>	<u>\$ 305</u>	<u>\$ 576</u>	<u>\$ 23,245</u>
Loans:							
Collectively evaluated for impairment	\$ 637,112	\$ 325,569	\$ 174,487	\$ 620,288	\$ 41,664	\$ 53,015	\$ 1,852,135
Individually evaluated for impairment	1,179	1,707	102	168	7	—	3,163
Purchased credit impaired	5,541	16,515	270	2,990	2,608	468	28,392
Balances, end of period	<u>\$ 643,832</u>	<u>\$ 343,791</u>	<u>\$ 174,859</u>	<u>\$ 623,446</u>	<u>\$ 44,279</u>	<u>\$ 53,483</u>	<u>\$ 1,883,690</u>

The following table presents the allocation of the ALL for each respective loan category with the corresponding percentage of the ALL in each category to total loans, net of deferred fees as of September 30, 2021 and December 31, 2020 (in thousands). PPP loans included in commercial and industrial loans in the below table do not have a corresponding ALL as they are fully guaranteed by the SBA:

	September 30, 2021		December 31, 2020	
	Amount	Percent of total loans	Amount	Percent of total loans
Commercial real estate	\$ 7,394	0.39 %	\$ 7,349	0.39 %
Consumer real estate	2,343	0.12	1,831	0.10
Construction and land development	4,110	0.22	3,476	0.18
Commercial and industrial	7,613	0.41	9,708	0.51
Consumer	435	0.02	305	0.02
Other	638	0.03	576	0.03
Total allowance for loan losses	<u>\$ 22,533</u>	<u>1.19 %</u>	<u>\$ 23,245</u>	<u>1.23 %</u>

The following table presents the Company's impaired loans that were evaluated for specific loss allowance, excluding purchased credit impaired ("PCI") loans, as of September 30, 2021 and December 31, 2020 (in thousands):

	September 30, 2021			December 31, 2020		
	Recorded investment	Unpaid principal balance	Related allowance	Recorded investment	Unpaid principal balance	Related allowance
With no related allowance recorded:						
Commercial real estate	\$ 1,154	\$ 1,135	\$ —	\$ 1,179	\$ 1,176	\$ —
Consumer real estate	884	909	—	1,707	1,608	—
Construction and land development	—	—	—	—	—	—
Commercial and industrial	63	63	—	168	457	—
Consumer	2	2	—	7	7	—
Other	—	—	—	—	—	—
Subtotal	2,103	2,109	—	3,061	3,248	—
With an allowance recorded:						
Commercial real estate	—	—	—	—	—	—
Consumer real estate	—	—	—	—	—	—
Construction and land development	—	—	—	102	102	66
Commercial and industrial	—	—	—	—	—	—
Consumer	—	—	—	—	—	—
Other	—	—	—	—	—	—
Subtotal	—	—	—	102	102	66
Total	\$ 2,103	\$ 2,109	\$ —	\$ 3,163	\$ 3,350	\$ 66

The following table presents information related to the average recorded investment and interest income recognized on impaired loans, excluding PCI loans, for the three and nine month periods ended September 30, 2021 and 2020 (in thousands):

	Three Months Ended September 30, 2021		Three Months Ended September 30, 2020		Nine Months Ended September 30, 2021		Nine Months Ended September 30, 2020	
	Average recorded investment	Interest income recognized	Average recorded investment	Interest income recognized	Average recorded investment	Interest income recognized	Average recorded investment	Interest income recognized
With no related allowance recorded:								
Commercial real estate	\$ 1,159	\$ 16	\$ 1,191	\$ 17	\$ 1,174	\$ 48	\$ 1,458	\$ 57
Consumer real estate	889	—	961	9	1,181	—	982	27
Construction and land development	—	—	—	—	—	—	—	—
Commercial and industrial	63	—	90	—	64	1	176	2
Consumer	2	—	4	—	49	—	4	—
Other	—	—	—	—	—	—	—	—
Subtotal	2,113	16	2,246	26	2,468	49	2,620	86
With an allowance recorded:								
Commercial real estate	—	—	—	—	—	—	—	—
Consumer real estate	—	—	—	—	—	—	—	—
Construction and land development	—	—	—	—	—	—	—	—
Commercial and industrial	—	—	107	—	—	—	108	—
Consumer	—	—	—	—	—	—	—	—
Other	—	—	—	—	—	—	—	—
Subtotal	—	—	107	—	—	—	108	—
Total	\$ 2,113	\$ 16	\$ 2,353	\$ 26	\$ 2,468	\$ 49	\$ 2,728	\$ 86

There was no interest income recognized on a cash basis for impaired loans during the three or nine month periods ended September 30, 2021 or 2020.

The following table presents the aging of the recorded investment in past due loans as of September 30, 2021 and December 31, 2020 by class of loans (in thousands):

	30 - 59 Days Past Due	60 - 89 Days Past Due	Greater Than 89 Days Past Due	Total Past Due	Loans Not Past Due	Total
September 30, 2021						
Commercial real estate	\$ 65	\$ —	\$ 1,257	1,322	\$ 767,514	\$ 768,836
Consumer real estate	425	496	187	1,108	314,104	315,212
Construction and land development	30	—	12	42	210,430	210,472
Commercial and industrial	437	503	45	985	474,860	475,845
Consumer	160	99	38	297	44,130	44,427
Other	78	316	—	394	57,792	58,186
Purchased credit impaired	932	79	794	1,805	19,466	21,271
Total	<u>\$ 2,127</u>	<u>\$ 1,493</u>	<u>\$ 2,333</u>	<u>\$ 5,953</u>	<u>\$ 1,888,296</u>	<u>\$ 1,894,249</u>
December 31, 2020						
Commercial real estate	\$ 409	\$ —	\$ 1,176	\$ 1,585	\$ 636,706	\$ 638,291
Consumer real estate	6,084	1,596	687	8,367	318,909	327,276
Construction and land development	2,670	745	—	3,415	171,174	174,589
Commercial and industrial	1,734	38	1,595	3,367	617,089	620,456
Consumer	270	40	7	317	41,354	41,671
Other	252	38	—	290	52,725	53,015
Purchased credit impaired	1,372	1,554	901	3,827	24,565	28,392
Total	<u>\$ 12,791</u>	<u>\$ 4,011</u>	<u>\$ 4,366</u>	<u>\$ 21,168</u>	<u>\$ 1,862,522</u>	<u>\$ 1,883,690</u>

The following table presents the recorded investment in non-accrual loans, past due loans over 89 days and accruing and troubled debt restructurings (“TDR”) by class of loans as of September 30, 2021 and December 31, 2020 (in thousands):

	Non-Accrual	Past Due Over 89 Days and Accruing	Troubled Debt Restructurings
September 30, 2021			
Commercial real estate	\$ 115	\$ 1,257	\$ 1,135
Consumer real estate	1,174	77	661
Construction and land development	—	12	—
Commercial and industrial	89	45	63
Consumer	47	—	—
Other	—	—	—
Purchased credit impaired	2,006	169	—
Total	<u>\$ 3,431</u>	<u>\$ 1,560</u>	<u>\$ 1,859</u>
December 31, 2020			
Commercial real estate	\$ 130	\$ 1,176	\$ 1,176
Consumer real estate	1,821	342	685
Construction and land development	107	—	—
Commercial and industrial	470	1,205	67
Consumer	9	5	—
Other	—	—	—
Purchased credit impaired	2,279	567	—
Total	<u>\$ 4,816</u>	<u>\$ 3,295</u>	<u>\$ 1,928</u>

As of September 30, 2021 and December 31, 2020, all loans classified as nonperforming were deemed to be impaired.

As of September 30, 2021 and December 31, 2020, the Company had a recorded investment in TDR of \$1.9 million. The Company had no specific allowance for those loans at September 30, 2021 or December 31, 2020 and there were no commitments to lend additional amounts. Loans accounted for as TDR include modifications from original terms such as those due to bankruptcy proceedings, certain modifications of amortization periods or extended suspension of principal payments due to customer financial difficulties. In order to determine whether a borrower is experiencing financial difficulty, an evaluation is performed of the probability that the borrower will be in payment default on any of its debt in the foreseeable future without the modification. This evaluation is performed under the Bank's loan policy. Loans accounted for as TDR are individually evaluated for impairment. In accordance with interagency guidance, short term deferrals granted due to the COVID-19 pandemic are not considered TDR unless the borrower was experiencing financial difficulty prior to the pandemic.

There were no new TDR identified during the three or nine months ended September 30, 2021 or 2020. There were no TDR for which there was a payment default within twelve months following the modification during the three or nine months ended September 30, 2021 or 2020.

A loan is considered to be in payment default once it is 30 days contractually past due under the modified terms.

Acquired Loans

On July 1, 2020, the Company acquired FCB and BOW (see Note 2 for more information). As a result of the acquisitions, the Company recorded loans with a fair value of \$294.7 million. Of those loans, \$33.6 million were considered to be purchased credit impaired (“PCI”) loans, which are loans for which it is probable at the acquisition date that all contractually required payments will not be collected. The remaining loans are considered to be purchased non-impaired loans and their related fair value discount or premium is recognized as an adjustment to yield over the remaining life of each loan.

The following table relates to acquired FCB and BOW PCI loans and summarizes the contractually required payments, which includes principal and interest, expected cash flows to be collected, and the fair value of acquired PCI loans at the acquisition date (in thousands):

	FCB and BOW acquisitions on July 1, 2020
Contractually required payments	\$42,443
Nonaccretable difference	4,501
Cash flows expected to be collected at acquisition	37,942
Accretable yield	4,349
Fair value of PCI loans at acquisition date	<u>\$33,593</u>

The following table relates to purchased non-impaired loans acquired and provides the contractually required payments, fair value, and estimate of contractual cash flows not expected to be collected at the acquisition date (in thousands):

	FCB and BOW acquisitions on July 1, 2020
Contractually required payments	\$296,527
Fair value of acquired loans at acquisition date	260,701
Contractual cash flows not expected to be collected	3,718

Purchased Credit Impaired Loans

The following table presents changes in the carrying value of PCI loans (in thousands) for the periods indicated:

	Three Months Ended September 30, 2021	Nine Months Ended September 30, 2021
Balance at beginning of period	\$ 22,765	\$ 28,392
Change due to payments received and accretion	(1,494)	(7,121)
Balance at end of period	<u>\$ 21,271</u>	<u>\$ 21,271</u>

The following table presents changes in the accretable yield for PCI loans (in thousands) for the periods indicated:

	Three Months Ended September 30, 2021	Nine Months Ended September 30, 2021
Balance at beginning of period	\$ 3,169	\$ 4,068
Accretion	(603)	(1,502)
Balance at end of period	<u>\$ 2,566</u>	<u>\$ 2,566</u>

PCI loans had no impact on the ALL for the three or nine months ended September 30, 2021.

NOTE 5 – PREMISES AND EQUIPMENT

The Company leases certain premises and equipment under operating leases. At September 30, 2021, the Company had lease liabilities totaling \$12.2 million and right-of-use assets totaling \$11.4 million related to these leases. Lease liabilities and right-of-use assets are reflected in other liabilities and other assets, respectively. At September 30, 2021, the weighted average remaining lease term for operating leases was 9.3 years and the weighted average discount rate used in the measurement of operating lease liabilities was 3.42%.

Lease costs were as follows (in thousands):

	Three Months Ended September 30, 2021	Nine Months Ended September 30, 2021
Operating lease cost	\$ 514	\$ 1,588
Short-term lease cost	—	—
Variable lease cost	—	—
Total lease cost	<u>\$ 514</u>	<u>\$ 1,588</u>

There were no sale and leaseback transactions, leveraged leases, or lease transactions with related parties during the three or nine months ended September 30, 2021 or 2020.

A maturity analysis of operating lease liabilities and reconciliation of the undiscounted cash flows to the total operating lease liability is as follows (in thousands):

	September 30, 2021
Lease payments due:	
2021	\$ 432
2022	1,751
2023	1,717
2024	1,425
2025	1,428
2026 and thereafter	7,655
Total undiscounted cash flows	<u>14,408</u>
Discount on cash flows	<u>(2,181)</u>
Total lease liability	<u>\$ 12,227</u>

NOTE 6 – SHORT TERM BORROWINGS AND LONG-TERM DEBT

Short-Term Borrowings

The Company had no outstanding advances as of September 30, 2021 compared to \$10 million as of December 31, 2020.

Advances from the FHLB are collateralized by investment securities with a market value of \$2.2 million, FHLB stock and certain commercial and residential real estate mortgage loans totaling \$634.1 million under a blanket mortgage collateral agreement. At September 30, 2021, the amount of available credit from the FHLB totaled \$448.9 million.

Subordinated Notes

The Company issued \$30.0 million of fixed-to-floating rate subordinated notes during the third quarter of 2020, which were recorded net of issuance costs of \$0.6 million, that mature June 30, 2030. Beginning on or after June 30, 2025, the Company may redeem the notes, in whole or in part, at their principal amount plus any accrued and unpaid interest. The notes have a fixed interest rate of 5.25% per annum for the first five years. Thereafter, the interest rate will reset quarterly to an interest rate per annum equal to a benchmark rate (which is expected to be Three-Month Term SOFR) plus 513 basis points. The carrying value of subordinated notes was \$29.5 million at September 30, 2021 and \$29.4 million at December 31, 2020.

NOTE 7 – ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)

The following were changes in accumulated other comprehensive income (loss) by component, net of tax, for the periods ended September 30, 2021 and 2020 (in thousands):

	Gains and Losses on Cash Flow Hedges	Unrealized Gains and Losses on Available for Sale Securities	Total
<u>Nine Months Ended September 30, 2021</u>			
Beginning balance	\$ —	\$ 7,728	\$ 7,728
Other comprehensive loss before reclassification, net of tax	—	(7,214)	(7,214)
Amounts reclassified from accumulated other comprehensive loss, net of tax	—	(15)	(15)
Net current period other comprehensive loss	—	(7,229)	(7,229)
Ending Balance	<u>\$ —</u>	<u>\$ 499</u>	<u>\$ 499</u>
<u>Nine Months Ended September 30, 2020</u>			
Beginning balance	\$ (2,679)	\$ 4,062	\$ 1,383
Other comprehensive income before reclassification, net of tax	—	2,797	2,797
Amounts reclassified from accumulated other comprehensive income, net of tax	2,679	(55)	2,624
Net current period other comprehensive income	2,679	2,742	5,421
Ending Balance	<u>\$ —</u>	<u>\$ 6,804</u>	<u>\$ 6,804</u>

The following amounts were reclassified out of each component of accumulated other comprehensive income (loss) for the three and nine months ended September 30, 2021 and 2020 (in thousands):

Details about Accumulated Other Comprehensive Income (Loss) Components	Three Months Ended September 30,		Nine Months Ended September 30,		Affected Line Item in the Statement Where Net Income is Presented
	2021	2020	2021	2020	
Realized losses on cash flow hedges	\$ —	\$ (2,060)	\$ —	\$ (2,466)	Interest expense - money market accounts
	—	(107)	—	(213)	Interest expense - Federal Home Loan Bank advances
	—	—	—	—	Income tax benefit (expense)
	<u>\$ —</u>	<u>\$ (2,167)</u>	<u>\$ —</u>	<u>\$ (2,679)</u>	Net of tax
Realized gains on available-for-sale securities	\$ 7	\$ 34	\$ 20	\$ 74	Net gain on sale of securities
	(2)	(9)	(5)	(19)	Income tax expense
	<u>\$ 5</u>	<u>\$ 25</u>	<u>\$ 15</u>	<u>\$ 55</u>	Net of tax

NOTE 8 – INCOME TAXES

The Company's effective tax rate for the three and nine month periods ended September 30, 2021 was 19.4% and 20.0%, respectively, compared to 22.0% and 18.0% for the three and nine months ended September 30, 2020, respectively.

The three month period decrease is attributable to a revision in the Company's expected annual effective tax rate for 2021 based on continued benefits in the Company's tax strategy. The increase in the effective tax rate from the nine month period ended September 30, 2020 is largely the result of the impact of certain provisions under the CARES Act, which were effective for 2020. The CARES Act permitted NOL's arising in taxable years beginning after December 31, 2017 and before January 1, 2021 to be carried back five taxable years. This enabled the Company to carry back losses in 2020, which were incurred during the taxable year 2018 to prior years with a higher statutory tax rate, creating a permanent tax rate benefit. As a result, the Company recorded an income tax benefit of \$0.8 million related to the permanent tax rate benefit during the first nine months of 2020.

The effective tax rate for the three and nine month periods ended September 30, 2021 compared favorably to the statutory federal rate of 21% and Tennessee excise tax rate of 6.5% primarily due to investments in qualified municipal securities, company owned life insurance, tax benefits of CapStar Bank's real estate investment trust subsidiary, community investment tax credits, and tax benefits associated with share-based compensation, net of the effect of certain non-deductible expenses.

NOTE 9 – COMMITMENTS AND CONTINGENCIES

In the normal course of business, the Company has outstanding commitments and contingent liabilities, such as commitments to extend credit and standby letters of credit, which are not included in the accompanying financial statements. The Company's exposure to credit loss in the event of nonperformance by the other party to the financial instruments for commitments to extend credit and standby letters of credit is represented by the contractual or notional amount of those instruments. The Company uses the same credit policies in making such commitments as it does for instruments that are included in the balance sheet.

The following table sets forth outstanding financial instruments whose contract amounts represent credit risk as of September 30, 2021 and December 31, 2020 (in thousands):

	Contract or notional amount	
	September 30, 2021	December 31, 2020
Financial instruments whose contract amounts represent credit risk:		
Unused commitments to extend credit	\$ 806,444	\$ 804,520
Standby letters of credit	10,397	10,403
Total	<u>\$ 816,841</u>	<u>\$ 814,923</u>

The Company is party to litigation and claims arising in the normal course of business. Management believes that the liabilities, if any, arising from such litigation and claims as of September 30, 2021, will not have a material impact on the financial statements of the Company.

NOTE 10 – DERIVATIVES

The Company utilizes interest rate swap agreements as part of its asset liability management strategy to help manage its interest rate risk position. The notional amount of the interest rate swaps does not represent amounts exchanged by the parties. The amount exchanged is determined by reference to the notional amount and the other terms of the individual interest rate swap agreements.

Interest Rate Swaps Designated as Cash Flow Hedges

There were no interest rate swaps designated as cash flow hedges as of September 30, 2021 and December 31, 2020. The Company previously terminated an interest rate swap during 2019, which resulted in a termination fee of \$1.5 million which continued to be amortized as the corresponding hedged items, consisting of LIBOR-based brokered deposits and FHLB borrowings, were expected to remain outstanding until the initial maturities of the terminated swaps. However, during the year ended December 31, 2020, it was determined that in light of the Company's surplus liquidity position this funding was expected to be terminated at the next renewal date and thus the previously terminated interest rate swaps which had been designated as cash flow hedges were no longer deemed effective, therefore, remaining unrealized losses of \$1.9 million included in accumulated other comprehensive income were recognized in net income. There are no other interest rate swap related unrealized gains or losses in accumulated other comprehensive income as of September 30, 2021.

Other Interest Rate Swaps

The Company enters into swaps to facilitate customer transactions and meet their financing needs. Upon entering into these transactions the Company enters into offsetting positions with large U.S. financial institutions in order to minimize market risk to the Company. A summary of the Company's customer related interest rate swaps was as follows (in thousands):

	September 30, 2021		December 31, 2020	
	Notional amount	Estimated fair value	Notional amount	Estimated fair value
Interest rate swap agreements:				
Pay fixed/receive variable swaps	\$ 58,040	\$ (2,118)	\$ 59,946	\$ (2,740)
Pay variable/receive fixed swaps	58,040	2,118	59,946	2,740
Total	<u>\$ 116,080</u>	<u>\$ —</u>	<u>\$ 119,892</u>	<u>\$ —</u>

Mortgage Banking Derivatives

The Company enters into various derivative agreements with customers in the form of interest-rate lock commitments, which are commitments to originate mortgage loans whereby the interest rate on the loan is determined prior to funding and the customers have locked into that interest rate. The derivatives are valued using a model that utilizes market interest rates and other unobservable inputs. Changes in the fair value of these commitments due to fluctuations in interest rates that are to be originated to our loans held for sale portfolio are economically hedged through the use of forward sale commitments of mortgage-backed securities. The gains and losses arising from this derivative activity are reflected in current period earnings under mortgage banking income. Interest rate lock commitments are valued using a model with significant unobservable market parameters. Forward sale commitments are valued based on quoted prices for similar assets in an active market with inputs that are observable.

The net (losses) gains relating to mortgage banking derivative instruments included in mortgage banking income were as follows (in thousands):

	Three Months Ended	Nine Months Ended
	September 30, 2021	September 30, 2021
Mortgage loan interest rate lock commitments	\$ (221)	\$ (1,528)
Mortgage-backed securities forward sales commitments	307	919
Total	<u>\$ 86</u>	<u>\$ (609)</u>

The amount and fair value of mortgage banking derivatives included in the consolidated balance sheets were as follows (in thousands):

	September 30, 2021		December 31, 2020	
	Notional amount	Estimated fair value	Notional amount	Estimated fair value
Included in other assets:				
Mortgage loan interest rate lock commitments	\$ 86,938	\$ 1,079	\$ 88,303	\$ 2,607
Mortgage-backed securities forward sales commitments	72,500	293	—	—
Included in other liabilities:				
Mortgage-backed securities forward sales commitments	\$ —	\$ —	\$ 87,000	\$ (626)

NOTE 11 – STOCK OPTIONS AND RESTRICTED SHARES

On April 23, 2021, the shareholders of CapStar Financial Holdings, Inc. approved the 2021 Stock Incentive Plan (the "Plan"). The Plan provides for the grant of stock-based incentives, including stock options, restricted stock units, performance awards and restricted stock, to employees, directors and service providers that are subject to forfeiture until vesting conditions have been satisfied by the award recipient under the terms of the award. The Plan is intended to help align the interests of employees and our shareholders and reward our employees for improved Company performance. A total of 1,168,543 shares of stock were reserved for issuance under the Plan. Stock incentives include both restricted share and stock option grants. Total shares issuable under the plan were 1,168,543 as of September 30, 2021.

The Company has recognized stock-based compensation expense, within salaries and employee benefits for employees, and within other non-interest expense for directors, in the consolidated statements of income as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2021	2020	2021	2020
Stock-based compensation expense before income taxes	\$ 373	\$ 330	\$ 1,169	\$ 1,231
Less: deferred tax benefit	(98)	(86)	(306)	(322)
Reduction of net income	<u>\$ 275</u>	<u>\$ 244</u>	<u>\$ 863</u>	<u>\$ 909</u>

Restricted Shares, Restricted Stock Units, and Performance Stock Units

We grant time-vested restricted stock units and performance stock units to certain key employees and directors under our stock award plan. Compensation expense is recognized over the vesting period of the awards based on the fair value of the stock at the issue date. Those granted after January 1, 2021, vest ratably over a two or three-year vesting period depending on the specific award.

Performance stock units vest based upon the attainment of certain performance metrics over a three-year cumulative performance period. Certain of these awards are eligible to receive dividend equivalent shares. The grant date fair value of these awards was estimated using a Monte Carlo simulation. For awards based upon the achievement of the performance goals, the awards are earned ratably from 0% to 188%. If the performance goals are met at the end of the performance period, the award is adjusted to reflect the Company's three-year total shareholder return (TSR) performance relative to a capital market peer group. This TSR modifier cannot cause the award to exceed the maximum of 188%.

The recipients have the right to vote and receive dividends but cannot sell, transfer, assign, pledge, hypothecate, or otherwise encumber the restricted stock until the shares have vested. A summary of the changes in the Company's nonvested restricted shares for the nine months ended September 30, 2021 follows:

Nonvested Shares	Restricted Shares	Weighted Average Grant Date Fair Value
Nonvested at beginning of period	148,414	\$ 14.39
Granted	140,549	14.81
Vested	(64,062)	14.99
Forfeited	(23,222)	14.52
Nonvested at end of period	<u>201,679</u>	<u>\$ 14.10</u>

As of September 30, 2021, there was \$1.9 million of unrecognized compensation cost related to nonvested shares granted under the Plan. The cost is expected to be recognized over a weighted-average period of 2.0 years. The total fair value of shares vested during the nine months ended September 30, 2021 was \$1.1 million.

Stock Options

Option awards are generally granted with an exercise price equal to the fair value of the Company's common stock at the date of grant. Option awards generally have a three year vesting period and a ten year contractual term.

The fair value of each option grant is estimated on the date of grant using the Black Scholes option pricing model. There were no options granted in 2021 or 2020.

A summary of the activity in stock options for the nine months ended September 30, 2021 follows:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (years)
Outstanding at beginning of period	226,589	\$ 11.73	
Granted	—	—	
Exercised	(96,344)	11.41	
Forfeited or expired	—	—	
Outstanding at end of period	<u>130,245</u>	<u>\$ 11.96</u>	<u>5.2</u>
Fully vested and expected to vest	<u>130,245</u>	<u>\$ 11.96</u>	<u>5.2</u>
Exercisable at end of period	<u>113,578</u>	<u>\$ 11.54</u>	<u>4.8</u>

Information related to stock options during each year follows:

	2021	2020
Intrinsic value of options exercised	\$ 821,174	\$ 188,662
Cash received from option exercises	1,077,489	105,847
Tax benefit realized from option exercises	148,312	16,524
Weighted average fair value of options granted	—	—

As of September 30, 2021, there was \$0.1 million of unrecognized compensation cost related to nonvested stock options granted under the Plan. The cost is expected to be recognized over a weighted-average period of 0.6 years.

NOTE 12 – REGULATORY CAPITAL REQUIREMENTS

The Company and the Bank are subject to regulatory capital requirements administered by the Federal Reserve and the Bank is also subject to the regulatory capital requirements of the Tennessee Department of Financial Institutions. Failure to meet capital requirements can initiate certain mandatory – and possibly additional discretionary – actions by regulators that could, in that event, have a material adverse effect on the institutions' financial statements. The relevant regulations require the Company and the Bank to meet specific capital adequacy guidelines that involve quantitative measures of their assets, liabilities and certain off-balance-sheet items as calculated under regulatory accounting principles. The capital classifications of the Company and the Bank are also subject to qualitative judgments by their regulators about components, risk weightings, and other factors. Those qualitative judgments could also affect the capital status of the Company and the Bank and the amount of dividends the Company and the Bank may distribute. The final rules implementing the Basel Committee on Banking Supervision's capital guidelines for U.S. banks (Basel III rules) became effective for the Bank on January 1, 2015 with full compliance with all of the requirements being phased in over a multi-year schedule, and fully phased in by January 1, 2019. The net unrealized gain or loss on available for sale securities is not included in computing regulatory capital. Management believes as of September 30, 2021, the Company and the Bank met all regulatory capital adequacy requirements to which they are subject.

The Company's and the Bank's capital amounts and ratios as of September 30, 2021 and December 31, 2020 are presented in the following table (dollars in thousands).

	Actual		Minimum capital requirement (1)		Minimum to be well-capitalized (2)	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
At September 30, 2021:						
Total capital to risk-weighted assets:						
CapStar Financial Holdings, Inc.	\$ 373,051	16.23 %	\$ 183,922	8.0 %	N/A	N/A
CapStar Bank	359,460	15.65	183,781	8.0	\$ 229,726	10 %
Tier I capital to risk-weighted assets:						
CapStar Financial Holdings, Inc.	320,700	13.95	137,941	6.0	N/A	N/A
CapStar Bank	336,608	14.65	137,835	6.0	183,781	8.00
Common equity Tier 1 capital to risk weighted assets:						
CapStar Financial Holdings, Inc.	320,700	13.95	103,456	4.5	N/A	N/A
CapStar Bank	320,108	13.93	103,377	4.5	149,322	6.50
Tier I capital to average assets:						
CapStar Financial Holdings, Inc.	320,700	10.28	124,771	4.0	N/A	N/A
CapStar Bank	336,608	10.82	124,449	4.0	155,561	5.00
At December 31, 2020:						
Total capital to risk-weighted assets:						
CapStar Financial Holdings, Inc.	\$ 338,426	16.03 %	\$ 168,910	8.0 %	N/A	N/A
CapStar Bank	324,152	15.36	168,808	8.0	\$ 211,010	10.0
Tier I capital to risk-weighted assets:						
CapStar Financial Holdings, Inc.	285,439	13.52	126,682	6.0	N/A	N/A
CapStar Bank	300,588	14.25	126,606	6.0	168,808	8.0
Common equity Tier 1 capital to risk weighted assets:						
CapStar Financial Holdings, Inc.	285,439	13.52	95,012	4.5	N/A	N/A
CapStar Bank	284,088	13.46	94,954	4.5	137,156	6.5
Tier I capital to average assets:						
CapStar Financial Holdings, Inc.	285,439	9.60	118,877	4.0	N/A	N/A
CapStar Bank	300,588	10.12	118,780	4.0	148,476	5.0

- (1) For the calendar year 2021, the Company must maintain a capital conservation buffer of Tier 1 common equity capital in excess of minimum risk-based capital ratios by at least 2.5% to avoid limits on capital distributions and certain discretionary bonus payments to executive officers and similar employees.
- (2) For the Company to be well-capitalized, the Bank must be well-capitalized and the Company must not be subject to any written agreement, order, capital directive, or prompt corrective action directive issued by the Federal Reserve to meet and maintain a specific capital level for any capital measure.

NOTE 13 – EARNINGS PER SHARE

The following is a summary of the basic and diluted earnings per share calculation for the three and nine month periods ended September 30, 2021 and 2020 (in thousands except share and per share data):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2021	2020	2021	2020
Basic net income per share calculation:				
Numerator – Net income	\$ 13,102	\$ 7,487	\$ 36,207	\$ 15,015
Denominator – Average common shares outstanding	22,164,278	21,948,579	22,114,948	19,558,281
Basic net income per share	<u>\$ 0.59</u>	<u>\$ 0.34</u>	<u>\$ 1.64</u>	<u>\$ 0.77</u>
Diluted net income per share calculation:				
Numerator – Net income	\$ 13,102	\$ 7,487	\$ 36,207	\$ 15,015
Denominator – Average common shares outstanding	22,164,278	21,948,579	22,114,948	19,558,281
Dilutive shares contingently issuable	54,124	11,911	50,182	25,167
Average diluted common shares outstanding	<u>22,218,402</u>	<u>21,960,490</u>	<u>22,165,130</u>	<u>19,583,448</u>
Diluted net income per share	<u>\$ 0.59</u>	<u>\$ 0.34</u>	<u>\$ 1.63</u>	<u>\$ 0.77</u>

NOTE 14 – FAIR VALUE

Fair value is the exchange price that would be received for an asset or paid to transfer a liability (exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. There are three levels of inputs that may be used to measure fair values:

- Level 1: Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.
- Level 2: Significant observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities, quoted prices in markets that are not active, or other inputs that are observable or can be corroborated by observable market data.
- Level 3: Significant unobservable inputs that reflect a reporting entity's own assumptions about the assumptions that market participants would use in pricing an asset or liability.

The Bank used the following methods and significant assumptions to estimate fair value:

Investment Securities: The fair values for investment securities are determined by quoted market prices, if available (Level 1). For securities where quoted prices are not available, fair values are calculated based on market prices of similar securities (Level 2), using matrix pricing. Matrix pricing is a mathematical technique commonly used to price debt securities that are not actively traded and values debt securities by relying on quoted prices for the specific securities and the securities' relationship to other benchmark quoted securities (Level 2 inputs). For securities where quoted prices or market prices of similar securities are not available, fair values are calculated using discounted cash flows or other market indicators (Level 3). See below for additional discussion of Level 3 valuation methodologies and significant inputs. The fair values of all securities are determined from third party pricing services without adjustment.

Derivatives-Interest Rate Swaps: The fair values of derivatives are based on valuation models using observable market data as of the measurement date (Level 2). The Bank's derivatives are traded in an over-the-counter market where quoted market prices are not always available. Therefore, the fair values of derivatives are determined using quantitative models that utilize multiple market inputs. The inputs will vary based on the type of derivative, but could include interest rates, prices and indices to generate continuous yield or pricing curves, prepayment rates, and volatility factors to value the position. The majority of market inputs are actively quoted and can be validated through external sources, including brokers, market transactions and third-party pricing services. The fair values of all interest rate swaps are determined from third party pricing services without adjustment.

Impaired Loans: The fair value of impaired loans with specific allocations of the allowance for loan losses is generally based on recent appraisals. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income data available for similar loans and collateral underlying such loans. Such adjustments result in a Level 3 classification of the inputs for determining fair value. Collateral may be valued using an appraisal, net book value per the borrower's financial statements, or aging reports, adjusted or discounted based on management's historical knowledge, changes in market conditions from the time of the valuation, and management's expertise and knowledge of the client and client's business, resulting in a Level 3 fair value classification. Impaired loans are evaluated on at least a quarterly basis for additional impairment and adjusted in accordance with the loan policy.

Other Real Estate Owned: Assets acquired through or instead of loan foreclosure are initially recorded at fair value less costs to sell when acquired, establishing a new cost basis. These assets are subsequently accounted for at lower of cost or fair value less estimated costs to sell. Fair value is commonly based on recent real estate appraisals which are updated no less frequently than annually. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach with data from comparable properties. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income data available. Appraisals may be adjusted or discounted based on management's historical knowledge, changes in market conditions from the time of the valuation, and/or management's expertise and knowledge of the collateral. Such adjustments result in a Level 3 classification of the inputs for determining fair value. Real estate owned properties are evaluated on a quarterly basis for additional impairment and adjusted accordingly. The Company had no other real estate owned carried at fair value at September 30, 2021 or December 31, 2020.

Loans Held For Sale: Loans held for sale are carried at either fair value, if elected, or the lower of cost or fair value on a pool-level basis. Origination fees and costs for loans held for sale recorded at lower of cost or market are capitalized in the basis of the loan and are included in the calculation of realized gains and losses upon sale. Origination fees and costs are recognized in earnings at the time of origination for loans held for sale that are recorded at fair value. Fair value is determined using quoted prices for similar assets, adjusted for specific attributes of that loan or other observable market data, such as outstanding commitments from third party investors (Level 2).

Derivatives-Mortgage Loan Interest Rate Lock Commitments: Interest rate lock commitments that relate to the origination of mortgage loans that will be held for sale are recorded at fair value, determined as the amount that would be required to settle each derivative instrument at the balance sheet date. The fair value of the interest rate lock commitment is derived from the fair value of related mortgage loans, which is based on observable market data and includes the expected net future cash flows related to servicing of the loans. In estimating the fair value of an interest rate lock commitment, the Company assigns a probability to the interest rate lock commitment based on an expectation that it will be exercised and the loan will be funded (a "pull through" rate). The expected pull through rates are applied to the fair value of the unclosed mortgage pipeline, resulting in a Level 3 fair value classification. The pull through rate is a statistical analysis of our actual rate lock fallout history to determine the sensitivity of the residential mortgage loan pipeline compared to interest rate changes and other deterministic values. New market prices are applied based on updated loan characteristics and new fallout ratios (i.e., the inverse of the pull through rate) are applied accordingly. Significant increases (decreases) in the pull through rate in isolation result in a significantly higher (lower) fair value measurement. Changes to the fair value of interest rate lock commitments are recognized based on interest rate changes, changes in the probability that the commitment will be exercised, and the passage of time.

Derivatives-Mortgage-Backed Securities Forward Sales Commitments: The Company utilizes mortgage-backed securities forward sales commitments to hedge mortgage loan interest rate lock commitments. Mortgage-backed securities forward sales commitments are recorded at fair value based on quoted prices for similar assets in an active market with inputs that are observable, resulting in a Level 2 fair value classification.

Assets and liabilities measured at fair value on a recurring basis are summarized below (in thousands):

	Fair value measurements at September 30, 2021			
	Carrying Value	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Assets:				
Securities available-for-sale:				
U. S. government agency securities	\$ 11,610	\$ —	\$ 11,610	\$ —
State and municipal securities	83,687	—	83,687	—
Mortgage-backed securities	320,500	—	320,500	—
Asset-backed securities	3,344	—	3,344	—
Other debt securities	64,637	—	64,637	—
Loans held for sale	79,842	—	79,842	—
Derivative assets:				
Non-hedging derivatives:				
Interest rate swaps - customer related	2,118	—	2,118	—
Mortgage loan interest rate lock commitments	1,079	—	—	1,079
Mortgage-backed securities forward sales commitments	293	—	293	—
Liabilities:				
Derivative liabilities:				
Non-hedging derivatives:				
Derivative Liabilities - customer related	(2,118)	—	(2,118)	—

	Fair value measurements at December 31, 2020			
	Carrying Value	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Assets:				
Securities available-for-sale:				
U. S. government agency securities	\$ 16,391	\$ —	\$ 16,391	\$ —
State and municipal securities	91,928	—	91,928	—
Mortgage-backed securities	336,363	—	336,363	—
Asset-backed securities	3,193	—	3,193	—
Other debt securities	38,340	—	38,340	—
Loans held for sale	97,303	—	97,303	—
Derivative assets:				
Non-hedging derivatives:				
Interest rate swaps - customer related	2,740	—	2,740	—
Mortgage loan interest rate lock commitments	2,607	—	—	2,607
Liabilities:				
Derivative liabilities:				
Non-hedging derivatives:				
Interest rate swaps - customer related	(2,740)	—	(2,740)	—
Mortgage-backed securities forward sales commitments	(626)	—	(626)	—

The table below presents a reconciliation of all assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the nine months ended September 30, 2021 and 2020 (in thousands):

	Mortgage Loan Interest Rate Lock Commitments	
	2021	2020
Balance of recurring Level 3 assets at January 1st	\$ 2,607	\$ 648
Total gains or losses for the period:		
Included in mortgage banking income	(1,528)	3,488
Balance of recurring Level 3 assets at September 30th	<u>\$ 1,079</u>	<u>\$ 4,136</u>

The following table presents quantitative information about recurring Level 3 fair value measurements (dollars in thousands):

September 30, 2021	Fair Value	Valuation Technique(s)	Unobservable Input(s)	Range (Weighted-Average)
Assets:				
Non-hedging derivatives:				
Mortgage loan interest rate lock commitments	\$ 1,079	Consensus pricing	Origination pull-through rate	59% - 96% (82%)

December 31, 2020	Fair Value	Valuation Technique(s)	Unobservable Input(s)	Range (Weighted-Average)
Assets:				
Non-hedging derivatives:				
Mortgage loan interest rate lock commitments	\$ 2,607	Consensus pricing	Origination pull-through rate	54% - 91% (74%)

There were no assets measured at fair value on a nonrecurring basis as of September 30, 2021. Assets measured at fair value on a nonrecurring basis as of December 31, 2020 are summarized below (in thousands).

	Fair value measurements at December 31, 2020			
	Carrying Value	Quoted prices in active markets for identical assets (level 1)	Significant other observable inputs (level 2)	Significant unobservable inputs (level 3)
Assets:				
Impaired loans:				
Commercial and industrial	\$ 36	—	—	36

The following table presents quantitative information about December 31, 2020 Level 3 fair value measurements for assets measured at fair value on a non-recurring basis (dollars in thousands):

December 31, 2020	Fair Value	Valuation Technique(s)	Unobservable Input(s)	Range (Weighted-Average)
Impaired loans:				
Commercial and industrial	\$ 36	Sales Comparison approach	Appraisal discounts	10%

Fair Value of Financial Instruments

The carrying value and estimated fair values of the Bank's financial instruments at September 30, 2021 and December 31, 2020 were as follows (in thousands):

	September 30, 2021		December 31, 2020		Fair value level of input
	Carrying amount	Fair value	Carrying amount	Fair value	
Financial assets:					
Cash and due from banks, interest-bearing deposits in financial institutions	\$ 339,367	\$ 339,367	\$ 277,439	\$ 277,439	Level 1
Federal funds sold	19,900	19,900	—	—	Level 1
Securities available-for-sale	483,778	483,778	486,215	486,215	Level 2
Securities held-to-maturity	1,788	1,847	2,407	2,504	Level 2
Loans held for sale	176,488	179,325	186,998	180,698	Level 2
Restricted equity securities	14,443	N/A	15,562	N/A	N/A
Loans held for investment	1,894,249	1,901,826	1,883,690	1,900,647	Level 3
Accrued interest receivable	7,606	7,606	8,771	8,771	Level 2
Other assets	83,072	83,072	46,381	46,381	Level 2 / Level 3
Financial liabilities:					
Deposits	2,674,392	2,535,324	2,568,001	2,472,860	Level 3
Subordinated notes and Federal Home Loan bank advances	29,499	31,022	39,423	41,400	Level 2
Other liabilities	2,902	2,902	3,334	3,334	Level 3

The methods and assumptions, not previously presented, used to estimate fair values are described as follows:

(a) *Cash and Due from Banks, Interest-Bearing Deposits in Financial Institutions*

For these short-term instruments, the carrying amount is a reasonable estimate of fair value.

(b) *Restricted Equity Securities*

It is not practical to determine the fair value of restricted securities due to restrictions placed on their transferability.

(c) *Loans*

The fair value of loans was measured using an exit price notion. Fair values for impaired loans are estimated using discounted cash flow models or based on the fair value of the underlying collateral.

(d) *Accrued Interest Receivable*

The carrying amounts of accrued interest approximate fair value.

(e) *Other Assets*

Included in other assets are bank owned life insurance and certain interest rate swap agreements. The fair values of interest rate swap agreements are based on independent pricing services that utilize pricing models with observable market inputs. For bank owned life insurance, the carrying amount is based on the cash surrender value and is a reasonable estimate of fair value.

(f) *Deposits*

The fair value of demand deposits, savings accounts and certain money market deposits is the amount payable on demand at the reporting date. The fair value of certificates of deposit is estimated by discounted cash flow models, using current market interest rates offered on certificates with similar remaining maturities.

(g) *Federal Home Loan Bank Advances and Subordinated Debt*

The fair value of fixed rate Federal Home Loan Bank Advances and subordinated notes is estimated using discounted cash flow models, using current market interest rates offered on certificates, advances and other borrowings with similar remaining maturities.

(h) *Other Liabilities*

Included in other liabilities are accrued interest payable and certain interest rate swap agreements. The fair values of interest rate swap agreements are based on independent pricing services that utilize pricing models with observable market inputs. The carrying amounts of accrued interest approximate fair value.

(i) *Off-Balance Sheet Instruments*

Fair values for off-balance sheet, credit-related financial instruments are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the counterparties' credit standing. The fair value of commitments is not material.

(j) *Limitations*

Fair value estimates are made at a specific point in time, based on relevant market information and information about the financial instruments. These estimates do not reflect any premium or discount that could result from offering for sale at one time the Bank's entire holdings of a particular instrument. Because no market exists for a significant portion of the Bank's financial instruments, fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments, and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and, therefore, cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

Fair value estimates are based on estimating on and off-balance sheet financial instruments without attempting to estimate the value of anticipated future business and the value of assets and liabilities that are not considered financial instruments. For example, fixed assets are not considered financial instruments and their value has not been incorporated into the fair value estimates. In addition, the tax ramifications related to the realization of the unrealized gains and losses can have a significant effect on fair value estimates and have not been considered in the estimates.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

The following is a discussion of our financial condition at September 30, 2021 and December 31, 2020 and our results of operations for the three and nine months ended September 30, 2021 and 2020. The purpose of this discussion is to focus on information about our financial condition and results of operations which is not otherwise apparent from the consolidated financial statements. The following discussion and analysis should be read along with our consolidated financial statements and the related notes included elsewhere in this Report and our 2020 10-K. Annualized results for interim periods may not be indicative of results for the full year or future periods.

The following discussion and analysis pertains to our historical results on a consolidated basis. However, because we conduct all of our material business operations through our wholly-owned subsidiary, CapStar Bank, the following discussion and analysis relates to activities primarily conducted at the subsidiary level.

All dollar amounts in the tables in this section are in thousands of dollars, except share or per share data or when otherwise specifically noted.

Overview

The third quarter of 2021 resulted in \$0.59 diluted net income per share of common stock, an increase of 73.5% compared to the third quarter of 2020. Annualized return on average assets was 1.64% for the third quarter of 2021 compared to 0.98% for the same period in 2020.

For the nine months ended September 30, 2021, diluted net income per share of common stock was \$1.63, an increase of 111.7% compared to the same periods in 2020. Annualized return on average assets was 1.57% for the nine months ended September 30, 2021 compared to 0.81% for the same period in 2020.

At September 30, 2021, loans held for investment increased to \$1.89 billion, as compared to \$1.88 billion at December 31, 2020. Total deposits increased to \$2.67 billion at September 30, 2021 from \$2.57 billion at December 31, 2020.

As the COVID-19 global pandemic (including various COVID-19 variants) has continued, the Company continues its proactive approach to protect our team members and their families. The Pandemic Committee continues to meet and discuss the health and safety of employees as well as to discuss updates provided by the CDC, state and local authorities. Best practices around social distancing, mask usage and cleaning of work areas has been incorporated into the daily work practice according to state, local and CDC recommendations. At this time, all financial centers and support operations centers are operating in a non-remote environment. The company is currently evaluating the potential impact of President Biden's pending COVID-19 Action Plan on the Company and its operations, which would require the Company to mandate vaccinations or test its employees weekly.

In an effort to provide relief to clients most impacted by the pandemic, CapStar Bank proactively offered a 90-day full deferment of all loan payments to CapStar borrowers that were less than 30 days past due. As a result, approximately 700 loans (representing approximately \$452 million in outstanding loan balances) were approved for payment deferment during the second quarter of 2020. As of September 30, 2021 the remaining loans still under deferment has been reduced to 5 loans (representing approximately \$33.4 million in outstanding loan balances). As of September 30, 2021, the outstanding balance of loans originated under the PPP totaled approximately \$64.2 million and was included in commercial and industrial loans.

As the pandemic continues, we will continue to assess the impact on our market. While it is uncertain losses will materialize in the future, we continue to proactively work with our clients and evaluate the potential impact of the pandemic on them and us.

Furthermore, we currently do not anticipate a significant adverse liquidity impact related to the COVID-19 pandemic. In fact, since the start of the pandemic, deposit inflows have increased sharply, significantly strengthening liquidity. Nonetheless, the Company has a comprehensive contingency funding plan that addresses potential adverse liquidity events and emergency cash flow requirements that may arise from the COVID-19 pandemic. See further discussion regarding the Company's management of liquidity risk in the subsequent section titled 'Liquidity'.

Despite the uncertainty the Company is well positioned to continue delivering on its strategic initiatives in a responsible manner by prioritizing things such as business continuity, liquidity management and maintaining an adequate allowance for loan losses.

Our primary revenue sources are net interest income and fees from various financial services provided to customers. Net interest income is the difference between interest income earned on loans, investment securities and other interest earning assets less interest expense on deposit accounts and other interest bearing liabilities. Loan volume and interest rates earned on those loans are critical to overall profitability. Similarly, deposit volume is crucial to funding loans and rates paid on deposits directly impact profitability. Business volumes are influenced by competition, new business acquisition efforts and economic factors including market interest rates, business spending and consumer confidence.

Net interest income increased \$3.3 million, or 16.8%, for the three months ended September 30, 2021, compared to the same period in 2020 and increased \$14.2 million, or 26.3% for the nine months ended September 30, 2021 compared to the same period in 2020. Net interest margin increased to 3.12% for the three months ended September 30, 2021, compared with 2.72% for the same period of 2020 and increased to 3.17% for the nine months ended September 30, 2021, compared with 3.09% for the same period of 2020.

There was no provision for loan losses for the third quarter of 2021 compared to a provision of \$2.1 million during the comparable period of 2020. The nine months ended September 30, 2021 yielded a \$0.4 million provision release compared to a \$11.3 million provision being recorded for the comparable period in 2020. The release of reserves was primarily attributable to improved asset quality trends, significant improvement in a specific classified loan, and other qualitative factors. Net charge-offs for the third quarter of 2021 were \$267 thousand compared to \$52 thousand for the comparable period of 2020. The provision for loan losses represents a charge to earnings necessary to establish an allowance for loan losses that, in management's evaluation, is adequate to provide coverage for the estimated probable inherent losses on outstanding loans. Our allowance for loan losses at September 30, 2021 was 1.19% of total loans held for investment compared to 1.22% as of September 30, 2020.

Total non-interest income for the third quarter of 2021 decreased \$3.2 million, or 21.3%, compared with the same period in 2020, and comprised 32% of total revenues. The decrease is attributable to mortgage banking results returning to more normalized levels. For the nine months ended September 30, 2021, total non-interest income remained relatively flat compared to the same period in 2020, with decreases in mortgage banking being offset by increases in SBA lending, Tri-Net, deposit service charges, and interchange and debit card transaction fees. Non-interest income comprised 30% of total revenues for the nine months ended September 30, 2021.

Total non-interest expense for the three months ended September 30, 2021 decreased \$4.4 million, or 19.2%, compared to the same period in 2020. For the nine months ended September 30, 2021, non-interest expense decreased \$1.0 million compared to the nine months ended September 30, 2020. The decreases for both periods were primarily driven by lower salaries and employee benefits, as well as acquisition related expenses. Our efficiency ratio for the three months ended September 30, 2021 was 53.06% compared to 65.99% for the same period in 2020. For the nine months ended September 30, 2021 our efficiency ratio was 55.01% compared to 65.37% for the same period in 2020.

Tangible common equity, a non-GAAP financial measure, is a measure of a company's capital which is useful in evaluating the quality and adequacy of capital. Our ratio of tangible common equity to total tangible assets was 10.51% as of September 30, 2021, compared with 10.00% at December 31, 2020. See "—Non-GAAP Financial Measures" for a discussion of and reconciliation to the most directly comparable measure calculated in accordance with the U.S. generally accepted accounting principles ("U.S. GAAP").

The following sections provide more details on subjects presented in this overview.

(a) Results of Operations

The following is a summary of our results of operations:

	Three Months Ended		2021 - 2020 Percent Increase (Decrease)	Nine Months Ended		2021 - 2020 Percent Increase (Decrease)
	September 30,			September 30,		
	2021	2020		2021	2020	
Interest income	\$ 24,690	\$ 24,642	0.2 %	\$ 73,800	\$ 67,121	10.0 %
Interest expense	1,726	4,986	-65.4 %	5,622	13,129	-57.2 %
Net interest income	22,964	19,656	16.8 %	68,178	53,992	26.3 %
Provision for loan losses	—	2,119	-100.0 %	(415)	11,295	-103.7 %
Net interest income after provision for loan losses	22,964	17,537	30.9 %	68,593	42,697	60.7 %
Noninterest income	11,651	14,804	-21.3 %	31,548	31,500	0.2 %
Noninterest expense	18,366	22,739	-19.2 %	54,859	55,883	-1.8 %
Net income before income taxes	16,249	9,602	69.2 %	45,282	18,314	147.3 %
Income tax expense	3,147	2,115	48.8 %	9,075	3,299	175.1 %
Net income	\$ 13,102	\$ 7,487	75.0 %	\$ 36,207	\$ 15,015	141.1 %
Basic net income per share of common stock	\$ 0.59	\$ 0.34	73.5 %	\$ 1.64	\$ 0.77	113.0 %
Diluted net income per share of common stock	\$ 0.59	\$ 0.34	73.5 %	\$ 1.63	\$ 0.77	111.7 %

Annualized return on average assets and annualized return on average shareholders' equity were 1.64% and 14.13%, respectively, for the third quarter of 2021, compared with 0.98% and 9.26%, respectively, for the same period in 2020.

Annualized return on average assets and annualized return on average shareholders' equity were 1.56% and 13.48%, respectively, for the nine months ended September 30, 2021, compared with 0.81% and 6.82%, respectively, for the same period in 2020.

Net Interest Income

The largest component of our net income is net interest income – the difference between the income earned on interest-earning assets and the interest paid on deposits and borrowed funds used to support our assets. Net interest income divided by total average interest-earning assets represents our net interest margin. The major factors that affect net interest income and net interest margin are changes in volumes, the yield on interest-earning assets and the cost of interest-bearing liabilities. Our margin can also be affected by economic conditions, the competitive environment, loan demand and deposit flow. Our ability to respond to changes in these factors by using effective asset-liability management techniques is critical to maintaining the stability of the net interest margin and our net interest income.

The following tables set forth the amount of our average balances, interest income or interest expense for each category of interest-earning assets and interest-bearing liabilities and the average interest rate for interest-earning assets and interest-bearing liabilities, net interest spread and net interest margin for the three and nine month periods ended September 30, 2021 and 2020:

	For the Three Months Ended September 30,					
	2021			2020		
	Average Outstanding Balance	Interest Income/Expense	Average Yield/Rate	Average Outstanding Balance	Interest Income/Expense	Average Yield/Rate
Interest-Earning Assets						
Loans (1)	\$ 1,884,935	\$ 20,942	4.41 %	\$ 1,899,182	\$ 21,398	4.47 %
Loans held for sale	173,402	1,408	3.22 %	163,390	1,398	3.56 %
Securities:						
Taxable investment securities (2)	455,583	1,816	1.59 %	271,838	1,332	1.96 %
Investment securities exempt from federal income tax (3)	60,294	344	2.90 %	51,851	343	3.35 %
Total securities	515,877	2,160	1.75 %	323,689	1,675	2.18 %
Cash balances in other banks	337,011	171	0.20 %	499,770	171	0.14 %
Funds sold	19,909	9	0.18 %	—	—	—
Total interest-earning assets	2,931,134	24,690	3.35 %	2,886,031	24,642	3.41 %
Noninterest-earning assets	240,048			157,816		
Total assets	\$ 3,171,182			\$ 3,043,847		
Interest-Bearing Liabilities						
Interest-bearing deposits:						
Interest-bearing transaction accounts	\$ 984,874	390	0.16 %	\$ 840,926	640	0.30 %
Savings and money market deposits	589,101	288	0.19 %	610,942	2,537	1.65 %
Time deposits	406,329	654	0.64 %	505,391	1,299	1.02 %
Total interest-bearing deposits	1,980,304	1,332	0.27 %	1,957,259	4,476	0.91 %
Borrowings and repurchase agreements	29,495	394	5.30 %	39,431	510	5.14 %
Total interest-bearing liabilities	2,009,799	1,726	0.34 %	1,996,690	4,986	0.99 %
Noninterest-bearing deposits	751,862			691,205		
Total funding sources	2,761,661			2,687,895		
Noninterest-bearing liabilities	41,714			34,446		
Shareholders' equity	367,807			321,506		
Total liabilities and shareholders' equity	\$ 3,171,182			\$ 3,043,847		
Net interest spread (4)			3.01 %			2.42 %
Net interest income/margin (5)		\$ 22,964	3.12 %		\$ 19,656	2.72 %

Footnotes appear below second table

	For the Nine Months Ended September 30,					
	2021			2020		
	Average Outstanding Balance	Interest Income/Expense	Average Yield/Rate	Average Outstanding Balance	Interest Income/Expense	Average Yield/Rate
Interest-Earning Assets						
Loans (1)	\$ 1,917,536	\$ 63,077	4.40 %	\$ 1,624,722	\$ 56,875	4.68 %
Loans held for sale	162,092	3,859	3.18 %	176,585	4,745	3.59 %
Securities:						
Taxable investment securities (2)	444,643	5,373	1.61 %	216,262	3,886	2.40 %
Investment securities exempt from federal income tax (3)	62,265	1,074	2.91 %	46,955	975	3.50 %
Total securities	506,908	6,447	1.77 %	263,217	4,861	2.59 %
Cash balances in other banks	290,454	405	0.19 %	278,647	640	0.31 %

Funds sold	12,866	12	0.12 %	24	—	2.77 %
Total interest-earning assets	2,889,856	73,800	3.43 %	2,343,195	67,121	3.84 %
Noninterest-earning assets	220,041			143,238		
Total assets	<u>\$ 3,109,897</u>			<u>\$ 2,486,433</u>		
Interest-Bearing Liabilities						
Interest-bearing deposits:						
Interest-bearing transaction accounts	\$ 952,393	1,216	0.17 %	\$ 715,740	3,371	0.63 %
Savings and money market deposits	587,252	896	0.20 %	534,859	4,819	1.20 %
Time deposits	429,454	2,317	0.72 %	380,198	4,197	1.47 %
Total interest-bearing deposits	1,969,099	4,429	0.30 %	1,630,797	12,387	1.01 %
Borrowings and repurchase agreements	30,931	1,193	5.16 %	23,907	742	4.14 %
Total interest-bearing liabilities	2,000,030	5,622	0.38 %	1,654,704	13,129	1.06 %
Noninterest-bearing deposits	717,122			509,739		
Total funding sources	2,717,152			2,164,443		
Noninterest-bearing liabilities	33,569			28,000		
Shareholders' equity	359,176			293,990		
Total liabilities and shareholders' equity	<u>\$ 3,109,897</u>			<u>\$ 2,486,433</u>		
Net interest spread (4)			3.05 %			2.78 %
Net interest income/margin (5)		<u>\$ 68,178</u>	3.17 %		<u>\$ 53,992</u>	3.09 %

- (1) Average loan balances include nonaccrual loans. Interest income on loans includes amortization of deferred loan fees, net of deferred loan costs.
- (2) Taxable investment securities include restricted equity securities.
- (3) Yields on tax exempt securities are shown on a tax equivalent basis.
- (4) Net interest spread is the average yield on total interest-earning assets minus the average rate on total interest-bearing liabilities.
- (5) Net interest margin is annualized net interest income calculated on a tax equivalent basis divided by total average interest-earning assets for the period.

The net interest margin was 3.12% and 2.72% for the third quarters of 2021 and 2020, respectively. For the nine months ended September 30, 2021 and 2020, the net interest margin was 3.17% and 3.09%, respectively. The increase in net interest margin for the three and nine months ended September 30, 2021 compared to September 30, 2020 was primarily due to decreases in deposit rates and revenues related to PPP loans.

The decreases in average loan yields, shown above, for the three and nine month periods ended September 30, 2021, were due to the impact of lower market interest rates on yields of new loan originations and yields of existing variable rate loans and was triggered by the Federal Reserve reducing the Federal Funds target rate by 1.50% in March 2020, one of numerous actions intended to offset the pandemic's impact on the U.S. economy. This decrease was partially offset by fees recognized on PPP loans. Average loans at September 30, 2021 remained relatively flat compared to the three months ended September 30, 2020. For the nine months ended September 30, 2021, average loans increased 18.0% compared to the 2020 relative period as a result of the FCB and BOW acquisitions, the Company's active participation in the SBA's Paycheck Protection Program ("PPP"), additional bankers in the Nashville and Knoxville MSA, and continued focus on attracting new clients.

For the three and nine month periods ended September 30, 2021, average security yields decreased compared to the 2020 comparable periods, primarily due to the impact of lower market interest rates on the yields of securities purchased to replace security maturities and paydowns, and the Company's purchase of additional conservative lower yield securities to deploy a portion of pandemic-related deposit growth.

The Company continues to experience favorable deposit trends. The Company experienced a favorable mix shift as average non-interest bearing deposits represented 27.5% and 26.7% of total deposits for the three and nine month periods ending September 30, 2021, increases of 3.2% and 25.5%, respectively, versus the three and nine month periods ending September 30, 2020. Deposit costs declined across all interest-bearing account types. Average funding sources slightly increased for the three months ended September 30, 2021 compared to September 30, 2020, and increased 25.5% for the nine months ended September 30, 2021 compared to the similar period in 2020. As shown in the tables above, the primary driver of our increased funding sources was growth in our average deposits, which was primarily driven by the FCB and BOW acquisitions as well as continued growth in our target markets, an enhanced focus on our deposit strategy, and increasing deposit balances from customers receiving COVID-19 related government stimulus funds. The COVID-19 related deposit increase, which led to a significant increase in interest bearing cash, was a major contributor to the net interest margin decline noted above as loan growth did not keep pace with deposit growth.

The average rate paid on interest-bearing liabilities was 0.34% for the second quarter compared to 0.99% for September 30, 2020. For the nine months ended September 30, 2021 and 2020, the average rate paid on interest-bearing liabilities was 0.38% and 1.06%, respectively. The majority of this decrease was due to 2020 decreases in the Federal Funds rate in response to the COVID-19 pandemic.

Asset/Liability Management and Interest Rate Risk

Managing interest rate risk is fundamental for the financial services industry. The primary objective of interest rate risk management is to mitigate effects of interest rate changes on net income. By considering both on and off-balance sheet financial instruments, management evaluates interest rate sensitivity while attempting to optimize net interest income within the constraints of prudent capital adequacy, liquidity needs, market opportunities and customer requirements.

Interest Rate Simulation Sensitivity Analysis

We use earnings at risk, or EAR, simulations to assess the impact of changing rates on earnings under a variety of scenarios and time horizons. The simulation model is designed to reflect the dynamics of interest earning assets, interest bearing liabilities and off-balance sheet financial instruments. These simulations utilize both instantaneous and parallel changes in the level of interest rates, as well as non-parallel changes such as changing slopes and twists of the yield curve. Static simulation models are based on current exposures and assume a constant balance sheet with no growth. By estimating the effects of interest rate increases and decreases, the model can reveal approximate interest rate risk exposure. The simulation model is used by management to gauge approximate results given a specific change in interest rates at a given point in time. The model is therefore a tool to indicate earnings trends in given interest rate scenarios and does not indicate actual expected results.

At September 30, 2021, our EAR static simulation results indicated that our balance sheet is asset sensitive to parallel shifts in interest rates. This indicates that our assets generally reprice faster than our liabilities, which results in a favorable impact to net interest income when market interest rates increase and an unfavorable impact to net interest income when market interest rates decline. Many assumptions are used to calculate the impact of interest rate fluctuations on our net interest income, such as asset prepayments, non-maturity deposit price sensitivity, and key rate drivers. Because of the inherent use of these estimates and assumptions in the model, our actual results may, and most likely will, differ from our static EAR results. In addition, static EAR results do not include actions that

our management may undertake to manage the risks in response to anticipated changes in interest rates or client behavior. For example, as part of our asset/liability management strategy, management has the ability to increase asset duration and/or decrease liability duration in order to reduce asset sensitivity, or to decrease asset duration and/or increase liability duration in order to increase asset sensitivity.

The following table illustrates the results of our EAR analysis to determine the extent to which our net interest income over the next 12 months would change if prevailing interest rates increased or decreased immediately by the specified amounts.

	Net interest income change
Increase 200bp	2.7%
Increase 100bp	1.0
Decrease 100bp	(3.1)

Provision for Loan Losses

Our policy is to maintain an allowance for loan losses at a level sufficient to absorb probable incurred losses inherent in the loan portfolio. The allowance is increased by a provision for loan losses, which is a charge to earnings, is decreased by charge offs and increased by loan recoveries. Our allowance for loan losses as a percentage of total loans was 1.19% and 1.23% at September 30, 2021 and December 31, 2020, respectively.

There was no provision expense for the three months ended September 30, 2021 compared to a \$2.1 million provision for the three month period ended September 30, 2020. For the nine months ended September 30, 2021, there was a provision release of \$0.4 million compared to an \$11.3 million provision for the comparable period in 2020. The release was primarily attributable to improved asset quality trends, significant improvement in a specific classified loan, and other qualitative factors. Provision expense is impacted by the absolute level of loans, loan growth, the credit quality of the loan portfolio and the amount of net charge-offs.

Based upon our evaluation of the loan portfolio, we believe the allowance for loan losses to be adequate to absorb our estimate of probable losses existing in the loan portfolio at September 30, 2021. While our policies and procedures used to estimate the allowance for loan losses, as well as the resultant provision for loan losses charged to operations, are considered adequate by management, they are necessarily approximate and imprecise.

There are factors beyond our control, such as conditions in the local and national economy, local real estate markets, or particular industry or borrower-specific conditions, which may materially negatively impact our asset quality and the adequacy of our allowance for loan losses and, thus, the resulting increase in our provision for loan losses could be material. We continue to assess the impact of and developments in the COVID-19 pandemic to our loan portfolio based on several factors including the expected impact of the pandemic to our loan portfolio.

See “Notes to Consolidated Financial Statements (Unaudited) — Note 4 — Loans and Allowance for Loan Losses” for additional information on our allowance for loan losses.

Noninterest Income

In addition to net interest margin, we generate recurring noninterest income from our lines of business. Our banking operations generate revenue from service charges and fees on deposit accounts. We have a mortgage banking line of business that generates revenue from originating and selling mortgages, a line of business that originates and sells commercial real estate loans (Tri-Net), and we have a revenue-sharing relationship with a registered broker-dealer, which generates wealth management revenue. In addition to these types of recurring noninterest income, we own insurance on several key employees and record income on the increase in the cash surrender value of these policies.

The following table sets forth the principal components of noninterest income for the periods indicated.

	Three Months Ended		2021 - 2020	Nine Months Ended		2021 - 2020
	September 30,		Percent	September 30,		Percent
	2021	2020	Increase (Decrease)	2021	2020	Increase (Decrease)
Noninterest income:						
Deposit service charges	\$ 1,187	\$ 1,064	11.6 %	\$ 3,398	\$ 2,531	34.3 %
Interchange and debit card transaction fees	1,236	936	32.1 %	3,555	2,389	48.8 %
Mortgage banking	4,693	9,686	(51.5)%	13,318	19,063	(30.1)%
Tri-Net	1,939	668	190.3 %	4,618	2,528	82.7 %
Wealth management	481	382	25.9 %	1,412	1,162	21.5 %
SBA lending	911	476	91.4 %	1,781	525	239.2 %
Net gain on sale of securities	7	34	(79.4)%	20	74	(73.0)%
Other noninterest income	1,197	1,558	(23.2)%	3,446	3,228	6.8 %
Total noninterest income	<u>\$ 11,651</u>	<u>\$ 14,804</u>	<u>(21.3)%</u>	<u>\$ 31,548</u>	<u>\$ 31,500</u>	<u>0.2 %</u>

The increase in deposit service charges for the nine months ended September 30, 2021 compared to the same period in 2020 is related to our acquisitions of FCB and BOW, as well as growth in our commercial and consumer deposit accounts.

The increase in interchange and debit card transaction fees is due to increased transaction volume, which included new volume related to the FCB and BOW acquisitions.

Mortgage banking income consists of mortgage fee income from the origination and sale of mortgage loans. These mortgage fees are for loans originated in our markets that are subsequently sold to third-party investors. Mortgage origination fees will fluctuate from quarter to quarter as the rate environment changes. The decrease above is indicative of the mortgage market returning to more normalized levels.

Tri-Net represents a line of business which originates and sells commercial real estate loans to third-party investors with the exception of certain loans originated to borrowers within our target market, which are retained at the discretion of management. All of these loan sales transfer servicing rights to the buyer. The volume of loan sales has increased through continued growth and development.

Wealth management income is derived from advisory services offered to specific customers. The increase in wealth management fees for the three and nine month periods ended September 30, 2021 compared to the same periods in 2020 was mostly driven by transaction volume, which can fluctuate from period to period.

The increase in SBA lending is primarily attributable to the Company's gains on sales of guaranteed portions of SBA loans, which was driven by continued growth and development of our SBA lending program.

Other noninterest income primarily consists of loan related fees, bank-owned life insurance, and other service-related fees. The largest driver of the increase across both comparative periods relates to income from bank-owned life insurance policies purchased in the first quarter of 2021.

Noninterest Expense

The following table presents the primary components of noninterest expense for the periods indicated.

	Three Months Ended		2021 - 2020	Nine Months Ended		2021 - 2020
	September 30,		Percent	September 30,		Percent
	2021	2020	Increase (Decrease)	2021	2020	Increase (Decrease)
Noninterest expense:						
Salaries and employee benefits	\$10,980	\$12,949	(15.2)%	\$31,210	\$33,256	(6.2)%
Data processing and software	2,632	2,353	11.9%	8,530	6,317	35.0%
Occupancy	1,028	999	2.9%	3,193	2,615	22.1%
Equipment	760	864	(12.0)%	2,640	2,295	15.0%
Professional services	469	638	(26.5)%	1,634	1,854	(11.9)%
Regulatory fees	279	397	(29.7)%	746	893	(16.5)%
Acquisition related expenses	—	2,548	(100.0)%	323	3,286	(90.2)%
Amortization of intangibles	477	539	(11.5)%	1,478	1,300	13.7%
Other operating	1,741	1,452	19.9%	5,105	4,067	25.5%
Total noninterest expense	\$18,366	\$22,739	(19.2)%	\$54,859	\$55,883	(1.8)%

The change in salaries and employee benefits was driven primarily by a reduction in compensation associated with mortgage banking. At September 30, 2021, our associate base decreased to 392 compared to 403 at September 30, 2020.

Data processing and software expense increased during both comparable periods presented due to increased transaction volumes related to the Company's recent acquisitions and services related to the processing of PPP loans.

The increase in occupancy expense during the periods presented was largely attributable to facilities related costs and the increasing cost of managing our IT network.

Our efficiency ratio was 53.06% and 65.99% for the three months ended September 30, 2021 and September 30, 2020, respectively. For the nine months ended September 30, 2021 and 2020, our efficiency ratio was 55.01% and 65.37%, respectively. The efficiency ratio is the ratio of noninterest expense to the sum of net interest income and noninterest income and measures the amount of expense that is incurred to generate a dollar of revenue. The efficiency ratio improved in 2021 due to operational improvements and synergies achieved through the FCB and BOW acquisitions compounded by increased revenues and a continued emphasis on expense discipline.

Income Tax Provision

The Company's effective tax rate for the three and nine month periods ended September 30, 2021 was 19.4% and 20.0%, respectively, compared to 22.0% and 18.0% for the three and nine month periods ended September 30, 2020, respectively. The three month period decrease is attributable to a revision in the Company's expected annual effective tax rate for 2021 driven by continued benefits in the Company's tax strategy.

The nine month period increase in the effective tax rate from the nine month period ended September 30, 2020 is largely the result of the impact of the provisions under the CARES Act, which were effective for 2020. The CARES Act permitted NOL's arising in taxable years beginning after December 31, 2017 and before January 1, 2021 to be carried back five taxable years. This enabled the Company to carry back in 2020 losses incurred during the taxable year 2018 to prior years with a higher statutory tax rate, creating a permanent tax rate benefit. As a result, the Company recorded an income tax benefit of \$0.8 million related to the permanent tax rate benefit during the nine months ended September 30, 2020.

The effective tax rate for the three and nine months ended September 30, 2021 compared favorably to the statutory federal rate of 21% and Tennessee excise tax rate of 6.5% primarily due to investments in qualified municipal securities, company owned life insurance, tax benefits of CapStar Bank's real estate investment trust subsidiary, community investment tax credits, and tax benefits associated with share-based compensation, net of the effect of certain non-deductible expenses. The Company anticipates its effective tax rate for 2021 to be approximately 20.0 percent.

(b) Financial Condition

Balance Sheet

Total assets increased \$125.1 million, or 4.2%, from \$2.99 billion on December 31, 2020 to \$3.11 billion on September 30, 2021. Loans held for investment grew \$10.6 million, or 0.6%, in the first nine months of 2021. Excluding PPP loans, loans held for investment increased \$128.0 million, or 7.5%, for the same period. Loans held for sale decreased \$10.5 million, or 5.6%, during the first nine months of 2021.

Total liabilities increased \$98.3 million, or 3.7%, from \$2.64 billion on December 31, 2020 to \$2.74 billion on September 30, 2021. Deposits increased \$106.4 million, or 4.1%.

Our growth in cash, loans and deposits has been significantly influenced by the U.S. government's various stimulus programs and their impact on our customers and economic uncertainty associated with the COVID-19 pandemic.

Loans

The composition of loans at September 30, 2021 and December 31, 2020 and the percentage of each classification to total loans are summarized as follows:

	September 30, 2021		December 31, 2020	
	Amount	Percent	Amount	Percent
Commercial real estate - owner occupied	\$ 193,139	10.2 %	\$ 162,603	8.6 %
Commercial real estate - non-owner occupied	579,857	30.6 %	481,229	25.5 %
Consumer real estate	328,262	17.3 %	343,791	18.3 %
Construction and land development	210,516	11.1 %	174,859	9.3 %
Commercial and industrial	478,279	25.2 %	623,446	33.1 %
Consumer	45,669	2.4 %	44,279	2.4 %
Other	58,527	3.2 %	53,483	2.8 %
Total loans	<u>\$ 1,894,249</u>	<u>100.0 %</u>	<u>\$ 1,883,690</u>	<u>100.0 %</u>

At September 30, 2021, our loan portfolio composition remained relatively consistent with the composition at December 31, 2020. Our primary focus has been on commercial and industrial and commercial real estate lending, which constituted 66% of our loan portfolio as of September 30, 2021. Although we expect continued growth with respect to our loan portfolio, we do not expect any significant changes over the foreseeable future in the composition of our loan portfolio or in our emphasis on commercial lending. Our loan growth since inception has been reflective of the target market that we serve. The commercial real estate category includes owner-occupied commercial real estate loans which are similar in many ways to our commercial and industrial lending in that these loans are generally made to businesses on the basis of the cash flows of the affiliated business rather than on the valuation and cash flows of the real estate from unaffiliated tenants. Since 2009, our commercial and industrial and commercial real estate portfolios have continued to experience strong growth, primarily due to implementation of our relationship-based banking model and the success of our relationship managers

in transitioning commercial banking relationships from other local financial institutions and in competing for new business from attractive small to mid-sized commercial clients. Many of our larger commercial clients have lengthy relationships with members of our senior management team or our relationship managers that date back to their employment by other financial institutions.

Non-Performing Loans and Assets

Information summarizing non-performing assets, including non-accrual loans follows:

	September 30, 2021	December 31, 2020
Non-accrual loans	\$ 3,431	\$ 4,816
Troubled debt restructurings	1,859	1,928
Loans past due over 89 days and still accruing	1,560	3,295
Non-performing loans	3,431	4,816
Other real estate owned	349	523
Non-performing assets	3,780	5,339
Non-performing loans as a percentage of total loans	0.18 %	0.26 %
Non-performing assets as a percentage of total assets	0.12 %	0.18 %

The following table sets forth the major classifications of non-accrual loans:

	September 30, 2021	December 31, 2020
Commercial real estate	\$ 115	\$ 130
Consumer real estate	1,174	1,821
Construction and land development	—	107
Commercial and industrial	89	470
Consumer	47	9
Other	—	—
Purchased credit impaired	2,006	2,279
Total loans	<u>\$ 3,431</u>	<u>\$ 4,816</u>

(c) Liquidity

Liquidity risk is the risk that we will be unable to meet our obligations as they become due because of an inability to liquidate assets or obtain adequate funding. To manage liquidity risk, management has established a comprehensive management process for identifying, measuring, monitoring and controlling liquidity risk. Because of its critical importance to the viability of the Bank, liquidity risk management is fully integrated into our risk management processes. Critical elements of our liquidity risk management include: effective corporate governance consisting of oversight by the board of directors and active involvement by management; appropriate strategies, policies, procedures, and limits used to manage and mitigate liquidity risk; comprehensive liquidity risk measurement and monitoring systems (including assessments of the current and prospective cash flows or sources and uses of funds) that are commensurate with the complexity and business activities of the Bank; active management of intraday liquidity and collateral; an appropriately diverse mix of existing and potential future funding sources; adequate levels of highly liquid marketable securities free of legal, regulatory, or operational impediments, that can be used to meet liquidity needs in stressful situations; comprehensive contingency funding plans that sufficiently address potential adverse liquidity events and emergency cash flow requirements; and internal controls and internal audit processes sufficient to determine the adequacy of the institution's liquidity risk management process.

The role of liquidity management is to ensure funds are available to meet depositors' withdrawal and borrowers' credit demands while at the same time maximizing profitability. This is accomplished by balancing changes in demand for funds with changes in the supply of those funds. Liquidity is provided by short-term liquid assets that can be converted to cash, investment securities available-for-sale, various lines of credit available to us, and the ability to attract funds from external sources, principally deposits.

Our most liquid assets are comprised of cash and due from banks, interest-bearing deposits in financial institutions, available-for-sale marketable investment securities and federal funds sold. Liquid assets increased significantly versus December 31, 2020 primarily due to continued strong deposit inflows since the start of the pandemic which have substantially bolstered liquidity. Interest-bearing deposits in financial institutions totaled \$287.4 million at September 30, 2021, an increase of \$50.2 million from December 31, 2020. The fair value of the available-for-sale investment portfolio was \$483.8 million at September 30, 2021, a slight decrease from December 31, 2020. We pledge portions of our investment securities portfolio to secure public fund deposits, derivative positions and Federal Home

Loan Bank advances. At September 30, 2021, total investment securities pledged for these purposes comprised 41% of the estimated fair value of the investment portfolio, leaving \$284.2 million of unpledged securities.

We have a large base of non-maturity customer deposits, defined as demand, savings, and money market deposit accounts. At September 30, 2021, such deposits totaled \$2.3 billion and represented approximately 85% of our total deposits.

Other sources of funds available to meet daily needs include \$448.9 million of borrowing capacity from the FHLB of Cincinnati, \$252.0 million of borrowing capacity from the Federal Reserve Bank of Atlanta's discount window and federal funds lines with correspondent banks totaling \$125.0 million at September 30, 2021.

The principal source of cash for CapStar Financial Holdings, Inc. (the "Parent Company") is dividends paid to it as the sole shareholder of the Bank. At September 30, 2021, the Bank was able to pay up to \$70.6 million in dividends to the Parent Company without regulatory approval subject to the ongoing capital requirements of the Bank.

Accordingly, management currently believes that our funding sources are at sufficient levels to satisfy our short-term and long-term liquidity needs.

(d) Capital Resources

At September 30, 2021, shareholders' equity totaled \$370.3 million, an increase of \$26.8 million since December 31, 2020. As of September 30, 2021, the Company and the Bank were well-capitalized under the regulatory framework for prompt corrective action. See the Consolidated Statement of Changes in Shareholders' Equity as well as Notes 11 and 12 of the consolidated financial statements for further detail of the changes in equity since the end of 2020.

Off-Balance Sheet Arrangements

In the normal course of business, we enter into various transactions that, in accordance with U.S. GAAP, are not included in our consolidated balance sheet. We enter into these transactions to meet the financing needs of our clients. These transactions include commitments to extend credit and standby letters of credit, which involve, to varying degrees, elements of credit risk and interest rate risk in excess of the amounts recognized in our consolidated balance sheets. Most of these commitments mature within two years and are expected to expire without being drawn upon. Standby letters of credit are included in the determination of the amount of risk-based capital that the Company and the Bank are required to hold.

We enter into contractual loan commitments to extend credit, normally with fixed expiration dates or termination clauses, at specified rates and for specific purposes. Substantially all of our commitments to extend credit are contingent upon clients maintaining specific credit standards until the time of loan funding.

Standby letters of credit are written conditional commitments issued by us to guarantee the performance of a client to a third party. In the event that the client does not perform in accordance with the terms of the agreement with the third party, we would be required to fund the commitment. The maximum potential amount of future payments we could be required to make is represented by the contractual amount of the commitment. If the commitment is funded, we would be entitled to seek recovery from the client. Our policies generally require that standby letter of credit arrangements contain security and debt covenants similar to those contained in loan agreements.

We minimize our exposure to loss under loan commitments and standby letters of credit by subjecting them to the same credit approval and monitoring procedures as we do for on-balance sheet instruments. We assess the credit risk associated with certain commitments to extend credit and establish a liability for probable credit losses. The effect on our revenue, expenses, cash flows and liquidity of the unused portions of these commitments cannot be reasonably predicted because there is no guarantee that the lines of credit will be used.

Our off-balance sheet arrangements are summarized in Note 9 of the consolidated financial statements.

(e) Non-GAAP Financial Measures

This Report includes the following financial measures that have been prepared other than in accordance with U.S. GAAP ("non-GAAP financial measures"): tangible common equity, tangible common equity to total tangible assets and tangible common equity per share. The Company believes that these non-GAAP financial measures (i) provide useful information to management and investors that is supplementary to its financial condition, results of operations and cash flows computed in accordance with U.S. GAAP, (ii) enable a more complete understanding of factors and trends affecting the Company's business, and (iii) allow investors to evaluate the Company's

performance in a manner similar to management, the financial services industry, bank stock analysts and bank regulators; however, the Company acknowledges that its non-GAAP financial measures have a number of limitations. As such, you should not view these disclosures as a substitute for results determined in accordance with U.S. GAAP, and they are not necessarily comparable to non-GAAP financial measures that other companies use.

The following table presents a reconciliation of tangible common equity, tangible common equity to total tangible assets and tangible common equity per share to the most directly comparable U.S. GAAP financial measures.

(dollars in thousands, except share and per share data)	<u>September 30, 2021</u>	<u>December 31, 2020</u>
Total equity	\$ 370,328	\$ 343,486
Less core deposit intangible	(7,152)	(8,630)
Less goodwill	(41,068)	(41,068)
Tangible common equity	<u>\$ 322,108</u>	<u>\$ 293,788</u>
Total assets	\$ 3,112,127	\$ 2,987,006
Less core deposit intangible	(7,152)	(8,630)
Less goodwill	(41,068)	(41,068)
Total tangible assets	<u>\$ 3,063,907</u>	<u>\$ 2,937,308</u>
Total shareholders' equity to total assets	11.90 %	11.50 %
Tangible common equity ratio	10.51 %	10.00 %
Total shares of common stock outstanding	22,165,760	21,988,803
Book value per share of common stock	\$ 16.71	\$ 15.62
Tangible book value per share of common stock	14.53	13.36

(f) Recently Issued Accounting Pronouncements

ASU 2016-13, Financial Instruments – Credit Losses

In June 2016, the FASB issued guidance to change the accounting for credit losses and modify the impairment model for certain debt securities. The amendments were originally to be effective for the Company for reporting periods beginning after December 15, 2019 with early adoption permitted for all organizations for periods beginning after December 15, 2018. However, in November 2019, the FASB issued ASU 2019-10, *Financial Instruments – Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): Effective Dates*, which finalized effective date delays for private companies, not-for-profit organizations, and certain smaller reporting companies applying the credit losses standard. The Company is not required to adopt this standard until January 1, 2023. The Company is currently assessing ASU 2016-13, timing of adoption, and its impact on its financial statements.

ASU 2019-05 – Applicable to entities that hold financial instruments:

In May 2019, the FASB issued guidance to provide entities with an option to irrevocably elect the fair value option, applied on an instrument-by-instrument basis for eligible instruments, upon adoption of ASU 2016-13, *Measurement of Credit Losses on Financial Instruments*. The amendments will be effective for the Company upon adoption of ASU 2016-13 in fiscal year 2023. The Company does not expect these amendments to have a material effect on its financial statements.

ASU 2019-12 – Applicable to entities within the scope of Topic 740, Income Taxes:

In December 2019, the FASB issued guidance to simplify accounting for income taxes by removing specific technical exceptions that often produce information investors have a hard time understanding. The amendments also improve consistent application of and simplify U.S. GAAP for other areas of Topic 740 by clarifying and amending existing guidance. The amendments are effective for fiscal years beginning after December 15, 2020, including interim periods within those fiscal years. These amendments were adopted on January 1, 2021 and did not have a material effect on the Company's financial statements.

(g) Impact of Inflation

The consolidated financial statements and related consolidated financial data presented herein have been prepared in accordance with U.S. GAAP and practices within the banking industry which require the measurement of financial position and operating results in terms of historical dollars without considering the changes in the relative purchasing power of money over time due to inflation. Unlike most industrial companies, virtually all the assets and liabilities of a financial institution are monetary in nature. As a result, interest rates have a more significant impact on a financial institution's performance than the effects of general levels of inflation.

Item 3. Quantitative and Qualitative Disclosures about Market Risk.

There have been no material changes in our market risk as of September 30, 2021 from that presented in our 2020 10-K. Information about our interest rate sensitivity is included in “Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations – Interest Rate Simulation Sensitivity Analysis” of this Report and incorporated herein by this reference.

Item 4. Controls and Procedures**Evaluation of Disclosure Controls and Procedures**

The Company, with the participation of its management, including its Chief Executive Officer and Chief Financial Officer, carried out an evaluation of the effectiveness of the design and operation of its disclosure controls and procedures (as defined in Exchange Act Rule 13a-15(e)) as of the end of the period covered by this Report. Based upon that evaluation, the Company’s Chief Executive Officer and Chief Financial Officer concluded that, as of the end of the period covered by this Report, the Company’s disclosure controls and procedures were effective as of the end of the period covered by this Report.

Changes in Internal Control over Financial Reporting

There have been no changes in the Company’s internal control over financial reporting (as such term is defined in Exchange Act Rule 13a-15(f)) that occurred during the period covered by this Report that have materially affected, or are reasonably likely to materially affect, the Company’s internal control over financial reporting.

PART II. OTHER INFORMATION

Item 6. Exhibits

Exhibit Number	Description
3.1	<u>Charter of CapStar Financial Holdings, Inc. (incorporated by reference herein to Exhibit 3.1 to the Company's Registration Statement on Form S-1 (File Number 333-213367) filed on August 29, 2016)</u>
3.2	<u>Articles of Amendment to the Charter of CapStar Financial Holdings, Inc. (incorporated by reference herein to Exhibit 3.1 to the Company's Current Report on Form 8-K filed on April 29, 2020)</u>
3.3	<u>Amended and Restated Bylaws of CapStar Financial Holdings, Inc. (incorporated by reference herein to Exhibit 3.1 to the Company's Current Report on Form 8-K filed on October 28, 2019)</u>
31.1	<u>Certification of Chief Executive Officer of CapStar Financial Holdings, Inc. pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended, adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, as amended.</u>
31.2	<u>Certification of Chief Financial Officer of CapStar Financial Holdings, Inc. pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended, adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, as amended.</u>
32.1	<u>Certification of Chief Executive Officer of CapStar Financial Holdings, Inc. pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, as amended.</u>
32.2	<u>Certification of Chief Financial Officer of CapStar Financial Holdings, Inc. pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, as amended.</u>
101	Interactive data files for Capstar Financial Holdings, Inc.'s Quarterly Report on Form 10-Q for the quarter ended September 30, 2021, formatted in Inline XBRL: (i) the Consolidated Balance Sheets (unaudited); (ii) the Consolidated Statements of Income (unaudited); (iii) the Consolidated Statements of Comprehensive Income (unaudited); (iv) the Consolidated Statements in Shareholders' Equity (unaudited); (v) the Consolidated Statements of Cash Flows (unaudited); and (vi) the Notes to Consolidated Financial Statements (unaudited).
104	The cover page from Capstar Financial Holdings, Inc.'s Quarterly Report on Form 10-Q for the quarter ended September 30, 2021 (formatted in Inline XBRL and included in Exhibit 101)

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

CAPSTAR FINANCIAL HOLDINGS, INC.

By: /s/ Denis J. Duncan
Denis J. Duncan
Chief Financial Officer
(Principal Financial Officer and Principal Accounting Officer)

Date: November 4, 2021

**CERTIFICATION OF CHIEF EXECUTIVE OFFICER PURSUANT TO RULE 13A-14(A) OF THE SECURITIES EXCHANGE ACT OF 1934,
AS AMENDED, ADOPTED PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002**

I, Timothy K. Schools, certify that:

1. I have reviewed this quarterly report on Form 10-Q of CapStar Financial Holdings, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 4, 2021

By: /s/ Timothy K. Schools

Timothy K. Schools

President and Chief Executive Officer

**CERTIFICATION OF CHIEF FINANCIAL OFFICER PURSUANT TO RULE 13A-14(A) OF THE SECURITIES EXCHANGE ACT OF 1934,
AS AMENDED, ADOPTED PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002**

I, Denis J. Duncan, certify that:

1. I have reviewed this quarterly report on Form 10-Q of CapStar Financial Holdings, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 4, 2021

By: /s/ Denis J. Duncan

Denis J. Duncan
Chief Financial Officer

CERTIFICATION OF CHIEF EXECUTIVE OFFICER PURSUANT TO 18 U.S.C. SECTION 1350, AS ADOPTED PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report on Form 10-Q of CapStar Financial Holdings, Inc. (the "Company") for the period ended September 30, 2021, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Timothy K. Schools, President and Chief Executive Officer of the Company, certify in my capacity as an officer of the Company, pursuant to 18 U.S.C. section 1350, as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002, that, to my knowledge:

1. The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities and Exchange Act of 1934, as amended; and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: November 4, 2021

By: /s/ Timothy K. Schools

Timothy K. Schools

President and Chief Executive Officer

CERTIFICATION OF CHIEF FINANCIAL OFFICER PURSUANT TO 18 U.S.C. SECTION 1350, AS ADOPTED PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report on Form 10-Q of CapStar Financial Holdings, Inc. (the "Company") for the period ended September 30, 2021, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Denis J. Duncan, Chief Financial Officer of the Company, certify in my capacity as an officer of the Company, pursuant to 18 U.S.C. section 1350, as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002, that, to my knowledge:

1. The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities and Exchange Act of 1934, as amended; and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: November 4, 2021

By: /s/ Denis J. Duncan

Denis J. Duncan

Chief Financial Officer
