

**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, 2020

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)

81-1527911

(IRS Employer
Identification No.)

1201 Demonbreun Street, Suite 700

Nashville, Tennessee

(Address of principal executive offices)

37203

(zip code)

(615) 732-6400

(Registrant's telephone number, including area code)

Not Applicable

(Former name, former address and former fiscal year, if changed since last report)

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

Accelerated Filer

Non-Accelerated Filer

Smaller Reporting Company

Emerging Growth Company

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 October 30, 2020

Common Stock, par value \$1.00 per share

21,945,314

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, future events and our financial performance. 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,” “roadmap,” “achieve,” “estimate,” “intend,” “plan,” “project,” “projection,” “forecast,” “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 on 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 COVID-19 pandemic is adversely affecting us, our customers, employees, and third-party service providers, and the ultimate extent of the impacts on our business, including on our credit quality, business operations and liquidity, as well as its impact on general economic and financial market conditions, is uncertain. Continued deterioration in general business and economic conditions, or turbulence in domestic or global financial markets 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 Company may not capitalize on opportunities to enhance market share in certain markets and 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”) mergers; reputational risks and the reaction of shareholders, customers, employees or other constituents of the Company to the FCB and BOW mergers; the acceptance by customers of FCB and BOW of the Company’s products and services; the possibility that the FCB and BOW merger integrations will be more expensive or take more time to complete than anticipated; 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 Market 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, ROAA 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 geographic concentrations 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 and leases; 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; our inability to realize operating efficiencies and tax savings from the implementation of our strategic plan; governmental legislation and regulation, including changes in the nature and timing of the adoption and effectiveness of new requirements under the Dodd-Frank Act of 2010, as amended, the Tax Cuts and Jobs Act of 2017, as amended, 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; strategic acquisitions we may undertake 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 those factors that are detailed from time to time in the Company's periodic and current reports filed with the Securities and Exchange Commission (the "SEC"), including those factors included in the Company's Annual Report on Form 10-K for the year ended December 31, 2019 under the heading "Item 1A. Risk Factors" and in the Company's Quarterly Reports on Form 10-Q and Current Reports on Form 8-K. 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. Consolidated Financial Statements

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

	September 30, 2020 (unaudited)	December 31, 2019
Assets		
Cash and due from banks	\$ 39,917	\$ 17,726
Interest-bearing deposits in financial institutions	416,008	83,368
Federal funds sold	—	175
Total cash and cash equivalents	<u>455,925</u>	<u>101,269</u>
Securities available-for-sale, at fair value	308,337	213,129
Securities held-to-maturity, fair value of \$2,526 and \$3,411 at September 30, 2020 and December 31, 2019, respectively	2,413	3,313
Loans held for sale, includes \$112,002 and \$30,740 measured at fair value at September 30, 2020 and December 31, 2019, respectively	198,603	168,222
Loans	1,906,603	1,420,102
Less allowance for loan losses	(23,167)	(12,604)
Loans, net	<u>1,883,436</u>	<u>1,407,498</u>
Premises and equipment, net	27,728	19,184
Restricted equity securities	13,625	13,689
Accrued interest receivable	9,814	5,792
Goodwill	41,068	37,510
Core deposit intangible, net	9,154	6,883
Other real estate owned, net	171	1,044
Other assets	74,074	59,668
Total assets	<u>\$ 3,024,348</u>	<u>\$ 2,037,201</u>
Liabilities and Shareholders' Equity		
Deposits:		
Non interest-bearing	\$ 716,707	\$ 312,096
Interest-bearing	791,601	607,211
Savings and money market accounts	604,495	506,692
Time	504,739	303,452
Total deposits	<u>2,617,542</u>	<u>1,729,451</u>
Federal Home Loan Bank advances	10,000	10,000
Subordinated notes	29,418	—
Other liabilities	33,493	24,704
Total liabilities	<u>2,690,453</u>	<u>1,764,155</u>
Shareholders' equity:		
Common stock, voting, \$1 par value; 25,000,000 shares authorized; 21,947,805 and 18,361,922 shares issued and outstanding at September 30, 2020 and December 31, 2019, respectively	21,948	18,362
Additional paid-in capital	246,847	207,083
Retained earnings	58,296	46,218
Accumulated other comprehensive income, net of income tax	6,804	1,383
Total shareholders' equity	<u>333,895</u>	<u>273,046</u>
Total liabilities and shareholders' equity	<u>\$ 3,024,348</u>	<u>\$ 2,037,201</u>

See accompanying notes to consolidated financial statements (unaudited).

CAPSTAR FINANCIAL HOLDINGS, INC. & SUBSIDIARY
Consolidated Statements of Income (Unaudited)
(Dollars in thousands, except share data)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2020	2019	2020	2019
Interest income:				
Loans, including fees	\$ 22,796	\$ 21,005	\$ 61,620	\$ 62,596
Securities:				
Taxable	1,193	1,028	3,465	3,540
Tax-exempt	343	354	975	1,093
Federal funds sold	—	1	—	26
Restricted equity securities	139	183	421	584
Interest-bearing deposits in financial institutions	171	645	640	1,502
Total interest income	<u>24,642</u>	<u>23,216</u>	<u>67,121</u>	<u>69,341</u>
Interest expense:				
Interest-bearing deposits	640	2,102	3,371	5,523
Savings and money market accounts	2,537	1,944	4,819	5,445
Time deposits	1,299	1,887	4,197	5,917
Federal funds purchased	—	—	—	4
Securities sold under agreements to repurchase	—	—	—	5
Federal Home Loan Bank advances	116	127	348	1,281
Subordinated notes	394	—	394	—
Total interest expense	<u>4,986</u>	<u>6,060</u>	<u>13,129</u>	<u>18,175</u>
Net interest income	<u>19,656</u>	<u>17,156</u>	<u>53,992</u>	<u>51,166</u>
Provision for loan losses	2,119	(125)	11,295	761
Net interest income after provision for loan losses	<u>17,537</u>	<u>17,281</u>	<u>42,697</u>	<u>50,405</u>
Noninterest income:				
Treasury management and other deposit service charges	1,064	788	2,531	2,399
Net gain (loss) on sale of securities	34	—	74	(108)
Tri-Net fees	668	847	2,528	2,511
Mortgage banking income	9,686	2,679	19,063	7,151
Wealth management fees	382	379	1,162	1,018
Interchange and debit card transaction fees	936	754	2,389	2,323
Other noninterest income	2,034	1,341	3,753	3,261
Total noninterest income	<u>14,804</u>	<u>6,788</u>	<u>31,500</u>	<u>18,555</u>
Noninterest expense:				
Salaries and employee benefits	12,949	9,229	33,256	26,224
Data processing and software	2,353	1,790	6,317	5,126
Professional fees	638	528	1,854	1,571
Occupancy	999	858	2,615	2,550
Equipment	864	1,012	2,295	2,890
Regulatory fees	397	18	893	564
Merger related expenses	2,548	187	3,286	2,491
Amortization of intangibles	539	408	1,300	1,258
Other operating	1,452	1,501	4,067	4,054
Total noninterest expense	<u>22,739</u>	<u>15,531</u>	<u>55,883</u>	<u>46,728</u>
Income before income taxes	<u>9,602</u>	<u>8,538</u>	<u>18,314</u>	<u>22,232</u>
Income tax expense	2,115	2,072	3,299	5,231
Net income	<u>\$ 7,487</u>	<u>\$ 6,466</u>	<u>\$ 15,015</u>	<u>\$ 17,001</u>
Per share information:				
Basic net income per share of common stock	<u>\$ 0.34</u>	<u>\$ 0.36</u>	<u>\$ 0.77</u>	<u>\$ 0.96</u>
Diluted net income per share of common stock	<u>\$ 0.34</u>	<u>\$ 0.35</u>	<u>\$ 0.77</u>	<u>\$ 0.91</u>
Weighted average shares outstanding:				
Basic	<u>21,948,579</u>	<u>17,741,778</u>	<u>19,558,281</u>	<u>17,729,518</u>
Diluted	<u>21,960,490</u>	<u>18,532,479</u>	<u>19,583,448</u>	<u>18,670,280</u>

See accompanying notes to consolidated financial statements (unaudited).

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2020	2019	2020	2019
Net income	\$ 7,487	\$ 6,466	\$ 15,015	\$ 17,001
Other comprehensive income:				
Unrealized gains (losses) on securities available-for-sale:				
Unrealized holding gains (losses) arising during the period	(440)	1,112	3,902	6,502
Reclassification adjustment for (gains) losses included in net income	(34)	—	(74)	108
Tax effect	(40)	(291)	(1,086)	(1,729)
Net of tax	(514)	821	2,742	4,881
Unrealized losses on cash flow hedges:				
Unrealized holding losses arising during the period	—	—	—	(702)
Reclassification adjustment for losses included in net income	2,167	265	2,679	627
Tax effect	—	—	—	(218)
Net of tax	2,167	265	2,679	(293)
Other comprehensive income	1,653	1,086	5,421	4,588
Comprehensive income	\$ 9,140	\$ 7,552	\$ 20,436	\$ 21,589

See accompanying notes to consolidated financial statements (unaudited).

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

	Preferred stock	Common Stock, voting		Common Stock, nonvoting		Additional paid-in capital	Retained earnings	Accumulated other comprehensive income	Total shareholders' equity
		Shares	Amount	Shares	Amount				
Balance December 31, 2019	\$ —	18,361,922	\$ 18,362	—	\$ —	\$ 207,083	\$ 46,218	\$ 1,383	\$ 273,046
Net issuance 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 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 of restricted common stock	—	13,899	14	—	—	(27)	—	—	(13)
Stock-based compensation expense	—	—	—	—	—	330	—	—	330
Issuance of common stock in conjunction with mergers	—	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

See accompanying notes to consolidated financial statements (unaudited).

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

	Preferred stock	Common Stock, voting		Common Stock, nonvoting		Additional paid-in capital	Retained earnings	Accumulated other comprehensive income (loss)	Total shareholders' equity
		Shares	Amount	Shares	Amount				
Balance December 31, 2018	\$ 878	17,592,160	\$ 17,592	132,561	\$ 133	\$ 211,789	\$ 27,303	\$ (3,316)	\$ 254,379
Net issuance of restricted common stock	—	13,801	14	—	—	(182)	—	—	(168)
Stock-based compensation expense	—	—	—	—	—	344	—	—	344
Net exercise of common stock options	—	182,002	182	—	—	998	—	—	1,180
Repurchase of common stock	—	(155,400)	(155)	—	—	(2,276)	—	—	(2,431)
Common and preferred stock dividends declared (\$0.05 per share)	—	—	—	—	—	—	(744)	—	(744)
Net income	—	—	—	—	—	—	4,779	—	4,779
Other comprehensive loss	—	—	—	—	—	—	—	2,412	2,412
Balance March 31, 2019	878	17,632,563	17,633	132,561	133	210,673	31,338	(904)	259,751
Net issuance of restricted common stock	—	(6,826)	(7)	—	—	(6)	—	—	(13)
Stock-based compensation expense	—	—	—	—	—	340	—	—	340
Net exercise of common stock options	—	22,778	23	—	—	51	—	—	74
Repurchase of common stock	—	(219,600)	(220)	—	—	(3,185)	—	—	(3,405)
Common and preferred stock dividends declared (\$0.05 per share)	—	—	—	—	—	—	(929)	—	(929)
Net income	—	—	—	—	—	—	5,756	—	5,756
Other comprehensive loss	—	—	—	—	—	—	—	1,090	1,090
Balance June 30, 2019	878	17,428,915	17,429	132,561	133	207,873	36,165	186	262,664
Net issuance of restricted common stock	—	(5,335)	(6)	—	—	(28)	—	—	(34)
Stock-based compensation expense	—	—	—	—	—	351	—	—	351
Net exercise of common stock options	—	39,000	39	—	—	431	—	—	470
Conversion of preferred stock to common stock	(878)	878,048	878	—	—	—	—	—	—
Conversion of non-voting common stock to common stock	—	132,561	133	(132,561)	(133)	—	—	—	—
Repurchase of common stock	—	(129,786)	(130)	—	—	(1,870)	—	—	(2,000)
Common and preferred stock dividends declared (\$0.05 per share)	—	—	—	—	—	—	(921)	—	(921)
Net income	—	—	—	—	—	—	6,466	—	6,466
Other comprehensive income	—	—	—	—	—	—	—	1,086	1,086
Balance September 30, 2019	\$ —	\$ 18,343,403	\$ 18,343	\$ —	\$ —	\$ 206,757	\$ 41,710	\$ 1,272	\$ 268,082

See accompanying notes to consolidated financial statements (unaudited).

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

	Nine Months Ended September 30,	
	2020	2019
Cash flows from operating activities:		
Net income	\$ 15,015	\$ 17,001
Adjustments to reconcile net income to net cash used in operating activities:		
Provision for loan losses	11,295	761
Accretion of discounts on acquired loans and deferred fees	(3,446)	(1,908)
Depreciation and amortization	2,261	2,192
Net amortization of premiums on investment securities	994	577
Net (gain) loss on sale of securities	(74)	108
Mortgage banking income	(19,063)	(7,151)
Tri-Net fees	(2,528)	(2,511)
Net gain on sale of loans	(525)	(823)
Net gain on disposal of premises and equipment	(303)	—
Net gain on sale of other real estate owned	(108)	(3)
Stock-based compensation	1,231	1,035
Deferred income tax expense	1,788	874
Origination of loans held for sale	(845,982)	(594,982)
Proceeds from loans held for sale	834,392	532,649
Cash payments arising from operating leases	(1,402)	(1,338)
Amortization of debt issuance expense	31	—
Net increase in accrued interest receivable and other assets	(6,406)	(9,287)
Net increase in accrued interest payable and other liabilities	4,186	10,352
Net cash used in operating activities	(8,644)	(52,454)
Cash flows from investing activities:		
Activities in securities available-for-sale:		
Purchases	(134,935)	(27,342)
Sales	77,338	54,133
Maturities, prepayments and calls	64,009	19,460
Activities in securities held-to-maturity:		
Maturities, prepayments and calls	880	396
Net redemption (purchase) of restricted equity securities	1,154	(1,862)
Net (increase) decrease in loans	(185,614)	20,661
Purchase of premises and equipment	(417)	(1,520)
Proceeds from the sale of premises and equipment	2,660	—
Proceeds from sale of other real estate	1,665	127
Cash received from mergers, net	63,482	—
Net cash (used in) provided by investing activities	(109,778)	64,053
Cash flows from financing activities:		
Net increase in deposits	445,414	161,755
Proceeds from Federal Home Loan Bank advances	680,000	75,000
Payments on Federal Home Loan Bank advances	(680,000)	(190,000)
Issuance of subordinated notes	29,387	—
Repurchase of common stock	(1,437)	(7,836)
Exercise of common stock options and warrants, net of repurchase of restricted shares	(29)	1,509
Common and preferred stock dividends paid	(2,936)	(2,573)
Termination of interest rate swap agreements and related reclassification adjustment for unrealized losses included in income	2,679	(876)
Net cash provided by financing activities	473,078	36,979
Net increase in cash and cash equivalents	354,656	48,578
Cash and cash equivalents at beginning of period	101,269	105,443
Cash and cash equivalents at end of period	\$ 455,925	\$ 154,021
Supplemental disclosures of cash paid:		
Interest paid	\$ 12,525	\$ 18,565
Income taxes	5,620	314
Supplemental disclosures of noncash transactions:		
Transfer of loans to other real estate	\$ 113	\$ 50
Loans charged off to the allowance for loan losses	1,014	532
Lease liabilities arising from obtaining right-of-use assets	668	—
Unrealized gains on securities available for sale	2,742	4,881
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	—
Conversion of preferred stock and non-voting common stock	—	1,011

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, 2020 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 footnotes 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 Company’s Annual Report on Form 10-K for the year ended December 31, 2019.

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 on the market price of the stock as of the closing of the acquisition.

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 Company’s Annual Report on Form 10-K for the year ended December 31, 2019.

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 events or transactions that occurred after September 30, 2020 through the date of the issued financial statements.

NOTE 2 – ACQUISITIONS

FCB Merger

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

Subject to the terms and conditions set forth in the FCB Merger Agreement, at the effective time of the FCB Merger, 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 Merger (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 Merger

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

On the terms and subject to the conditions set forth in the BOW Merger Agreement, at the effective time of the BOW Merger, 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 Merger (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 Mergers 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 Mergers 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 Mergers is not amortizable for book or tax purposes. The following table summarizes the consideration paid for the Mergers 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.

Consolidated revenue and earnings information for FCB and BOW was not available for the three and nine months ended September 30, 2019. As such, the presentation of comparative supplemental pro forma revenue and earnings for the three and nine months ended September 30, 2020 and 2019 of the combined results of the Company, FCB and BOW as if the merger had occurred as of January 1, 2019 was impracticable.

NOTE 3 – SECURITIES

The amortized cost and fair value of securities available-for-sale and held-to-maturity at September 30, 2020 and December 31, 2019 are summarized as follows (in thousands):

	September 30, 2020				December 31, 2019			
	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	\$ 12,909	\$ 79	\$ —	\$ 12,988	\$ 10,421	\$ 4	\$ (94)	\$ 10,331
State and municipal securities	53,972	2,293	(92)	56,173	44,053	1,927	(20)	45,960
Mortgage-backed securities	205,734	4,975	(263)	210,446	137,305	1,834	(460)	138,679
Asset-backed securities	3,325	—	(194)	3,131	3,325	—	(128)	3,197
Other debt securities	25,383	340	(124)	25,599	14,839	141	(18)	14,962
Total	\$ 301,323	\$ 7,687	\$ (673)	\$ 308,337	\$ 209,943	\$ 3,906	\$ (720)	\$ 213,129
Securities held-to-maturity:								
State and municipal securities	\$ 2,413	\$ 113	\$ —	\$ 2,526	\$ 3,313	\$ 98	\$ —	\$ 3,411
Total	\$ 2,413	\$ 113	\$ —	\$ 2,526	\$ 3,313	\$ 98	\$ —	\$ 3,411

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, 2020 and December 31, 2019, 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, 2020						
U. S. government agency securities	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —
State and municipal securities	9,095	(92)	—	—	9,095	(92)
Mortgage-backed securities	53,584	(200)	1,531	(63)	55,115	(263)
Asset-backed securities	—	—	3,131	(194)	3,131	(194)
Other debt securities	8,080	(114)	1,493	(10)	9,573	(124)
Total temporarily impaired securities	\$ 70,759	\$ (406)	\$ 6,155	\$ (267)	\$ 76,914	\$ (673)
December 31, 2019						
U. S. government agency securities	\$ 6,694	\$ (51)	\$ 1,637	\$ (43)	\$ 8,331	\$ (94)
State and municipal securities	2,356	(12)	814	(8)	3,170	(20)
Mortgage-backed securities	30,570	(136)	21,364	(324)	51,934	(460)
Asset-backed securities	—	—	3,197	(128)	3,197	(128)
Other debt securities	3,012	(16)	1,502	(2)	4,514	(18)
Total temporarily impaired securities	\$ 42,632	\$ (215)	\$ 28,514	\$ (505)	\$ 71,146	\$ (720)

As noted in the table above, as of September 30, 2020, the Company had gross unrealized losses of \$0.7 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 a 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, 2020, 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, 2020.

Securities with a carrying value of \$60.8 million at September 30, 2020 were pledged to collateralize public deposits, derivative positions and Federal Home Loan Bank advances.

Results from sales of securities were as follows (in thousands):

	<u>Nine Months Ended September 30, 2020</u>	<u>Nine Months Ended September 30, 2019</u>
Proceeds	\$ 77,338	\$ 54,133
Gross gains	83	370
Gross losses	(9)	(478)

The amortized cost and fair value of securities at September 30, 2020, 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.

	<u>Available-for-sale</u>		<u>Held-to-maturity</u>	
	<u>Amortized cost</u>	<u>Estimated fair value</u>	<u>Amortized cost</u>	<u>Estimated fair value</u>
Due in less than one year	\$ 21,552	\$ 21,660	\$ 599	\$ 614
Due one to five years	34,023	34,839	1,814	1,912
Due five to ten years	31,646	33,262	—	—
Due beyond ten years	5,043	4,999	—	—
Mortgage-backed securities	205,734	210,446	—	—
Asset-backed securities	3,325	3,131	—	—
Total	<u>\$ 301,323</u>	<u>\$ 308,337</u>	<u>\$ 2,413</u>	<u>\$ 2,526</u>

NOTE 4 – LOANS AND ALLOWANCE FOR LOAN LOSSES

A summary of the loan portfolio as of September 30, 2020 and December 31, 2019 follows (in thousands):

	<u>September 30, 2020</u>	<u>December 31, 2019</u>
Commercial real estate	\$ 644,442	\$ 559,899
Consumer real estate	350,238	256,097
Construction and land development	176,751	143,111
Commercial and industrial	648,018	394,408
Consumer	42,104	28,426
Other	45,050	38,161
Total	<u>1,906,603</u>	<u>1,420,102</u>
Allowance for loan losses	<u>(23,167)</u>	<u>(12,604)</u>
Total loans, net	<u>\$ 1,883,436</u>	<u>\$ 1,407,498</u>

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-year term and will earn interest at a rate of 1%. The Company assisted customers with applications for resources through the program and funded 1,475 loans. As of September 30, 2020, the outstanding balance of loans originated under the PPP totaled \$222.3 million 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 \$5.6 million as of September 30, 2020. These fees are deferred and amortized over the life of the loan.

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 the novel coronavirus (“COVID-19”) global pandemic and the resulting impact on the Company’s loan portfolio as of September 30, 2020, 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 present the loan balances by category as well as risk rating (in thousands):

September 30, 2020	Pass/Watch	Special Mention	Substandard	Doubtful	Total Impaired Loans	Total
Commercial real estate	\$ 601,861	\$ 31,598	\$ 2,843	\$ —	\$ 1,193	\$ 637,495
Consumer real estate	327,953	2,239	1,264	35	930	332,421
Construction and land development	171,105	5,168	8	—	106	176,387
Commercial and industrial	595,034	24,351	25,091	—	83	644,559
Consumer	38,708	393	18	5	4	39,128
Other	44,350	34	—	93	—	44,477
Purchased credit impaired	20,545	5,735	4,446	1,410	—	32,136
Total	\$ 1,799,556	\$ 69,518	\$ 33,670	\$ 1,543	\$ 2,316	\$ 1,906,603

December 31, 2019						
Commercial real estate	\$ 551,929	\$ 915	\$ 4,438	\$ —	\$ 2,507	\$ 559,789
Consumer real estate	252,952	503	1,551	—	483	255,489
Construction and land development	142,978	—	16	—	112	143,106
Commercial and industrial	370,475	14,341	8,241	—	487	393,544
Consumer	28,382	6	15	—	5	28,408
Other	38,161	—	—	—	—	38,161
Purchased credit impaired	—	—	1,605	—	—	1,605
Total	\$ 1,384,877	\$ 15,765	\$ 15,866	\$ —	\$ 3,594	\$ 1,420,102

The following table details the changes in the ALL for the three and nine months ended September 30, 2020 and 2019 (in thousands):

	Commercial real estate	Consumer real estate	Construction and land development	Commercial and industrial	Consumer	Other	Total
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>
Three Months Ended September 30, 2019							
Balance, beginning of period	\$ 3,922	\$ 1,142	\$ 1,733	\$ 5,518	\$ 166	\$ 422	\$ 12,903
Charged-off loans	—	—	—	(282)	(30)	(20)	(332)
Recoveries	4	2	—	356	18	2	382
Provision for loan losses	(36)	101	209	(468)	53	16	(125)
Balance, end of period	<u>\$ 3,890</u>	<u>\$ 1,245</u>	<u>\$ 1,942</u>	<u>\$ 5,124</u>	<u>\$ 207</u>	<u>\$ 420</u>	<u>\$ 12,828</u>

	Commercial real estate	Consumer real estate	Construction and land development	Commercial and industrial	Consumer	Other	Total
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>

Nine Months Ended September 30, 2019

Balance, beginning of period	\$ 3,309	\$ 1,005	\$ 2,431	\$ 5,036	\$ 105	\$ 227	\$ 12,113
Charged-off loans	—	—	—	(308)	(109)	(115)	(532)
Recoveries	16	18	—	371	60	21	486
Provision for loan losses	565	222	(489)	25	151	287	761
Balance, end of period	<u>\$ 3,890</u>	<u>\$ 1,245</u>	<u>\$ 1,942</u>	<u>\$ 5,124</u>	<u>\$ 207</u>	<u>\$ 420</u>	<u>\$ 12,828</u>

A breakdown of the ALL and the loan portfolio by loan category at September 30, 2020 and December 31, 2019 follows (in thousands):

	Commercial real estate	Consumer real estate	Construction and land development	Commercial and industrial	Consumer	Other	Total
September 30, 2020							
Allowance for Loan Losses:							
Collectively evaluated for impairment	\$ 5,829	\$ 1,817	\$ 3,112	\$ 11,700	\$ 200	\$ 439	\$ 23,097
Individually evaluated for impairment	—	—	70	—	—	—	70
Purchased credit impaired	—	—	—	—	—	—	—
Balances, 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>
Loans:							
Collectively evaluated for impairment	\$ 636,302	\$ 331,491	\$ 176,281	\$ 644,476	\$ 39,124	\$ 44,477	\$ 1,872,151
Individually evaluated for impairment	1,193	930	106	83	4	—	2,316
Purchased credit impaired	6,947	17,817	364	3,459	2,976	573	32,136
Balances, end of period	<u>\$ 644,442</u>	<u>\$ 350,238</u>	<u>\$ 176,751</u>	<u>\$ 648,018</u>	<u>\$ 42,104</u>	<u>\$ 45,050</u>	<u>\$ 1,906,603</u>
December 31, 2019							
Allowance for Loan Losses:							
Collectively evaluated for impairment	\$ 3,599	\$ 1,231	\$ 2,058	\$ 5,074	\$ 222	\$ 420	\$ 12,604
Individually evaluated for impairment	—	—	—	—	—	—	—
Purchased credit impaired	—	—	—	—	—	—	—
Balances, end of period	<u>\$ 3,599</u>	<u>\$ 1,231</u>	<u>\$ 2,058</u>	<u>\$ 5,074</u>	<u>\$ 222</u>	<u>\$ 420</u>	<u>\$ 12,604</u>
Loans:							
Collectively evaluated for impairment	\$ 557,282	\$ 255,006	\$ 142,994	\$ 393,057	\$ 28,403	\$ 38,161	\$ 1,414,903
Individually evaluated for impairment	2,507	483	112	487	5	—	3,594
Purchased credit impaired	110	608	5	864	18	—	1,605
Balances, end of period	<u>\$ 559,899</u>	<u>\$ 256,097</u>	<u>\$ 143,111</u>	<u>\$ 394,408</u>	<u>\$ 28,426</u>	<u>\$ 38,161</u>	<u>\$ 1,420,102</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, 2020 and December 31, 2019. 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 (dollars in thousands):

	September 30, 2020		December 31, 2019	
	Amount	Percent of total loans	Amount	Percent of total loans
Commercial real estate	\$ 5,829	0.31%	\$ 3,599	0.25%
Consumer real estate	1,817	0.10	1,231	0.09
Construction and land development	3,182	0.17	2,058	0.14
Commercial and industrial	11,700	0.61	5,074	0.36
Consumer	200	0.01	222	0.02
Other	439	0.02	420	0.03
Total allowance for loan losses	<u>\$ 23,167</u>	<u>1.22%</u>	<u>\$ 12,604</u>	<u>0.89%</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, 2020 and December 31, 2019 (in thousands):

	September 30, 2020			December 31, 2019		
	Recorded investment	Unpaid principal balance	Related allowance	Recorded investment	Unpaid principal balance	Related allowance
With no related allowance recorded:						
Commercial real estate	\$ 1,193	\$ 1,176	\$ —	\$ 2,507	\$ 2,446	\$ —
Consumer real estate	930	945	—	483	497	—
Construction and land development	—	—	—	112	117	—
Commercial and industrial	83	318	—	487	710	—
Consumer	4	4	—	5	5	—
Other	—	—	—	—	—	—
Subtotal	<u>2,210</u>	<u>2,443</u>	<u>—</u>	<u>3,594</u>	<u>3,775</u>	<u>—</u>
With an allowance recorded:						
Commercial real estate	—	—	—	—	—	—
Consumer real estate	—	—	—	—	—	—
Construction and land development	106	111	70	—	—	—
Commercial and industrial	—	—	—	—	—	—
Consumer	—	—	—	—	—	—
Other	—	—	—	—	—	—
Subtotal	<u>106</u>	<u>111</u>	<u>70</u>	<u>—</u>	<u>—</u>	<u>—</u>
Total	<u>\$ 2,316</u>	<u>\$ 2,554</u>	<u>\$ 70</u>	<u>\$ 3,594</u>	<u>\$ 3,775</u>	<u>\$ —</u>

The following presents information related to the average recorded investment and interest income recognized on impaired loans, excluding PCI loans, for the three and nine months ended September 30, 2020 and 2019 (in thousands):

	Three Months Ended September 30, 2020		Three Months Ended September 30, 2019		Nine Months Ended September 30, 2020		Nine Months Ended September 30, 2019	
	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	\$ 1,191	\$ 17	\$ 2,511	\$ 40	\$ 1,458	\$ 57	\$ 2,512	\$ 118
Consumer real estate	961	9	670	6	982	27	679	23
Construction and land development	—	—	116	—	—	—	122	4
Commercial and industrial	90	—	932	6	176	2	1,043	20
Consumer	4	—	12	—	4	—	13	—
Other	—	—	—	—	—	—	—	—
Subtotal	2,246	26	4,241	52	2,620	86	4,369	165
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	\$ 2,353	\$ 26	\$ 4,241	\$ 52	\$ 2,728	\$ 86	\$ 4,369	\$ 165

There was no interest income recognized on a cash basis for impaired loans during the three months ended September 30, 2020 or 2019.

The following table presents the aging of the recorded investment in past due loans as of September 30, 2020 and December 31, 2019 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, 2020						
Commercial real estate	\$ 20	\$ 1,176	\$ —	\$ 1,196	\$ 636,299	\$ 637,495
Consumer real estate	162	772	380	1,314	331,107	332,421
Construction and land development	464	64	—	528	175,859	176,387
Commercial and industrial	959	654	328	1,941	642,618	644,559
Consumer	90	12	4	106	39,022	39,128
Other	182	—	—	182	44,295	44,477
Purchased credit impaired	1,799	222	1,069	3,090	29,046	32,136
Total	\$ 3,676	\$ 2,900	\$ 1,781	\$ 8,357	\$ 1,898,246	\$ 1,906,603
December 31, 2019						
Commercial real estate	\$ 372	\$ —	\$ —	\$ 372	\$ 559,417	\$ 559,789
Consumer real estate	3,567	408	501	4,476	251,013	255,489
Construction and land development	653	—	—	653	142,453	143,106
Commercial and industrial	1,277	8	440	1,725	391,819	393,544
Consumer	67	—	26	93	28,315	28,408
Other	—	—	—	—	38,161	38,161
Purchased credit impaired	75	81	149	305	1,300	1,605
Total	\$ 6,011	\$ 497	\$ 1,116	\$ 7,624	\$ 1,412,478	\$ 1,420,102

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, 2020 and December 31, 2019 (in thousands):

	Non-Accrual	Past Due Over 89 Days and Accruing	Troubled Debt Restructurings
September 30, 2020			
Commercial real estate	\$ 24	\$ —	\$ 1,176
Consumer real estate	1,128	20	—
Construction and land development	122	—	—
Commercial and industrial	382	10	—
Consumer	21	—	—
Other	—	—	—
Purchased credit impaired	1,268	512	709
Total	<u>\$ 2,945</u>	<u>\$ 542</u>	<u>\$ 1,885</u>
December 31, 2019			
Commercial real estate	\$ —	\$ —	\$ 2,446
Consumer real estate	292	12	—
Construction and land development	102	—	—
Commercial and industrial	427	—	271
Consumer	—	26	—
Other	—	—	—
Purchased credit impaired	643	—	—
Total	<u>\$ 1,464</u>	<u>\$ 38</u>	<u>\$ 2,717</u>

As of September 30, 2020 and December 31, 2019, all loans classified as nonperforming were deemed to be impaired.

As of September 30, 2020 and December 31, 2019, the Company had a recorded investment in TDR of \$1.9 million and \$2.7 million, respectively. The Company had no specific allowance for those loans at September 30, 2020 or December 31, 2019 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 TDRs 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, 2020 or 2019. 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, 2020 or 2019.

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

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Acquired Loans

On July 1, 2020, the Company merged with FCB and BOW (see Note 2 for more information). As a result of the mergers, the Company recorded loans with a fair value of \$294.7 million. Of those loans, \$33.6 million were considered to be 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 PCI loans acquired in the merger 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 mergers 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 in the merger 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 mergers 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

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

	Three Months Ended September 30, 2020	Nine Months Ended September 30, 2020
Balance at beginning of period	\$ 1,545	\$ 1,605
Additions due to the Merger	\$ 33,593	\$ 33,593
Change due to payments received and accretion	(3,002)	(3,062)
Balance at end of period	<u>\$ 32,136</u>	<u>\$ 32,136</u>

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

	Three Months Ended September 30, 2020	Nine Months Ended September 30, 2020
Balance at beginning of period	\$ 829	\$ 915
Additions due to the Merger	\$ 4,349	\$ 4,349
Accretion	(672)	(758)
Balance at end of period	<u>\$ 4,506</u>	<u>\$ 4,506</u>

PCI loans had no impact on the ALL for the three or nine months ended September 30, 2020 or 2019.

NOTE 5 – PREMISES AND EQUIPMENT

The Company leases certain premises and equipment under operating leases. At September 30, 2020, the Company had lease liabilities totaling \$12.3 million and right-of-use assets totaling \$11.5 million related to these leases. Lease liabilities and right-of-use assets are reflected in other liabilities and other assets, respectively. At September 30, 2020, the weighted average remaining lease term for operating leases was 9.6 years and the weighted average discount rate used in the measurement of operating lease liabilities was 3.40%.

Lease costs were as follows (in thousands):

	Three Months Ended September 30, 2020	Nine Months Ended September 30, 2020
Operating lease cost	\$ 483	\$ 1,430
Short-term lease cost	—	—
Variable least cost	—	—
Total lease cost	<u>\$ 483</u>	<u>\$ 1,430</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, 2020 or 2019.

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, 2020
Lease payments due:	
2020	\$ 428
2021	1,726
2022	1,605
2023	1,558
2024	1,266
2025 and thereafter	7,815
Total undiscounted cash flows	14,398
Discount on cash flows	(2,144)
Total lease liability	<u>\$ 12,254</u>

NOTE 6 – SHORT TERM BORROWINGS AND LONG-TERM DEBT

Short-Term Borrowings

The Company had outstanding borrowings totaling \$10.0 million at September 30, 2020 and December 31, 2019, via various advances. These advances are non-callable; interest payments are due monthly, with principal due at maturity.

The following is a summary of the contractual maturities and average effective rates of outstanding advances (dollars in thousands):

Year	September 30, 2020		December 31, 2019	
	Amount	Interest Rates	Amount	Interest Rates
2020	\$ —	—	\$ 10,000	2.05%
2021	10,000	0.30%	—	—
Total	<u>\$ 10,000</u>	<u>0.30%</u>	<u>\$ 10,000</u>	<u>2.05%</u>

Advances from the FHLB are collateralized by investment securities with a market value of \$2.3 million, FHLB stock and certain commercial and residential real estate mortgage loans totaling \$822.3 million under a blanket mortgage collateral agreement. At September 30, 2020, the amount of available credit from the FHLB totaled \$211.9 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 \$29.4 million at September 30, 2020. There were no subordinated notes at December 31, 2019.

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, 2020 and 2019 (in thousands):

	Gains and Losses on Cash Flow Hedges	Unrealized Gains and Losses on Available for Sale Securities	Total
Nine Months Ended September 30, 2020			
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 (loss), 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>
Nine Months Ended September 30, 2019			
Beginning balance	\$ (2,636)	\$ (680)	\$ (3,316)
Other comprehensive income before reclassification, net of tax	325	4,961	5,286
Amounts reclassified from accumulated other comprehensive income (loss), net of tax	(618)	(80)	(698)
Net current period other comprehensive income (loss)	(293)	4,881	4,588
Ending Balance	<u>\$ (2,929)</u>	<u>\$ 4,201</u>	<u>\$ 1,272</u>

The following were significant amounts reclassified out of each component of accumulated other comprehensive income (loss) for the three and nine months ended September 30, 2020 and 2019 (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
	2020	2019	2020	2019	
Realized losses on cash flow hedges	\$ (2,060)	\$ (212)	\$ (2,466)	\$ (436)	Interest expense - money market
	(107)	(53)	(213)	(191)	Interest expense - Federal Home Loan
	—	—	—	9	Bank advances
	<u>\$ (2,167)</u>	<u>\$ (265)</u>	<u>\$ (2,679)</u>	<u>\$ (618)</u>	Income tax benefit
Realized gains (losses) on available-for-sale securities	\$ 34	\$ —	\$ 74	\$ (108)	Net gain (loss) on sale of securities
	(9)	—	(19)	28	Income tax benefit (expense)
	<u>\$ 25</u>	<u>\$ 0</u>	<u>\$ 55</u>	<u>\$ (80)</u>	Net of tax

NOTE 8 – INCOME TAXES

The Company's effective tax rate for the three and nine months ended September 30, 2020 was 22.0% and 18.0% compared to 24.3% and 23.5% for the three and nine months ended September 30, 2019, respectively.

The effective tax rate compared favorably to the statutory federal rate of 21% and Tennessee excise tax rate of 6.5% primarily due to the enactment of new Net Operating Loss (“NOL”) provisions under the Coronavirus Aid, Relief, and Economic Security Act (“CARES Act”). The CARES Act permits NOLs 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 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 period ended March 31, 2020. In addition to the permanent tax rate benefit, the effective tax rate compared favorably to the statutory rate due to investments in qualified municipal securities, company owned life insurance, state tax credits, net of the effect of certain non-deductible expenses and the recognition of excess tax benefits related to stock compensation.

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, 2020 and December 31, 2019 (in thousands):

	Contract or notional amount	
	September 30, 2020	December 31, 2019
Financial instruments whose contract amounts represent credit risk:		
Unused commitments to extend credit	\$ 761,203	\$ 672,933
Standby letters of credit	11,065	9,634
Total	<u>\$ 772,268</u>	<u>\$ 682,567</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, 2020, 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, 2020 and December 31, 2019. 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 period ended September 30, 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 unrealized gains or losses in accumulated other comprehensive income as of September 30, 2020.

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 risk to the Company. A summary of the Company's customer related interest rate swaps was as follows (in thousands):

	September 30, 2020		December 31, 2019	
	Notional amount	Estimated fair value	Notional amount	Estimated fair value
Interest rate swap agreements:				
Pay fixed/receive variable swaps	\$ 54,951	\$ (3,020)	\$ 45,053	\$ (926)
Pay variable/receive fixed swaps	54,951	3,020	45,053	926
Total	<u>\$ 109,902</u>	<u>\$ —</u>	<u>\$ 90,106</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 gains (losses) relating to mortgage banking derivative instruments included in mortgage banking income were as follows (dollars in thousands):

	Three Months Ended	Nine Months Ended
	September 30, 2020	September 30, 2020
Mortgage loan interest rate lock commitments	\$ 493	\$ 3,488
Mortgage-backed securities forward sales commitments	(1,663)	(5,225)
Total	<u>\$ (1,170)</u>	<u>\$ (1,737)</u>

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

	September 30, 2020		December 31, 2019	
	Notional amount	Estimated fair value	Notional amount	Estimated fair value
Included in other assets:				
Mortgage loan interest rate lock commitments	\$ 131,057	\$ 4,136	\$ 44,694	\$ 648
Included in other liabilities:				
Mortgage-backed securities forward sales commitments	\$ 118,000	\$ (426)	\$ 38,500	\$ 148

NOTE 11 – STOCK OPTIONS AND RESTRICTED SHARES

During 2008, the board of directors of the Bank approved the CapStar Bank 2008 Stock Incentive Plan. Following the formation of CapStar Financial Holdings, Inc. in 2016, and in connection with the Share Exchange, the outstanding awards of restricted stock and stock options under the CapStar Bank 2008 Stock Incentive Plan were exchanged for similar awards of restricted stock and stock options issued by CapStar Financial Holdings, Inc. under the CapStar Financial Holdings, Inc. Stock Incentive Plan (the "Plan"), which the board of directors adopted in 2016. The Stock Incentive 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. The Plan reserved 1,569,475 shares of stock for issuance of stock incentives. Stock incentives include both restricted share and stock option grants. During 2018, the board of directors approved the addition of 400,000 shares of stock for issuance of stock incentives under the Plan. Total shares issuable under the plan were 287,734 at September 30, 2020.

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,	
	2020	2019	2020	2019
Stock-based compensation expense before income taxes	\$ 330	\$ 351	\$ 1,231	\$ 1,035
Less: deferred tax benefit	(86)	(92)	(322)	(271)
Reduction of net income	\$ 244	\$ 259	\$ 909	\$ 764

Restricted Shares

Compensation expense is recognized over the vesting period of the awards based on the fair value of the stock at the issue date. The fair value of each restricted stock grant is based on valuations performed by independent consultants. 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. Restricted shares fully vest on the third anniversary of the grant date. A summary of the changes in the Company's nonvested restricted shares for the nine months ended September 30, 2020 follows:

<u>Nonvested Shares</u>	<u>Restricted Shares</u>	<u>Weighted Average Grant Date Fair Value</u>
Nonvested at beginning of period	84,697	\$ 17.44
Granted	98,981	13.76
Vested	(64,324)	16.64
Forfeited	(3,958)	16.36
Nonvested at end of period	115,396	\$ 14.77

As of September 30, 2020, there was \$1.1 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 1.5 years. The total fair value of shares vested during the nine months ended September 30, 2020 and 2019 was \$0.9 million and \$1.0 million, respectively.

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 2020. The Company granted 50,000 options during 2019.

The fair value of options granted during 2019 was determined using the following weighted average assumptions as of the grant date.

	<u>2019</u>
Dividend yield	1.35%
Expected term (in years)	6.50
Expected stock price volatility	29.55%
Risk-free interest rate	2.25%

A summary of the activity in stock options for the nine months ended September 30, 2020 follows:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (years)
Outstanding at beginning of period	271,202	\$ 11.22	
Granted	—	—	
Exercised	(24,613)	6.75	
Forfeited or expired	(20,000)	10.92	
Outstanding at end of period	<u>226,589</u>	<u>\$ 11.73</u>	<u>4.1</u>
Fully vested and expected to vest	<u>226,589</u>	<u>\$ 11.73</u>	<u>4.1</u>
Exercisable at end of period	<u>193,255</u>	<u>\$ 11.19</u>	<u>3.3</u>

Information related to stock options during each year follows:

	2020	2019
Intrinsic value of options exercised	\$ 188,662	\$ 2,208,930
Cash received from option exercises	105,847	1,723,704
Tax benefit realized from option exercises	16,524	37,468
Weighted average fair value of options granted	—	5.35

As of September 30, 2020, 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 1.6 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, 2020, 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, 2020 and December 31, 2019 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, 2020:						
Total capital to risk-weighted assets:						
CapStar Financial Holdings, Inc.	\$ 328,295	15.96%	\$ 164,521	8.00%	N/A	N/A
CapStar Bank	314,424	15.29	164,497	8.00	\$ 2,056	10%
Tier I capital to risk-weighted assets:						
CapStar Financial Holdings, Inc.	275,391	13.39	123,391	6.00	N/A	N/A
CapStar Bank	290,938	14.15	123,373	6.00	164,497	8.00
Common equity Tier 1 capital to risk weighted assets:						
CapStar Financial Holdings, Inc.	275,391	13.39	92,543	4.50	N/A	N/A
CapStar Bank	274,438	13.35	92,530	4.50	133,654	6.50
Tier I capital to average assets:						
CapStar Financial Holdings, Inc.	275,391	9.23	119,400	4.00	N/A	N/A
CapStar Bank	290,938	9.74	119,527	4.00	149,409	5.00
At December 31, 2019:						
Total capital to risk-weighted assets:						
CapStar Financial Holdings, Inc.	\$ 237,857	13.45%	\$ 141,436	8.00%	N/A	N/A
CapStar Bank	224,443	12.70	141,388	8.00	\$ 176,735	10%
Tier I capital to risk-weighted assets:						
CapStar Financial Holdings, Inc.	225,074	12.73	106,077	6.00	N/A	N/A
CapStar Bank	211,660	11.98	106,041	6.00	141,388	8.00
Common equity Tier 1 capital to risk weighted assets:						
CapStar Financial Holdings, Inc.	225,074	12.73	79,558	4.50	N/A	N/A
CapStar Bank	195,160	11.04	79,531	4.50	114,878	6.50
Tier I capital to average assets:						
CapStar Financial Holdings, Inc.	225,074	11.37	79,201	4.00	N/A	N/A
CapStar Bank	211,660	10.70	79,150	4.00	98,938	5.00

- (1) For the calendar year 2020, 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 months ended September 30, 2020 and 2019 (in thousands except share data):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2020	2019	2020	2019
Basic net income per share calculation:				
Numerator – Net income	\$ 7,487	\$ 6,466	\$ 15,015	\$ 17,001
Denominator – Average common shares outstanding	21,948,579	17,741,778	19,558,281	17,729,518
Basic net income per share	<u>\$ 0.34</u>	<u>\$ 0.36</u>	<u>\$ 0.77</u>	<u>\$ 0.96</u>
Diluted net income per share calculation:				
Numerator – Net income	\$ 7,487	\$ 6,466	\$ 15,015	\$ 17,001
Denominator – Average common shares outstanding	21,948,579	17,741,778	19,558,281	17,729,518
Dilutive shares contingently issuable	11,911	790,701	25,167	940,762
Average diluted common shares outstanding	21,960,490	18,532,479	19,583,448	18,670,280
Diluted net income per share	<u>\$ 0.34</u>	<u>\$ 0.35</u>	<u>\$ 0.77</u>	<u>\$ 0.91</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. The Company had no impaired loans carried at fair value at December 31, 2019.

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, 2020 or December 31, 2019.

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, 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-sponsored agencies	\$ 12,988	\$ —	\$ 12,988	\$ —
Obligations of states and political subdivisions	56,173	—	56,173	—
Mortgage-backed securities-residential	210,446	—	210,446	—
Asset-backed securities	3,131	—	3,131	—
Other debt securities	25,599	—	25,599	—
Loans held for sale	112,002	—	112,002	—
Derivative assets:				
Non-hedging derivatives:				
Interest rate swaps - customer related	3,020	—	3,020	—
Mortgage loan interest rate lock commitments	4,136	—	—	4,136
Liabilities:				
Derivative liabilities:				
Non-hedging derivatives:				
Derivative Liabilities - customer related	(3,020)	—	(3,020)	—
Mortgage-backed securities forward sales commitments	(426)	—	(426)	—

	Fair value measurements at December 31, 2019			
	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-sponsored agencies	\$ 10,331	\$ —	\$ 10,331	\$ —
Obligations of states and political subdivisions	45,960	—	45,960	—
Mortgage-backed securities-residential	138,679	—	138,679	—
Asset-backed securities	3,197	—	3,197	—
Other debt securities	14,962	—	14,962	—
Loans held for sale	30,740	—	30,740	—
Derivative assets:				
Non-hedging derivatives:				
Interest rate swaps - customer related	926	—	926	—
Mortgage loan interest rate lock commitments	648	—	—	648
Liabilities:				
Derivative liabilities:				
Non-hedging derivatives:				
Interest rate swaps - customer related	(926)	—	(926)	—

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, 2020 and 2019 (dollars in thousands):

	Mortgage Loan Interest Rate Lock Commitments	
	2020	2019
Balance of recurring Level 3 assets at January 1st	\$ 648	\$ —
Total gains or losses for the period:		
Included in mortgage banking income	3,488	807
Balance of recurring Level 3 assets at September 30th	<u>\$ 4,136</u>	<u>\$ 807</u>

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

September 30, 2020	Fair Value	Valuation Technique(s)	Unobservable Input(s)	Range (Weighted-Average)
Assets:				
Non-hedging derivatives:				
Mortgage loan interest rate lock commitments	\$ 4,136	Consensus pricing	Origination pull-through rate	59% - 97% (74%)
December 31, 2019				
Assets:				
Non-hedging derivatives:				
Mortgage loan interest rate lock commitments	\$ 648	Consensus pricing	Origination pull-through rate	68% - 95% (83%)

Assets measured at fair value on a nonrecurring basis are summarized below (in thousands): There were no assets measured at fair value on a nonrecurring basis at December 31, 2019.

	Fair value measurements at September 30, 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:				
Construction and land development	\$ 36	—	—	36

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

September 30, 2020	Fair Value	Valuation Technique(s)	Unobservable Input(s)	Range (Weighted-Average)
Impaired loans:				
Construction and land development	\$ 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, 2020 and December 31, 2019 were as follows (in thousands):

	September 30, 2020		December 31, 2019		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	\$ 455,925	\$ 455,925	\$ 101,094	\$ 101,094	Level 1
Federal funds sold	—	—	175	175	Level 1
Securities available-for-sale	308,337	308,337	213,129	213,129	Level 2
Securities held-to-maturity	2,413	2,526	3,313	3,411	Level 2
Loans held for sale	198,603	199,469	168,222	169,072	Level 2
Restricted equity securities	13,625	N/A	13,689	N/A	N/A
Loans	1,906,603	1,925,544	1,420,102	1,414,757	Level 3
Accrued interest receivable	9,814	9,814	5,792	5,792	Level 2
Other assets	46,420	46,420	36,393	36,393	Level 2 / Level 3
Financial liabilities:					
Deposits	2,617,542	2,621,366	1,729,451	1,730,206	Level 3
Federal Home Loan Bank advances and other borrowings	39,418	38,930	10,000	10,014	Level 2
Other liabilities	4,239	4,239	1,394	1,394	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) *Federal Funds Sold*

Federal funds sold clear on a daily basis. For this reason, the carrying amount is a reasonable estimate of fair value.

(c) *Restricted Equity Securities*

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

(d) *Loans*

In accordance with the prospective adoption of ASU No. 2016-01, 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.

(e) *Accrued Interest Receivable*

The carrying amounts of accrued interest approximate fair value.

(f) *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.

(g) *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.

(h) *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.

(i) *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.

(j) *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.

(k) *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, 2020 and December 31, 2019 and our results of operations for the three and nine months ended September 30, 2020 and 2019. 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 Annual Report on Form 10-K for the year ended December 31, 2019. Annualized results for interim periods may not be indicative of results for the full year or future periods. In addition to historical information, this discussion and analysis contains forward-looking statements that involve risks, uncertainties and assumptions that could cause actual results to differ materially from our current expectations. Factors that could cause such differences are discussed in the section entitled “Cautionary Note Regarding Forward-Looking Statements” in this Report and the section entitled “Item 1A. Risk Factors” in our Annual Report on Form 10-K for the year ended December 31, 2019. We assume no obligation to update any of these forward-looking statements except to the extent required by applicable law.

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 per share data or when otherwise specifically noted.

Overview

The third quarter of 2020 resulted in \$0.34 diluted net income per share of common stock, a decrease of 2.3% compared to the third quarter of 2019. Annualized return on average assets was 0.98% for the third quarter of 2020 compared to 1.28% for the same period in 2019.

For the nine months ended September 30, 2020, diluted net income per share of common stock was \$0.77, a decrease of 15.8% compared to the same period in 2019. Annualized return on average assets was 0.81% for the nine months ended September 30, 2020 compared to 1.14% for the same period in 2019.

At September 30, 2020, loans increased to \$1.91 billion, as compared to \$1.42 billion at December 31, 2019. Total deposits increased to \$2.62 billion at September 30, 2020 from \$1.73 billion at December 31, 2019.

The recent outbreak of a novel coronavirus, COVID-19, has resulted in a global pandemic causing the extended shutdown of certain businesses in the region. The recent developments to contain COVID-19 has adversely affected economic conditions in the United States generally and our markets in particular. The Company expects the effects of this health crisis, which include disruptions or restrictions in clients’ supply chains, closures of clients’ facilities or decreases in demand for clients’ products and services, to continue to adversely impact economic conditions. Also related to the health crisis, the U.S. has been operating under a presidential declared emergency since March 13, 2020, with various actions by the U.S. Congress and regulatory agencies. As a result of COVID-19, the Company experienced the decline of asset prices, reduction in interest rates, widening of credit spreads, borrower credit deterioration and market volatility. Although the Company is unable to estimate the extent of the impact, the continuing pandemic and related global economic crisis is likely to adversely impact its future operating results. Management is actively monitoring the situation and taking necessary actions to adjust operations to protect the health and well-being of employees and clients. 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.

The Company has taken a proactive approach to protecting our team members and their families as a result of COVID-19. The Company was an early adopter of a work from home strategy having previously made significant investments in laptops, virtual private network access, and bandwidth. Through its business continuity procedures, employees tested remote access the first week of March and all non-financial center employees have been working remotely since March 11. Management has organized a Committee (“Pandemic Committee”) which meets regularly to ensure the health of employees, discuss the state of operations, and ensure we are providing the best possible client service and support during this challenging time. Additionally, non-essential business travel has been suspended and company-wide cleaning efforts have been enhanced.

As of March 23, 2020, the Company expanded its social distancing practice by modifying the operations of its financial center network to support the efforts of public health authorities and to help curtail the spread of COVID-19. The Company is temporarily redirecting clients to its digital channels, drive-thrus, and ATMs which can handle most financial transactions. The pandemic is constantly evolving and the Company is making every effort to ensure its response is aligned with its priority to protect the health and safety of employees, clients and the communities we serve.

The redirect model for the financial center network was phased out after ongoing monitoring of CDC, state, local COVID-19 guidelines and area COVID-19 statistics. The reopening of the financial center network was handled in a controlled reopening model at the recommendation of the Pandemic Committee. The key to this reopening was the implementation of safety protocols in the

COVID-19 environment for the bank staff and customers based on geographic area results of the state. Currently, all financial centers are open to the public.

On October 1, 2020, support service staff working remotely for the bank began to return to the workplace in limited numbers on a rotation schedule. This return from the remote work environment was by design and a direct result of the number of employees housed in these areas. Best practices around social distancing, mask usage and cleaning of work areas has been incorporated into the daily work practice. Staff rotation of the support services teams will continue as needed to accommodate CDC and local gathering guidelines.

The Pandemic Committee continues to meet to review changes in guidelines with staff and customer safety related to COVID-19 at the forefront. The Pandemic Committee reports on developments within the bank footprint and the possible impact on the banks business model. As a result, adjustments to the protocol are made as needed.

While the ultimate impact of the COVID-19 pandemic is largely uncertain, based on an initial assessment of the impact to our loan portfolio we increased our allowance for loan losses through a provision for loan losses of \$7.6 million during the first quarter of 2020, and an additional \$1.6 million and \$2.1 million during the second and third quarters of 2020, respectively. 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, 2020 the remaining loans still under deferment has been reduced to less than 50 loans (representing approximately \$91 million in outstanding loan balances). CapStar Bank was actively involved in assisting clients applying for loans under the SBA's Paycheck Protection Program ("PPP"). Through this program we have approved approximately 1,475 PPP loans or \$222.3 million which were outstanding and recorded in total loans on the consolidated balance sheet as of September 30, 2020. As the pandemic continues, we will continue to assess the impact on our market. While it is likely 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'.

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 \$2.5 million, or 14.6%, for the three months ended September 30, 2020 compared to the same period in 2019 and increased \$2.8 million, or 5.5%, for the nine months ended September 30, 2020 compared to the same period in 2019. Net interest margin decreased to 2.72% for the three months ended September 30, 2020, compared with 3.66% for the same period of 2019 and decreased to 3.09% for the nine months ended September 30, 2020, compared with 3.70% for the same period of 2019.

Provision for loan losses was \$2.1 million for the third quarter of 2020 compared to \$(0.1) million during the comparable period of 2019. Net charge-offs (recoveries) for the third quarter of 2020 were \$(13) thousand compared to \$(50) thousand for the comparable period of 2019. 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, 2020 was 1.22% of total loans, compared with 0.89% of total loans at December 31, 2019.

Total noninterest income for the third quarter of 2020 increased \$8.0 million, or 118.1%, compared with the same period in 2019, and comprised 38% of total revenues. For the nine months ended September 30, 2020, total non-interest income increased \$12.9 million, or 69.8%, compared with the same period in 2019, and comprised 32% of total revenues. These increases were primarily the result of higher mortgage banking income.

Total noninterest expense for the three and nine months ended September 30, 2020 increased \$7.2 million, or 46.4%, and \$9.2 million, or 19.6%, respectively, compared with the same periods in 2019. Included in noninterest expense for the three and nine months ended September 30, 2020 were \$2.5 million and \$3.3 million, respectively, of pretax merger related charges compared to \$0.2 million and \$2.5 million, respectively, for the three and nine months ended September 30, 2019. Our efficiency ratio for the three months ended September 30, 2020 was 66.0% compared to 64.9% for the same period in 2019. For the nine months ended September 30, 2020 our efficiency ratio was 65.4% compared to 67.0% for the same period in 2019.

Our effective tax rate for the three and nine months ended September 30, 2020 was 22.0% and 18.0%, respectively, compared to 24.3% and 23.5% for the same periods in 2019. The decrease in the effective tax rate is largely the result of the enactment of new provisions under the CARES Act. The CARES Act permits 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 us to carry back 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, we recorded an income tax benefit of \$0.8 million related to the permanent tax rate benefit during the first quarter of 2020. We also implemented new strategies during 2020, including the establishment of a Real Estate Investment Trust subsidiary, which also contributed to a lower effective tax rate.

Tangible common equity, a non-GAAP 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 9.54% as of September 30, 2020, compared with 11.47% at December 31, 2019. See “—Non-GAAP Financial Measures” for a discussion of and reconciliation to the most directly comparable U.S. GAAP measure.

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 September 30,		2020 - 2019 Percent Increase (Decrease)	Nine Months Ended September 30,		2020 - 2019 Percent Increase (Decrease)
	2020	2019		2020	2019	
Interest income	\$ 24,642	\$ 23,216	6.1%	\$ 67,121	\$ 69,341	(3.2)%
Interest expense	4,986	6,060	(17.7)%	13,129	18,175	(27.8)%
Net interest income	19,656	17,156	14.6%	53,992	51,166	5.5%
Provision for loan losses	2,119	(125)	(1793.0)%	11,295	761	1384.6%
Net interest income after provision for loan losses	17,537	17,281	1.5%	42,697	50,405	(15.3)%
Noninterest income	14,804	6,788	118.1%	31,500	18,555	69.8%
Noninterest expense	22,739	15,531	46.4%	55,883	46,728	19.6%
Net income before income taxes	9,602	8,538	12.5%	18,314	22,232	(17.6)%
Income tax expense	2,115	2,072	2.1%	3,299	5,231	(36.9)%
Net income	\$ 7,487	\$ 6,466	15.8%	\$ 15,015	\$ 17,001	(11.7)%
Basic net income per share of common stock	\$ 0.34	\$ 0.36	(6.4)%	\$ 0.77	\$ 0.96	(19.9)%
Fully diluted net income per share of common stock	\$ 0.34	\$ 0.35	(2.3)%	\$ 0.77	\$ 0.91	(15.8)%

Annualized return on average assets and annualized return on average shareholders' equity were 0.98% and 9.26%, respectively, for the third quarter of 2020, compared with 1.28% and 9.63%, respectively, for the same period in 2019.

Annualized return on average assets and annualized return on average shareholders' equity were 0.81% and 6.82%, respectively, for the nine months ended September 30, 2020, compared with 1.14% and 8.69%, respectively, for the same period in 2019.

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 months ended September 30, 2020 and 2019:

	For the Three Months Ended September 30,					
	2020			2019		
	Average Outstanding Balance	Interest Income/Expense	Average Yield/Rate	Average Outstanding Balance	Interest Income/Expense	Average Yield/Rate
Interest-Earning Assets						
Loans (1)	\$ 1,906,449	\$ 21,398	4.47%	\$ 1,445,755	\$ 19,955	5.48%
Loans held for sale	156,123	1,398	3.56%	101,835	1,050	4.09%
Securities:						
Taxable investment securities (2)	271,838	1,332	1.96%	160,528	1,211	3.02%
Investment securities exempt from federal income tax (3)	51,851	343	3.35%	50,932	354	3.52%
Total securities	323,689	1,675	2.18%	211,460	1,565	3.14%
Cash balances in other banks	499,770	171	0.14%	110,690	645	2.31%
Funds sold	—	—	—	144	1	3.46%
Total interest-earning assets	2,886,031	24,642	3.41%	1,869,884	23,216	4.95%
Noninterest-earning assets	157,816			136,066		
Total assets	<u>\$ 3,043,847</u>			<u>\$ 2,005,950</u>		
Interest-Bearing Liabilities						
Interest-bearing deposits:						
Interest-bearing transaction accounts	\$ 840,926	640	0.30%	\$ 527,759	2,102	1.58%
Savings and money market deposits	610,942	2,537	1.65%	494,183	1,944	1.56%
Time deposits	505,391	1,299	1.02%	349,046	1,887	2.14%
Total interest-bearing deposits	1,957,259	4,476	0.91%	1,370,988	5,933	1.72%
Borrowings and repurchase agreements	39,431	510	5.14%	12,174	127	4.12%
Total interest-bearing liabilities	1,996,690	4,986	0.99%	1,383,162	6,060	1.74%
Noninterest-bearing deposits	691,205			333,885		
Total funding sources	2,687,895			1,717,047		
Noninterest-bearing liabilities	34,446			22,462		
Shareholders' equity	321,506			266,441		
Total liabilities and shareholders' equity	<u>\$ 3,043,847</u>			<u>\$ 2,005,950</u>		
Net interest spread (4)			2.42%			3.21%
Net interest income/margin (5)		<u>\$ 19,656</u>	2.72%		<u>\$ 17,156</u>	3.66%

- (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.

For the Nine Months Ended September 30,

	2020			2019		
	Average Outstanding Balance	Interest Income/Expense	Average Yield/Rate	Average Outstanding Balance	Interest Income/Expense	Average Yield/Rate
Interest-Earning Assets						
Loans (1)	\$ 1,630,455	\$ 56,875	4.66%	\$ 1,458,828	\$ 59,673	5.47%
Loans held for sale	170,852	4,745	3.71%	86,895	2,923	4.50%
Securities:						
Taxable investment securities (2)	216,262	3,886	2.40%	176,951	4,124	3.11%
Investment securities exempt from federal income tax (3)	46,955	975	3.50%	53,360	1,093	3.46%
Total securities	263,217	4,861	2.59%	230,311	5,217	3.19%
Cash balances in other banks	278,647	640	0.31%	84,333	1,502	2.38%
Funds sold	24	—	2.77%	990	26	3.52%
Total interest-earning assets	2,343,195	67,121	3.84%	1,861,357	69,341	5.00%
Noninterest-earning assets	143,238			138,252		
Total assets	<u>\$ 2,486,433</u>			<u>\$ 1,999,609</u>		
Interest-Bearing Liabilities						
Interest-bearing deposits:						
Interest-bearing transaction accounts	\$ 715,740	3,371	0.63%	\$ 476,755	5,523	1.55%
Savings and money market deposits	534,859	4,819	1.20%	487,743	5,445	1.49%
Time deposits	380,198	4,197	1.47%	380,566	5,917	2.08%
Total interest-bearing deposits	1,630,797	12,387	1.01%	1,345,064	16,885	1.68%
Borrowings and repurchase agreements	23,907	742	4.14%	57,472	1,290	3.00%
Total interest-bearing liabilities	1,654,704	13,129	1.06%	1,402,536	18,175	1.73%
Noninterest-bearing deposits	509,739			312,505		
Total funding sources	2,164,443			1,715,041		
Noninterest-bearing liabilities	28,000			22,953		
Shareholders' equity	293,990			261,615		
Total liabilities and shareholders' equity	<u>\$ 2,486,433</u>			<u>\$ 1,999,609</u>		
Net interest spread (4)			2.78%			3.27%
Net interest income/margin (5)		<u>\$ 53,992</u>	3.09%		<u>\$ 51,166</u>	3.70%

- (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.

Our net interest margin was 2.72% and 3.66% for the third quarter of 2020 and 2019, respectively. For the nine months ended September 30, 2020 and 2019, our net interest margin was 3.09% and 3.70%, respectively. The decrease in net interest margin for both periods was primarily due to declining yields on earning assets partially offset by reduced deposit costs. Additionally, included in interest expense for savings and money market deposits in the third quarter of 2020 is a loss on previously terminated interest rate swaps of \$1.9 million.

For the third quarter of 2019 and 2020, average loan yields decreased from 5.48% to 4.47% which was primarily driven by decreases in short-term interest rate indexes affecting the variable rate portion of our loan portfolio. From December 31, 2018 to September 30, 2020, the LIBOR – 1 month interest rate decreased from 2.50% to 0.15%. Similarly, the Bank Prime Loan Rate decreased from 5.50% to 3.25% over the same time period. Approximately 49% of our loan portfolio at September 30, 2020 is variable in nature.

For the third quarter of 2019 and 2020, average security yields decreased from 3.14% to 2.18% and from 3.19% to 2.59% for the nine months ended September 30, 2019 and 2020, respectively, primarily due to decreases in the LIBOR rate on the variable rate portion of our securities portfolio, and reinvestment of security paydowns or maturities at lower market rates. The resulting yield on average interest-earning assets decreased 154 basis points for the third quarter of 2020 compared to the similar period in 2019 and 116 basis points for the nine months ended September 30, 2020 compared to the similar period of 2019.

Average funding sources increased 56.5% and 26.2% for the three and nine months ended September 30, 2020 compared to the similar period in 2019. The primary driver of our increased funding sources was growth in our average deposits of 55.3% and 29.1% for the three and nine months ended September 30, 2020 compared to the similar periods in 2019 which was primarily driven by the FCB and BOW mergers 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. Average noninterest bearing deposits increased 107.0% and 63.1% for the three and nine months ended September 30, 2020 compared to the similar period in 2019. 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 0.99% for the third quarter of 2020, as compared to 1.74% for the same period in 2019. For the nine months ended September 30, 2020 and 2019, the average rate paid on interest-bearing liabilities was 1.06% and 1.73%, respectively. The majority of this decrease was due to decreases in the Fed Funds rate. The Fed Funds rate decreased from 2.40% at December 31, 2018 to 0.09% at September 30, 2020. We passed along a portion of this 231 basis point rate decrease to our clients.

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 neutralize 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 new growth. Dynamic simulation models are also utilized that rely on detailed assumptions regarding changes in existing lines of business, new business, and changes in management and client behavior. 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, 2020, 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. 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 decay rates, 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 immediately increased or decreased by the specified amounts.

	Net interest income change
Increase 200bp	5.3%
Increase 100bp	2.3
Decrease 100bp	0.7
Decrease 200bp	2.0

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 1.22% and 0.89% at September 30, 2020 and December 31, 2019, respectively.

The provision for loan losses amounted to \$2.1 million and \$11.3 million, respectively, for the three and nine months ended September 30, 2020 compared to \$(0.1) million and \$0.8 million, respectively, for the three and nine months ended September 30, 2019. 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, 2020. 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. Based on our initial assessment of the impact of the COVID-19 pandemic to our loan portfolio we increased our allowance for loan losses through a provision for loan losses of \$7.6 million during the first quarter of 2020. During the second and third quarters of 2020 we continued to assess the impact of the pandemic to our loan portfolio and increased our provision based on several factors including the expected impact of the pandemic to our loan portfolio. As a result, an additional provision for loan losses of \$2.1 million was added during the third quarter of 2020.

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 fees. 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 September 30,		2020 - 2019 Percent Increase (Decrease)	Nine Months Ended September 30,		2020 - 2019 Percent Increase (Decrease)
	2020	2019		2020	2019	
Noninterest income:						
Treasury management and other deposit service charges	\$ 1,064	\$ 788	35.1%	\$ 2,531	\$ 2,399	5.5%
Net gain (loss) on sale of securities	34	—	11621.4%	74	(108)	168.2%
Tri-Net fees	668	847	(21.1)%	2,528	2,511	0.6%
Mortgage banking income	9,686	2,679	261.6%	19,063	7,151	166.6%
Wealth management fees	382	379	0.7%	1,162	1,018	14.1%
Interchange and debit card transaction fees	936	754	24.2%	2,389	2,323	2.9%
Other noninterest income	2,034	1,341	51.6%	3,753	3,261	15.1%
Total noninterest income	\$ 14,804	\$ 6,788	118.1%	\$ 31,500	\$ 18,555	69.8%

The increase in treasury management and other deposit service charges for the three and nine months ended September 30, 2020 compared to the same period in 2019 was driven by transaction volume, which can fluctuate throughout and from period to period and by customers electing to compensate for services through deposit balances rather than fees. The increase in the third quarter was also largely attributable to the FCB and BOW mergers.

Tri-Net fees represent a line of business which originates and sells commercial real estate loans to third-party investors. All of these loan sales transfer servicing rights to the buyer. The volume of loan sales fluctuates from period to period based on various factors, including market conditions.

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. Mortgage banking income increased 261.6% and 166.6% for the three and nine months ended September 30, 2020, respectively, compared to the same periods in 2019. This increase was primarily due to a higher volume of originations related to market conditions and the current interest rate environment.

Wealth management fees are derived from advisory services offered to specific customers. The increase in wealth management fees for the three and nine months ended September 30, 2020 compared to the same period in 2019 was mostly driven by transaction volume, which can fluctuate from period to period.

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 mergers.

Other noninterest income primarily consists of loan related fees and income from bank owned life insurance. However, during the third quarter of 2020, a gain on sale of \$0.4 million was recognized related to the sale of two dormant branches acquired in the Athens Federal acquisition, which was the primary driver of the 51.6% increase for the three months ended September 30, 2020.

Noninterest Expense

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

	Three Months Ended September 30,		2020 - 2019 Percent Increase (Decrease)	Nine Months Ended September 30,		2020 - 2019 Percent Increase (Decrease)
	2020	2019		2020	2019	
Noninterest expense:						
Salaries and employee benefits	\$ 12,949	\$ 9,229	40.3%	\$ 33,256	\$ 26,224	26.8%
Data processing and software	2,353	1,790	31.5%	6,317	5,126	23.2%
Professional fees	638	528	20.9%	1,854	1,571	18.0%
Occupancy	999	858	16.4%	2,615	2,550	2.6%
Equipment	864	1,012	(14.6)%	2,295	2,890	(20.6)%
Regulatory fees	397	18	2133.7%	893	564	58.3%
Merger related expenses	2,548	187	1266.1%	3,286	2,491	31.9%
Amortization of intangibles	539	408	32.1%	1,300	1,258	3.3%
Other operating	1,452	1,501	(3.4)%	4,067	4,054	0.3%
Total noninterest expense	<u>\$ 22,739</u>	<u>\$ 15,531</u>	<u>46.4%</u>	<u>\$ 55,883</u>	<u>\$ 46,728</u>	<u>19.6%</u>

Salaries and employee benefits increased 40.3% and 26.8%, respectively, for the three and nine months ended September 30, 2020 compared to the same periods in 2019. The increase is primarily from the FCB and BOW mergers and higher incentive compensation related to increases in mortgage banking income between periods. The number of full-time employees increased from 290 at September 30, 2019 to 403 at September 30, 2020, due to the FCB and BOW mergers.

Data processing and software expense increased during the periods presented primarily due to infrastructure related costs from implementing the PPP and other general IT infrastructure improvements.

Equipment expense decreased between periods primarily due to cost savings resulting from restructuring the administration of our IT network.

Merger related expenses in 2019 and 2020 relate to our mergers with Athens, FCB and BOW.

Our efficiency ratio (ratio of noninterest expense to the sum of net interest income and noninterest income) was 66.0% for the three months ended September 30, 2020 compared to 64.9% for the three months ended September 30, 2019. For the nine months ended September 30, 2020 and 2019, our efficiency ratio was 65.4% and 67.0%, respectively. The efficiency ratio measures the amount of expense that is incurred to generate a dollar of revenue.

Income Tax Provision

During the three and nine months ended September 30, 2020, we recorded income tax expense of \$2.1 million and \$3.3 million, respectively, compared to \$2.1 million and \$5.2 million, respectively, for the three and nine months ended September 30, 2019. Our income tax expense for the nine months ended September 30, 2020 reflects an effective income tax rate of 18.0% compared to 23.5% for the same period in 2019. Our effective tax rate differs from the statutory tax rate primarily due to the enactment of new NOL provisions under the CARES Act. The CARES Act permits 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 us to carry back 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 first quarter of 2020. In addition to the permanent tax rate benefit, the effective tax rate compared favorably to the statutory rate due to investments in qualified municipal securities, company owned life insurance, state tax credits, net of the effect of certain non-deductible expenses and the recognition of excess tax benefits related to stock compensation.

(b) **Financial Condition**

Balance Sheet

Total assets increased \$987.1 million, or 48.5%, from \$2.04 billion on December 31, 2019 to \$3.02 billion on September 30, 2020. Loans grew \$486.5 million, or 34.3%, in the first nine months of 2020. Loans held for sale increased \$30.4 million, or 18.1%, during the first nine months of 2020.

Total liabilities increased \$926.3 million, or 52.5%, from \$1.76 billion on December 31, 2019 to \$2.69 billion on September 30, 2020. Deposits increased \$888.1 million, or 51.4%.

Our 2020 growth in cash, loans and deposits has been significantly influenced by the FCB and BOW mergers and the U.S. government's various stimulus programs and their impact on our customers.

Loans and Leases

The composition of loans and leases at September 30, 2020 and December 31, 2019 and the percentage of each classification to total loans are summarized as follows:

	September 30, 2020		December 31, 2019	
	Amount	Percent	Amount	Percent
Commercial real estate - owner occupied	\$ 164,336	8.6%	\$ 172,456	12.1%
Commercial real estate - non-owner occupied	480,106	25.1%	387,443	27.3%
Consumer real estate	350,238	18.4%	256,097	18.0%
Construction and land development	176,751	9.3%	143,111	10.1%
Commercial and industrial	648,018	34.0%	394,408	27.8%
Consumer	42,104	2.2%	28,426	2.0%
Other	45,050	2.4%	38,161	2.7%
Total loans	<u>\$ 1,906,603</u>	<u>100.0%</u>	<u>\$ 1,420,102</u>	<u>100.0%</u>

At September 30, 2020, our loan portfolio composition remained relatively consistent with the composition at December 31, 2019, with the exception of Commercial and Industrial loans which increased significantly during 2020 primarily due to the origination of loans under the PPP, of which \$222.3 million were outstanding as of September 30, 2020. The commercial real estate category includes owner-occupied commercial real estate loans which is 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 business rather than on the valuation of the real estate. Included in total loans as of September 30, 2020 is approximately \$286.7 million related to the FCB and BOW mergers.

Non-Performing Loans and Assets

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

	September 30, 2020	December 31, 2019
Non-accrual loans	\$ 2,945	\$ 1,464
Troubled debt restructurings	1,885	2,717
Loans past due over 89 days and still accruing	542	38
Non-performing loans	2,945	1,464
Other real estate owned	171	1,044
Non-performing assets	3,116	2,508
Non-performing loans as a percentage of total loans	0.15%	0.10%
Non-performing assets as a percentage of total assets	0.10%	0.12%

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

	September 30, 2020	December 31, 2019
Commercial real estate	\$ 200	\$ —
Consumer real estate	1,939	894
Construction and land development	140	117
Commercial and industrial	533	440
Consumer	129	13
Other	4	—
Total loans	\$ 2,945	\$ 1,464

(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, 2019, partly due to the FCB acquisition, though primarily due to strong deposit inflows since the start of the pandemic which have substantially bolstered liquidity. Interest-bearing deposits in financial institutions totaled \$416.0 million at September 30, 2020, an increase of \$332.6 million since December 31, 2019. The fair value of the available-for-sale investment portfolio was \$308.3 million at September 30, 2020, an increase of \$95.2 million since December 31, 2019. We pledge portions of our investment securities portfolio to secure public fund deposits, derivative positions and Federal Home Loan Bank advances. At September 30, 2020, total investment securities pledged for these purposes comprised 19% of the estimated fair value of the investment portfolio, leaving \$250.1 million of unpledged securities, an increase of \$103.9 million since December 31, 2019.

We have a large base of non-maturity customer deposits, defined as demand, savings, and money market deposit accounts. At September 30, 2020, such deposits totaled \$2.11 billion and represented approximately 81% of our total deposits.

Other sources of funds available to meet daily needs include FHLB advances. As a member of the FHLB of Cincinnati, the Company has access to credit products offered by the FHLB. At September 30, 2020, available credit from the FHLB totaled \$211.9 million. Additionally, we had available federal funds purchased lines with correspondent banks totaling \$125.0 million at September 30, 2020.

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, 2020, the Bank was able to pay up to \$42.3 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, 2020, shareholders' equity totaled \$333.9 million, an increase of \$60.8 million since December 31, 2019. As of September 30, 2020, 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 and Note 12 of the consolidated financial statements for further detail of the changes in equity since the end of 2019.

Off-Balance Sheet Arrangements

In the normal course of business, we enter into various transactions that, in accordance with 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 generally accepted accounting principles in the United States ("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 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 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 GAAP financial measures.

(dollars in thousands, except per share data)	<u>September 30, 2020</u>	<u>December 31, 2019</u>
Total equity	\$ 333,895	\$ 273,046
Less core deposit intangible	(9,154)	(6,883)
Less goodwill	(41,068)	(37,510)
Tangible common equity	<u>\$ 283,673</u>	<u>\$ 228,653</u>
Total assets	\$ 3,024,348	\$ 2,037,201
Less core deposit intangible	(9,154)	(6,883)
Less goodwill	(41,068)	(37,510)
Total tangible assets	<u>\$ 2,974,126</u>	<u>\$ 1,992,808</u>
Total shareholders' equity to total assets	11.04%	13.40%
Tangible common equity ratio	9.54%	11.47%
Total shares of common stock outstanding	21,947,805	18,361,922
Book value per share of common stock	\$ 15.21	\$ 14.87
Tangible book value per share of common stock	12.92	12.45

(f) Recently Issued Accounting Pronouncements

ASU 2016-02, Leases

In February 2016, the FASB amended the Leases topic of the Accounting Standards Codification to revise certain aspects of recognition, measurement, presentation, and disclosure of leasing transactions. The amendments will be effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early adoption is permitted.

The Company adopted the guidance using the modified retrospective method and practical expedients for transition. The practical expedients allow the Company to largely account for our existing leases consistent with current guidance except for the incremental balance sheet recognition for lessees. The Company evaluated the new guidance and its impact on the Company's financial statements. Based on leases outstanding at December 31, 2018, the impact of adoption on January 1, 2019 was recording a lease liability of approximately \$13.4 million, a right-of-use asset of approximately \$12.8 million, and elimination of deferred rent of approximately \$0.6 million. The leasing liability and right-of-use asset are recorded in other liabilities and other assets, respectively.

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 supposed 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 finalizes effective date delays for private companies, not-for-profit organizations, and certain smaller reporting companies applying the credit losses standard. The Company has elected to delay implementation of the new standard until 2023.

ASU 2017-04, Simplifying the Test of Goodwill Impairment

In January 2017, the FASB amended the Goodwill and Other Topic of the Accounting Standards Codification to simplify the accounting for goodwill impairment for public business entities and other entities that have goodwill reported in their financial statements and have not elected the private company alternative for the subsequent measurement of goodwill. The amendment removes Step 2 of the goodwill impairment test. A goodwill impairment will now be the amount by which a reporting unit's carrying value exceeds its fair value, not to exceed the carrying amount of goodwill. The effective date and transition requirements for the technical corrections were effective for the Company for reporting periods beginning after December 15, 2019. These amendments did not have a material effect on the financial statements.

ASU 2018-07, Compensation – Stock Compensation

In June 2018, the FASB amended the Compensation—Stock Compensation Topic of the Accounting Standards Codification. The amendments expand the scope of Topic 718 to include share-based payment transactions for acquiring goods and services from nonemployees. The amendments were effective for years beginning after December 15, 2018. These amendments did not have a material effect on the Company's financial statements.

ASU 2019-04 — Applicable to entities that hold financial instruments:

In April 2019, the FASB issued guidance that clarifies and improves areas of guidance related to the recently issued standards on credit losses, hedging, and recognition and measurement of financial instruments. The amendments related to credit losses were effective for the Company for reporting periods beginning after December 15, 2019. The amendments related to hedging were effective for the Company for interim and annual periods beginning after December 15, 2018. The amendments related to recognition and measurement of financial instruments were effective for the Company for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. There was no material effect on the 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 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. Early adoption is permitted. The Company does not expect these amendments to have a material effect on its 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.

Information required by this item 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.

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 Rules 13a-15(e) and 15d-15(e) under the Exchange Act) 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 to ensure that information required to be disclosed in the Company's filings under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms and to ensure that such information is accumulated and communicated to the Company's management, including its Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

Changes in Internal Control over Financial Reporting

There have been no changes in the Company's internal control over financial reporting 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 1. Legal Proceedings

General

From time to time, the Company is party to legal actions that are routine and incidental to its business. Given the nature, scope and complexity of the extensive legal and regulatory landscape applicable to the Company's business, including laws and regulations governing consumer protection, fair lending, fair labor, privacy, information security and anti-money laundering and anti-terrorism laws, the Company, like all banking organizations, is subject to heightened legal and regulatory compliance and litigation risk. However, based upon available information and in consultation with legal counsel, management does not expect the ultimate disposition of any or a combination of these actions to have a material adverse effect on the Company's assets, business, cash flow, condition (financial or otherwise), liquidity, prospects and/or results of operations.

Litigation Against Gaylon M. Lawrence & The Lawrence Group

On October 31, 2017, CapStar filed a complaint, captioned *CapStar Financial Holdings, Inc. v. Gaylon M. Lawrence & The Lawrence Group*, Case No. 3:17-cv-01421 (the "Action"), in the U.S. District Court for the Middle District of Tennessee, in connection with Mr. Lawrence and The Lawrence Group's acquisition of our common stock. The complaint alleges that defendants violated Section 13(d) of the Exchange Act by filing materially false and misleading Schedules 13D regarding defendants' acquisition of a minority stake (1,156,675 shares) of our common stock. It also alleged that defendants violated the Change in Bank Control Act, 12 U.S.C. § 1817(j) (the "CBCA"), by attempting to acquire control of CapStar without first receiving approval from the Federal Reserve, and also that defendants violated Tennessee Code Section 45-2-107 by controlling banks without having registered as a bank holding company.

By order dated December 18, 2017, the court granted our motion for expedited discovery, which is presently underway. Defendants have filed a motion to dismiss the Action as well as a separate motion to stay. The motion to stay was denied by the court on May 21, 2018. On September 24, 2018, the court denied in part and granted in part defendants' motion to dismiss, permitting our claims that defendants violated Tennessee Code Section 45-2-107 under Section 13(d) of the Exchange Act to proceed.

Mr. Lawrence also filed an Interagency Notice of Change in Control pursuant to the CBCA with the Federal Reserve on October 30, 2017 (the "Notice"), seeking permission to acquire up to 15% of the outstanding voting shares of our common stock. At the Federal Reserve's direction, on March 13, 2018, Mr. Lawrence requested that the Federal Reserve suspend processing of this Notice. On November 6, 2018, the Federal Reserve notified us that it has determined not to disapprove the Notice, subject to compliance by Mr. Lawrence and his affiliates with extensive representations and commitments set forth in correspondence between Mr. Lawrence and the Federal Reserve. On November 19, 2019, Mr. Lawrence filed an amended Schedule 13D in which he asserted that the Federal Reserve's determination not to disapprove his Notice has now expired, and in which Mr. Lawrence further stated that he "does not presently intend to file a new Interagency Notice of Change in Control with the Federal Reserve."

On July 23, 2020, CapStar and Mr. Lawrence entered into a settlement agreement, whereby CapStar agreed to file a joint stipulation, dismissing the Action without prejudice. On July 24, 2020, CapStar filed the stipulation, which the court granted on July 24, 2020.

Item 1A. Risk Factors

In evaluating an investment in the Company's securities, investors should consider carefully, among other things, information under the heading "Cautionary Note Regarding Forward-Looking Statements" in this Report as well as those factors that are detailed from time to time in the Company's periodic and current reports filed with the SEC, including those factors included in the Company's Annual Report on Form 10-K for the year ended December 31, 2019 under the heading "Item 1A. Risk Factors" and in the Company's Quarterly Reports on Form 10-Q and Current Reports on Form 8-K.

We are providing this additional risk factor to supplement the risk factors contained in Item 1A. of our Annual Report on Form 10-K for the year ended December 31, 2019.

Our business, financial condition, credit quality, and results of operations have been, and will likely continue to be, adversely affected by the emergence of the COVID-19 pandemic. The extent to which the COVID-19 pandemic will continue to negatively affect our business, financial condition, credit quality, and results of operations will depend on future developments, which are highly uncertain and cannot be predicted.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

Unregistered Sales of Equity Securities

The following table shows information relating to the repurchase of shares of common stock by the Company during the three months ended September 30, 2020.

	Total number of shares purchased (1)	Average price paid per share	Total number of shares purchased as part of publicly announced plan (2)	Maximum remaining dollar value of shares that may be purchased under the plan
July 1 - July 31	149	\$ 11.08	—	\$7.56 million
August 1 - August 31	940	10.15	—	\$7.56 million
September 1 - September 30	—	—	—	\$7.56 million
Total	<u>1,089</u>	<u>\$ 10.28</u>	<u>—</u>	<u>\$7.56 million</u>

- (1) Activity represents shares of common stock withheld to pay purchase price and taxes due upon vesting of restricted shares and exercise of stock options.
- (2) On December 21, 2018, the board of directors approved the Company's share repurchase program which authorized the Company to repurchase up to \$8 million of shares of common stock (the "Repurchase Program"). On September 5, 2019, the Board approved an expansion of the Repurchase Program (the "Expanded Repurchase Program"). Under the Expanded Repurchase Program, the amount of common stock that the Company is authorized to repurchase has been increased from approximately \$2.2 million to \$11 million. The Expanded Share Repurchase Program will terminate on the date on which the Expanded Maximum Dollar Amount of Common Stock has been repurchased.

Use of Proceeds

On September 27, 2016, the Company sold 1,688,049 shares of its common stock, including 387,750 shares purchased by the underwriters pursuant to the full exercise of their purchase option, in its initial public offering ("IPO"). In addition, certain selling shareholders participated in the IPO and sold an aggregate of 1,284,701 shares of the Company's common stock.

The shares were sold at a public offering price of \$15.00 per share, resulting in aggregate gross proceeds of approximately \$44.6 million. The aggregate offering price for the shares sold by the Company was approximately \$25.3 million, and after deducting approximately \$1.6 million for the underwriting discount and approximately \$2.1 million of offering expenses paid to third parties, the Company received net proceeds of approximately \$21.6 million. The aggregate offering price for the shares sold by the selling shareholders was approximately \$19.3 million.

All of the shares were sold pursuant to our Registration Statement on Form S-1, as amended (File No. 333-213367), which was declared effective by the SEC on September 21, 2016. The offering did not terminate until all of the shares offered were sold. The Company made no payments to its directors, officers or persons owning ten percent or more of its common stock or to their associates, or to its affiliates in connection with the issuance and sale of the common stock or in connection with the use of IPO proceeds. Keefe, Bruyette & Woods, Inc. and Sandler O'Neill & Partners, L.P. acted as lead book-running managers for the initial public offering. Our common stock is currently trading on the NASDAQ Global Select Market under the symbol "CSTR."

There has been no material change in the planned use of proceeds from our IPO as described in our prospectus filed with the SEC on September 23, 2016 pursuant to Rule 424(b)(4) under the Securities Act. Pending application of the IPO proceeds, we have invested the net proceeds in short-term investments. During 2017, the Company provided \$10.0 million of the IPO proceeds as a capital contribution to the Bank for working capital purposes.

Item 6. Exhibits

Exhibit Number	Description
2.1	<u>Agreement and Plan of Merger, dated as of June 11, 2018, by and between CapStar Financial Holdings, Inc. and Athens Bancshares Corporation (incorporated by reference herein to Exhibit 2.1 to the Company's Current Report on Form 8-K filed on June 14, 2018)</u>
2.2	<u>Agreement and Plan of Merger, dated as of January 23, 2020, by and between CapStar Financial Holdings, Inc. and FCB Corporation (incorporated by reference herein to Exhibit 2.1 to the Company's Current Report on Form 8-K filed on January 29, 2020)</u>
2.3	<u>Plan of Bank Merger, dated as of January 23, 2020, by and among CapStar Financial Holdings, Inc., CapStar Bank and The Bank of Waynesboro (incorporated by reference herein to Exhibit 2.2 to the Company's Current Report on Form 8-K filed on January 29, 2020)</u>
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>
4.1	<u>Form of Common Stock Certificate (incorporated by reference herein to Exhibit 4.1 to Amendment No. 2 to the Company's Registration Statement on Form S-1 (File Number 333-213367) filed on September 20, 2016)</u>
4.2	<u>Second Amended and Restated Shareholders' Agreement, dated as of August 22, 2016, among CapStar Financial Holdings, Inc., CapStar Bank, Corsair III Financial Services Capital Partners, L.P., Corsair III Financial Services Offshore 892 Partners, L.P., North Dakota Investors, LLC and certain other persons named therein (incorporated by reference herein to Exhibit 4.2 to the Company's Registration Statement on Form S-1 (File Number 333-213367) filed on August 29, 2016)</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.INS*	Inline XBRL Instance Document - the instance document does not appear in the Interactive Data File because its XBRL tags are embedded within the inline XBRL document.
101.SCH*	Inline XBRL Taxonomy Extension Schema Document.
101.CAL*	Inline XBRL Taxonomy Extension Calculation Linkbase Document.
101.LAB*	Inline XBRL Taxonomy Label Linkbase Document.
101.PRE*	Inline XBRL Taxonomy Presentation Linkbase Document.
101.DEF*	Inline XBRL Taxonomy Extension Definition Linkbase Document.
104	The cover page from the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2020, has been formatted in Inline XBRL.

* The XBRL related information in Exhibit 101 to this quarterly report on Form 10-Q shall not be deemed "filed" for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, or otherwise subject to liability of that section and shall not be incorporated by reference into any filing or other document pursuant to the Securities Act of 1933, as amended, except as shall be expressly set forth by specific reference in such filing or document.

** Furnished with this Quarterly Report on Form 10-Q.

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
Denise J. Duncan
Chief Financial Officer
(Principal Financial Officer and Principal Accounting Officer)

Date: November 5, 2020

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 5, 2020

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 5, 2020

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, 2020, 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 5, 2020

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, 2020, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Denis J. Duncan, Chief Financial Officer and Chief Administrative 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 5, 2020

By: /s/ Denis J. Duncan
Denis J. Duncan
Chief Financial Officer