Florida Capital Group, Inc.

Management's Discussion and Analysis for the Quarter Ended June 30, 2019

Summary

Florida Capital Group, Inc. (the "Company") and its wholly owned bank subsidiary Florida Capital Bank, N.A. (the "Bank") reported net income of $2.02 million for the quarter ended June 30, 2019 and $2.55 million for the first six months of 2019. These reported earnings compare very favorably to the 2018 comparable period reported amounts, and reflect the board and management's continuing commitment to improve operating results for shareholders. Compared to the first six months of 2018, the $2.55 million of earnings was $1.99 million greater than the $560 thousand reported for that period, and also significantly exceeded year-to-date 2019 budgeted earnings of $1.44 million.

Earnings were positively impacted by an improving mortgage market (see mortgage and warehouse lines of business sections), as both business lines reported substantially higher earnings contributions in the second quarter. Both wholesale and retail mortgage originations rose during the quarter, and warehouse balances increased sharply along with higher utilization rates on the warehouse facilities. As a result, balance sheet assets peaked at over $500 million in early June, and the higher level of earning assets increased net interest income to $6.74 million at June 30, 2019 compared to $5.43 million at June 30, 2018 – a $1.31 million or 24% increase. The earning asset growth was funded by an increase in non-interest bearing deposits generated by the Bank's specialty banking line of business and by a mix of wholesale funds. At the same time, improved margins resulted in a higher current period level of mortgage banking income (primarily gains on sale and related fee income). Below the line, the Bank continues to focus on the management of overhead expenses, specifically staffing levels and related expenses.

Management has continued to enhance the Company's reserve for credit losses, and for the first six months of 2019 the provision for loan losses was $400 thousand and the allowance for loan losses increased by $240 thousand to $2.2 million. Although credit quality is stable and losses remain modest to date, management has elected to build reserves to address continued loan growth (particularly in the Government Guaranteed Lending line of business), and the uncertain prospect of the future economic environment. From a regulatory capital perspective, the increased level of assets has resulted in lower regulatory capital ratios at June 30, 2019 (tier 1 leverage of 8.38% and total risk-based capital of 11.21%) relative to June 30, 2018 (tier 1 leverage ratio of 8.94% and total risk-based capital ratio of 13.31%.

Although the Bank's capital ratios have declined, the rebooking of the Bank's net deferred tax asset at the end of 2018 has positive capital implications for the Bank. The portion of the deferred tax asset that is not related to the Company's historical tax net operating loss carryforward (approximately $1.2 million of the total $4.6 million net deferred tax asset) has been included in the Bank's tier 1 capital in accordance with regulatory capital rules. In addition, a $2.0 million valuation allowance that reduces the carrying value of the deferred tax asset from $6.6 million to $4.6 million is available to offset the deferred tax expense associated with the Bank's higher level of current profitability. This $2.0 million valuation allowance will ultimately result in higher reported earnings and an increased capital formation rate for the Bank.

Since the termination of the Bank's regulatory consent order, many initiatives have been undertaken by the board and management to improve profitability and generate greater shareholder returns. These activities are reflected in the results discussed herein, and are more fully discussed in the 2018 Letter to Shareholders and the March 31, 2019 Management's Discussion and Analysis located on the Company's website at floridacapitalbank.com.

In addition to working diligently for the benefit of our shareholders, the board and management continue to focus on the customer experience. Our goals are to provide exceptional service, to attract and nurture relationships, and to provide needed financial solutions and services. To meet these objectives, the Bank is pleased to announce the unveiling in a few weeks of a new logo, tagline and website to emphasize the importance of our relationship-based approach to banking. Keep an eye out in the coming weeks for our new look. If you have questions about the new brand, take a moment to visit www.floridacapitalbank.com/Expanded-outlook for a list of common questions and answers about the new brand.

Mortgage Line of Business

A previously stagnant mortgage market was revived earlier in 2019 when long-term interest rates fell in response to a variety of political and economic uncertainties. As of the market's close on July 30, 2019, the yield on the ten-year U.S. Treasury note closed at 2.06% compared to 2.66% as the year began. The combination of lower long-term rates in conjunction with the large number of mortgage market participants who exited the market during 2018 has resulted in higher quarter two origination levels as well as improved margins.

At the beginning of the year, 2019 mortgage origination was expected to be 11% lower than the 2018 level; however, for the second quarter of 2019, total mortgage production was $229 million compared to $139 million reported during the first quarter. Based on July's mortgage origination level of $105 million, the third quarter is showing continued strength. The six-month figures significantly exceed the Bank's year-to-date budgeted level of mortgage production (favorable variance of $41 million or 13%). From a balance sheet perspective, mortgage held-for-sale balances were $63 million at June 30, 2019 compared to a budgeted level of $37 million. From a pricing perspective, the year-to-date margin of 1.86% significantly exceeds the budgeted margin of 1.46%, and is substantially ahead of the 1.42% margin reported for the comparable period in 2018. The combination of these volume and pricing variances combined to generate a year-to-date mortgage gain on sale of $6.8 million, which was $2.0 million or 43% ahead of budget year-to-date.

From a cost perspective, management has utilized a combination of staffing strategies to manage the higher staffing levels required for fulfillment. These strategies include the use of overtime, part-time and temporary employees and outsourcing arrangements. This approach effectively results in the Bank incurring costs at the margin instead of adding fixed costs, which are difficult and expensive to reduce when origination volumes subsequently decline.

Warehouse Line of Business

Warehouse lending reported total production of $963 million in the second quarter of 2019 compared to first quarter production of $712 million – an increase of $251 million or 35%. Second quarter production is comparable to originating $4.0 billion on an annualized basis. From a balance sheet perspective, total outstanding warehouse balances were $131 million at June 30, 2019, compared to a budgeted level of $58 million and compared to a balance of $63 million at June 30, 2018. Total year-to-date interest income from warehouse lending was $2.8 million, compared to budgeted interest income of $1.7 million, which is a $1.1 million or 66% favorable budget variance.

The Bank's warehouse lending business line is primarily responsible for the growth of earning assets that has occurred during the second quarter, and has made a substantial contribution toward the increased level of profits reported during 2019. Notwithstanding the sharp increase in non-interest bearing deposits generated by the specialty banking business line, this rapid loan growth has required the Bank to tap incremental wholesale sources of liquidity at market rates to fund these originations. These funding sources are predominately comprised of brokered and institutional certificates of deposit with short-term maturities that offset the interest rate risk exposure of these very short duration warehouse loans. Management pays close attention to the volatility of this line of business when it chooses funding sources, and if these balances wane then funding will be retired and leverage removed from the balance sheet. The growth in warehouse lending balances is also primarily responsible for the decline in the Bank's capital ratios, and management carefully manages these balances through participation arrangements with third parties in order to maintain the Bank's regulatory capital ratios at acceptable levels consistent with the nature of the associated risk exposures.

From a cost management perspective, no additional staff was required to manage this substantially higher level of warehouse production. As a result, the contribution margin from the warehouse line of business was substantial. Gross committed facilities are approximately $303 million, and utilization rates (excluding overline amounts) have recently averaged between 50% - 55%.

Government Guaranteed Lending (GGL)

This business line continues to underperform relative to expectations. Origination and secondary market activities associated with SBA and USDA-guaranteed lending opportunities diminished during the second quarter. Both production and secondary market gains on sale reflect unfavorable variances from budget. To date, the Bank has reported gains on sale of $116 thousand compared to a budgeted level of $775 thousand - a $659 thousand or 85% unfavorable budget variance. Secondary market activity also lags 2018 levels. For the period ended June 30, 2018, the Bank reported $913 thousand of GGL gains on sale. From a credit quality perspective, recent credit losses primarily have been related to government-guaranteed loans originated within the last 3-5 years. However, the board and management acknowledge that this business line exhibits a higher than normal risk/return proposition. Yields remain attractive and secondary market pricing for guaranteed balances is stable.

Some of the unfavorable production variance reflects the impact of the U.S. government shut-down in the first quarter of 2019. However, two other factors have contributed to the GGL line's present underperforming level. The first of these two factors relates to the ongoing restructuring of this business line – both from a management and a staffing perspective. Second, as noted in the first quarter MD&A, this line of business is presently focused on two origination channels. The first channel is a "direct to backroom" approach for smaller balance SBA 7(a) originations, which uses referral sources to generate originations that are managed in the Bank's credit administration area. The second factor pointing to underperformance relates to this "direct to backroom" channel.

During late 2018, the Bank exited one of the two "direct to backroom" referral sources due to a lack of quality credit from this referring source. The second primary source of "direct to backroom" originations has recently slowed referrals to the Bank, and, as a result, originations from this referring partner have been less than originally anticipated. Management is presently assessing this relationship, and continues to believe that the Bank should seek to be a significant provider of credit to small businesses nationwide, and that a "direct to backroom" approach can be a significant contributor to overall profitability. The Bank will continue to focus on its second origination channel, which is the origination of larger balance SBA and USDA-guaranteed loan relationships.

Specialty Banking

Specialty banking is comprised of fee-based ACH third party payment processing, money service business relationships that require cash handling, health savings account relationships, and a deposit generating, card-based program. Effective July 15, 2019, the Bank exited the money service business, and continues to explore other attractive opportunities to raise low cost, long-term deposits. At its July board meeting, the board approved the Bank's entry into the hemp banking market in Florida. The production, processing and retail distribution of hemp-based products is now legal in the state of Florida. The board and management view this agricultural commodity as an attractive banking market with opportunities to grow deposits and generate fee income.

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Specialty banking non-interest bearing deposits have increased significantly since the business line was first organized about three years ago. Deposits peaked at $100 million during the first quarter of 2019, and have declined slightly since that date due to the seasonal nature of the card-based programs. As of June 30, 2019 specialty banking held $71 million of low cost deposits (cost of funds is 7 basis points), and this level has been stable throughout the second quarter. This business line continues to be a strategic source of very low cost funding for the warehouse line of business, because warehouse assets are not eligible collateral for FHLB borrowing purposes.

Year-to-date 2019, the Bank's core deposits have exceeded budget by $19 million or 9% and this favorable variance is largely attributable to the specialty banking business line. For a brief period early in the first quarter, the Bank was able to eliminate the majority of its borrowings from the FHLB due to growth in non-interest bearing deposits, which allowed the Bank to significantly reduce its overall cost of funds. The second quarter resurgence of mortgage banking activity precluded the continuation of this favorable activity; however, the profitable earning assets associated with this mortgage activity justified incremental wholesale borrowings. As management gains more experience with the volatility of specialty banking deposits, additional strategies will be deployed to maximize the immensely valuable contribution of these deposits.

Community Bank

Branch deposits remain stable, and represent a valuable base of loyal customer relationships as opposed to depositors shopping for rates. Base deposit levels have exhibited very little volatility in the last twelve to eighteen months. Recently higher market rates and significantly increased competitor deposit rates have segregated deposit customers between those depositors seeking a rate-only relationship with a bank, and those depositors who value the service levels and product selections of their bank. In addition, management continues efforts to create a treasury management unit that will bridge the gap between branch deposit sales efforts, and the many deposit opportunities associated with linking sophisticated commercial borrowers with an attractive treasury management platform.

Traditional community bank commercial lending – primarily real estate focused - continues in the Bank's target markets. Current strategic efforts focus on the retention of quality, legacy loans, as well as sales efforts to attract new borrowers. Management is presently seeking a relationship based lender to prospect in its headquarters Jacksonville market, and possibly the Tampa Bay market.

Balance Sheet

Total assets of $455 million at June 30, 2019 were $85 million or 23% greater than the $370 million reported at June 30, 2018, and exceeded the $406 million reported at the end of 2018. For both comparative periods, the asset growth was centered in the loan portfolio (excluding mortgages held-for-sale), which increased $45 million compared to year-end 2018, and was $71 million greater than the reported amount at June 30, 2018. For the same period, mortgage held-for-sale balances increased by $10 million or 19% compared to both year-end 2018 and June 30, 2018. The primary driver of loan growth - warehouse lending - increased from $63 million to $131 million from June 30, 2018 to the same period in 2019, and rose $42 million compared to year-end 2018. For the first six months of 2019, commercial lending balances reflected an $8 million or 11% favorable budget variance.

Deposit growth continued during the second quarter of 2019. At June 30 2019, total deposits were $286 million, which represented a $46 million or 19% increase compared to year end 2018, and a $30 million or 12% increase relative to June 30, 2018. The majority of this growth occurred in the specialty banking line of business, which is reflected in the growth of non-interest bearing deposits. For the period ended June 30, 2019, non-interest bearing deposits increased $22 million or 26% compared to year-end 2018, and were $35 million or 47% higher compared to June 30, 2018. From a budget perspective, June 30, 2019 total deposits (excluding brokered deposits) were $19 million or 9% in excess of budget.

Other borrowings were $118 million at June 30, 2019 compared to $102 million at the end of 2018 and $79M at June 30, 2018. Growth in specialty banking deposits allowed the Bank to materially reduce its Federal Home Loan Bank borrowings during the first quarter of 2019; however, the second quarter growth in warehouse lending, and to a secondary extent mortgage held for sale balances, reversed this course of events. As a result, this secured borrowing arrangement has been supplemented by the Bank's active participation in the brokered and institutional certificate of deposit markets for most of 2019. At June 30, 2019, total time deposits were $108 million compared to $81 million at year end 2018 and $94 million at June 30, 2018. All of this growth has come from activity in the brokered and institutional deposit markets. The Bank's liquidity management remains robust, capital is adequate, and asset quality trends remain stable.

Income Statement

For the second quarter of 2019, net interest income was $3.6 million, which was a $900 thousand or 35% improvement compared to the second quarter 2018 reported amount of $2.7 million. For the first six months of 2019, net interest income was $6.8 million compared to $5.8 million budgeted, which represented a $1.0 million or 17 % favorable budget variance. Year-to-date 2019 total interest income of $9.5 million was $1.4 million or 17% in excess of budget, and $2.0 million or 28% higher than the June 30, 2018 reported amount. The majority of the increased interest income was contributed by the warehouse line of business - $1.1 million favorable budget variance in 2019. For the same period, interest expense was $2.7 million or $400 thousand in excess of budget and $700 thousand or 37% greater than the amount reported at June 30, 2018. Non-interest income was $10.3 million at June 30, 2019 compared to $9.7 million at June 30, 2018 representing a $600 thousand or 6% improvement. For the same period, non-interest expenses were $14.1 million compared to $14.5 million. Higher commissions related to higher mortgage originations largely offset the non-interest expense reductions associated with management actions taken during 2018 to reduce staffing levels and related expenses.

Florida Capital Group, Inc. and Subsidiary
Consolidated Statements of Financial Condition
(Unaudited June 30, 2019 and June 30, 2018 - Audited December 31, 2018)

	Unaudited June 30, 2019	Unaudited June 30, 2018	Audited December 31, 2018
Assets:			
Cash and due from banks	$ 9,513,991	$ 8,940,543	$ 9,077,903
Interest-bearing deposits in banks	15,671,756	10,773,201	15,539,877
Cash and cash equivalents	25,185,747	19,713,744	24,617,780
Securities available for sale	14,064,761	20,272,606	27,038,291
Restricted equity securities, at cost	6,493,650	4,642,400	5,661,741
Loans receivable, net of allowance for loan losses of $2,196,788 at June 30, 2019, $2,230,550 at June 30, 2018 and $1,956,613 in 2018	314,596,809	243,403,065	270,007,044
Loans held for sale	62,509,601	52,635,114	52,197,104
Accrued interest receivable	1,515,608	941,784	1,215,632
Foreclosed real estate	2,110,500	2,885,694	3,703,158
Premises and equipment, net	529,188	1,833,312	572,076
Cash surrender value of life insurance	10,682,934	10,432,796	10,559,325
Loan servicing rights	1,813,365	2,034,821	1,975,602
Deferred tax asset, net	4,600,170	-	4,600,170
Other assets	10,559,304	10,932,271	3,927,656
Total Assets	$ 454,661,637	$ 369,727,607	$ 406,075,579
Liabilities:			
Noninterest-bearing demand deposits	$ 108,156,844	$ 73,592,357	$ 86,062,135
Interest-bearing demand deposits	20,140,854	15,104,409	16,169,168
Money market and savings deposits	49,647,591	72,547,144	56,255,437
Time deposits	108,033,357	94,423,075	81,062,111
Total Deposits	285,978,646	255,666,985	239,548,851
Federal Home Loan Bank advances	117,900,000	78,700,000	102,000,000
Fed funds purchased	4,999,997	-	24,000,000
Repurchase agreements	1,277,024	379,420	1,472,021
Notes payable	150,000	150,000	150,000
Accrued interest payable	556,091	371,874	420,441
Accrued expense and other liabilities	4,346,624	3,180,787	2,006,931
Total Liabilities	415,208,382	338,449,066	369,598,244
Commitments and contingencies	-	-	-
Stockholders' Equity:			
Preferred stock Series A, 1,000,000 shares authorized; liquidation preference of $20 per share; 139,553 shares issued	2,791,060	2,791,060	2,791,060
Common stock, $.01 par value; 617,113,408 shares authorized, and 617,030,226 issued in 2019 and 2018	6,170,303	6,170,303	6,170,303
Additional paid-in capital	170,053,745	170,053,745	170,053,745
Accumulated deficit	(139,292,434)	(146,888,514)	(141,838,540)
Treasury stock, 375,763 shares at cost in 2019 and 2018, respectively	(1,809)	(1,647)	(3,191)
Accumulated other comprehensive loss	(267,610)	(846,406)	(696,042)
Total Stockholders' Equity	39,453,255	31,278,541	36,477,335
Total Liabilities & Stockholders' Equity	$ 454,661,637	$ 369,727,607	$ 406,075,579

In the opinion of management, the June 30, 2019 and 2018 unaudited condensed financial statements have been prepared on the same basis as the audited financial statements for the year ended December 31, 2018, and include all adjustments, consisting of normal recurring adjustments, necessary for a fair presentation of the Company's financial position at June 30, 2019 and 2018, and statements of operations for the six months ended June 30, 2019 and 2018. Certain amounts have not been reclassified to conform to the presentation format of the audited financial statements; however, in the opinion of management these reclassifications are not material to the fair presentation of the financial statements.

Florida Capital Group, Inc. and Subsidiary
Consolidated Statements of Income
(Unaudited June 30, 2019 and June 30, 2018 - Audited December 31, 2018)

	Unaudited Period Ended June 30, 2019	Unaudited For The Period Ended June 30, 2018	Audited Year Ended December 31, 2018
INTEREST INCOME:			
Loans receivable and fees on loans	$ 8,755,068	$ 6,955,432	$ 14,709,846
Investment securities	368,199	237,743	554,131
Interest-bearing deposits in banks	339,571	227,235	492,453
Total interest income	9,462,838	7,420,410	15,756,430
INTEREST EXPENSE:			
Deposits	1,484,358	1,054,966	2,285,663
Other	1,234,318	934,714	2,060,567
Total interest expense	2,718,676	1,989,680	4,346,230
NET INTEREST INCOME	6,744,162	5,430,730	11,410,200
	3,575,497	2,655,037	920,460
PROVISION FOR LOAN LOSSES	400,000	0	0
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	6,344,162	5,430,730	11,410,200
NONINTEREST INCOME:			
Service charges on deposit accounts	117,539	146,559	648,161
Mortgage banking income	Incl in Other income	Incl in Other income	13,825,851
Gain on sale of SBA Loans	Incl in Other income	Incl in Other income	1,626,398
Other income	10,173,741	9,534,209	2,319,943
Total noninterest income	10,291,280	9,680,768	18,420,353
NONINTEREST EXPENSE:			
Salaries and employee benefits	9,191,560	9,318,918	18,878,618
Occupancy and equipment expense	774,247	759,752	1,461,874
Data processing, communications and telephone	979,670	979,765	2,571,803
Loan related expense	Incl in Other expense	Incl in Other expense	220,646
Foreclosed real estate expense	Incl in Other expense	Incl in Other expense	359,290
Mortgage banking related expense	Incl in Other expense	Incl in Other expense	1,294,309
Regulatory fees	206,502	205,064	357,107
Professional fees	Incl in Other expense	Incl in Other expense	896,026
Marketing expense	Incl in Other expense	Incl in Other expense	1,128,545
Other expenses	2,925,703	3,239,598	1,614,460
Total noninterest expense	14,077,682	14,503,097	28,782,678
Income Before Income Taxes	2,557,760	608,401	1,047,875
Income Taxes	10,158	10,329	-
Net Income	$ 2,547,602	$ 598,072	$ 1,047,875

In the opinion of management, the June 30, 2019 and 2018 unaudited condensed financial statements have been prepared on the same basis as the audited financial statements for the year ended December 31, 2018, and include all adjustments, consisting of normal recurring adjustments, necessary for a fair presentation of the Company's financial position at June 30, 2019 and 2018, and statements of operations for the six months ended June 30, 2019 and 2018. Certain amounts have not been reclassified to conform to the presentation format of the audited financial statements; however, in the opinion of management these reclassifications are not material to the fair presentation of the financial statements.