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COMPANY INTERVIEW

THOMAS M. VERTIN

Pacific Mercantile Bancorp (NASDAQ:PMBC)

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Pacific Mercantile Bancorp (NASDAQ:PMBC)



THOMAS M. VERTIN has served as President and Chief Executive Officer of Pacific Mercantile Bancorp since January 1, 2016. Mr. Vertin joined Pacific Mercantile Bank as President of the Commercial Banking Division in September 2012. Additionally, he assumed responsibility for central and bank operations, and as interim chair of the bank's executive management committee. Mr. Vertin's 25 years of management experience includes Executive-in-Residence at Carpenter & Company, and 18 years with Silicon Valley Bank — SVB. During his tenure with SVB, Mr. Vertin served in the positions of Chief Operating Officer, Head of California Division, Head of Sales and Service bankwide; he also led three turnarounds: Southeast region, San Francisco Bay region, and the nationwide asset-based lending group. His responsibilities included the client service

operation, product advisory sales — investments, cash management and international trade services — currency trading, SVB securities and SVB Asset Management. His sales teams were responsible for essentially all of the bank's noninterest income — 30% of SVB revenue. Earlier in his banking career, Mr. Vertin also taught finance for eight years at San Jose State University. Prior to his career in banking, he served for three years with the World Health Organization in Geneva, Switzerland. Mr. Vertin served on the board of governors of the Commonwealth Club of California, the nation's oldest and largest public affairs forum. He was a director of the Churchill Club and a member of the San Jose State University College of Business Campaign Committee. He is an active public speaker on topics of leadership, entrepreneurship and innovation. Mr. Vertin earned a bachelor's degree in political science and psychology, and a master's degree in public administration from San Jose State University. He was invited back to his alma mater to deliver the fall 2008 commencement speech for the College of Business.

SECTOR — BANKING

(AZP603) TWST: Please start with some key milestones that have shaped Pacific Mercantile, and tell us about your history with the bank.

Mr. Vertin: Pacific Mercantile was started in 1999. And from 1999 to about 2008, it was one of the fastest-growing banks in California, maybe in California's history, growing from zero to \$1.4 billion in assets. It did that by originating real estate loans, mostly what we call investor real estate loans. The portfolio was lopsided, mostly real estate, and it was funded by CDs; about 80% of the deposits came from CDs.

When the Great Recession hit, it hit the bank hard, which ultimately created the opportunity for a private equity firm to come in and buy a controlling interest in 2012. The private equity firm had their eye on PMBC from about 2011, and that's when I began talking to them.

Prior to PMBC, I worked at Silicon Valley Bank for 18 years. I rose up the ranks and did a lot of different things, but mostly focusing on organic growth and turnarounds of certain divisions within the bank. So when the bank had a division that was underperforming, they would often send me in. I began talking to the private equity firm, Carpenter & Company, in December 2011 and then joined them as Executive-in-Residence in early 2012 in preparation for them to take a controlling interest in PMBC, and ultimately having me do a turnaround of the bank.

I started with the bank in late September of 2012 and

began to bring together my team, four of which were former Silicon Valley Bank people. And we began to change the direction of the bank. We took the bank from a real-estate-focused bank to what's known as a C&I bank, a commercial and industrial bank.

We went from a transaction-oriented bank to a relationship-oriented bank, where we would bank a company's loans, deposits and treasury management. And it took a lot of work to rebuild it and to build the treasury-management products that we needed to be able to offer in order to serve the clients that we aspired to serve. It took us a while to train the lenders and to recruit lenders that understood commercial and industrial lending.

We now have a bank that is poised to grow very nicely. We have changed the balance sheet substantially. In kind of round numbers, 60% of our loan portfolio today is what I would call relationship-based; it's owner-occupied real estate and a lot of C&I loans — lines of credit, asset-based loans, term loans and equipment loans. Now, approximately 32% of our loans are funded by CDs. So we took the CD dependence down from 80% to the low 30s, and we hope to drive that even further down in the future. So we're now a relationship-oriented bank. We have a team in place. We have vendors in place. We have an outstanding credit and risk-mitigation foundation, and we're ready now to complete the turnaround and enjoy some good growth.

So the turnaround is done; it's complete. Now what we need to do is to generate earnings; we need to continue to build the revenue engine. And we are, I believe, on the road to do just that. So it's a growth story now.

TWST: Officially, you took the helm very recently. Was it just back in December of 2015?

Mr. Vertin: Actually, I've been driving the turnaround since September of 2012. I became CEO on January 1, 2016. So the strategy and the team to lead the strategy, the production-oriented team were people that I brought into the bank. Steve Buster did a great job in building out the executive team, including our Chief Operating Officer and Chief Risk Officer, and other positions like that. So I feel like I've been at the helm kind of arm in arm with the CEO, but the transition to a C&I banking model was designed by me.

“The change in our client base has reduced the importance of branches. The clients that we serve now and the ones we are pursuing are more sophisticated companies. They aren't using branches. They use our treasury-management products to handle their banking needs, which eliminates the need to go to a branch.”

Steve did great work. He got us out from underneath the enforcement action that we had with the regulators. We're now in good standing. He closed down, ultimately, the residential mortgage division that was very problematic for us for a number of reasons. He did great work on the bigger-picture items, while my team and I executed the turnaround strategy in the overall banking model and client base.

TWST: What are some of the changes or improvements that you're planning in order to sustain the kind of growth you're targeting?

Mr. Vertin: When you look at a bank of our size, our peers, we've identified 20 of them that we study for various measurements. For instance, 45% of their human resources are involved in infrastructure, accounting and finance, HR, and credit and risk mitigation, and all of that. 55% are involved in production. Well, we fit that model exactly, with 45% of our people in infrastructure and 55% of our people in production. Unfortunately, nearly half of our production people are in branches, and the branches are the least productive deployment of our people.

The change in our client base has reduced the importance of branches. The clients that we serve now and the ones we are pursuing are more sophisticated companies. They aren't using branches. They use our treasury-management products to handle their banking needs, which eliminates the need to go to a branch. So what we are doing is recapturing facilities expense and some HR expense, and redeploying both of these cost savings to highly productive client-acquisition, client-underwriting and portfolio-management positions.

So we are starting the year with seven branches. By July, we'll have four branches, and then, we'll see where we go from there. So we are looking at substantial savings in facilities and substantial savings in branch personnel as we transform our offices to loan production offices. And those savings are going to be redeployed to gain more production people, more client-acquisition people. So client acquisition, analysis, portfolio management, that is where we will continue to invest, while

holding our expenses generally flat. We can hold expenses flat while investing in more productive activities in 2016 owing to the fact that we are becoming less reliant on branches.

When I was at Silicon Valley Bank, they had offices across the country and only one branch. I look at some of the best-performing banks in the country — Square 1, Bridge Bank — they have offices across the country and only one branch. It's a model that I appreciate.

TWST: So PMBC's primary customer base is gravitating toward online banking?

Mr. Vertin: Our clients aren't gravitating. They're there. The clients that we've brought in since 2013 rarely go to branches. Instead, they use our suite of treasury-management products.

One of the people I brought over from Silicon Valley Bank — SVB — was Cindy Verity; she ran my \$40 million treasury-management business at SVB. I brought her here, and she recreated a suite of treasury-management products, so there's no reason why any of our sophisticated clients need to walk into a branch, and they don't. We're aspiring to serve companies with revenue from \$10 million to \$60 million, and we're able to serve them in a way that makes branches obsolete. In the third quarter of 2015, 593 branches were closed across the country by all kinds of banks. That is the trend in the industry, and it's one that I think will persist.

TWST: Can you give us a closer look at how the fabric of your customer base has evolved since you've been at Pacific Mercantile?

Mr. Vertin: Before I got here, our client base was largely real estate developers, and the primary transaction we did was investor — i.e., non-owner-occupied commercial — real estate loans. Typically, we needed to be the cheapest deal on the table. Today, we're no longer targeting real estate loans unless we have the entire banking relationship with the company. We'll do owner-occupied real estate where we have a relationship that extends beyond just loans. And fortunately, we no longer need to be the cheapest deal on the table to win because we add value in ways that the little banks can't and the big banks won't.

So let me give you an idea of what I'm talking about. We call it Horizon Analytics. Early in my tenure, we began to understand the aspirations that each client has for their business. And then, we do analysis that compares their operations with their industry peers, and we show them where they can improve. We show them what their sustainable growth rate is. We bank them like the bankers used to bank a company 20 years or 30 years ago.

We show them their sustainable growth rate. We show them what their company might be worth. We show them what would happen if they could collect their receivables a little faster or what would happen if they could take advantage of some of the discounts from their vendors. So we do all this modeling for them. We do it upfront, even before they are clients. And that makes us unlike any bank they've ever encountered.

So when we involve Horizon Analytics, we win eight out of 10 times. When we don't involve Horizon Analytics, we win maybe half the time. So we have found a way to differentiate ourselves from all the other banks. It's not only the treasury-management tools that we offer, it's not only the fact that we now have a high caliber of C&I bankers, but it's also because we provide Horizon Analytics.

We provide them insights into the financial decisions that they make.

“It’s an outstanding performing portfolio, and there are not a lot of banks that do it. Many banks avoid film production financing because the perceived risk far exceeds the real risk. We structure these deals in such a way that, whether it’s a box office hit or not, we get our money back. So we have a specialized industry group called entertainment industries.”

Most of the companies that we bank have two advisers, two sources of counsel; one is a CPA, and the other is a lawyer. The CPA often advises them on aggressive tax avoidance. Now, we’ve provided a third adviser, and that’s our banker. And if what they want to do is leave a legacy for their kids and build the business, we can show them the pathway forward, and often, it’s not through aggressive tax avoidance. It’s through reinvesting in the business. So it’s a different conversation we’re making available to our clients and prospects, and it’s one that is really resonating well and driving the growth of our business.

TWST: Are all of these analytics completely accomplished online? If not, how does this fit into the increasingly branchless distribution model?

Mr. Vertin: We will maintain our offices. We are not closing offices; we are transforming them from full branches to loan production offices. We often sit down face to face with our clients. The online part of our business is treasury management. It’s just managing the money that moves into the accounts, managing the money that moves out of the accounts, having information about the accounts and providing an appropriate amount of control and security.

So we’re not cutting branches. We’re transforming branches to banking offices. We’re going to have seven offices. We’re not lowering the number of offices. We’re not changing our geographical footprint. So the branch in Ontario becomes an office, a loan production office. The branch in San Diego becomes a loan production office. The branch in South Orange County becomes a loan production office. So we’re not closing anything, we’re just transforming them.

So where the facilities savings comes from is moving from expensive and large retail space to less expensive office space. We’re giving up the expensive retail space, and instead, we’re moving to offices up on the second or third or fourth floor because we don’t need that ground-floor branch any longer. The space requirement is smaller and less costly. And it’s through the combination of those two things that we’re saving money on facilities.

TWST: Do you focus on or specialize in serving any particular industry or business type?

Mr. Vertin: I can answer that question in two ways. We have one specialized industry, and that is our entertainment division. And through the entertainment division, we do film production financing. We’ve been doing it for six or seven years, well before my tenure started. It’s an outstanding performing portfolio, and there

are not a lot of banks that do it. Many banks avoid film production financing because the perceived risk far exceeds the real risk. We structure these deals in such a way that, whether it’s a box office hit or not, we get our money back. So we have a specialized industry group called entertainment industries.

We have another specialized group that is asset-based lending. One of the things I did at Silicon Valley Bank was turn around the asset-based lending group and grew it substantially. So as a result of that experience, I was well aware of asset-based lenders in Southern California. We recruited one of the bankers from Silicon Valley Bank to build our asset-based lending group. We have infused it with powerful infrastructure both in terms of technology and credit risk management, and we anticipate substantial growth coming from our asset-based lending group.

TWST: Aside from the clear secular trend toward online banking, what other demographic, secular or macroeconomic trends do you see ahead?

Mr. Vertin: Southern California is doing really, really well, both in terms of increasing its share of venture capital investment and in terms of its general economy. So unemployment is trending down, and the economy is robust in the four counties that we serve: San Diego County, Orange County, LA and what’s called the Inland Empire. So we are in a part of the country that has a very robust economic environment, and I think that bodes well for us and other banks in the area.

TWST: What are the challenges that might emerge in the coming year, and what worries you most on a day-to-day basis?

Mr. Vertin: The greatest challenge has been finding good people, finding the best people. And so we painstakingly have done that over the last three years. There are positions that we left open for six months because we weren’t happy with the people that we have applying to fill those. Well, we have now filled them all. And we now have a reputation for winning when we compete against another bank — the probability of our winning is greater than I think most.

Therefore, our people have become targets, and so I’m concerned about holding on to our best and brightest that we have so painstakingly put together. Probably the thing that keeps me awake at night is how I can keep people aligned and infused with enthusiasm for helping their clients succeed. And that’s what we’re all about.

TWST: What’s your growth strategy going forward over the short and longer term? Is there M&A ahead or, more likely, organic growth?

Mr. Vertin: I could say emphatically that it’s organic growth. We’ve looked around, and there’s nobody that we want to buy. There’s nobody that we think will be really accretive to our balance sheet. If there was a bank out there that was just full of deposits, then we probably would take a look at them, but that’s not the way it works. We think that we have the opportunity to grow substantially organically. We think we have enough of the competitive advantage both in terms of entertainment- and asset-based lending.

And now, in our seven offices, we have the talent that we need to outperform and outcompete the other banks. So I think that we will be growing substantially through our asset-based lending, and our noninterest income will be driven by our treasury-management products suite, including our recently released corporate credit card, which companies can use to manage their payables. And all of those

treasury-management tools generate fee income for us. So I just think we're going to be a really well-grounded bank. We're going to be self-funding through deposit acquisition, and I'm really excited about the next couple of years. I can't see out 10 years all that well, but I could see out over the next 24 months, and I think that we're going to outperform the industry.

TWST: How worried are you about the rising threat of cyber risk?

Mr. Vertin: It's something that we take very, very seriously. We take it so seriously that we have a new board member that is an expert in cyber risk. We think we have the state-of-the-art cyber risk mitigation. We take it very, very seriously. But we think we're on top of it, and it's something that we look at all the time. We have a new head of IT, and he's very well-versed in cybersecurity. So it's never something I'll be comfortable about, but I believe we're doing everything we can to manage the risk.

TWST: Do you feel that Wall Street has a good understanding of Pacific Mercantile? Is there anything you'd like to clarify before we close?

Mr. Vertin: I don't think that we've really been on the Wall Street radar. We've been such a poorly performing company for so long, I think we've been forgotten. I am beginning to do investor conferences. I can deliver with great enthusiasm our vision for the future, point to some successes we've had in the last couple of years. I think that we'll be growing investor interest

as we perform in 2016. Right now, we're thinly traded. I would imagine that it will be different this time next year.

TWST: Can you share a few key points that prospective investors should focus on when evaluating the stock?

Mr. Vertin: I would say to look at the changes in the deposit and loan mix, and the growth in the loan portfolio. I think that we'll also have a widening net interest margin, and not only due to rising rates. By the way, I don't think rates are going to be rising anymore in 2016. But we're going to have a rising net interest margin driven by our clients' recognition of the value of what we're offering, and the change in mix to more C&I and asset-based lending, and the move toward cheaper deposits. That will cause our margin to increase.

TWST: Thank you. (VSB)

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