Alerus Financial Corporation
Q4 2020 Earnings Conference Call
January 29, 2020 at 10:00 a.m. Eastern

CORPORATE PARTICIPANTS
Randy Newman - Chairman, President, and Chief Executive Officer
Katie Lorenson - Chief Financial Officer
Karin Taylor - Chief Risk Officer
PRESENTATION

Operator
Good day and welcome to the Alerus Financial Corporation’s Earnings Conference Call. All participants will be in listen-only mode. Should you need assistance, please signal a conference specialist by pressing the star key followed by zero. After today’s presentation, there will be an opportunity to ask questions. Please note that this event is being recorded.

This call may include forward-looking statements, and the company’s actual results may differ materially from those indicated in any forward-looking statements. Important factors that could cause actual results to differ materially from those indicated in in the forward-looking statements are listed in the earnings release and the company’s SEC filings.

I would now like to turn the conference over to Alerus Financial Corporation’s Chairman, President, and CEO, Randy Newman. Please go ahead.

Randy Newman
Thank you and good morning, everyone. Let me first begin by giving a high-level overview of the fourth quarter as well as some overall comments about 2019.

We are pleased to report net income of $7.652 million for the fourth quarter and record net income for Alerus of $29.54 million, an increase of 14.2% over the $25.87 million reported in 2018. Our CFO, Katie Lorenson, will explain our results in more detail later, but there was about $2 million in non-reocuring [sic] income in 2019. If you take that out, our core earnings increased $1.8 million over 2018, or a 7% increase. Year-to-date ROA was 1.34, ROE was 12.78, and ROTCE was 17.46% for 2019.

The ROE and ROTCE ratios were influenced both by the increase in earnings but also by the increase in shareholders’ equity from the capital raised in September. Dividends per share increased $0.04 per share to $0.57, and EPS on a fully diluted basis increased from $1.84 in 2018 to $1.91/share in 2019. Earnings per share in 2019 was affected by both the increase in earnings and also by the 3.6 million increase in outstanding shares as a result of the IPO.

Two thousand and nineteen was a very successful year for Alerus, both with record financial results as that — as well as with the achievement of several key strategic objectives. With disciplined planning and focused execution, we have significantly improved the foundation of Alerus and established great momentum for us as we begin 2020 and a new decade.

In 2019, we exercised a sense of urgency as we made improvements in both our credit quality and credit leadership. We successfully completed an IPO that improved our capital ratios and positioned us well to grow both organically and selectively by acquisition. We became NASDAQ listed, which improves our shareholder liquidity and gives us the option of potentially offering our stock as an alternative currency for potential acquisition opportunities. In addition, we completed several technology projects, all aimed at enhancing our clients’ experiences and improving our ability to grow organically.

These projects do more than just move the needle in terms of client experience. They also help us advance revenue synergies from our high-value professional services business model and from the numerous acquisitions we have completed over the last decade. In the past year, we have completed a number of client-application technologies. Our strong and diversified core operating earnings have allowed us to achieve better-than-average financial results, while still
meeting the needs of our clients by investing in client-application technologies with a digital delivery solution and access to their total financial information.

In the last decade and as a result of strategic planning focus on growing the Alerus franchise, we tripled the size of Alerus. We entered two new national growth markets, the Twin Cities of Minnesota and the Phoenix/Scottsdale metropolitan area in Arizona. We added complementary business lines with the addition of our benefit services and ESOP advisory national practice. And we also significantly grew our mortgage business line with the addition of a high performing mortgage company.

These strategic initiatives greatly enhance our product and service offerings, while increasing our brand recognition, client base, and financial performance. In addition, they have provided significant revenue and balance sheet synergies to Alerus. This is a very strong strategic focus of our organic growth strategies and led to the formalization of a national market in 2019 and the naming of a national market president. To date, synergies in these areas have produced $425 million of deposits sourced from our HSA and retirement and benefit plan clients, $500 million of excellent quality single-family residential loans that we have added to our loan portfolio, and over $500 million of IRA rollovers that we have added in our Wealth Management Division.

As mentioned, we completed several key strategic initiatives in 2019 that have significantly improved our foundation. In September, we completed our IPO and launched the MY ALERUS holistic digital client portal. In November, our Board approved a five-year strategic plan focusing on organic and strategic acquisitions to deploy the IPO capital. As mentioned, we completed several technology projects aimed at enhancing client experience, and we have grown and developed our leadership depth and talent by promoting several internal leaders, while adding external talent where necessary. After strengthening our infrastructure foundation and leadership, we are now in a position to focus externally.

I will now turn it over to our CFO, Katie Lorenson, to discuss our financials in more detail.

**Katie Lorenson**

Thank you, Randy. Good morning, everyone. Thank you for joining our call today. I will spend just a few minutes today providing some additional color on the financial results for the quarter. On summary — in summary, we are very pleased with the results of the quarter, and we look forward to seeing the momentum built in the last few months, carrying into a strong 2020.

I’ll start with a few comments about the net interest income and the margin. Net interest income was fairly stable for the quarter, and excluding the recovery for the third quarter, would have been up slightly. The net-interest margin dropped to 345 from 360 in the third quarter. This decline was primarily due to the elevated liquidity and the deposit growth and to the growth in the commercial real estate portfolio.

We did see a decrease in our funding costs, most significantly in our money market accounts, which include our deposit source from our wealth and retirement lines of business. With the continued pressure on our margins, our focus is on building earnings through our diversified business model and continuing to drive revenue towards non-interest income. Our Mortgage, Retirement, and Wealth Management Divisions all delivered a great quarter of results to end the year.

A couple of highlights to note. Starting with our retirement benefits line of business, the fourth quarter included approximately $500,000 of plan document fees. This related to a change in
law — IRS regulations in late — the late third quarter of 2019. It should be noted this is one time in nature. We also recognized nearly a $1 million increase in fees from the third quarter, partly due to seasonality but also related to fee schedule changes that we’ve been implementing throughout 2019. Revenue sharing stabilized in the third quarter and returned to an average run rate of approximately $600,000. Lastly, our ESOP business closed the quarter strong and finished with a record year.

Our wealth management line of business also had a record fourth quarter, with revenue over $4.1 million. Our advisors delivered impressive new IRA business of $53 million, and there were several key wins in our Grand Forks, Fargo, and Minneapolis markets as well as our largest business owner liquidity event in company history at $148 million, all of which pushed assets under management to surpass the $3 million threshold at year-end.

Revenue in our Mortgage Division continued at a robust pace in Q4. We ended the year at nearly $950 million in originations, with a 70/30 purchase versus refi split. The transition to mandatory delivery in February of this year as well as the investments in technology has greatly improved the possibility of the division, the capacity of the originators, and the efficiency of the operation.

Other non-interest income returned to a more typical run rate after two quarters of non-recurring gains, as Randy mentioned, with the sale of our Duluth office in Q2 and the sale of the land from our Grand Forks express branch in Q3.

Moving on to expenses, from an expense standpoint, a fairly clean quarter, some adjustments to accruals and expected seasonal decreases in incentives related to mortgages — mortgage benefits and payroll assets.

From a loan credit-quality provision standpoint, we experienced a tremendous amount of change in our company over the past 18 months. That included a change in credit leadership, significant investments in technology, and talent and sales training. We also realigned our client-facing teams to specifically focus on either consumer or business clients. We are very pleased and begin to see the impacts of these changes and investments.

Loan grown was solid for the quarter and was fueled by taking advantage of CRE opportunities in our markets, the result of a relatively low concentration of non-owner occupied CRE in our portfolio, and the expertise acquired through our leadership teams. The increase in the provisions expense for the quarter was aligned with this balance sheet growth.

Overall, credit quality continues to improve with a year-over-year decrease in criticized loans of over $20 million, or 24%. Non-performing loans increased during the quarter due to one commercial credit; however, the overall level of non-performing assets remains low at $7 million, with an allowance to non-performing ratio of over 3 times.

Lastly, on the funding and synergies side, growth in our core funding side of the balance sheet was very strong. Our deposit portfolio continues to be well balanced with one of the higher percentages of non-interest-bearing deposit portfolios relative to our peers. We had some really nice wins for Commercial Treasury Management, and we continue to benefit from looking across our business lines for deposits. We have increased our deposits in our national markets, which again has growth deposits that aren’t tied to a physical location, by nearly $200 million in 2019.
With that, that concludes our prepared remarks, so we would welcome any questions.

QUESTIONS AND ANSWERS

Operator
We will now begin the question-and-answer session. To ask a question, you may press star, then 1 on your touchtone phone. If you are using a speakerphone, please pick up your handset before pressing the keys. To withdraw your question, please press star, then 2. At this time, we will pause momentarily to assemble our roster.

Our first question comes from Jeff Rulis, D.A. Davidson. Please go ahead.

Jeff Rulis
Thanks, good morning.

Katie Lorenson
Good morning, Jeff.

Jeff Rulis
Just a question on the — Randy, you spoke about the — in the opening comments, kind of focusing externally. I wanted to get an update on the MY ALERUS transition into 2020 and how that translates to either steady or accelerating efficiency, maybe more specifically, speak to kind of the expense run rate that you’d expect to see over the balance of the year.

Katie Lorenson
Hi, Jeff, I’ll — this is Katie — I will take that question. So again, a couple of things. MY ALERUS is our way of life. It is our culture, but it also involves many things such as breaking down our silos throughout the company and, within that, optimizing everything we do and focusing on building clients through extending relationships, of course, as well as new client development. So it’s very, very broad, but specifically to the extent is, we look to have low single-digit growth in expenses as we look into 2020. I think run rates in the first quarter should be pretty similar to what we saw in the fourth quarter of 2018 — or 2019, excuse me.

Jeff Rulis
Got it. Okay. Thank you. And then I guess on the margin, if you exclude that interest recovery in the third quarter, still saw some, you know, some margin pressure, and you kind of walked through some of the reasons for that. I guess the — what perhaps has changed maybe on the margin front and how that translates to the 2020 outlook?

Katie Lorenson
Yes. This is Katie again. Good question, and we do expect to see further compression into Q1, down to around the 340 level and really just a result of continued growth in that — in the deposit portfolio and liquidity and taking some time to put that into the Barnes portfolio as well as the loan portfolio. So we do expect it to stabilize, assuming no rate changes subsequent or in 2020, but the mix is certainly having an impact on some of that compression.

Jeff Rulis
Got it. Okay. I’ll step back. Thank you.
Katie Lorenson
Thank you.

Operator
Again, if you have a question, please press star, then 1. This concludes our question-and-answer session. I would now like to turn the conference back over to Randy Newman.

Oh, excuse me, there has — two questions just came in now. One moment, please.

The next question comes from Daniel Cardenas from Raymond James. Please go ahead.

Daniel Cardenas
Good morning, guys.

Randy Newman
Hi.

Katie Lorenson
Good morning.

Daniel Cardenas
Maybe if you could provide just kind of a quick update on the M&A front. What’s the environment looking like right now, and, again, just a reminder of its focus primarily on the retirement and benefits side, or were you having a renewed interest on the traditional bank side?

Randy Newman
Well, we’re — we’re fortunate. We are looking, and we have sourced a number of opportunities that we are looking at. Consistent with what we put in the S-1, you know, we like the split we have. We would like to maintain that, and right now we have been shown some banking and — or banking and/or branch opportunities, and we have been able to look at a couple of what we call fee-income acquisitions, primarily again or solely in the retirement and benefit areas.

Daniel Cardenas
Great. And then on the loan side, a really kind of better-than-expected loan growth this quarter. Do you feel that kind of robbed a little bit from Q1 ’20, and what’s your outlook for overall loan growth in 2020?

Karin Taylor
Sure, Dan, this is Karin. No, I don’t think it necessarily robbed from first quarter. We have a fairly solid pipeline overall for 2020. We are still expecting mid-single-digit growth.

Daniel Cardenas
Great. I’ll step back. Thank you, guys.

Karin Taylor
Thanks, Dan.

Operator
Our next question comes from Nathan Race, Piper Sandler. Please go ahead.
Nathan Race
Hi, everyone. Good morning.

Randy Newman
Hi, Nathan.

Katie Lorenson
Hi, Nathan.

Nathan Race
I apologize. I got on a little late, but I was just curious if there was any color provided on the retirement and benefit services income and just the growth outlook for 2020. Obviously, you know, a nice increase sequentially in the fourth quarter so just curious how we should think about the run rate kind of trajectory over the course of this year.

Katie Lorenson
Yes, great question, Nathan. This is Katie Lorenson. So the outlook for ’20, I would say we think it’s flat, so it will actually be down, excluding the one-time $500,000 that we recognized in the fourth quarter. There is some seasonality in the numbers, so we would expect to be in the mid 15s for the first quarter, because there is — there will be less going-forward seasonality, but there will be — there will always be because of the ESOP transactions, et cetera, some lumpiness and weighting towards the fourth quarter.

Nathan Race
Gotcha. And, Katie, you mentioned there was $500,000 of elevated fees in the fourth quarter, if I caught that right?

Katie Lorenson
That’s correct. Yes.

Nathan Race.
Okay, great. And just going back to credit quality — I’m not sure if it was touched on — but [inaudible] quarter. Oh, sorry. I’m just curious if you can provide any color on what drove that [unintelligible] overall outlook for provisioning in 2020 as well.

Katie Lorenson
Sure. The increase in non-performings was due to one commercial real estate loan. It’s actually a credit in service by our Special Credit Services Department for some time. It does continue to pay, however, with some updated information late in the fourth quarter, we did choose to move it to non-accrual.

In general, credit quality has improved, and we believe that it will be fairly stable through here. You know, in terms of provisioning, we expect it to come down from 2019, probably in the mid $5 million range.

Nathan Race
Okay. That’s very helpful. And then, I guess just going back to the overall balance sheet [inaudible] on kind of mid-single-digit loan growth, is the expectation that, just given all the synergies that you guys are seeing with [unintelligible], that your expectation is that deposit growth could exceed loans in 2020?
Katie Lorenson
It’s a good question. I think as we look at it, we look for the increases to be fairly aligned. We did capitalize on some significant opportunities in 2019, and we believe there will be a couple more of those as far as the pools of deposits in 2020, but it certainly won’t be at the pace that we saw within 2019. That being said, what we’ve seen from our markets and the growth in the commercial deposits has also really — in the fourth quarter, was also very impressive. We do anticipate that that will help make up some of the ground from the national market not growing as — at as robust of a pace. So I would put deposit growth in that mid-to-upper single digit range also.

Nathan Race
Okay, got it. I appreciate all the color. Thank you

Katie Lorenson
Thanks.

Operator
Yeah, if you have a question, please press star, then 1. This concludes the question-and-answer session.

Now I’d like to turn the conference back over to Mr. Randy Newman for any closing remarks.

CONCLUSION

Randy Newman
All right. Thank you. Let me extend our appreciation to everyone who joined our call this morning. Thank you for listening and thank you for your questions.

As you heard in our discussion, 2019 was a very good year for Alerus, both in terms of our solid financial performance and also in terms of achieving strategic non-financial initiatives. We balance long-term strategic technology investments, while simultaneously achieving record performance. This is not by chance. We have a long history of planning backed by an engaged team of employees who continuously perform at high levels. Two thousand nineteen was transformative in so many ways, and our foundation has never been stronger. With key client technologies in place, an organized team focused on serving our consumer or business clients, continued progress of synergistic growth opportunities, and a strong capital position, we have great momentum entering the next decade.

Thank you again for joining today’s call.

Operator
This conference has now concluded. Thank you for attending today’s presentation. You may now disconnect.