

Alerus Financial Corp.

Q1 2021 Earnings Conference Call

Thursday, April 29, 2021 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 morning, and welcome to the Alerus Financial Corporation earnings conference call. All participants will be in a 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 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 Chairman, President, and CEO, Mr. Randy Newman. Please go ahead.

Randy Newman

Thank you, Cameron, and good morning, everyone. This morning, we intend to discuss our first-quarter 2021 and also to give a current update on the impact of the COVID-19 pandemic. Today, I'm joined by our Chief Financial Officer, Katie Lorenson; our Chief Risk Officer, Karin Taylor; and our Chief Shared Services Officer, Ann McConn. As always, we appreciate your interest in our company, and we invite your questions at the end of our introductory remarks.

We are pleased to report our record performance of 2020 carried through end of the first quarter of 2021. Alerus continues to be well positioned for growth with our diversified business model, large and growing client base, and our holistic advisor-focused approach to serving clients. We started 2021 with several hiring initiatives, and we're pleased to have two of the top mortgage producers in the Twin Cities region join our team in the first quarter. We continue to focus on adding talent to our organization, especially in areas that will grow revenue.

Our fee income business lines delivered strong results, with mortgage originations exceeding \$500 million for the quarter. Retirement and benefits revenue increased over 8% as the integration of our recent acquisition of RPS 24-hour Flex continues to go as planned. Wealth management revenue grew during the quarter almost 4% as our advisors remain focused on proactive outreach to our clients and our local footprint and nationwide. During the quarter, we continued to see stable credit quality, strengthening local economies and low levels of loan deferrals.

Our reserve levels remained very robust at over 2% of loans, excluding PPP. In addition, we saw a modest uptick in commercial line utilization, solid loan demand and building pipelines. In addition to our emphasis on growth, we are also focused on technology investments, a journey which started in 2017. Over the last several years, we have invested in new technology for both our business and consumer clients, and now we continue to develop robotics and other automation to improve our efficiency and support our ongoing growth initiatives. Furthermore, we recently became one of 66 limited partners in a fund focused on the acceleration of technology for community banks. We believe this is a valued partnership that will allow us to stay abreast of emerging technology trends in the community banking landscape.

Also in the first quarter, we redeemed our previously issued sub debt at a rate of 5.75% and refinanced with the Bank of North Dakota at a rate of 3.5%.

Our capital levels remain strong, and we believe we have top-tier capital return potential with our proven ability to execute accretive M&A, our history of strong dividend yields and our newly approved stock buyback plan. We believe our ability to execute a diversified business model, in tandem with our strong financial foundation, will maximize stockholder value long term. We also approved a \$0.15 per share cash dividend payable in the first quarter. My records go back to the late '60s and show that Alerus has always paid a cash dividend. But since 1987, we have increased our cash dividend every year at an average of 10% per year for the past 35 years, with an average annual cash dividend payout of 30%. When measured over 10 years, our annual increase in cash dividends has averaged 7.4%, with an average cash dividend payout of 31%.

At our February 2021 board meeting, our board approved a three-year stock buyback program for the repurchase of up to 770,000 shares effective immediately. Repurchases, if and when made, would be in the open market and based upon market conditions.

In addition, I'd like to mention that last quarter, we announced that we had been named to the Piper Sandler All-star list and also to the American Banker 85 Best Banks to Work For. This quarter, we are proud to announce that we were named to the inaugural Hub D High Performers List and to the Raymond James Community Bankers Cup for 2020.

Finally, we are most proud of our annual Employee Satisfaction Survey, where our overall satisfaction score increased from 76% to 81%, an increase of five points, a significant improvement during a very challenging year. These recognitions are valuable to us because we continue to focus our success with our employees, our clients, the communities we serve and driving long-term growth for our shareholders. We know our ability to continue to focus on driving growth the right way and succeeding with our clients wins in the long run, evidenced by another successful quarter.

With that, let me turn it over to Katie.

Katie Lorenson

All right. Thank you, Randy. And thank you to all of you who are joining our call this morning or listening at a later time. I'll be brief in my comments this morning as the quarter results were very strong and generally in line with our expectations. I do believe Alerus is one of the few financial institutions reporting linked quarter growth in noninterest income or fee income, so I will start there with my prepared remarks.

As Randy mentioned, mortgage had another strong quarter and, in fact, a historic record for first quarter volume. This is also our highest quarter ever of refi volume. At the end of 2020, we anticipated a steady decline in the pipeline during the first quarter. The pipeline did decline some, but not to the level we anticipated and the valuation of the pipeline actually increased slightly as the value and related pricing and mandatory delivery of loans to the secondary market continued to increase.

We are seeing the refi business slow, consistent with the market and the valuation of the pipeline decline. As such, we do anticipate the first quarter to be the high watermark for mortgage revenue as originations decline and the gain on sale margins normalized. As the forward pipeline declines, the decreases in its value will act as an additional headwind to the reported mortgage revenue.

As we mentioned in our release, and Randy mentioned earlier, during the first two quarters we added two high-producing purchase-focused originators to our team, and it's important to note that our Alerus mortgage division and our team have always historically been predominantly focused and highly

successful on the purchase side of the mortgage business. Our typical split is 70% purchased, and we did see purchase volume at strong levels for the first quarter despite the lack of inventory in the Twin Cities. In summary, we expect our mortgage division to continue to shine and deliver higher than peer origination levels and revenue despite the pullback on the refi business.

We're also pleased to report the retirement revenue growth with a full quarter of revenue from our recent RPS and 24-hour Flex acquisition. The integration of the teams and the business continues to go really well, and all of our team members have done a tremendous job of client retention, identifying growth opportunities and seamlessly converting the clients and employees into the Alerus network.

Last but not least, on the fee income side was wealth management, which grew on the linked quarter, and typically that's a seasonal low for us in the first quarter. So shout out to our Alerus advisors who delivered really strong production and revenue growth of 23% on a year-over-year basis.

As I say on every call, we believe our diversified business model and revenue has never been more valuable in the backdrop of the environment. In that regard, I'll turn it over to brief commentary on the margin and the related outlook based on what we know today.

During the quarter, we recognized approximately \$3 million of PPP interest income and revenue, and we have approximately \$6 million of PPP deferred loan fees and interest remaining to be recognized. We continue to move the cash into the investment portfolio, which ended the quarter at nearly \$800 million. Despite the increase, cash levels remained at \$200 million as deposits continue to grow due to government stimulus, success in the commercial acquisition side and PPP forgiveness.

Our total cost of deposits is at a record low, 16 basis points, and the net interest margin continues to be heavily impacted by the huge amount of liquidity on our balance sheet. We anticipate moving further from our scratching to get to 3% and could see that 2.8 core margin in the future.

Lastly, touching on expenses. Generally pleased with our expense management. You'll see our occupancy rate dropped 70% in the linked quarter, which is a result of our office closures that we announced last year. Compensation dropped primarily due to mortgage incentives decreasing from \$7.9 million to \$6.7 million for the quarter, and we expect to see compensation decreasing in correlation with those mortgage volumes declining.

There were really no outliers or nonrecurring items of note in the other line items.

And I'll end with just a high-level comment and piggyback to Randy's opening remarks. First off, I want to say thank you to our Alerus team members, most of whom are shareholders and many of whom will be listening to this call. You all just continue to do amazing work in serving our clients and growing our business.

Although we face industry headwinds, like so many financial institutions, we continue to prove that our business model, diversified revenue and team members who are full of passion and driven by purpose to serve our clients, deliver exceptional results. We believe we will continue to execute and deliver above-average returns compared to our peers despite the headwinds we and all financial institutions face.

So with that, I'll turn it over to Karin Taylor, our Chief Risk Officer.

Karin Taylor

Thank you, Katie, and good morning, everyone. I will begin with a quick update on our banking market.

With the vaccine rollout and the continued lifting of business restrictions, activity is picking up in all of our markets. We are making progress in expanding the reopening of our lobbies across our footprint, while also continuing to serve clients virtually and digitally.

Loans decreased by \$42 million during the first quarter due to decreases in the C&I and consumer portfolios. PPP forgiveness outpaced second round PPP production, and while commercial line utilization picked up slightly to just under 23%, it remains low compared to historical utilization, which is typically closer to 35%. The decrease in the consumer portfolio was due to mortgage refinance activity paying down home equity loans and lines, as well as runoff in the indirect portfolio following our decision to exit that business line.

As of April 21st, we had processed almost 2,400 PPP applications for \$478 million. That includes 800 second round applications for \$111 million. We continue to work with our clients on the PPP forgiveness process, and the SBA has approved over 1,100 of our applications totaling \$199 million.

With respect to deferrals, we granted some type of deferral on about \$154 million in balances, or 9% of the portfolio. Request for payment relief were very limited during the quarter, and as of March 31st, approximately \$8.4 million in loan balances remained on deferral, or about 0.5% of outstanding and guaranteed loan balances. \$767,000 in deferred balances were in the initial deferral period, and the \$7.6 million of deferred balances in an additional deferral period are concentrated in our one to four family residential portfolio.

Our credit metrics remained strong during the quarter. Nonperforming loans to total loans remained low at 25 basis points, or 28 basis points excluding PPP loans. Loans downgraded or moved to nonaccrual during the quarter remained at very manageable levels and are best characterized as normal migration in the portfolio.

We recorded net charge-offs of 488,000 during the quarter. This was primarily the result of a write-down on a commercial real estate property that was stressed prior to the onset of the pandemic.

No provision was recorded during the quarter due to strong credit metrics and the decrease in loan balances. The level of the reserve continues to be driven by qualitative adjustments due to economic uncertainty.

As Randy mentioned, the ratio of the allowance to total unguaranteed loan balances was 2.01% at the end of the first quarter, and the allowance to nonperforming loans increased to 710%. Our credit continues to perform better than we had expected it would last spring; however, some uncertainty remains about future performance as all of the stimulus comes to an end. We continue to monitor the portfolio closely and believe our strong balance sheet, credit culture, diverse loan portfolio and geographic footprint position us very well to address the continued economic impact of the pandemic.

We expect loan growth will continue to be challenged through the second quarter given the high levels of liquidity on the part of borrowers; however, our markets are reporting increasing activity. We expect pipelines to continue to strengthen as we approach the second half of the year as our business advisors are seeing more opportunities and as efforts that have been focused on PPP can be redirected to more new business development.

This concludes our prepared comments, and we will now open it up for questions.

Questions & Answers:**Operator**

Thank you. To ask a question, you may press star then one on your telephone keypad. If you're using a speakerphone, please pick up your handset before pressing the keys. To withdraw your question, please press star then two. At this time, we will pause momentarily to assemble the roster of questioners.

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

Jeff Rulis

Hi, good morning.

Katie Lorenson

Good morning, Jeff.

Jeff Rulis

On just some line item detail. Katie, I think I got a pretty clear read on the mortgage if we kind of back out the MSR and the outlook there. I heard you on the high watermark and the push and pull. But how about the retirement and benefit, and then the wealth management lines, I would imagine the sequential retirement and benefits with RPS was a bit of a one-off, but do you expect growth from here as well as what do you see in the wealth management? Thanks.

Katie Lorenson

Sure. Run rates in regard to both moving forward, again, strong production on the wealth management side, exceeded our expectations. I think we were in excess of \$100 million of production this quarter. Last year, we were at \$300 million for the year. So I'd expect to see, assuming stability in markets, pretty consistent results for that line item. And I would guide to the same on the retirement side.

Jeff Rulis

OK. Great. And then if I can just follow-on with the expense side. Is that a pretty sustainable drop? You talked about some hires and continue to look for talent when it comes. And I'm sure you'll be opportunistic but wanted to kind of see about this \$43 million run rate. Any expectations for expenses through the year?

Katie Lorenson

Based on where I would guide to today, again, I think that we'll be pretty consistent in this line item also, with the exception, of course, of the incentive comp dropping on the mortgage side of originations.

Jeff Rulis

Got you. OK. And maybe just the last one and bigger picture. I noticed the synergistic deposits down in the quarter. Really, rare times from a liquidity standpoint. Maybe just big picture, kind of what are you seeing – I mean, I imagine that's still a focus, but also, you've got a ton of liquidity, so anything to touch on in terms of your funding base?

Katie Lorenson

It's a good question. The decline in synergistic deposits was driven mostly as we saw some of the retirement money market cash that flowed in during the times of volatility in 2020 being redeployed into the markets in that particular synergistic deposit, and so that was really the driver of that decline. And overall, on a funding basis, as I mentioned, we've had some really nice wins on the commercial

acquisition side of deposits, and we'll continue to build both core deposits. Even despite the levels of liquidity, we know that we'll be able to put it to work eventually.

Jeff Rulis

Thanks, Katie. I'll step back.

Operator

Thank you. Your next question is from Nathan Race, Piper Sandler. Please go ahead.

Nathan Race

Hi, everyone. Good morning.

Katie Lorenson

Good morning, Nate. Good morning.

Nathan Race

Katie, just to follow up on that discussion around the margin outlook, I think you alluded to ex PPP the market kind of trending into the 280 range over the next few quarters or two. Does that just contemplate some redeployment of excess liquidity in the securities book that you guys have been doing lately, along with – I'd be curious to get your kind of timing expectations for pickup in loan growth. I'm not sure if you guys are expecting kind of flat growth here in 2Q and a pickup maybe in the low single-digit range in the back half of this year, but any additional color within that context.

Katie Lorenson

Yes, yes. So I think from a margin outlook, I think we've guided to the 280 last quarter, and we just haven't seen much change. And so my guidance is until we see some of this liquidity move out, because no matter how much we continue to build the investment portfolio, the cash just seems to replenish itself. And so I think the NIM bottom, which we thought was maybe going to be Q2, is probably now modestly later than anticipated in maybe the 3Q, 4Q.

In regard to loan growth, I think we'll continue to be challenged in the second quarter. We saw little uptick in line utilization. But at this point, we think mid-single-digit growth starts to come in that third and fourth quarter.

Nathan Race

OK. Great. And maybe changing gears a little bit, just kind of thinking about the credit cost outlook. All of your asset quality metrics continue to improve and I think the outlook remains fairly benign, particularly just based on where deferral stand at the end of the quarter. Any sense in terms of kind of where you guys see the reserve tracking to maybe as a percentage of loans, ex PPP over the next few quarters?

Karin Taylor

Yes. This is Karin. Our provisioning this year is going to be driven by loan growth and/or credit deterioration. So if we don't see deterioration at this point, we'll see what happens as some of the stimulus comes to an end, how that performance looks.

And as you know, we are still in the accrued loss model and much of our reserve is due to qualitative adjustments for economic factors. And so, I think we'd want to see a little more sustained economic improvement and continued performance of the portfolio as that stimulus and before we would start to release reserves.

Nathan Race

OK. So kind of a perhaps a stable outlook over the near term. I appreciate that, Karin. That's all I had for now. I will step back. I appreciate the color. Thank you, everyone.

Katie Lorenson Thanks, Nate.

Operator

Thank you. A reminder, if you do wish to ask a question, you can register by pressing star then one on your phone.

Your next question comes from William Wallace at Raymond James. Please go ahead.

William Wallace

Thank you. Good morning, all. I'd like to circle back on NIM. So understanding that the liquidity just kind of doesn't seem to end. Maybe help us think about what your guidance means from just an NII dollar basis. Do you think that we see growth there? Or does continued potential kind of pipeline weakness in the loan portfolio and pricing pressures drive declines – continued declines ex PPP?

Katie Lorenson

You know, I think it's going to be tough to hold ex PPP without some substantial loan growth here. So I think that we will see some decreases probably characterized in much like we saw in the first quarter ex PPP on the net interest income side.

William Wallace

OK. Great. And Katie, I don't know if it was my cellphone or what, but when you were talking about your expectations on the fee income line for wealth and retirements business, did you say continued growth or stabilization at current levels, I apologize. It sounds like you were saying growth.

Katie Lorenson

Well, I apologize. So thank you for the follow-up question. Based on what we see today, I would say those line items will be stable from the level of Q1 revenue.

William Wallace

OK. And then along the same lines, within those two businesses, I'm just curious, I don't know, Randy, if this is for you or Katie, are you seeing additional opportunities for potential acquisitions within either of those fee businesses?

Katie Lorenson

I'll take that one. Yes, we are. We continue to explore opportunities, and we continue to be proactive in our outreach too. So we're seeing more opportunities come to us, but we're also continuing to build that pipeline of kind of proactive outreach and establishing some relationships with some potential partners out there.

William Wallace

OK. Great. I'll stop there. Thank you.

Katie Lorenson

Thanks.

Operator

Thank you. Your next question is a follow-up question from Nathan Race. Please go ahead.

Nathan Race

I apologize. My follow-up question is answered. Thank you.

Katie Lorenson

No problem. Thanks, Nate.

Operator

That concludes our question-and-answer session. I'll now hand back to Mr. Newman for closing remarks.

Randy Newman

OK. Thank you. Thank you to everyone who joined our call this morning. Thanks for listening and also asking questions.

The 2020 financial performance was record-setting, and the first quarter continued this pace. We know our company and the industry at large is facing headwinds that will catch up and impact our future performance. For so many years, this is why we have focused on diversification. We believe diversification creates long-term value for our shareholders and have a long history of building a strong and growing diversified business model. This includes diversification of revenue streams, diversification of market geographies and diversification across industries. Although our industry is still facing economic uncertainty, we believe our business model stands the test of time and will continue to deliver for long-term shareholder value.

We have a very talented leadership team who is focused on growth, success with our clients and engaging all employees. We continue to retain and attract top talent, and we continue to execute on growing our company both organically and through strategic acquisitions.

Most importantly, we do it the right way. Do the right thing and always in your best interest are cornerstones to our culture and how we operate. We are very proud of what our team accomplished in the first quarter, and we thank you for your continued support and interest in our company.

Again, thank you for joining today's call.

Operator

Thank you, Ladies and gentlemen, that concludes our conference call today. Thank you for participating. You may now disconnect your line.