# Alerus Financial Corporation

## Third Quarter 2020 Earnings Conference Call

## October 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*

**Ryan Goldberg***, Chief Revenue Officer*

**PRESENTATION**

**Operator**
Good morning and welcome to the Alerus Financial Corporation 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 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, Randy Newman. Please go ahead.

**Randy Newman**
Thank you, Rachel, and good morning, everyone. This is our fifth earnings call since our IPO one year ago in September of 2019. This morning we intend to discuss our third quarter 2020 financial results and the current 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 Revenue Officer, Ryan Goldberg. As always, we appreciate your interest in our company.

During the third quarter, we continued to ensure that our employees were safe and that we meet the needs of our clients during this period of uncertainty. We remain confident in our ability to continue to navigate the uncertainties of this downturn, while also driving significant value for all of our stakeholders. As we navigate through the remainder of 2020, I'm very proud of how our organization has responded to this uncertain and challenging environment. Our company has accomplished so much in 2020, despite COVID-19, which is a testament to our team and our business model. I'd like to thank our employees for their extraordinary efforts during these unprecedented times.

For the third quarter 2020, we reported record net income of $17.7 million, or 99 cents per share — diluted earnings per share. While our net interest income remains under pressure from historically low interest rates, our fee income business has continued to produce solid results, a testament to our high value professional services business model and our diversified financial services company. This is most notably seen in our mortgage, retirement and benefits, and wealth management divisions, all of which grew from the previous quarter.

During the third quarter, we saw several other areas of improvement. Our capital ratio strengthened at both the bank and the holding company. Many of our asset quality indicators, including net charge-offs, improved, and our liquidity position remains very strong. Our prudent historical underwriting and conservative balance sheet, combined with the actions we've taken to innovate and strategically involve — evolve our businesses over the last several years has led to our strong operating performance through the pandemic and enabled us to serve and support our clients effectively during these unprecedented times.

Our third quarter financial results further demonstrate this and continues our efforts to build a fortress-like balance sheet, with preference for fee income over margin-dependent banking revenue. Given the uncertainty that remains and the economic outlook, we will remain focused on monitoring our borrowers' credit situations and will continue to make adjustments as new information emerges.

As I've discussed before, we are intensely focused on serving our clients. Furthermore, we continue our progress in transforming our operations, processes, and technology. Our continued innovation over the last several years has enabled us to provide support and advice to our clients during these uncertain times. Our long-term philosophy is, and has always been, to remain relevant with clients by evolving the way we serve our clients as their preferences change and new technologies emerge. It is still early, but we're excited about the prospects of being able to reach and support more clients as we grow. In doing so, we'll continue to drive long-term value for our shareholders.

Finally, I'm proud to announce our Board of Directors approved a 15-cent-per share dividend for the third quarter. I've been with Alerus since 1981, and unfortunately my records only go back to 1969, but this would be over 247 consecutive quarters that we have paid a cash dividend. I also know that over the past 40 years, my career, we have paid out approximately 30 percent of our earnings and averaged almost a 9 percent annual increase in the cash dividend to shareholders. This is another example of the value that we have delivered to our shareholders over a very long period of time.

That concludes my initial remarks, and I'd now like to turn it over to Katie Lorenson, our CFO, and Karin Taylor, our Chief Risk Officer, to more specifically discuss our financial performance, our credit quality, and more of our company's response to the challenges of COVID-19. We look forward to your questions at the end of their initial discussions. With that, I'll turn it over to Katie.

**Katie Lorenson**
All right. Thank you, Randy. Good morning, everyone. Thank you for joining our call today. I'll briefly walk through some of the highlights for the quarter and then, as Randy mentioned, I'll turn it over to Karin to provide an update on credit-related matters and provisioning and our COVID response.

Let's start with mortgage. Results for the quarter were simply stunning. Originations exceeded $500 million, and we surpassed the billion-dollar mark for the year. This unprecedented volume would not be possible without the long-term investments made by the company in recent years. From a technology aspect, over 90 percent of our applications were processed through our digital channel, and our printing has been reduced from 200,000 pages to 20,000.

From a talent perspective, the company's investment and move to mandatory delivery was extraordinarily well timed as margins are even higher than expected due to the operational constraints facing the industry. Our Alerus team members continue to produce purchase volume at levels exceeding 2019. The mix of purchase has moved to less than 50 percent of the volume, and September was our largest month ever in the division.

The pipeline for the quarter reached historic levels. The combination of the strong pipeline and the higher margins moved the mark-to-market on the hedge up $6 million in the quarter, bringing the year-to-date change in fair value of the hedge to a gain of over $11 million of the nearly $45 million of revenue that's reported. We anticipate fourth quarter volumes to remain strong, with originations near to Q3 level; however, the application volume declined 12 percent in September, a trend we do expect to continue with seasonality. As such, we expect the value of the forward pipeline, or the hedge, to decline in the fourth quarter and into 2021, putting pressure on overall mortgage revenues.

Sticking with the fee income theme, which comprises nearly 65 percent of total revenue, up from 60 percent a year ago, our retirement revenue rebounded in the third quarter after exiting the revenue sharing, a strategic move to be more consistent with our industry practices. We expect this run rate to be fairly consistent, assuming market conditions are stable. Wealth management revenue also improved in the quarter, and September was the largest month of the year from a new-asset standpoint as our advisors continued their proactive outreach to clients in the retirement vertical by leveraging our salesforce technology investments.

Sticking with the proactive outreach, our business advisors continued to cultivate new PPP client expansion efforts, again leveraging our technology to track and report these leads. We are pleased with the results so far, including over a third of our 300-plus new PPP clients opening a deposit account with Alerus.

On to the balance sheet, which remains full, and throughout the third quarter, we continued to build the investment portfolio from cash, both with short- and long-term purchases. Cash levels did dip at the end of the quarter but returned quickly in October to the $200-million range consistent with what we've seen most of 2020.

Line utilization dipped again in the third quarter to historic lows, deposit balances remained robust, and we had our highest quarter ever of online account opening. Notably, total deposits sourced outside of our banking geography exceeded $600 million at the end of the third quarter.

From a net interest margin standpoint, we did have a slight recovery in the quarter. Fees and interest income from PPP loans increased to 3.2 in the quarter. Excess cash continues to weigh a heavy burden on the NIM despite ongoing decreases in our cost of deposits. We expect the margin to scrape to 3 percent, excluding the impact of PPP.

Last but not least, expenses for the quarter, which were in line with expectations — compensation rolls in conjunction with the increase in mortgage originations, a trend we expect will continue into the fourth quarter. Other notables were the decrease in postage, part of our ongoing war on paper to reduce expenses and move to electronic everything throughout our company. In addition, we did have a normalized adjustment to our provision for off-balance sheet commitments compared to the out-sized adjustments that we had in the second quarter.

From an expense outlook, we are very pleased with the progress made thus far by our team members. We are focused on productivity and doing more with less, leveraging our technology and infrastructure to grow our company without adding incremental expense. So far, we have made the decision not to re-open two of our client-facing locations, and we continue to evaluate additional opportunities to exit some of our non-client-facing locations. We will likely see some noise in the fourth quarter run rate from an expense standpoint as we look to finalize some of those decisions as well as transition a portion of our employees to work permanently from their home office.

As a final point, we are pleased to see our investments in our ONE ALERUS culture, our talent and technology translate into results. Our teams are working with urgency to identify additional opportunities to increase efficiencies and reduce expenses. Although uncertainty remains, it is clear the enterprise value of this company is strong and resilient to incredible challenges.

And, with that, I'll turn it over to Karin.

**Karin Taylor**
Thank you, Katie, and good morning, everyone. First, I'll provide a brief update on our banking markets. Both North Dakota and Minnesota have seen recent increases in the number of cases of COVID-19. To date, there have not been changes in business restrictions at the state level in either state; however, some cities have reduced capacity limits for certain types of businesses, primarily bars and restaurants. The situation in Arizona showed steady improvement over the third quarter. We continue to serve our clients in all markets by virtual and digital means as well as via the drive-thru and in-person based on market needs and conditions.

[Unintelligible] increased by $337 million since December of 2019. The increase is attributable to PPP balances of $349 million and an increase in commercial real estate of just over $40 million. This growth was offset by a decrease in consumer loans and commercial line usage over the same period.

The utilization rate on commercial lines remained low at the end of the third quarter at just under 24 percent. This compares to normal seasonal utilization rates of 35 to 40 percent. Increased borrower liquidity due to various relief programs, including the PPP, is contributing to the lower utilization rate.

We granted over 1600 PPP loans for $363 million; 784 of those loans, or about 16 million, are $50,000 or less and qualify for the SBA streamline forgiveness process. As of October 22nd, we had submitted 79 applications to the SBA for forgiveness, totaling $51.7 million. To date, we have received approval for forgiveness from the SBA on just one small loan.

Requests for payment relief tapered off during the third quarter. We have granted 552 deferrals with a total outstanding balance of $151 million. This represents about 9 percent of the portfolio. As of September 30th, 27 of those loans, totaling $16.9 million in balances, had been granted a second deferral. This group of loans is comprised primarily of $12.6 million of residential real estate loans as well as one commercial real estate-relationship for $4.2 million.

Fifty-six loans totaling $12 million remain in the first deferral period. Total outstanding balances of loans on deferral as of the end of the third quarter, represented about 1.7 percent of outstanding unguaranteed loan balances. All remaining loans have been returned to normal payment status.

As Randy mentioned, our credit metrics remain strong. Non-performing assets to total assets decreased slightly to 17 basis points at the end of the third quarter, and we recorded net recoveries of $581,000 for the quarter.

Increasing COVID-19 cases in our markets have the potential to cause local governments to dial back on business re-openings. In addition, the lack of continued Federal stimulus may create further headwinds for our borrowers and consequently our loan quality. In the face of this uncertainty, we continue to build our reserves. Our provision for loan losses for the third quarter was $3.5 million. Increased allocations [unintelligible] all segments for current economic conditions as well as the potentially higher-risk portions of the portfolio.

The third quarter provision moved our ratio of allowance to total unguaranteed loan balances to 1.83 percent compared to 1.62 percent at the end of June. Our allowance to non-performing loans also increased over 650 percent at the end of September.

We still lack clarity about when loan losses will begin to emerge, but we believe our strong credit culture, diverse loan portfolio, and geographic footprint will help us withstand the economic impact of COVID-19 relatively well. While we expect loan growth will be challenged in the current environment, we remain open for business. Our business advisors continue to source new credit opportunities, and we are extending credit that meets our lending standards.

With that, I'll hand it back to Randy. I'm sorry, I think we can open it up —

**Randy Newman**
First —

**Karin Taylor**
— for questions.

**Randy Newman**
Yeah, let's take questions first thing.

## QUESTIONS AND ANSWERS

**Operator**
Thank you. 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.

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

**Jeff Rulis**
Thanks. Good morning, all. Just trying to gauge —

**Operator**
[Inaudible]

**Jeff Rulis**
— the expense line. Katie, we got your comments on some of the near-term. I just wanted to take a step back. I think a pretty strong spike in revenue this quarter, without a big increase in costs, I think that's, you know, a product of prior investment, I'm sure, but is that sustainable in '21, i.e., kind of holding moderate expense growth, or are there a few expenditures coming up in the next year? And we got your 4Q comments that there's a couple — some noisy items, but, bigger picture, if you could frame up '21, how that — how — what your expectations are for expenses. Thanks.

**Katie Lorenson**
Yes, absolutely. Thanks, Jeff. From a '21 perspective, we — and, you know, we don't anticipate any ramp-up in any expense line items from a compensation standpoint, with the outlook of mortgage likely decreasing in terms of originations into 2021. We do expect to actually see a decrease in overall compensation. And so as I look at the line items outside of compensation, I think run rate in third quarter should be pretty consistent moving forward. And we'll have a little bit more color, again, next quarter in regards to some of the changes that we look to make and decisions we look to finalize in the fourth quarter that will impact of course 2021 run rate.

**Jeff Rulis**
Okay. Thanks. And just to follow on that, the mortgage — we could kind of make our projections there if it's a lighter year. Is there a range-bound expectation for this line? Obviously, 3Q was a huge number, but I'm trying to get a sense for if you started the year — that's a big range, just trying to kind of get a full-year expectation.

**Katie Lorenson**
Yeah, and you're — from the expense side, Jeff?

**Jeff Rulis**
No, on the mortgage revenue line.

**Katie Lorenson**
The mortgage revenue line, the MBA is predicting that originations will decline 29 percent from 2020 to 2021. We think we can do better than that. What is, I think, very critical to note is — I mentioned — we do have the mark-to market unrealized gain on the hedge of $11 million right now in the revenue line item. We believe that that will run off closer to zero over the next five quarters, and that's a factor to take into play as we look at mortgage revenue.

The margins, of course, have been elevated. We think they return closer to somewhere in the 275-280 range for us into 2021, and so those factors, we believe, will both impact the revenue for this particular business line pretty significantly into 2021, potentially cutting it in half.

**Jeff Rulis**
Got it. Okay. And maybe one last one, perhaps for Randy. Just on capital management, I would think kind of ideal priorities would be sort of funding organic growth and the M&A, maybe dividends, and, lastly, buyback, but I guess the environment may not bring that or allow for that ideally. I guess maybe your ideal deployment versus the reality or what — if you could frame up what your capital plan would be. Thanks.

**Randy Newman—**
Sure. Well, our first priority was to create a fortress-like balance sheet and make sure that we were well prepared to handle anything that came up with COVID and any credit-related issues, and I think that has been our focus up to this time. Obviously, we're now in a position to really — to begin to continue to look to the future in capital deployment, and all of the things that you've mentioned are certainly alternatives for us to consider. But we would like to focus, obviously, on organic growth and looking for acquisitions primarily on the fee income side to both support the model that we have built.

**Jeff Rulis**
And then I guess the near-term use of a buyback is certainly well down the line of what you'd prioritize.

**Randy Newman**
At this time, yes.

**Jeff Rulis**
Great. I'll step back. Thank you.

**Operator**
Thank you. And the next question comes from Nathan Race of Piper Sandler. Please go ahead.

**Nathan Race**
Yes, hi, everyone. Good morning.

**Katie Lorenson**
Good morning, Nate.

**Nathan Race**
I want to just start on credit. Maybe, Karin, a little bit of an increase in special mention in the quarter and sub-standard. I imagine that was maybe confined to the commercial real estate credits that remain on deferral. Just any commentary around those upticks and just how we should be thinking about additional reserve builds into the fourth quarter. You guys obviously continue to provide a pretty substantial level here in the third quarter, and it seems like, you know, with deferrals trending the way they are, there's maybe less of a need going forward, but there's still, I think, a high degree of uncertainty out there. Just curious what — any thoughts along those lines.

**Karin Taylor**
Sure, thanks, Nate, this is Karin. We did have an increase, particularly in the special mention. The actual increase, when excluding those PPP balances that are part of the special mention relationship, was about $8 million from quarter 2 to quarter 3. I would generally characterize increases as fairly normal migrations. There was one relationship in there that had some COVID impact, but as businesses returned to more normal levels, the company's taken some proactive actions and we expect that to improve. And, you know, and, really, they were across different industries, and some was commercial real estate related [unintelligible] operating lines as well. So no real patterns there.

With regard to reserving, our provisioning has continued to be driven primarily by two factors related to the economic uncertainty, and we would expect that to continue into the fourth quarter, but as we look forward, we've spent 2020 really [unintelligible] building a robust reserve, and so absent significant deterioration in credits, I think the pace of that build may be less as we get into 2021.

**Nathan Race**
Okay. And that's helpful. And then it seems like loan growth was a nice positive in the quarter as well X PPP, so just curious kind of where you guys are seeing opportunities? Is it related to some of those new clients that you guys have onboarded as part of that program, or just any thoughts on how we should be thinking about overall loan balances X PPP into the fourth quarter and into '21 as well?

**Karin Taylor**
Sure, you know, some of that increase has been a result of new opportunities. There continue to be some really good opportunities out there. There's a lot of competition for those, obviously, but there are companies that are doing very well through this crisis, and so we've seen some nice commercial opportunities. We've seen — continue to see some nice commercial real estate opportunities that are structured in a way that we're comfortable moving forward with those.

And I think we'll continue to see those, but we do have significant headwinds with the amount of liquidity our borrowers have. As we've mentioned before, we expect that most of our loans will be fully forgiven, and we do have borrowers that are generally conservative and may be putting off some capital expenditures and things until there's a little bit more clarity around the economy.

**Nathan Race**
Okay. That's great to hear. And then if I could just ask one more clarifying question for the fourth quarter. I apologize if — short-term orientated, but Katie, mortgage, it sounds like it's supposed to come down in the fourth quarter, but is it expected to be higher than we saw in the second quarter? And I imagine the accounts increase that we saw in the third quarter was mainly tied to that increase in production, just curious. I was just kind of thinking about those two components and then the revenue line and also overall expenses in the fourth quarter.

**Katie Lorenson**
Sure. From a revenue standpoint, you know, we think originations will hold, but we do anticipate some pressure on revenue just as the value again of that forward hedge decreases, and that'll be an offset to the revenue component.

On the expense side for mortgage for the fourth quarter, I would anticipate the compensation to go up or the variable expenses related to that in both the mortgage lending expense as well as the compensation to go up, probably a million and a half as our compensation levels are tiered, and so as our producers hit that highest tier, along with the origination volume, we will see an increase in the expense side of it.

**Nathan Race**
Okay. That's great. Appreciate all the color. I'll step back. Thank you.

**Katie Lorenson**
Uh-huh.

**Operator**
Thank you. Once again, if you wish to ask a question, please press star, then 1 and wait for your name to be announced.

The next question is from William Wallace from Raymond James. Please go ahead.

**William Wallace**
Thank you. Morning, all.

**Katie Lorenson**
Good morning.

**Randy Newman**
Morning.

**William Wallace**
Katie, just — since you just were on top of the mortgage, did you say that the hedge gain was $6 million in the third quarter?

**Katie Lorenson**
It was $6 million in the third quarter so year to date, we're sitting on about $11 million.

**William Wallace**
Okay. And you anticipate giving all that back over the course of next year?

**Katie Lorenson**
We do, with typical seasonality, and we would anticipate that.

**William Wallace**
Yeah. Okay. And then you just said expense off of that one-and-a-half million in the fourth quarter, but the expense line — I think I heard earlier — you think maybe you can kind of hold the line to third quarter next year as variable comp, et cetera, comes down and --

**Katie Lorenson**
Uh-huh.

**William Wallace**
Okay. Okay.

**Katie Lorenson**
Yes, sir.

**William Wallace**
Great. And then on your prepared remarks, you mentioned — I missed the word you said — you said something on the net interest margin to 3 percent, excluding noise from the PPP. Is that — was that guidance for the fourth quarter or where you think the margin trends over the coming quarters?

**Katie Lorenson**
Both, and [unintelligible] for 3 is our goal, excluding the PPP, for the — for next quarter as well as the [inaudible]. And, again, that's assuming these cash levels continue where they're at.

**William Wallace**
Okay.

**Katie Lorenson**
We had some hope at the end of the quarter that they were going to stay off, but it's quickly ramped back up, if we can get the liquidity put to work, that's the assumption, is that the NIM will drag down to that 3 percent.

**William Wallace**
Okay. And then sort of stabilized. It sounds like you'd get that quick, or you think you'll get there quick.

**Katie Lorenson**
Exactly.

**William Wallace**
Okay.

**Katie Lorenson**
And we're [inaudible] —

**William Wallace**
[Inaudible]

**Katie Lorenson**
— really hard to stabilize at 3.

**William Wallace**
Okay. Understood. Understood. And then on the PPP side, I think you said one loan has been forgiven. What's the — how's the kind cadence of forgiveness applications that you're sending to the SBA?

**Karin Taylor**
Yeah, Wally, this is Karin, we — you know, we sent initially 79 applications. That was through October 22nd, and we're continuing to submit them. Actually, some of the initial applications we submitted were for larger loans, and we believe that based on what we're hearing with regard to what's being forgiven, we believe as we submit more of our smaller loans, those will probably be forgiven more quickly. That seems to be the approach the SBA is taking.

**William Wallace**
Okay. And are you all ramping up to start submitting the smaller loans, or are you waiting to see if Congress does anything to make it easier for everybody?

**Karin Taylor**
No, once they indicated that the $50,000 loans or less had the streamlined process, we have started ramping up those applications.

**William Wallace**
Okay. Great. Thanks. And then, Randy, just bigger picture, I'm curious if the uncertainty in the current environment has changed the cadence or conversations you have with bankers or companies just around any potential M&A fee business lines, or is it just as hard to come by now as it was before, or harder?

**Randy Newman**
Well, again, our focus is primarily on the fee income business for several reasons, and what we're beginning to see is there are [sic] some deal flow out there, and so I think we're in a — certainly a position, given how we've managed the company throughout 2020, putting ourselves in this position to once again begin to engage in some of those conversations.

**William Wallace**
Do you think that this environment changes the appetite of the demands from other buyers? In other words, could the pricing be improving based on anything you've seen, or is that still [inaudible]?

**Randy Newman**
You know, I — well, I think there's a consolidation going on in that line of business as well for several reasons, and I think given the low rate environment, that I wouldn't be surprised if there are more competitors out there who are looking to perhaps build the business model that Alerus has spent many, many years building. I think our scale and our experience in that gives us an advantage in certainly executing or whatever, but I wouldn't be surprised if the price may go up on some of those opportunities.

**William Wallace**
Okay. Okay. Okay, thanks, I'll step out and see if anybody else has a question.

**Operator**
Thank you. Once again, if you wish to ask a question, please press star, then 1 on your telephone keypad. Since there are no other questions at this stage, that does conclude our question-and-answer session. I would like to turn the conference back over to Randy Newman for any closing remarks.

**CONCLUSION**

**Randy Newman**
Thank you. Let me close with some remarks, by first extending our appreciation to everyone who joined our call this morning. Thank you for listening and asking questions.

You know, I'd like to continue to state that Alerus is a company focused on balance and diversification, and I think we've done a very good job over the years of balancing growth, risk, and profitability. We manage for the long-term benefit of all of our stakeholders, and no doubt the timely investments we've made in technology over the last several years are helping us achieve even more success in today's unprecedent environment.

We also believe strongly in diversification and have a long history of a diversified business model, diversification of revenue streams, diversification of market geographies, diversification across industries, and a very strong diversified balance sheet. Our diversified model is proving to be a key ingredient to our incredible success this year.

The performance of our company over the past nine months has been extremely strong; 2019 was a record year for Alerus when we earned $29½ million. Year-to-date 2020, we have already eared $34½ million. So 2020 will go down as a record and historic year for Alerus as we navigate through these challenging times.

We have built a fortress-like balance sheet that we will continue to reinforce until the environment proves more certain. We have a steady focus on client needs, investing in technology, and the way we serve to meet the evolving expectations and needs of our clients.

Most recently, we have been recognized by several sources for our risk-return performance that includes being named to the prestigious Piper Sandler Small Cap All Stars Class of 2020. Yesterday we were named in the *American Banker* Top 85 Best Banks to Work for in 2020. And while we are very proud of our past successes and performance, we are even more optimistic about our future.

And, lastly, we are a very resilient company. Our culture is built to do the right thing, embrace change, and serve with passion. These beliefs have never shown stronger than they do today within each and every one of our employees. I'm very and incredibly proud of our performance this year, but I'm even more proud of how we do it as a company.

And, again, thank you for joining today's call.

**Operator**
Thank you. The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.