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Alerus Financial Corp

Third Quarter 2023 Earnings

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CORPORATE SPEAKERS:

Katie Lorenson

Alerus Financial Corp.; President, Chief Executive Officer

Alan Villalon

Alerus Financial Corp.; Chief Financial Officer

Karin Taylor

Alerus Financial Corp.; Chief Risk and Operating Officer

Jim Collins

Alerus Financial Corp.; Chief Banking and Revenue Officer

PARTICIPANTS:

Jeff Rulis

D.A. Davidson; Analyst

David Feaster

Raymond James; Analyst

Nathan Race

Piper Sandler; Analyst

Matthew Renck

KBW; Analyst

PRESENTATION:

Operator^ Hello, everyone. And welcome to the Alerus Financial Corporation Earnings Conference Call. (Operator Instructions)

Please also remember that this call is being recorded.

This call may include forward-looking statements, and the company's actual results may differ materially from those indicated in the 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 call over to Alerus Financial Corporation, President and CEO, Katie Lorenson.

Please go ahead.

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Katie Lorensen^ Good morning. Thank you, [Bruno]. And thank you to everyone joining our call today. We appreciate your interest and investment in Alerus.

Joining me today is Alerus' CFO, Al Villalon, who will discuss our financial performance and results for the quarter. Also on the call is Karin Taylor, our Chief Risk and Operating Officer; and Jim Collins, our Chief Banking and Revenue Officer.

This morning I will provide some commentary on the continued execution of our strategic initiatives and ongoing momentum in building a highly valued franchise.

During the quarter, we continue to feel the impacts of the challenging interest rate environment and intense deposit competition.

However the NIM improved during the quarter and overall the deposit balances held steady. As our team members constant focus on clients and our relationship banking model was evident as commercial, consumer and synergistic deposit categories all grew in the quarter and new accounts open again surpassed closed accounts. Notably, non-interest-bearing balances remained steady at 25% of our overall deposit portfolio and highly selective disciplined modest loan growth also continued during the quarter as we added high-quality franchise building clients to our portfolio.

The loan-to-deposit ratio remained manageable at just over 90%, and I'd emphasize again that this is with no broker deposits at this time. Our uniquely diversified revenue mix of 58% fee income helped to stabilize the revenue headwinds caused by the net interest margin compression.

As a reminder, within this fee income mix, approximately 90% is highly annuitized recurring and noncyclical revenue with minimal capital allocation and balance sheet risk. Specifically, Alerus' top 25 ranked national retirement services business delivers the majority of this fee income. The business is highly valuable, and we remain committed to extracting this value by growing our scaled and highly profitable product lines of the business.

Last year, we exited the payroll offering, and this quarter, we spun off our ESOP trustee business. These strategic divestitures allow us to direct resources and prioritization on the products and solutions where we continue to have the most opportunity for growth and delivering strong returns. The core business is growing with new plans and participants, which is the driver of most of the fees.

As such, core revenues are trending higher despite headwinds due to market conditions on AUA. Several initiatives appear to have early traction and new revenue and loss revenue are tracking with expectations. Synergies from the business remain highly valuable as a key source of deposits, and we have again surpassed \$100 million of annual [wealth] management rollovers.

Moving over to our Wealth Management business, which is again focused on advisory services and planning for high net worth client segment in our geographies and (inaudible) brought our

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footprint nationally in connection with our retirement business. Over 90% of our wealth management revenues are annuitized recurring revenues with an exceptionally high level of client retention. During the quarter, we lifted out a team of private bankers and the formal launch and integration with Wealth Management has come together quickly.

Our trend of retaining dollars in the company through our holistic client service model produced key One Alerus wins again driven by company sales and referrals by employees of large commercial banking clients.

Our mortgage business produced results consistent with the second quarter, but it remains a very challenging environment. Expense management remained a key priority throughout the company with year-over-year expenses down nearly 8%, even in the face of inflationary pressures in wages, contracts and increasing assessments and professional fees. We remain balanced in our investments in attracting and retaining high-performing revenue-producing talent to support future growth while prudently building a team aligned with our One Alerus culture of excellence and accountability.

Our ongoing emphasis on improving efficiencies is not an arbitrary directive to cut expenses, it is a planful and purposeful effort to improve automation and optimize processes and procedures.

We are working with urgency to leverage our operating platforms and the technology we have in place today to develop a faster, more seamless client experience and consequently increase the production capacity of our sales and service teams. This progress is evident with our abilities to grow accounts and acquire clients with nearly 10% less headcount than a year ago.

From a balance sheet standpoint, the theme of diversification continues throughout our granular loan and deposit portfolios, loan concentrations and uninsured deposits remain low. Key talent adds during the year include experienced professionals and deposit-rich verticals and segments of C&I banking, government and not-for-profit, medical and professional services and our treasury management team.

Credit quality remains strong with low levels of past dues and non-performing loans. Alerus experienced another quarter of net recoveries and our allowance-to-loan losses remained robust at 1.39% of total loans, in addition to the CECL (inaudible) of approximately \$5.5 million related to the Metro Phoenix acquisition. We remain highly selective in our lending and committed to franchise building relationships. Capital levels also remain robust with TCE of 7.72% and CET1 of 13.1%.

During the quarter, Alerus returned \$5 million to our shareholders through dividends and share repurchases.

As we look ahead, the industry will continue to battle headwinds, Alerus too has some remaining near-term pressures. However we are building a stronger-than-ever franchise. We are prudently

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adding new client relationships and improving profitability through ongoing infrastructure rightsizing and optimization.

We are investing in key business lines while exiting noncore or franchise-accretive products and offerings. Each move is purposeful and strategic in positioning Alerus to bring expertise to our clients in fast, frictionless, highly responsive manner, while delivering valued advice and experience, which we believe will directly translate into value creation for our shareholders.

And with that, I will turn it over to AI to talk about our quarter and the financial performance.

Alan Villalon^ Thanks, Katie. I'll start my commentary on page 14 of our investor deck that is posted on the Investor Relations part of our website. Let's start with our key revenue drivers. On a reported basis, net interest income declined 8.3% on a linked quarter basis. The decline was driven primarily by continued increase in funding costs.

Net interest income represented 41.8% of revenues. Switching to fee income; non-interest income increased 10.2% on a linked-quarter basis, primarily driven by the impact of the divestiture of our ESOP trustee business within our Retirement and Benefit Services division.

Excluding the ESOP trustee business, non-interest income grew 1.6% on a linked-quarter basis. I'll go into detail about each of our fee income segments in later slides. Turning to page 15; net interest income was \$20.4 million in the third quarter. Net interest margin was 2.27% a decrease of 25 basis points from the prior quarter.

Impacting the net interest margin was about 3 basis points of accretion from the Metro Phoenix deal. During the third quarter, we saw improvement in our net interest margin after our index liabilities repriced in July. On a monthly basis, July was the low point for net interest margin during the quarter.

As the quarter progressed, we saw our net interest margin gradually improve. We ended the quarter with a net interest margin of 2.3% for the month of September, which is higher than the 2.27% that we reported for the quarter. Based on the Fed hike last July, we do expect our net interest margin to compress another 7 basis points to 10 basis points from the 2.27% since our indexed deposits will reprice in October.

Should the Fed be done with raising rates, we do anticipate our net interest margin to continue to improve gradually as our earnings assets continue to remix and reprice into higher-yielding loans.

Let's turn to page 16 to talk about our loan portfolio. Total loans grew 2.9% from the prior quarter driven by growth in C&I, commercial real estate and residential real estate, offset by a decline in consumer based loans. We continue to see strong growth in relationship-based lending, where we are providing multifaceted solutions to clients via our One Alerus strategy.

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For the remainder of 2023, we do continue to expect modest loan growth. Turning to page 17; on a period ending basis, our deposits increased 0.7% from the prior quarter.

Non-interest-bearing deposits still represent 25% of total deposits.

Client retention remains very high, and we continue to attract new clients. For the remainder of the year, we expect deposit levels to remain stable. Turning to page 18, you can see a further breakdown of our strong deposit base. Our synergistic deposit, those funds sourced from our Wealth and Retirement businesses grew 21% over the prior year and 2.7% over the prior quarter. The strong year-over-year growth in synergistic deposits was driven mainly by strong organic client growth within our Retirement and Wealth segments.

Synergistic deposits sourced from our retirement and wealth business now account for 26.5% of our deposit base.

Within synergistic deposit, HSA balances grew to \$175.7 million, a \$1.3 million increase over the prior quarter. HSA now accounts for over 23% of our synergistic deposits. HSA is a low-cost funding source and grows gradually over time due to its sticky nature. As you can see here, continued growth in our synergistic deposits shows the strength of our unique and differentiated business model. Turning to page 19, you'll see details about our investment portfolio.

Currently, almost 68% of our securities are available for sale versus 32% in held to maturity. We did see unrealized losses increase as interest rates rose during the quarter.

The duration of our investment portfolio remains slightly over 5 years. We continue to let the investment portfolio run down and remix the balance sheet towards commercial lending relationships that will add higher-yielding loans and treasury management relationships. On page 20, I'll start to talk about our fee income businesses. On this page, I'll provide some highlights on our Retirement business, which accounted for approximately [38%] of our total revenues.

End-of-quarter assets under management decreased 1.4%, mainly due to lower equity and bond markets. Participants within retirement have grown over 3% year-to-date.

Revenues increased over 17% on a linked-quarter basis, mainly due to the divestiture of our ESOP trustee business. On the bottom right of this slide, excluding the impact of the ESOP trustee business in both quarters core retirement and benefits revenues were up over 3% on a linked quarter basis. On a go-forward basis, \$15.3 million is the right launch point for our Retirement and Benefit Services division. For the fourth quarter, excluding any impact, we do expect fee income from our Retirement businesses to go up slightly from the \$15.3 million.

Turning to page 21, you can see highlights from our Wealth Management business.

On a linked quarter basis, revenues decreased 3.3% while end-of-quarter assets under management decreased 3.5% due to challenged equity and bond markets. Like retirement, wealth

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provides a strong source of funding for the bank as it accounts for over 29% of as f our synergistic deposits. For the third quarter, excluding any market impact, we do expect fee income for our Wealth business to be up slightly as well. Turning to page 22, I'll talk about our Mortgage business. Mortgage revenues decreased 13.6% from the prior quarter as originations were stable, but fair value hedges impacted results.

Mortgage originations receivable from prior quarter, which is slightly better than MBA Purchase Index which saw a 4% decrease.

For the fourth quarter, we do expect mortgage originations to decrease over 30% as we enter a seasonally weaker quarter for our mortgage business. Page 23 provides an overview of our non-interest expense. During the quarter, non-interest expense increased 2.4%. Compensation remained stable while professional fees increased due to high leap of fees related to the divestiture of our ESOP trustee business. Despite inflationary pressures, we continue to expect expenses to be down low to mid-single digits for 2023 on a year-over-year basis.

We continue to be focused on improving our profitability by reducing expenses and increasing capacity throughout our organization.

We recently made continued progress on rightsizing our expense infrastructure through numerous initiatives. Some of these expense saves will be reinvested in efficiency improvements and revenue production initiatives. Turning to page 24; credit continues to remain very strong. We had net recoveries of 9 basis points in the quarter. Our non-performing assets percentage was 23 basis points compared to 7 basis points in the prior quarter.

And our allowance for credit losses on loans to total loans remained stable at 1.39%.

I'll discuss our capital and liquidity on page 25. During the quarter, we repurchased \$1.2 million of outstanding stock at an average price of \$17.98. Our capital remains well above the regulatory minimums even after share repurchases done during the quarter. Our common equity Tier 1 capital to risk-weighted assets is over 13%, which is over 300 basis points above the 9.9% stress minimum required by the largest financial institutions subjected to the Dodd-Frank Stress Test. On the bottom right, you'll see the breakdown of -- in the sources of \$2 billion in potential liquidity.

Overall, we continue to remain well-positioned for both the liquidity and capital standpoint to weather any economic uncertainty.

To summarize on page 26, we are focused on making fundamental improvement and improving returns for our stakeholders. Our capital remains strong and we remain committed to returning capital prudently. Our diversified business continues to be to provide stability in a challenging macro environment as almost over 50% of our revenues come from fee income. Should the Fed remain on pause, we do expect our net interest margin to fully improve as asset repricing and remixing should improve as earning asset yields improve.

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With that, I'll open it up for Q&A.

QUESTION & ANSWER:

Operator^ (Operator Instructions) We do have our first question. It comes from Jeff Rulis from D.A. Davidson.

Jeff Rulis^ Just a quick question -- on the -- Al, on the margins, I just want to make sure I got this right. You talked about kind of another leg down 7 basis points to 10 basis points given the index deposits. So I'm trying to meet that with kind of the commentary about if the Fed pauses -- is that kind of more of an idea well into '24? If you could just guide me through Q4 and '24 expectations on the margin?

Alan Villalon^ Yes. Thanks, Jeff. So for Q4, we do expect about 7 basis points to 10 basis points of margin compression, but we do expect our exit rate to improve from basically from October to December. So as we go into 2024, we do expect net interest margin improvement throughout 2024 even if there's another Fed hike in there. And a Fed hike we're anticipating right now.

Go ahead.

Jeff Rulis^ Sorry. If we do not have a hike, that's net better for the margin.

Alan Villalon^ Correct. Correct. And what I was going to clarify is that we are anticipating based on the Fed (inaudible) plus another 25 basis points of Fed hike.

Jeff Rulis^ On the credit side, just wanted to kind of get where the type of loans that the nonaccruals where those came from kind of how the legacy relationship is? Just a little more detail on what was added.

Karin Taylor^ Sure. Jeff, this is Karin. Yes, that's a commercial credit. And it's in our Arizona market. It's -- I would say it's a part of what we expect in terms of just credit normalization.

The issues this credit is experiencing are unique to the credit. It's not indicative of a broader issue.

Jeff Rulis^ So it was really centered in one credit then was the increase?

Karin Taylor^ Yes. The entire increase is in one credit.

Jeff Rulis^ Okay got it. I guess just one last one. Just the buyback appetite that seems like a little pickup this quarter. But as we look out and balancing sort of capital and the environment, where do you stand on that as we head into Q4?

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Alan Villalon^ So Jeff, we have the buyback is in place, but we are watching price because we want to make sure that the payback is within our -- within three years of what we typically look at.

Operator^ Our next question comes from David Feaster from Raymond James.

David Feaster^ Maybe just starting out on the funding dynamics from your perspective and just some of the trends you're seeing, obviously it's incredibly competitive. I'm just curious some of the deposit initiatives that you're putting in place to drive core deposit growth. And then how are core deposits and deposit costs trending across your footprint? I appreciate the balances are expected to be stable. But just I'm curious how the core deposit side is trending and whether you're able to see that mix improve or are CDs going to be the stop gap near term?

And just how you think about cost?

Katie Lorensen^ Sure. I'll start. This is Katie. From an initiative standpoint, it is all about the talent that we're attracting into the organization. And so as I mentioned earlier, mid-market C&I bankers -- bankers focused in the deposit-rich verticals as well as continuing to invest and build on our treasury management team.

And so that has been key to the wins as well as the retention. From a mix standpoint, we certainly are seeing an increase in the CD book. I will say the majority of that business is multiple relationships. And so continue to be core client business. We also are able to retain dollars.

We're seeing increases in our wealth management money market fund, but the dollars are staying with the company, which we believe is a key positive. Does that answer your question? Al, do you have?

Alan Villalon^ Yes. David, just in terms of pricing, the way I would like to think about it is that our index deposits typically reprice in the first month of a new quarter, if there's any hikes in the prior quarter. So you'll see a little bit of repricing in October from those. And those will hit on money market specifically, but we only have about 14% of our deposits are indexed, okay? We're not seeing much more pressure in terms of broad-based lift.

That was kind of all front-end loaded at the beginning of the year. So we've seen our deposit beta stabilize at this point.

So I think at this point, it would just be a little bit on the margin here and there outside of this index liabilities. But again to something we were focused on two from a strategy standpoint is constantly looking at where we can get new relationship/low-cost funding for us, and that's why we highlighted in the prepared comments, HSAs because those are really a great source for us, especially when they carry a cost of only about 10 basis points to 20 basis points.

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David Feaster^ Yes. That makes a ton of sense. And then maybe kind of just following up on -- maybe touching on the other side of the coin, right? I mean you guys have done a great job growing loans. Obviously new loan yields are much improved.

I'm just curious, how do you think about the pace of remix in the earning asset and the repricing schedule there? And ultimately, kind of how does that play into the pace of margin expansion? I appreciate the guidance on the next quarter, but -- and then we're going to be expanding throughout 2024. I'm just curious, how do you think about the pace of expansion because you guys are doing a great job defending deposit costs and repricing higher. Just curious how you think about that.

Alan Villalon^ Yes. David, this is Al. I can take that one on. In terms of our expansion, I mean the way I kind of think about it, there's kind of two parts of the net interest margin. The first part of it is that we do have a securities book with about a 5-year duration, okay?

So if you think about that, now granted there was some investments of that came in -- those came in later in 2021, in 2020 -- early '22, but that should roll off and provide us a source of liquidity. And that investment portfolio right now is yielding somewhere in like the 2.5% mid-2s range. So that's going to mature.

We're remixing that into funding loans on a go-forward basis. Now also, too, when you look at our commercial book, ex resident and quoting ex residential loans, our commercial book has about a 5-year also life in there as well. So as those loans kind of some of those loans that were done pre-pandemic, that were done at lower yields kind of come off, they'll be remixing as well until higher-yielding products loans for us as well.

So those are two components. But then the third component also to be aware of is that about 40% of our loans are floating as well or adjustable.

David Feaster^ Okay. Okay. Perfect. And then just last one for me. You guys have done a great job managing expenses.

You talked about that in the prepared remarks. I guess first, I was hoping you could maybe elaborate on the decision to sell the ESOP business and maybe the plans to redirect that capital in those resources. Just how you think about additional investments going forward? Is now the right time to be maybe a bit more opportunistic with hiring and maybe segment or geographic expansion while others are starting to pull back? Just curious how you think about that.

Katie Lorensen^ Yes. This is Katie. Absolutely, now is the time. In regard specifically to the ESOP business, a very small piece of the overall business and again it was the ESOP trustee business. So we retained the recordkeeping and administration of that ESOP business but the trustee business, a very small portion.

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And so better suited served for the leaders that took that over and then their ability to grow it so that we are redirecting our resources all to those core product lines where the opportunity to scale and continue to grow in the business is very significant, especially in -- with Secure Act 2.0 that we've talked about on previous calls.

And our investments in that business line, we invested in the consultant to come in. We are continuing to invest in talent. We are investing in our internal resources in terms of project prioritization into that business line, again to streamline, to improve processes and at the end of the day of course make for a better client experience. In addition, we are investing in an executive 100% focused on the business. The last time that Alerus had an executive whose primary and total responsibility was on the retirement business was when we experienced tremendous growth from \$2 million to \$60 million in revenue.

So that would be the other facet of the investments in this business line.

Operator^ (Operator Instructions) Our next question is from Nathan Race from Piper Sandler.

Nathan Race^ I hope everyone is doing well. A question maybe for Al. It sounds like with the margin guidance is going to come down a little further here in the fourth quarter. And just curious to kind of get your thoughts on how you think about high growth next year and a higher for longer interest rate environment. Looks like NII is tracking down 12%, 13% for this year.

But just curious how you think about the growth potential of NII under that environment.

Alan Villalon^ Yes. Thanks, Nate. I mean so for NII growth, I mean we are looking at (inaudible) to be stable, up some next year, but a lot of it we're just looking right now what is the loan outlook to drive that. But from a NIM basis, we do think that we are closer to a trough on our net interest margin too. So those are kind of things we're kind of thinking about as we head into 2024.

Nathan Race^ Got you. And in terms of funding future loan growth, it sounds like you have some cash flow coming out, just curious about how that can help that? And hopefully, there will be some deposit growth starting year after some stability this year. So do you see an opportunity to kind of reduce some (inaudible) funding levels to hopefully support greater NII growth next year or how you kind of just think about the level of wholesale funding that you could potentially unwind as hopefully deposit growth increases in 2024?

Alan Villalon^ Yes. We definitely would love to see more deposits coming to door, deposits is king. And we'd love to -- deposits is what just -- its music to my ears these days. So as we look into our 2024 planning we are very focused on bringing in deposits and deposit relationships. The question right now is given how much liquidity is coming on to the system, what is out of our control is trying to figure that out as well. But we've brought in a tremendous amount of talent, especially in the treasury management side to help us with those deposit gathering activities.

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Nathan Race^ Got you. Makes sense. And then just kind of a bigger picture question on some of the fee income lines. Obviously challenging equity markets was a headwind to wealth management and retirement revenue in the third quarter. But if we get kind of more stable market valuations going forward and with all the initiatives that you guys have put in place to increase the capture rate from the retirement platform into wealth, how are you guys kind of thinking about the opportunity to grow those two lines in the next year, particularly as you allocate more resources to the retirement unit led the ESOP trustee sale?

Alan Villalon^ Go ahead, Katie.

Katie Lorenson^ Okay. So in regards to just top line revenue growth, certainly stable, improving markets will help both of those divisions. From a momentum standpoint in both business lines, we continue to add new clients, core client business really within our sweet spot and within our target markets. The initiatives I speak to are really about improving efficiencies and margins in the business as well as opening up additional capacity to continue to bring on that new business. So we have some initiatives where we're seeing early success.

I think it's still a little bit too early to call, but definitely putting the right processes in place to really grow this and are seeing some early indications of success. With that, I think I'll turn it over to you, Al, in terms of guidance.

Alan Villalon^ Yes. So just as we think about next year, I mean the \$15.3 million for lease retirement is the launch point which we talked about. We'll see probably gradual improvement in there because only about 35% of our revenues there are market sensitive. So the rest of it is really (inaudible) growth and plans and participants, which we would continue to see growth in that area. So we're pretty optimistic on that side.

And then Jim, is there anything you want to add on there?

Jim Collins^ Nate, I was just going to -- this is Jim Collins. I was just going to add and reiterate really what Katie said is our expectation of core new client growth from our existing staff due to the oncoming of the private banking team and the synergies that those teams are building, I think is really important that we will see that growth. In addition, we've instituted a much more aggressive recruiting plan for those lower entry-level advisers that can help harvest out of the 401(k) rollovers. So I think that's what we'll see additional growth next year.

Nathan Race^ Got it. Very helpful. And just maybe one last one for Katie. Curious if you're kind of more or less optimistic today on potential acquisitions on the retirement side of things in light of what you're seeing from a pricing perspective in your discussions with potential partners and what you're seeing from a competitive perspective relative to other entities that are also maybe looking to expand in that space.

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Katie Lorensen^ I think we sit very well-positioned from a competitive standpoint in all of our business lines. I think our company has got a really unique story to tell and a very strong reputation. And that in and of itself is having more volume of calls coming our direction in terms of interest in looking to potentially partner with us. So we'll continue to be very prudent and disciplined as we look at those opportunities. But I would say the momentum is trending in the right direction for future talent lift-out, strategic, opportunistic acquisitions.

Operator^ Our next question comes from Damon DelMonte from KBW.

Matthew Renck^ This is Matt Renck from KBW filling in for Damon DelMonte. I hope everybody is doing well. Most of my questions have been asked and answered, but this is a follow-up. Just as a follow-up, the IRA roller is \$100 million, just to put some context around that number, where do you think you could grow that to in 2024 with the new initiatives?

Katie Lorensen^ Sure. Just for context, that's about an 8% capture rate today and has been mostly on the reactive side and the initiatives are really around proactive reach out to these individuals at a very timely way and high-touch way. And then as Jim referenced, continuing to build our talent pool with the opportunity, then we are a very -- we have a differentiator in attracting that talent to our company because of this opportunity. So we anticipate continuing to see that capture rate of 8% increasing.

Matthew Renck^ Okay. So do you think it could potentially reach like 10% to 15% or is it more gradual than that?

Katie Lorensen^ I would say it takes time, so it will be a little more gradual than that.

Operator^ We currently have no further questions.

So I would like to hand back to Katie Lorensen for closing remarks.

Over to you.

Katie Lorensen^ Perfect. Thank you. And thank you everyone, for the questions.

I will end with just a comment about the company and our unique strength of our diversified business model, which, again continues to differentiate our ability to attract and retain clients as well as talented professionals.

We remain laser-focused on our strong and diversified balance sheet, talent investments, fee income and investments in our key business lines while again optimizing our infrastructure to return our company to our long history of delivering strong profitability, tangible book value growth and top-tier returns to our shareholders.

Thank you to our investors, our analysts and to everyone joining the call today.

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Have a great day.

Operator^ Ladies and gentlemen, this concludes today's call. Thank you for joining.

You may now disconnect your lines.