

Alerus Financial Corporation

Q2 2021 Earnings

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CORPORATE PARTICIPANTS

Randy Newman – *Chairman, President, and CEO*

Ryan Goldberg – *Chief Revenue Officer*

Katie Lorenson – *CFO*

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 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. Good morning, everyone, and thank you for taking the time to join or listen to our call today. I am very proud to report another quarter of incredible financial results and even more proud of our team members and how they continue to focus on serving our clients through holistic advice and unparalleled service. Our diversified business model, built on decades of execution, continues to set us apart in both performance and total shareholder returns. These key attributes of our company have also become a competitive advantage in attracting talent. During the quarter, we added one of the best SBA teams in the country to our talented employee base. With our strong commercial base of clients and the expertise and experience of this team, we believe this product will continue to help differentiate Alerus and the value we bring to our business clients.

Strategically, we are laser focused on organic growth led by our Chief Revenue Officer, Ryan Goldberg, who is joining us on the call today. The investments we have made in our sales force, both in training and technology, we believe will set us apart in bringing in new clients, as well as expanding relationships with our significant client base of more than 18,000 business clients and over half a million consumer clients. During the second quarter, production levels on all products were strong, and we continued to see momentum building in our pipelines and preflights. Low line utilization, higher than historical prepayments, and continued extraordinary levels of liquidity have been a sustained headwind. In addition to growth, we are also concentrating on expense management, process improvement, and driving efficiencies in our organization. We are so impressed with our talented team members across the company who are reinventing how we do business throughout all areas of product lines, finding ways to replace manual processes with robotics, automation, and, soon, artificial intelligence. These efforts will improve the profitability of our business units and, just as important, provide a better client experience that allows us to scale effectively as we continue to grow both organically and through acquisitions.

Speaking to acquisitions, our Colorado transaction continues to go very well from a client and employee integration standpoint. Results are right in line with our modeling. The synergies we can extract in our business model are remarkable and affords us an opportunity to be a player in a very competitive M&A space. We continue to build on our acquisition pipeline, on the fee (sp) income and banking side, with proactive poke reach to potential partners, as well as exploring opportunities of companies which are currently looking for a sale or exit. In summary, another great quarter and strong shareholder returns. Our business model, our strategies, and our strong foundation of capital and robust allowance levels have aloud Alerus position for continued success. I will now turn it over to our Chief Revenue Officer, Ryan Goldberg.

Ryan Goldberg

Thank you very much, Randy. Second quarter continued to build on the successes our business and financial advisors realized during the first quarter. The team remained focused on proactive client interactions, understanding how Alerus can assist in building a better financial future for each business and consumer client, and then recommending the most appropriate solutions on an individualized basis. Wealth management revenue increases can be attributed to sales of businesses, which are creating liquidity events for the owners, offering additional value-added services to retirement plan participants such as 401K rollovers, and remaining focused on having discussions with clients who are seeking more attractive returns in this low interest rate environment. Looking at retirement services, we have been very pleased with the progress we are making in our group with the acquisition of new plans and expanding the services that our clients are obtaining from Alerus in the areas of fiduciary, administrative, and health and welfare solutions.

Looking at lending performance, our new consumer and business loan originations are in line with our internal expert expectations, but the balance sheet benefit has been muted by lower-than-expected line of credit utilization and larger prepayments and balance reductions, which can be attributed to the excess liquidity that borrowers have access to currently. Second quarter loan volume was stronger than what we saw in the first quarter and continues to trend in a positive direction. The loan pipeline is building. It can be attributed to identifying client opportunities with multiple entry points into our expanding Alerus client base.

We're very pleased with the SBA team that has recently joined Alerus during the second quarter. They have integrated well into the company, and the impact of their expertise is already being realized with new SBA loan volume being closed. SBA lending is an exceptional opportunity for us. Coming out of the PPP process, there is much more awareness of SBA programs and a willingness of borrowers to consider these options where the previous sentiment was not necessarily as favorable. In addition, for many businesses rebounding after the worst of the COVID pandemic, this provides a set of solutions that can mitigate certain risk components of a lending application, allowing us to provide more options to make loans in our market.

Through our focus on segmentation and talent identification strategies, we plan to add advisors and lending segments of focus that have expertise with CNI and CRE (sp) relationships in the communities we serve. We plan to continue our aggressive approach in adding revenue producing individuals in our market. We have recently seen high quality hires beyond just the SBA team but also within our mortgage group, wealth management segment, and retirement services group. At this point, I'm going to turn the call over to our CFO, Katie Lorenson, for some additional financial commentary.

Katie Lorenson

Thank you, Ryan. Good morning, everyone. I'll spend just a few minutes this morning on some highlights from another truly excellent quarter of results. First and foremost, Alerus' pre-tax, pre-provision results continue to outperform our peers. And a key differentiator in our performance ratios is notably driven by Alerus' non margin dependent annuitized earnings, which have no credit risk and requires significantly less capital allocation. As PPP forgiveness accelerated during the quarter and liquidity levels remained at all-time highs, our NIMs contracted further than expected. However, the Alerus business model and diversified earnings continued to deliver exceptional returns to our shareholders.

On the fee income side, I'll start with the Alerus mortgage division, which continues to execute at exceptional levels. Origination pull through gain on sale margins had another strong quarter. The revenue results were weighed down by the decline in fair value of the hedge, which is what we expected and have guided to over the last several quarters. We are seeing our business return to the purchase side. Historically, refi's make up only about 20% to 25% of our origination volume. The second quarter for Alerus was our highest quarter ever of purchase volume, and

application trends are reflecting a return to that purchase side. We expect the third quarter volume to remain strong but trend down from second quarter levels and the fourth quarter volume returning to a more typical Q4 production level.

On the retirement, health, and welfare benefits revenue side, that continues to be strong with earning of the creation from our recently completed acquisition. We expect the run rate to settle in around 17.5 million for the rest of the year, assuming that market conditions hold steady. Our wealth management revenue is up 24% on a year-over-year basis. As Ryan mentioned, these impressive results are driven by record levels of new business and production as we have invested in numerous financial advisors over the past four years. We are pleased with our continued success of adding talent to grow and expand solutions in our massive consumer client base.

Last but not least, expense management. From an expense standpoint, our execution in controlling costs continues, and we delivered another solid quarter of managed expenses. We continue to extract efficiencies and processes, operations and facility closures while growing our client base and engaging our clients in our robust technology investments. All of this while employee satisfaction scores and recognitions continue to distinguish Alerus as an employer of choice. With that, I will turn it over to Karin Taylor, our Chief Risk Officer.

Karin Taylor

Thank you, Katie, and good morning, everyone. The second quarter marked progress in moving toward our new normal. We have adopted a flexible approach to our work environment, allowing many of our employees to work from home long term. As vaccines became more widely available in the spring, we implemented our phase return to office plan, reopening our offices, and returning those employees who will work from new an Alerus office. We expect all phases of the plan to be complete in September. As of July 23rd, \$155 million in PPP loans remained on the books, comprised of 51 million in first round loans and 104 million in second round loans. 319 million had been forgiven through that date.

Remaining payment deferrals totaled just under 6 million, or 0.3% of outstanding unguaranteed balances. These are almost entirely in our one to four family(inaudible) portfolio. Asset quality metrics remain strong during the second quarter. Nonperforming assets increased during the quarter due to two loans moving to nonaccrual, one commercial loan, and one commercial real estate loan. In addition, other real estate owned increased as we took possession of collateral securing a long-term workout loan. I would characterize this as normal migration in the portfolio not specifically attributable to the impact of the pandemic. We recorded a net recovery of 6,000 for the quarter. No provision was recorded during the quarter due to strong credit metrics and a decrease in loan balances.

The level of the reserve continues to be driven by qualitative adjustments due to economic uncertainty. The ratio of the allowance to total loans excluding PPP loan balances was 2.02% at the end of the quarter, and the allowance to non-performing loans was 485%. As Ryan noted, low line utilizations and prepayments due to high levels of liquidity continued to be headwinds to loan growth. As of June 30th, utilization on our C&I (sp) line was under 20% compared to 23% at March 31st and historical seasonal utilization rate normally in the mid to high 30% range. That concludes our prepared comments. We'll open it up for discussion and questions, with closing comments from Randy to follow.

Operator

We will now begin the question-and-answer session. To ask a question, you may press star then one 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 two. At this time,

we'll pause momentarily to assemble the roster. The first question comes from Jeff Rulis of D.A. Davidson. Please go ahead.

Jeff Rulis

Good Morning. Question on the loan grow side. Wanted—a couple of things. I wanted to check in on the indirect portfolio, how much—the size of that and what's left to kind of run off.

Karin Taylor

Sure, Jeff. This is Karin. We've got about 37 million left in that portfolio, and we've been seeing about 6 million to 7 million of a quarter run off on that (sp).

Jeff Rulis

Got it. Okay. And maybe, Karin or Ryan, you talked about the SBA team. And I guess, just sort of the inflection point, if we continue to see that indirect kind of modest drag on the portfolio. Just wanted to check in on inflection. You got some SBA—a team there and just thinking about kind of the balance of the year, what net growth could look like, absent PPP.

Karin Taylor

Ryan, do you want to take that?

Ryan Goldberg

Sure. Thank you, Jeff. So, what I would tell you at the at the start is, we have some expectations as we as we go forward with our with our SBA team. They are off to a, I would say, a faster start than we expected. I think this is attributed to the quality of the group that we have brought in. They're working hard to establish the foundation within Alerus for this particular program. We're seeing really a broad-based set of loan opportunities that have come into our team for evaluation. They're already starting to close business. We're optimistic about what the rest of the year would look like and believe that this will just be the catalyst as we move into the next couple of years.

Jeff Rulis

Okay. So, the overall portfolio—I know that you said payoff activity is tough to peg (sp). But in terms of the net balance of loans, kind of—do you look at it at net growth position in the second half given--.

Ryan Goldberg

We do. There's a variety of different things that we have options to pull in terms of levers for us to achieve some of the growth. But our expectation is in the low single digits for growth when you look at all of our lending asset classes on an aggregate basis. We're not exactly sure where each of the line items will play out at this point in time. Some of that's going to be opportunistic. Some of it's going to be environmentally driven. But that's what our expectation is at this point is in that low single digits for the for the rest of the year, and that's what we're aspiring to, based on the different initiatives and activities that I mentioned in my earlier comments.

Jeff Rulis

Thanks, Ryan. And, Katie, I just wanted to send it back into the mortgage banking a bit. I'm surprised gain on (sp) sale is increasing, and your volumes remain pretty strong. That's a pretty significant—I know you've indicated some of the MSR adjustments. But the net line, could you remind me what kind of—where you've guided to on that? I heard your comments about Q3, Q4 kind of volumes coming in but the net number—any guide there? I kind of maybe lost track versus the previous quarters.

Karin Taylor

Yeah. No problem. Thanks, Jeff, for the question. So, from an origination standpoint, I think we'll go under 400 for the third quarter but probably in the upper three hundreds. We do expect the gain on sale margins to drop. This was probably a high-level, high-level watermark for us. And then, we do have probably around 2 million to 3 million of hedge to unwind for the rest of the year, and so I would consider that in the headwinds also.

Jeff Rulis

Is that per quarter or just remaining--.

Karin Taylor

In total.

Jeff Rulis

Okay. So, that's a significant—I mean, relative to the—hit you took this quarter—that's going to minimize quite a bit. And—or—so, the net figure maybe you can hold that up pretty well if I'm reading that correctly.

Karin Taylor

Yeah, we—I mean, in regards to- we'll see, we obviously took—had a significant headwind in the revenue this quarter. But with the drop in origination plus that continued headwinds, we'll see the mortgage revenue drop probably around 8 million or so. We'll settle in there, we think.

Jeff Rulis

Okay.

Karin Taylor

8 million to 9 million.

Jeff Rulis

Thanks. Okay. Thank you.

Operator

As a reminder, if you have a question, please press star one. The next question comes from Nathan Race of Piper Sandler. Please go ahead.

Nathan Race

Hi, everyone. Good morning.

Karin Taylor

Morning, Nate.

Nathan Race

Just maybe hoping to get some color on the outlook for RB&S (sp) revenue going forward. Imagine some of the market strength that we saw in the second quarter contributed to the solid sequential growth in that (inaudible) line in 2Q. So, just curious if you can kind of parse out how much that growth was related to that appreciation in the market versus just kind of ongoing organic growth in that line and kind of the outlook for organic growth within RB&S over the back half of 2021.

Karin Taylor

Yeah. Good question, Nate. We think revenue there probably settled in around 17.5 million from a run rate basis based on what we see today and where the market is today. And then, on a go forward basis, we look to grow that revenue in the low single digits.

Nathan Race

Okay. Perfect. Very helpful. And along the lines and thinking about RB&S going forward, I believe we saw some announcements during the last few months around some other acquisitions, other entities have done in that space. So, would love to hear your kind of updated thoughts on what you guys are seeing as it relates to future deals within that segment going forward and so forth.

Katie Lorenson

Yes. (Inaudible) this is Katie. I'll take that one. And I mentioned in my opening comments the competition for fee income acquisitions continues to be elevated but are—with Alerus and our organization and the synergies that we're able to extract, we believe and we know that we can be very competitive in the M&A space. And so, we continue to see more opportunities from a reactive basis as just awareness of the company and our capital that's available to deploy becomes more widespread, as well as proactive outreach efforts continue to intensify with some urgency around our team because of the competitive nature and the number of players that are attempting to enter this space or build scale.

Nathan Race

Got it. Understood. Makes sense. Just a couple housekeeping questions if I could. Just thinking about the overall balance sheet size going forward, deposit inflows to you (sp) in the quarter, and I imagine that function just the macro factors that play these days and as you guys continue to execute on some one (sp) Alerus synergy deposit growth. So, just expectations for just the overall balance sheet size and if we should expect some continued growth with those strategies continuing to play out and even as the PPP forgiveness process ensues and perhaps as you know some clients' liquidity levels come down.

Katie Lorenson

Right. From a balance sheet perspective, I mean, I think we're continuously surprised at the level of liquidity that maintains. I—we'll continue to put more into the investment portfolio and move that up to a billion dollars. From a deposit balance side, we are seeing some outflows as we did last quarter with our retirement money markets, but we are also at a low watermark for some of our public funds, which we don't we don't have very much of. So, I don't believe we'll see any liquidity, or at least we're not expecting any liquidity outflow at this time.

Nathan Race

Okay. Got it. And then just one last one. I apologize if you guys already touched on this, but the other expense line was lower by about half quarter over-quarter. Anything to speak of there and just thoughts on just the overall operating expense run rate in the back half of 2021?

Katie Lorenson

Yes. I think that there's been some noise in that number in both quarters, and so I think that's more of an \$800,000 to \$900,000 run rate going forward in a typical quarter. And from an expense standpoint with the mortgage origination volume declining, I think we would expect to drop another million (sp) of expense down in the third quarter and then potentially another million in the fourth quarter from that.

Nathan Race

Okay. That's very helpful. I appreciate all the color. Thanks, everyone.

Operator

As a reminder, if you have a question, please press star one. This concludes our question-and-answer session. I would like to turn the conference back over to Randy Newman for closing remarks.

Randy Newman

Thank you and thanks to everyone for joining our call this morning. Thank you for listening and asking questions. Our financial performance in 2020 was record setting. The first and second quarters of 2021 have continued this base. Although the industry is facing headwinds, our company, which has historically outperformed our peers, remains well positioned for future success because of our diversified business model. We continue to see momentum building in our pipelines for new business and client expansion across all products and a high level of engagement within our team. We have a constancy of purpose that is embraced and magnified by our leadership team, and we remain focused on working together to grow the company. This steady and strong foundation is allowing us to retain and recruit top talent, serve in the best interests of our clients, and deliver long term value for our shareholders. We are very pleased with our performance year to date and thank all of our shareholders for their investment and our team members who work daily to positively impact our clients' financial potential. We thank you for your continued support and interest in our company, and again, thank you for joining or listening to today's call.

Operator

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