



Alerus Financial Corporation

Earnings Conference Call

October 27, 2022

CORPORATE PARTICIPANTS

Katie Lorenson, *President and Chief Executive Officer*

Al Villalon, *Chief Financial Officer*

Jim Collins, *Chief Banking and Revenue Officer*

CONFERENCE CALL PARTICIPANTS

Jeffrey Rulis, *D.A. Davidson*

Nathan Race, *Piper Sandler*

PRESENTATION

Operator

Hello, everyone, and welcome to the Alerus Financial Corporation Earnings Conference Call.

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, President and CEO, Katie Lorenson. Please go ahead.

Katie Lorenson

Thank you. Good morning, everyone, and thank you for dialing into our call today.

Joining me today is Jim Collins, our Chief Banking and Revenue Officer; and Al Villalon our CFO.

We ended the third quarter with net income of \$9.6 million or \$0.47 of earnings per share. Included in the quarter were \$1.8 million of merger-related expenses as we closed and converted the Metro Phoenix Bank acquisition during the quarter. Adjusted earnings per share, excluding the merger and integration-related expenses, was \$0.54 per share.

The integration of Metro Phoenix Bank marks a historic milestone as the Company's twenty-fifth acquisition and system conversion. This strategic acquisition adds greater scale in the fastest-growing

major MSA in the country. We look forward to watching the team's continued success in attracting more talent as one of the few community banks in the market.

Highlights for the quarter included strong production and continued NIM expansion. Our retirement and wealth management division saw a decline in assets, but revenues displayed their durability in the face of ongoing volatile markets. We continue to emphasize the recurring noncapital-intensive revenues of our fee income, with over 80% of revenues in our retirement division tied to annual plan revenue and 87% of our wealth management revenue related to asset management and not transaction-based.

Production in both business units is exceeding expectations and prior year levels. Mortgage production headwinds continued during the quarter, and gain on sale margins hit a low point. We have and will continue to adjust for the decline in business through expense rightsizing. Expense management is a priority of the team and solid cost controls were evident again this quarter as expenses, excluding merger-related and unfunded commitments tied to loan growth, were down for the quarter even while we added on the Metro team.

Loan pipelines were robust coming into the third quarter, and our team members and clients were able to close many of the opportunities before the quarter end. Loan growth continues to be very planful and purposeful. More than four years ago, the Company began to restructure the credit team and established a robust credit infrastructure. We have invested in expertise and significantly improved our risk management. We have and continue to add and retain talented producers who deeply understand the segment they work in and their clients' businesses. We are focused on client selection and diversification.

While we remain disciplined in credit underwriting and deal selection, we will also continue to attract talent to our franchise as we're uniquely well positioned for sustainable and profitable growth. Alerus presents a compelling opportunity for teams and professionals to have continued success through the current and upcoming economic cycles. We have strong capital levels and resilient revenues to support superior loan growth. We are well diversified in our loan portfolio and well positioned in strong geographic markets. Our regulatory capital levels remain robust with fully funded reserves of 1.51%, excluding the Metro Phoenix portfolio. Lastly, we have long prioritized core deposits and maintaining a strong core funding base, as evidenced by our loan-to-deposit ratio of 78%.

With that, I will hand it off to AI to discuss the financial details of the quarter.

AI 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.

For the third quarter of 2022, reported average loans increased 23.1% on a linked-quarter basis. Excluding the impact of PPP and Metro, average core loans increased 8.1% on a linked-quarter basis, which was in line with the guidance provided. The increase in core average loans was driven by a 10.3% growth in CRE and 3.8% growth in C&I. We saw a pickup in commercial loan demand as clients pulled forward loan growth in anticipation of further rate hikes.

Excluding the impact of Metro, average deposits declined 2.7% on a linked-quarter basis due to a seasonal decline in interest-bearing deposits in the second quarter that lingered into the third quarter. While average balances were down in the quarter, we did see the typical seasonal increase during the fall as end-of-period core deposits, excluding Metro, were up 1.7%.

Turning to Page 15, credit continues to remain very strong. We had net charge-offs of seven basis points in the third quarter, which showed no change from the prior quarter. Our nonperforming assets percentage was 17 basis points compared to 16 basis points in the prior quarter. Our allowance is 1.34% of period-end loans, which included the acquisition of Metro Phoenix Bank.

On Page 16, our core funding mix remains very strong. We saw a small increase in our cost of funds due to rising interest rates. Given the further rise in interest rates, we have responded by increasing our deposit rates more recently. We have been strategic in lagging (phon) our deposit cost in this rapid raising interest rate environment. However we are seeing more competitive pressures, and we have started to respond by offering competitive deposit rates. Despite the competitive pressures, our funding base remains very strong and sticky as our loan-to-deposit ratio is at 78.3%.

On Page 17, our capital base remains very strong as our common equity Tier 1 ratio is at 13.6%. As a frame of reference, the medium common equity Tier 1 for the largest financial institutions subject to the Frank-Dodd stress test was 8.0%.

On this slide, you'll also note that we have over \$2 billion in potential liquidity. Given increasing concerns of potential economic uncertainty, we are well positioned from both a capital and liquidity standpoint.

Turning to Page 18 are some key revenue metrics. On a reported basis, net interest income increased 24.3% on a linked-quarter basis. Excluding the impact of PPP and Metro, net interest income increased 5.7%, mainly due to higher loan growth and higher net interest margin. Noninterest income declined 7.6% on a linked-quarter basis due to lower mortgage and wealth management and slightly higher retirement revenues. This was a little worse than expected as the markets and higher mortgage rates pressured these segments again. I'll go into further detail about those segments in later slides.

Turning to Page 19. Net interest margin was 3.21% in the second quarter, an increase of 23 basis points from the prior quarter. There was no purchase accounting accretion in the reported net interest margin. Excluding the impact of Metro, our core net interest margin was 3.04%, an increase of six basis points on the prior quarter, which is consistent with the guidance we gave of margin expansion. Core net interest margin benefited from higher investment portfolio yields along with higher loan yields from our commercial real estate and C&I portfolios.

Turning to Page 20, \$978 million or over 42% of our loans are floating, as you can see at the top left of the slide. As you see, almost all of our variable loans are above their stated floors, or have no floors. On the bottom left, you can see a waterfall of net interest income and net interest margin. Better volumes and rate, as previously mentioned, positively impacted our results.

On Page 21, I'll provide some highlights on our retirement business. AUM declined 3.8% due mainly to market volatility, with S&P 500 and Aggregate Bond Index both down 5.3% in the third quarter. While AUM declined, we did see the number of participants increase to approximately 457,000 versus 450,000 in the prior quarter. Revenues increased 1.9% from the prior quarter due to a onetime document restatement fee of \$721,000 from the SECURE Act.

Turning to Page 22, you can see highlights of our wealth management business. Revenues declined approximately \$700,000 from the prior quarter as lower insurance sales brokerage commissions and AUM levels impacted our results. AUM declined 17.2% from the prior quarter, mainly due to a decrease in custody assets from our temporary count. The temporary custody count was related to the sale of a business by one of our commercial clients. Executing on our One Alerus strategy, the team converted numerous participants into wealth management opportunities.

Going forward, the custody account rolled off, but the annualized revenue picked up from these wealth management opportunities will exceed the custody revenue. Excluding this custody deal, AUM declined 2.8% due to market volatility.

Turning to Page 23, I'll talk about our mortgage business. Mortgage revenues declined \$2.3 million from the prior quarter due to lower originations and gain on sale margin as the environment remained challenged. Mortgage originations decreased approximately 15% from the prior quarter as the mortgage bankers Purchase Index saw a similar decline of approximately 19%. While originations are tracking slightly higher than 2019 levels, the environment has become more challenging as the 30-year mortgage has eclipsed 7%.

Lastly, turning to Page 24, is an overview of our noninterest expense. During the quarter, noninterest expense increased 7%, mainly due to the inclusion of Metro. We also saw an increase in professional fees due to higher M&A expenses of \$1.8 million in the quarter. Other expenses increased as a result of higher provision for unfunded commitments as we saw an increase in commitments related to the growth in commercial real estate. This higher provision will be part of other expenses upon implementation of CECL in 2023. Excluding the impact of Metro and merger-related costs, noninterest expenses were down 0.4%, which was in line with our expectations of core expenses being flat over the prior quarter.

Now I'll provide some forward-looking guidance for the fourth quarter. We are expecting loan growth on an average balance basis to moderate in the quarter. While we expect growth in our Arizona market, especially with Metro, we expect some headwinds in our more seasoned markets. We saw some pull-forward of loan growth in the third quarter ahead of further rate hikes as we have previously experienced loan growth of 18.2%, excluding Metro and PPP, since the end of 2021. We expect net interest margin to be stable. We're anticipating rising deposit costs due to further Fed rate hikes while offsetting improvement from loan yields. We do expect three to five basis points of loan accretion from the Metro deal.

On the fee income side, we expect the following. Mortgage volumes will likely decrease in 4Q as we only expect \$800 million of total originations for 2022. We typically see a seasonal slowdown in the Twin Cities in the fourth quarter. The seasonal slowdown, coupled with higher mortgage rates and continued low inventory levels in the Twin Cities, will continue to pressure our mortgage business. Wealth revenues will be stable as we're not anticipating any equity or bond market growth. Then for retirement, excluding the onetime planned restatement fees from the SECURE Act in third quarter results, we expect retirement revenues to increase by low single digits.

Credit, we expect credit to remain strong and continue to expect charge-offs to be below historic levels. Finally, on a reported basis, we expect noninterest expenses will be down mid-single digits. Overall, this decline in expenses will drive positive operating leverage in the fourth quarter.

With that, let me open it up for Q&A.

Operator

Thank you. Our first question today comes from Jeff Rulis from D.A. Davidson. Your line is now open.

Jeffrey Rulis

Thank you. Good morning.

Al Villalon

Hi, Jeff.

Katie Lorenson

Hi.

Jeffrey Rulis

I wanted to follow-up on the expenses. Katie, you mentioned it's been a focal point. I just wanted to make sure, because it came right after the mortgage discussion. Is that tightening of expenses really focused on the mortgage unit, or is it more broad-based, sort of bank wide?

Katie Lorenson

It is both, Jeff. Certainly from an immediacy standpoint in the mortgage division, but it has been initiatives and a focus throughout the Company.

Jeffrey Rulis

Okay. I think ex merger costs, inside of flat incrementally, I think that's encouraging, and then the guide to somewhat lower in the fourth quarter. Just wanted to see as we roll into '23, and not so much guidance, but just kind of get a frame of reference for that expense focus. I guess, kind of remind us of the conversion timing, is that complete? Do you have sort of cost savings or tailwinds that might drive, I guess, getting to an expense growth rate in '23? Any commentary about what we should be thinking about a little further out?

Katie Lorenson

Sure. So we did complete the conversion and integration on September 17 this quarter. As we look at, historically, our Company in terms of efficiency ratio, we have done a nice job managing that down. We believe there is continued capacity in this Company to grow without adding incremental expense and continue to drive that efficiency ratio down. So from a cost savings perspective for the Metro deal, we are tracking according to plan, if not ahead of plan, and we'll continue to see some expense saves into 2023 from that transaction.

Jeffrey Rulis

Okay. Thank you. Then just wanted to check in on the margin. A lot going on. Trying to get a sense for the impact of Metro. I think they carried a little bit higher margin, smaller in scale, but just wanted to see how that—and how margin trended in the quarter.

I know that you're speaking to sort of flattish margin sequentially in the fourth quarter. But how did that trend kind of legacy margin versus as Metro was rolled in? Just the puts and takes would be helpful.

Al Villalon

Hi, Jeff, it's Al.

Yes, on our core margin, actually, it expanded about six basis points quarter on quarter, so excluding the impact of Metro and PPP. So we did see some margin expansion there on the core legacy books. We are seeing very good loan yields come on our books, especially with rising rates, and we're able to lag

deposit pricing again another quarter. With that being said, though, the guidance of stable margin is because we are seeing a higher deposit costs coming in the markets now.

In terms of Metro itself, they do have a higher margin and came in at a higher margin, and that's what lifted us up to about 3.21%, about a 17 basis-point—

Jeffrey Rulis

Got you. Your comment about having to increase deposit rates, did that come on later in the quarter or most recently, or was that sort of processed throughout the third quarter?

AI Villalon

It's very recent. It did not impact us in 3Q, and it's just more recent. That's where we're actually not doing that.

Jeffrey Rulis

Appreciate it. Thank you.

AI Villalon

Welcome, Jeff.

Operator

Our next question today comes from Nathan Race from Piper Sandler. Please go ahead.

Nathan Race

Yes, hi, everyone. Good morning. Thanks for taking my questions.

A couple of questions just on some of the balance sheet dynamics as it relates to the margin outlook going forward. Curious if the plan for loan growth funding going forward is largely just going to be a function of securities portfolio cash runoff. I'm curious how much of that you have per quarter in terms of coming off the securities book, and if that can maybe help support some additional margin expansion into the first half next year.

AI Villalon

Yes. So Nate, so the strategy on the balance sheet right now, is we are running off some of our investment portfolio to the tune of, I would say, \$30 million a quarter right now. I'd like to get that percentage of earning assets from investments down some. So that's going to be funding and remixing towards to help support loan growth that we're seeing, especially both C&I and CRE. We'd like to remix that into there.

There is going to be a little bit lift that we're expecting, because as we mix the investment side into more higher loan yielding side for us. But again, the thing I've been telling a lot of people with deposit costs, it's kind of like that beach ball being kept under water. It's beginning to pop now. We're seeing, especially with a lot of banks out there with loan-to-deposit ratios north of 100%, they're increasing deposit costs very rapidly right now. So we're beginning to respond to that.

Nathan Race

Okay. Understood. That outlook, Al, does that kind of contemplate continued stable deposit balances? I think, excluding Metro Phoenix in the quarter, your legacy balances were stable. So as you guys become a little bit more competitive on deposit price, how do you think that impacts your deposit growth prospects going forward?

Al Villalon

Yes. We are trying to be competitive in deposits as we definitely want to make sure our deposit base stays with us. Also too, we would like to gather deposits. We have a 78% loan-to-deposit ratio, but we know that other banks are trying to gear up to get deposits elsewhere. We don't want to be a source of funds for them.

With that being said, though, we are looking at maintaining our balances and growing them and we are seeing the seasonal pickup in our deposit balances. Hence why I commented on the end of the period loans—sorry, end of period deposits were up for us versus 2Q, ex Metro.

Nathan Race

Got you. I apologize if you touched on earlier, but just related to the retirement and benefit services growth outlook going forward. I think, typically, looking back over the last couple of years, you guys typically see an increase in 4Q within that line. Is that something that we can continue to expect in the fourth quarter this year?

Then just in terms of what you guys are doing within RB&S to make it more durable and less market-sensitive piece of the revenue pie going forward, what are kind of your expectations for RB&S revenue growth into 2023, albeit I know we're in the early innings of kind of thinking about 2023 financials?

Al Villalon

Yes. I think right now I don't think we have much to comment on 2023. But what we're looking at for the fourth quarter is for low single-digit increase in that segment. We do know that there's some seasonality there, as well, and that's incorporated in our numbers. But with that being said, we are starting up a little bit lower AUM base going into 2023 and we are actually having a commercial expansion strategy right now to expand and increase our One Alerus strategy to other commercial clients. So that hopefully will provide some more revenue uplift for us as well.

Katie Lorenson

Yes. I would add, Nate.

In terms of we are focused more than ever on organic growth within that business unit. We've pulled levers that we haven't pulled historically in our Company in terms of adding to our sales force, getting ourselves onto different platforms, as well as investing internal resource time and streamlining the onboarding of the clients and their client experience to reduce attrition. So certainly, a number of levers there that we're pulling to not only sustain the levels of growth, but continue to grow it. As we've talked about in previous calls, there is a natural organic component within that as we add plans and companies grow and add participants. That's another lever that just pushes the organic growth higher. Our planned sales, as I mentioned in my comments, as well as participants are up this year compared to prior years and exceeding expectations.

Nathan Race

Katie, are those new plan sales largely offsetting just the natural attrition of client assets that you guys typically see in retirement, in RB&S?

Katie Lorenson

Yes. I believe for the third quarter they were, yes.

Nathan Race

Okay. Great. Good to hear. Then I apologize for the housekeeping questions, but the other fee income line was up about \$500,000 or so versus the second quarter. Anything to call out there? Is that kind of run rate going forward?

AI Villalon

Flattish going forward.

Nathan Race

From the third quarter, AI?

AI Villalon

Yes.

Nathan Race

Okay. Great. Then just maybe one last one, just thinking about the outlook for the reserve going forward. Obviously, credit continues to improve, and you guys have very low levels of nonperforming assets and criticized loans pretty much relative to any institution out there. So just curious, should we expect provisioning to remain pretty negligible at least over the next couple of quarters? Or how do you guys think about maybe just providing some additional reserves just given the increasing macro uncertainty that exists today?

AI Villalon

No, I would say that our credit remains very healthy right now and strong. I mean, I think your expectations of minimal would be fair. But with that being said, though, we are implementing, we are running CECL parallel right now, and we'll have a day-one adjustment that will be coming on next year. That's really going to be dependent to—that CECL day-one adjustment will be dependent on what macro factors and community factors are at the end of the quarter.

Nathan Race

Got you. One last one, just kind of longer term on the loan growth outlook, with all the recent hires you've made and with Jim coming on board, I guess, what inning do you think we are in, in terms of a number of those hires kind of hitting their stride, bringing over the relationships some of their prior institutions, and really kind of augmenting the long-term growth trajectory of Alerus from a loan and deposit growth perspective, I suppose?

Jim Collins

Hi, this is Jim Collins. I'll take that one.

As we brought in the CRE group and we've bolstered the SBA group and fine-tuned that, those teams are off and running and looking really good, we will start bringing in additional talent towards the end of fourth quarter into first quarter of 2023 and really focusing on the C&I part of banking and broadening those relationships into our other cores of private banking and retirements. So, going into first quarter is probably the most key part.

Nathan Race

Got it. So putting those pieces together, is it fair to assume that even with some macro slowdowns or a recession to some degree, you guys still feel like just by pulling market share that you can generate maybe mid-single-digit loan growth into 2023?

Jim Collins

Yes.

Nathan Race

Okay, great. I appreciate you guys taking all the questions. Thank you.

Al Villalon

Thank you, Nate.

Jim Collins

Thanks.

Operator

We have no further questions at this time, so that concludes our question-and-answer session. I would like to turn the conference back over to Katie Lorensen for any closing remarks.

Katie Lorensen

Thank you. Thank you, everyone, for joining our call this morning, and thank you for listening and for the questions.

We want to take this time to thank our Alerus team members for their tremendous hard work and dedication. Despite the higher-than-anticipated headwinds of mortgage, our diversified business model is proving its value as we grow our client base and continue to retain and expand clients with One Alerus wins.

As we add scale and sustainably grow revenues, we remain committed to becoming more efficient and providing our clients with a fast and seamless experience. Our goal remains to maintain a top quartile return on equity and ultimately drive value creation while we continue to differentiate ourselves from the rest of the industry with our durable fee income and robust capital and long-term book value accretion.

Thank you, everyone, and have a great day.

Operator

The conference has now concluded. Thank you for attending today's presentation.