Alerus Financial Corporation Q1 2020 Earnings

Wednesday, April 29, 2020, 10:30 AM Eastern

CORPORATE PARTICIPANTS

Randy Newman - *Chairman, President, CEO*

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 specialists by pressing the star key followed by zero.

After today's presentation, there will be an opportunity to ask questions. Please note that this event is being recorded.

This call may include forward-looking statements, and the company's actual results may differ materially from those indicated in any forward-looking statements. Important factors that could cause actual results to differ materially from those indicated in the forward-looking statements are listed in the earnings release and the company's SEC filings.

I would now like to turn the conference over to Alerus Financial Corporation Chairman, President, and CEO, Randy Newman. Please go ahead, sir.

Randy Newman
Thank you, Chuck, and good morning, everyone. This is our third earnings call since our IPO in September of 2019. This morning we intend to discuss our first quarter 2020 financial results and our response to and the current impact of the COVID-19 pandemic.

Today, I'm joined by our Chief Financial Officer, Katie Lorenson, and our Chief Risk Officer, Karin Taylor. As always, we appreciate your interest in our company. We recently released an updated presentation for investors. This presentation is available on our Investor Relations website and will serve as a supplement to today's remarks. I will first highlight our pandemic response and other key points before turning it over to Katie and Karin. After that, we would welcome your questions.

Before I begin, I'd like to first acknowledge the incredible challenges we are all facing together. Our hearts and thoughts are with all individuals who have been affected by the coronavirus pandemic and subsequent economic crisis. Like many of you, we too are experiencing uncertainty as the impact of this pandemic is being felt in our company, our clients, and in the communities where we operate and do business. Although one can never fully prepare for a crisis, you can learn from past experience and apply these lessons moving forward.

Our company's past experience with adversity has allowed us to move quickly, respond proactively, and remain agile. This discipline doesn't just happen. It's built over time. Quite frankly, it's been built at Alerus over the last 20 years. Coming out of the devastating flood and fire in 1997, our corporate headquarters and operations center were destroyed.

Our employees and clients were displaced. Businesses were completely shut down and our Grand Forks community faced the most significant economic challenge of its time. Our company didn't just survive and thrive coming out of this event, we learned from it. We learned the importance of diversification. We learned the importance of a fortress balance sheet. We learned to balance growth, risk, profitability, and infrastructure investments.

Most importantly, in the last two decades since the tragic fire, our team learned how to be agile, to be innovative, and to respond on a moment's notice. This discipline resulted in a unique project management structure, allowing us to be organized, fluid, and nimble. This tragedy helped us build a culture focused on balancing the multiple needs of employees, clients, our communities, and our shareholders.

Again, while no one can fully prepare for the worst, I do believe our past history of going through such a devastating time has made our company stronger and better prepared than others to respond to the current pandemic. We are prepared to stand by our clients. We continue to support our employees. We are focused not only on doing the right thing, but also doing it the right way. And we will continue to respond accordingly as the pandemic continues to evolve.

Now more specifically, I'd like to highlight our response to the COVID-19 pandemic and the steps we are taking to ensure the safety of our employees and clients as well as the support and financial well-being of our clients. Again, our COVID-19 response is also highlighted within the investor presentation recently posted to our investor website.

Prior to the pandemic, we had both a business continuity plan and pandemic policy in place. Both of these served as guideposts, allowing us to move swiftly in our response to a rapidly escalating environment. Our BCP team began daily meetings in early March. At this time, we activated both our BCP plan and our pandemic policy response protocol.

For the past six weeks, we have had daily meetings of the BCP team, the Alerus leadership council, and our C-suite. We have also had weekly meetings with our corporate board risk committee. Each of these checkpoints allowed us to ensure we were quickly responding to the ever-changing environment, all while maintaining a wide viewpoint across our community, our company, and the reaching impacts of COVID-19.

Again, because of our past experience with abrupt disasters, our leadership team and project management discipline were instrumental in our seamless transition to responding to the COVID-19 challenges. The safety of our employees and the establishment of the safe working environment was our first priority.

Within one week, we transitioned over 85% of our staff, or 660 employees, to a fully operational remote working environment. We introduced relief pay for employees who were not able to work full-time due to branch closures and/or childcare concerns. We also established on-site pay for employees who remained in the office serving clients in drive-up locations or who were needed to perform critical tasks on site.

In addition to creating a safe working environment for all of our team, we began weekly all-employee calls hosted by our C-suite leadership team, and offered mental wellness webinars. We are pleased to report over 85% of our employees are engaging live with these meetings and webinars. We believe it is important to support our employees and help prioritize their physical, mental, and financial well-being. By supporting, engaging, and taking care of our entire team, they can then continue to take care of and support our clients.

Serving our clients and advising them on their financial needs, especially during times of crisis, was our second priority. In mid-March, we began proactively reaching out to clients and then ramped up these efforts as the CARES Act was introduced and passed and ultimately impacted several of our business lines.

In total, our financial advisers have logged over 7,500 calls in the month following this initial effort. In addition to these proactive calls, we hosted seven client webinars dealing with a host of important financial topics relative specifically to the CARES Act, financial markets, and the Paycheck Protection Program. We have had a long-held belief in our organization to serve as a trusted financial adviser. Now more than ever, serving in this capacity and operating as a partner is the best way we can help clients.

With the closing of our lobbies, we immediately increased our efforts to encourage clients to interact with us digitally and take advantage of the technology applications we have invested in over the past couple of years. We saw this engagement spike in mid-March as banking client digital logins increased 76%, coinciding with the first economic impact payments. We engaged clients with our financial wellness technology, and financial workouts continued to increase this past month.

Next, we moved quickly with the SBA PPP program and have taken over 900 applications and funded over $300 million of loans for borrowers, including both existing and new clients. Finally, we have offered various loan payment modifications and waived early CD withdrawal penalties. We continue to work one-on-one with clients whose financial situations have been adversely impacted by the coronavirus and stand ready to support our clients from a position of strength.

Over the past several years, our company has invested in several technologies to ensure we can continue to meet client needs and remain relevant. Because this foundational work was already complete, we were able to leverage these investments during our COVID-19 response. Prior to COVID-19, over half of our team had laptops, meaning they could already work remotely. Additionally, we transitioned Citrix' license to non-laptop users to quickly ensure a fully operational remote workforce. Both of these investments for our employees allowed us to move 85% of our staff to work from home within one week.

Several years ago, we invested in Salesforce as our company's CRM system. We leveraged this technology to proactively measure our reach to clients, adjust our clients' communication strategy, and closely monitor the PPP program. In addition to these investments in technology for our employees, we've also invested in technology for our clients. This includes the MY ALERUS, a financial wellness digital hub designed to help clients make better financial decisions.

We also recently launched an integrated online and mobile banking experience, user-friendly online account opening, robust business banking digital applications, a new alerus.com website, leading marketing automation software, and secure virtual meeting technology. Each of these applications has made it easier for our clients to interact with us and allowed us to remain fully operational in serving clients even while our lobbies remained closed. Because of these timely infrastructure investments, we are able to respond proactively to inform and meet our clients' financial needs.

As mentioned earlier, our past experiences have greatly influenced our strategic decisions. Since 1997, we have diversified into new growth markets, added new fee-based services, invested in our infrastructure, technology and client applications, and added key leadership where needed. Our guiding principles, our constancy of purpose, and the consistency of our leadership has resulted in a shared direction and philosophy to balance growth, return risk, and infrastructure investments.

When we compare ourselves to the SNL public company peer groups, we believe that we have a higher risk-adjusted return. Our last five year financial performance have outperformed the average of the SNL peer groups with less balance sheet risk and less dependency on margin income.

Our conservative balance sheet philosophy has served us well in the past 20 years of crisis management by allowing us to enter these times of crisis with strong core operating earnings, strong credit quality, and with a strong capital position that not only allows us to meet challenge but to preserve, protect, and enhance shareholder value by taking advantage of strategic opportunities when they present themselves.

After 9/11, in 2003 we bought Pension Solutions, a $400 million retirement plan administration company that had grown into $30 billion of assets under administration at the end of 2019, and expanded into other synergistic fee-based services such as payroll, FSA, and HSA. In 2009, we did not need to take TARP. And because of our conservative operating philosophies and strong foundation, we were able to take advantage of strategic opportunities by expanding into mortgage banking, the Twin Cities, and Phoenix/Scottsdale marketplaces.

We believe we are entering into this economic crisis with a similar strong foundation, ready to take advantage of strategic opportunities when the timing is right. This strong foundation at Alerus includes a diversified professional services business model. Our diverse business model is not primarily dependent upon interest income which, in today's low rate environment, gives us an annuity stream of consistent core operating earnings.

Alerus has close to 60% of its revenue coming from fee-based areas of professional services. The level of non-interest revenue we generate through retirement and benefits, mortgage, and wealth management is rare amongst our competitors. This diverse revenue stream better positions our company to continue to perform at high levels.

With our past experiences, we learned to not have all of our eggs in one basket. During the agricultural challenges of the '80s, we had well over a 25% concentration in the cyclical agricultural community industry. Today we have about 3% in ag and virtually nothing in oil and gas.

And just like our revenue is dispersed across different products, our revenue is also dispersed across different markets. Strategically, we expanded into growth markets that allow us to grow organically and enhance shareholder value expectations.

We are very fortunate to have passionate, loyal, professional, and committed employees. The Alerus culture emphasizes doing the right thing, serving clients with advice and guidance, and to being an employer of choice. Professional employees want to work for a reputable company that does the right thing for its employees, its clients, and its communities, Alerus is that company.

As mentioned, we have strong and diversified core operating earnings. Our strong and consistent earnings allow us to continue to honor our commitment to our shareholders by maintaining our $0.15 per share quarterly cash dividend.

As mentioned, we have a strong, diversified balance sheet. Our credit quality, credit metrics, and capital ratios are very strong heading into the heart of COVID-19. At the end of the first quarter, our nonperforming assets to assets ratio equaled 0.29%. Our reserve to loans equaled 1.54%, and our coverage ratio of reserves to nonperforming assets equaled 388%. We also reported a net recovery of $565,000 in the first quarter.

In addition to our strong credit quality metrics and in response to our philosophy of conservative credit discipline, in the past two years we have reviewed and rewrote our credit policy, strengthened our underwriting staff, and added a new chief risk officer and new chief credit officer. We pride ourselves on our relationships with our regulators and our financial and legal advisers.

We have strong, diversified leadership that includes our C-suite, a 21 person Alerus leadership council, and a strong and engaged corporate board. Alerus has a very diverse, engaged, and professional leadership team. Our collaborative and professional leadership culture is a source of strength for Alerus and results in high engagement, strong leadership development, great pride, passion, and high personal responsibility and accountability and ownership for not only what we do but, more importantly, how we perform, serve clients, and conduct ourselves.

Alerus has always developed strong internal leadership talent, evidenced by the fact that over half of our Alerus leadership council has been with the company over double-digit years. But we don't just develop talent internally and promote from within, we also recognize the benefit of attracting top talent from other organizations. Because of our sound business model, unique diversification of revenue, and collaborative culture, we're able to attract top talent.

The combination of newer and existing leaders enhances our consistency, foundation, and culture. We are a better leadership team and company because of this blended perspective. Everyone on our leadership team is highly engaged and contributing greatly to our company during these challenging times.

Finally, let me mention again our history of past financial, acquisition, and disaster achievement and successes. We believe our past financial performance results speak for themselves. We believe in operating from a source of strength. We believe we are headed into this next economic downturn in better earnings and balance sheet strength than most of our peers.

We believe we will engage our professional staff, serve and meet our clients' needs, and protect and enhance shareholder value. Our focus today is on our employees and our clients and maintaining our strong foundation that has been built. We believe this will result in organic growth opportunities and position us to consider strategic growth opportunities at the right time and when they present themselves.

I'll now turn it over to our CFO, Katie Lorenson, to discuss our first quarter financial results in more detail.

Katie Lorenson
Thank you, Randy. Good morning, everyone, and thank you for joining our call today. I will spend a few minutes today providing some additional color on the financial results for the first quarter. In summary, we were very pleased with the results of the quarter. Obviously, given the incredible uncertainty of the duration of the health crisis, it is difficult to speak with confidence about forward-looking earnings or expectations.

Let me start first with what we believe is the most important attribute of a financial institution today, safety and soundness in our balance sheet. As Randy mentioned previously, we entered this crisis from a significant position of strength due to our recent capital raise. Our TCE at the end of the first quarter exceeded 10%, and our allowance to total loan ratio was 1.54%, with allowance coverage nearly four times the amount of our nonperforming loans at March 31st.

Our liquidity position was further strengthened in the first quarter as we added $150 million of core deposits, a 7.6% linked quarter growth rate. Approximately half of this growth came from our retirement and wealth division, and represents sticky and stable funding with quarterly repricing going forward. The other half of this growth was driven by new business and increases in commercial balances.

Generally speaking, all consumer deposit products and health savings accounts ended the first quarter up from year-end. We generally see deposit balances decreasing in the second quarter due to public fund seasonality. However, because of our strong liquidity position in the first quarter, we were limited in our bidding for public funds. This has left us in a better position from an interest expense standpoint and, furthermore, we should see less seasonal fluctuation in the second quarter as we are generally holding only operating accounts from most public entities.

Our loan-to-deposit ratio at March 31st was just under 83% as loan growth for the quarter was a solid 2%. C&I loans grew 6% and CRE loans grew 5%, which was offset by declines in the consumer and residential real estate portfolios.

The first round of PPP loans in April will add approximately $300 million to the balance sheet, while nearly $200 million of the initial disbursements went into Alerus deposit accounts. We are closely monitoring our line of credit usage for our commercial borrowers. Usage was 38% on March 31st compared with 39% a year ago. Usage of lines in our HELOC portfolio continued to decline, and fell to 45% at the end of the first quarter.

We continue to see typical line usage into April, and it remains consistent with seasonal trends. Of note, line utilization has historically peaked in the second quarter in the lower 40% range. We are providing payment relief, as Randy mentioned, to both business and consumer clients, as well as following the Fannie Mae guidelines for residential mortgages. Karin Taylor, our Chief Risk Officer, is on the line and will speak to the volumes and numbers during the Q&A session.

Turning to our investment portfolio, over the course of the past year we have worked to continue to reduce our asset sensitivity. This includes increasing the investment portfolio from $250 million to $350 million today. The investment portfolio has been slowly restructured to add duration and yield.

We purchased approximately $44 million in the first quarter prior to the Fed's actions. Duration has been increased to over four years from three while building in yield. We plan to continue to reinvest, but have moved toward high quality taxable munis and 15-year mortgage-backed securities. It is a high quality portfolio, which puts off about $50 million in cash flow over a 12-month period. And lastly, we have approximately 65% of that portfolio available for pledging if needed.

Next I'll transition to the net interest margin, which dropped 10 basis points in the quarter. Most of the drop was due to the change in earning asset mix and lower asset yields, offset by decreases in deposit cost. As we look forward, we expect to see continued NIM pressure, as the Fed rate cuts in March really did not have a significant impact on our variable rate loan portfolio until the beginning of April.

The impact of the PPP loans at 1% plus the related fees will likely drive the net interest margin down or at least add volatility in the coming months. In this low rate environment and uncertain credit environment, we always emphasize the importance of our diversified business model and the ability to continue to generate revenue without additional balance sheet risk and non-interest income.

Performance in our mortgage, retirement, and wealth management divisions was truly impressive in the first quarter. I'll start with mortgage and a record-breaking first quarter, with total originations of over $229 million, an 82% year-over-year increase. The volume our loan officers and operational teams have handled is really simply amazing and was critically supported by the technology investments made over the past year and a half.

As Randy mentioned earlier, a huge percentage of our employees transitioned to work from home in mid-March, which drove even further use of technology throughout the company but specifically in the mortgage division, which had over 85% of March applications completed using Omni Technologies, up from 68% the previous month. In addition, the division's goal to be paperless by the end of 2020 happened in a matter of days.

Purchase activity began to decline in March. The purchase refi and mix finished the quarter at a 50/50 split, a notable change from our historical average trend of 80/20. The margins in the mortgage division have increased approximately 30 basis points over the course of 12 months due to the transition to mandatory delivery in early 2019.

Please note, at the end of the first quarter, the mortgage revenue line item did include an unrealized loss of nearly $900,000 related to the mark-to-market on our hedge loan pipeline. As the Fed reduced their daily purchasing and the mortgage-backed markets stabilized in April, we were able to work through the unfavorable positions.

Moving on to the retirement and benefits line of business, assets under administration declined to $27 billion at the end of March compared to nearly $32 billion at the end of 2019. Assets with asset-based fees dropped from $13 billion to $10 billion, or a 21% decrease in direct correlation with the S&P decline through March 1st.

Total asset-based fees were $7 million or 45% of total fees for the first quarter. The asset-based revenue is primarily tied to average daily value, which were at record highs in the first part of Q1. The negative impact of these fees due to sustained down market will be more significant in future quarters.

As we noted in our call in January, there is always some--there was some infrequent in nature revenue in the fourth quarter that totaled about $500,000, and there is some seasonality in distributions that eats up transaction fees, which led to a linked quarter decrease in revenue. Year-over-year, revenue increased nearly 8% due to the fee project as well as an increase in the number of plans and participants, which drives recordkeeping and administrative revenue.

Our wealth management revenue declined on a linked-quarter basis due to where the S&P landed on March 31st. A majority of the division's revenue is based on the quarter-end value. I would be remiss not to highlight, however, the year-over-year performance of our advisers, who delivered a nearly 12% increase in revenue and 20% plus increase in the Blueprint and Dimension products.

Lastly, a quick note on the non-interest expense line item, which bumped up slightly, and was due to a recognition of a swap fee of about $200,000.

Moving on to expenses, non-interest expenses were largely in line with expectations, with increases in personnel expenses related to 401(k) and payroll taxes. Professional fees returned to a more normalized run rate after some accrual adjustments in the fourth quarter. Marketing and advertising decreased, which is typical in the first quarter. And as expected, travel expense declined, especially in March as we limited travel of our employees. As noted in our earnings release, the mortgage and lending line expense line item included a $400,000 impairment of our $3.8 million mortgage servicing asset, which is primarily tied to Fannie Mae loans we originate and retain servicing.

Lastly, other non-interest expense, which includes a lot of little stuff, this line item can be a bit lumpy due to the provision for unfunded commitments. There was not a significant increase in the commitment provision expense in the linked quarter, but in Q1 of 2019, there was nearly a $400,000 credit to expense.

Last but not least, provision expense; again, we cannot (inaudible) the truly high level of uncertainty that remains in regards to the duration of the crisis and the impact on credit quality. It was incredibly difficult to determine where to land in regards to provision expense for the quarter. We have been building our level of allowance since 2017. And as we ended 2019, we had nearly $2.2 million of unallocated reserves. We are very pleased to be in the position that we are today at a reserve that is over 150 basis points to total loans.

During the first few months of 2020, our credit quality continued to show improvement, and we ended the quarter with a net recovery of over $500,000. As we evaluated our methodology and qualitative factors throughout March and into April, we made the decision to prudently continue to build our reserves.

We added 15 basis points for economic conditions to all loan types and risk ratings. We added 1% additional allocations to our watch credits, and we added an additional 25 basis points to our small business credits. Those additions drove us to a provision of $2.5 million for the quarter, which has allowed us to maintain our level of unallocated near the $2 million mark. We anticipate we will be allocating that as we move through the crisis and gain more understanding of the credit impact.

With that, I'll turn it back to Chuck to open it up for Q&A.

QUESTION AND ANSWER

Operator
Thank you. 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 the handset before pressing the keys. To withdraw your question, please press star then two.

At this time, we'll pause momentarily to assemble our roster. And our first question will come from Jeff Rulis of D.A. Davidson. Please go ahead.

Jeff Rulis
Thanks. Good morning.

Katie Lorenson
Hi, Jeff.

Jeff Rulis
Randy, you had detailed pretty limited exposure in the ag and oil and gas. More broadly speaking, looking at the portfolio, have you looked at maybe sort of re-fencing total exposure to most at-risk portfolios, perhaps in the hospitality or retail? Is there a figure that you've assigned too as far as those most at risk?

Randy Newman
Yes. I'll let Karin Taylor answer that.

Karin Taylor
Yes. Jeff, good morning. We have taken a look at the segments that we think are at highest risk. And in our C&I portfolio, it includes accommodation, food service, arts and entertainment, oil and gas, and some of our other retail trade, which is our smaller businesses. And then, of course, in commercial real estate, we do have about $118 million in retail as the underlying

property type. And we have about $36 million in medical or nursing facilities, and we have just $7.5 million in hotels.

And so, in the investor presentation we posted on our website, there is a slide that summarizes that information. So, overall we would put that at about $162 million. The caveat I would give is that that entire retail commercial real estate has a great degree of variability in terms of risk just based on what the underlying tenants look like.

Jeff Rulis
Got it. Sorry, I may have missed in the slide deck the number there. Thanks for the detail there.

I guess moving to the fee income bucket, previously--obviously, things have changed quite a bit, but I think in the last call, you mentioned the retirement benefits line item expected to be flattish in '20. You've obviously got a jumpstart on a pretty solid mortgage production this year. Any thoughts on how we navigate through the year in terms of a fee income contribution?

Katie Lorenson
Thanks, Jeff. This is Katie. Certainly, I can't emphasize again the uncertainty that we will--that we're seeing in our fee income as well as in our margin and provision expense. Really, as we break down each component, we are continuing to see mortgage operate at extremely high levels of applications through April and May.

We are seeing now a transition to--actually, I think the most recent was 30% purchase versus refi. And so, the sustainability of that I think is something that we're not exactly sure of. That being said, we have not done really any marketing or active reach out to our clients. So, I think we'll see a strong second quarter for mortgage. And then after that, again, just the uncertainty of how long and the duration of the crisis will have an impact.

On the retirement side, we're very pleased with the year-over-year growth. The market sensitive revenue will certainly be impacted in a sustained down market. But that's just a portion of the revenue. There are other attributes of that revenue which bear some uncertainty today. Those would be around the distribution and the loan and the fees surrounding those.

We have seen only a modest increase in distributions and loans coming into April, and we have not been waiving any fees on those, though there is some of our competitors who are doing that. The other piece of the retirement revenue would be our ESOP transaction fees, which are typically heavily weighted toward the fourth quarter. But most of those transactions are on hold too.

And on the wealth management side, again, really impressive growth, impressive outreach by our advisers, and just really highly dependent on the market volatility there. So, that's a lot. But I guess what I would say is where we see today and where we see the second quarter, I think our results for the first quarter can be sustained at least into the second quarter.

Jeff Rulis
Fair enough. Thanks, Katie.

And maybe one last one just on the--Randy, you spent a good amount just sort of detailing the diversity and I guess the position that you've put Alerus in, almost acknowledging some trying times, but part of that is setting yourself up for being opportunistic should things return to some form of normalcy. I guess on the M&A side, how do you view having those conversations and anything that's kind of--that you're looking at on that end. Maybe it's a back burner item, but should we kind of emerge from this, what are you thinking about on M&A? Thanks.

Randy Newman
I'll offer up a couple of thoughts. In your choice of words, which is true, right now we definitely have put that on the back burner. Our focus is, as I expressed, our employees, our clients, and then just making sure that we operate from a great source of strength with a fortress balance sheet.

That being said, we do have that past experience, which I think is real and I think is very much a part of our culture that every one of the--9/11, 2009, we entered those periods, which I think again speaks to the conservative financial guidelines of the company, philosophies of the company, is that I think we entered those in very, very good balance sheet strength and we were able to take advantage of opportunities.

So, as a result of the IPO last year, heading into 2020 top of mind was really the deployment of that capital. And we were in some discussions with some key companies. And we have visited with them and put them on hold, and we'll reengage with our board at the right time.

Jeff Rulis
Great. Thank you.

Operator
Our next question will come from Nathan Race with Piper Sandler. Please go ahead.

Bob Shone
Good morning. This is actually Bob Shone on for Nathan. How you guys doing?

Katie Lorenson
Morning.

Bob Shone
My first question is around the strong deposit growth you saw in the quarter. You mentioned that you had $200 million of the PPP loans go directly into operating accounts. Can you maybe talk about the excess liquidity and how that impacts the margin going forward?

Katie Lorenson
Sure. This is Katie, great question. Yes. So the PPP loans, which were disbursed of course in April, significant impact on the margin if we can continue to keep those fundings in-house. What we also don't know, which impacts the margin, is the speed at which those pay off and the recognition of those fees upon paying off.

So, it is--there will be lumpiness in the margin, so I think it's kind of anybody's guess as to how it plays out. But I think because of the fees and because we do anticipate at this point that a majority of the loans will pay off within the first 6 months or so of disbursement, I think that we will see the margin actually kind of stabilize with where--and potentially increase in 2020, assuming again that those loans pay off fairly quickly and we recognize all the fee income within the net interest margin, or a majority of the fee income in the margin.

Bob Shone
Okay. Thanks.

And then in regards to the PPP loans, do you by chance know the percentage of commercial loans that were granted payment relief that have also been approved for PPP loans?

Karin Taylor
Yes, this is Karin. I don't have the exact percentage, but there has been a correlation between the two.

Bob Shone
Okay.

And then you spoke to both approving PPP loans for existing and new customers. Do you guys have the breakdown by chance between new and existing clients? And then maybe if you could provide some color on how those new clients came to the bank, were they existing prospects or them calling in? Thanks.

Karin Taylor
Sure. So, during the first round, the 900 loans we did initially for just over $300 million, about $40 million of that $300 million was either to existing clients who didn't have a previous lending relationship with us. So, they had a different kind of relationship or a few new clients. We were really focused on prioritizing our existing clients through that first round.

I can tell you that through the second round, we have seen more applications from prospects. And those are primarily prospects that we've been working with in our markets for some time in order to win their business.

Bob Shone
Okay.

And then last one for me, in the slide deck I saw that you provided the average LTVs for the residential real estate portfolio. But do you by chance have the average loan to values of the CRE portfolios that you deem more at risk, the retail, medical, and hotel?

Karin Taylor
I don't have the actual LTVs. I can tell you that our LTV limits are generally 75%. And on retail, sometimes it's lower than that. In terms of the hotels on the books, one larger relationship is newer and would have been within those target limits. The others have been aged on the books for some time.

Bob Shone
Okay, thanks. I'll step back.

Operator
Our next question will come from William Wallace with Raymond James. Please go ahead.

William Wallace
Thank you. Maybe as a quick follow-up to the PPP lines of questioning, correct me if I heard this wrong, but of the $300 million, you're saying $40 million were to non-lending customers, but all $40 million were--or almost all $40 million were customers of the bank in another form. Is that correct?

Karin Taylor
That's correct. There were a few customers new to the bank, but not many.

William Wallace
Okay. And what are the average fees on that $300 million?

Karin Taylor
In terms of dollar amount?

William Wallace
Yes, or if you've--yes, if you know the dollar amount of the fees expected or the percentage. Either way is fine.

Katie Lorenson
Average fee is 0.8.

William Wallace
I'm sorry?

Katie Lorenson
About $8.8 million in total fees on the first round, about 2.95% on average.

William Wallace
Okay, great. And then what is the pipeline on kind of the second wave here?

Karin Taylor
Right. So, we received over 500 applications. And those are tending to be lower dollar loan amounts, and so we're looking at about $57 million or $58 million in the pipeline.

William Wallace
Do you know the average fees on that? I assume it's probably higher given the smaller--.

Karin Taylor
--The percentage will be higher because the loan size is so much smaller, yes.

William Wallace
Yeah, okay.

So, Katie, I'm going to ask the margin question a different way. Let's just take PPP out of the equation. What would you anticipate to see on a net interest margin in the second quarter ex all of that noise?

Katie Lorenson
Certainly a decline. The commercial portfolio we expect, excluding the PPP loans, would have dropped probably about 20 basis points in yield. Now, what we have done has been very aggressive on our deposit cuts, and so we expect moving into the--an average of 30 basis points cuts by product moving into the second quarter and continuing on through the year.

As we talked about, those pools of deposits that reprice every quarter, a couple hundred million of that was that 1.64% at the end of March. We anticipate that moving down to well below 1% by the end of the year. So, there is some balance there, but we would have expected to see continued compression in the yield without the--within the NIM without the PPP loans.

William Wallace
Right. So, I'm wondering if you could maybe help quantify it. If I look at your scenarios in your K, 150 basis points of cuts would imply as much as close to 40 basis points of pressure to the NIM. I don't anticipate it would be that great. I wondered if you could just, kind of putting all those pieces together, give us a sense of what that level of pressure might be.

Katie Lorenson
I think with the deposit cuts, I think it could be altogether on the NIM, probably about 20 basis points pressure.

William Wallace
Yes. Thank you. That's helpful. Great.

And then the wealth and retirement businesses, you mentioned in your preamble the fee is calculated on average daily basis. Can you kind of give us a sense of what's left in the second quarter? Are we talking about probably starting at a level of down about 10%?

Katie Lorenson
Right.

William Wallace
Okay.

Katie Lorenson
Right. So, yes, I think that's--yes, we certainly saw some recovery. So, we're not going to see the 20% impact that we saw those couple of weeks in March.

William Wallace
Yes. Great. Okay. And then obviously, whatever happens for us this quarter will inform the ultimate result.

In the prepared remarks, there was two comments about mortgage. I believe you said there was a pipeline hedge loss, and then I didn't catch the dollar amount there, and then I think you said a $400,000 impairment on the MSR. Can you give me that dollar amount of the hedge loss? And then also, that $400,000 impairment, did that flow through the fee income line?

Katie Lorenson

Yes, no problem. So, it was approximately $900,000 of unrealized loss in the mortgage revenue line item at the end of the first quarter. And then there was an approximately $400,000 of expense in the mortgage and lending expense line item that related to the MSR impairment.

William Wallace
Okay. I thought maybe you said it went through expense. So, where does that roll up to? Is that in other in the consolidated financials?

Katie Lorenson
That is its own separate line item on mortgage and lending expense.

William Wallace
Okay. Oh, yes, duh. All right. Thank you.

And if you could, on the retirement and businesses segment, can you kind of--Randy, maybe this is for you, just kind of talk us through bigger picture how this shutdown disrupts that business, if it disrupts it, and what it takes to kind of get back to "normal?" Not talking about market moves, but just sort of the customer acquisition and customer retention side of it. Thanks.

Randy Newman
And, Wally, on what business? I'm sorry.

William Wallace
The retirement and benefits business.

Katie Lorenson
Yes. Randy, maybe I'll take that one to start, and you then you can supplement.

Randy Newman
Sure, go ahead.

Katie Lorenson
So, on the retirement business, in terms of--let me start with clients. First of all, there's obviously a lot of outreach to our clients. Randy talked about that in the call. But the CARES Act could increase distributions. It could increase loans.

From a new business standpoint, we had a really, really solid pipeline coming into the year and coming into the first quarter and the second quarter. Most of those clients have put us on notice of pause, so that is a strain on new business. But of course, it's a positive when it comes to attrition, and clients that had notified us that they were leaving for one reason or another certainly are pushing that out, too.

I think the uncertainty that comes with this, and I don't think it's a 2020 impact, but we do service a fair amount of small businesses, small clients. And how they weather this storm could mean that plan terminations because of closures becomes a headwind in the future. It could also mean that companies stop providing matches. And so, we could be at risk of where outflows are exceeding inflows in terms of distributions exceeding those contribution levels. So, that's some of the color that I would provide on just the overall landscape of the business.

William Wallace
Okay. Thanks.

And then I guess on the other side, to the extent that you guys have customers that may be leaving, they stick around as well. What's the turnover like in that business?

Katie Lorenson
We usually see attrition of about 5%. So, that's been declining as we've introduced new technology. That was--the technology investments were both an offensive as well as a defensive play. But historically that rate has been about 5%.

William Wallace
Okay. Thanks, Katie. That's helpful. I appreciate it. I'll let somebody else ask a question.

Operator
Again, if you have a question, please press star then one.

This concludes our question and answer session. I would like to turn the conference back over to Randy Newman for any closing remarks. Please go ahead.

CONCLUSION

Randy Newman
Okay. First, let me extend our appreciation to everyone who joined our call this morning. Thank you for listening and asking questions.

2019 was a record year for Alerus, both in terms of our solid financial performance and also in terms of achieving strategic non-financial initiatives. We were fortunate to have had our IPO last year for many reasons. We were very optimistic in the first quarter of 2020 of sourcing opportunities to deploy the capital that we raised and to continue the strategic growth of the Alerus franchise.

Due to COVID-19, we have prudently paused these efforts and focused on our employees' safety, serving our clients, and making sure that our balance sheet is fortress strong. While we are concerned about the health related impact of the virus and the resultant effects on our economy and borrowers, we are patient, focused, and ready to pursue at the right time strategic opportunities when they present themselves.

For the reasons expressed during today's call, we are confident in our leadership abilities to manage through the crisis, and we believe that our strong balance sheet and core operating earnings will enable us to perform well during this period of economic uncertainty. Thank you again for joining today's call.

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