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Corporation** NasdaqCM:ALRS

Earnings Call

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Presentation

Operator

Hello, everyone, and welcome to the Alerus Financial Corporation Earnings Conference Call. [Operator Instructions]. 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 call over to the Alerus Financial Corporation President and CEO, Katie Lorenson, to begin. Katie, please go ahead.

Katie A. Lorenson

President, CEO & Director

Good morning, everyone. Thank you for joining us today for our quarterly earnings call. Here in the Twin City today with me is Al Villalon, our CFO; Karin Taylor, our Chief Operating and Risk Officer; and Jim Collins, our Chief Revenue Officer and Head of our Commercial Wealth Bank. Forrest Wilson, our Chief Retirement Services Officer is also joining us on the call.

I'll start the call with some prepared remarks and strategic highlights for the quarter. Al will spend a few minutes hitting on the key financial highlights, and then we will address your questions. There is no question that this was a tough quarter for Alerus. We are not and will not be satisfied with our results until we are delivering superior returns. That being said, we also firmly believe success is not measured by a single quarter. And while the third quarter came up short, it was also a period of continued progress and execution of our key long-term strategic initiatives for our company.

While the path to returning to top performance is not linear, the substantial strides we've made demonstrate our commitment to achieving our consistent top-tier performance. Our focus remains on driving shareholder value through steady growth, diversified revenue positive operating leverage and maintaining conservative efforts.

Let me begin with the transformational changes we've been making over the past 1.5 years as we build a premier commercial wealth bank. Over this period, we have added key talent, continue to diversify our loan portfolio and closed on our largest acquisition to date. We've also managed through the challenging work of numerous restructurings, rightsizing and exiting of several business lines, which were not core to our focus.

Regarding talent, we have worked with urgency on getting the right people in the right seats. And our great culture and best-in-class diversified business model has allowed us to retain top balance and recruit dozens of new team members to the company, including many key hires with areas of deep expertise. Our additions on the revenue proving side are supported with key hires and continued investments in risk management infrastructure. These are all long-term investments that put some near-term pressure on operating expenses, but keep growing in the right way to support the consistent top-tier returns we expect to deliver in the future and have delivered in the past.

A key strategic priority was, and will continue to be to build strong mid-market and business-making C&I teams in our larger markets to support the well-established and successful teams in our North Dakota markets. Changes of this significance take time to show through to the bottom line, but the momentum is clear with nearly 45% of year-to-date loan origination to C&I clients compared to our pre-transformation origination percentages of 17%.

We recently rolled out our formal private banking offering after adding a team of professionals and the synergies between wealth management commercial banking and mortgage are exceeding our expectations, particularly in deposit and wealth generation. We remain deeply committed to diversification

and believe establishing verticals to augment traditional C&I banking is important to growing the client base and expanding relationships. We've added specialty areas of SBA, government non profit, and most recently, our equipment finance vertical.

Turning to our most recent announcement, which was the receipt of regulatory approval and the closing of our Home Federal acquisition, both of which happened in the expected time frame, and a signal of our position of strength, relationships with our regulators and capabilities in executing acquisitions.

The Home Federal partnership is our 26th acquisition in the past 20-ish years. Our playbook of integration is proven. And in this particular partnership, the conversion is more straightforward than the previous smaller mix we've acquired. We are so pleased with the leaders and the banking group that have joined us. Together as a bigger company, we are committed to getting better and achieving the results in our pro forma company and feel confident in our ability to do so.

As for the results of the third quarter, our deposit growth for the year is over 7% and despite facing the headwinds of seasonal outflows we held deposits flat by continuing to win new clients despite the incredibly competitive environment. We experienced some positive migration, but it's important to note the majority was simply in movement between accounts. We continue to operate with no brokered deposits and highlight our CD portfolio that is core clients with a rollover rate in excess of 96%.

Loan growth was also robust during the year with the majority of business coming from market share gains of long-established companies. Although the economy in our market continues to be strong, we remain highly selective. And in commercial real estate, where we run below regulatory guidelines in terms of concentration, we are stringent with our dry powder, reserving capacity for the highest quality sponsors with underwriting structures that fit within our time-tested underwriting standards and those relationships that deliver superior ROEs.

Credit quality remains a key area of focus. Early identification of problem loans, coupled with proactive and decisive actions are part of our credit culture. We continue to closely monitor and proactively downgrade loans where we see potential or emerging weaknesses. We monitor the individual loan level on an ongoing basis, severing of our large multifamily projects, and we do not see systemic issues in this portfolio.

However, normalization of credit in the broader portfolio continued during the quarter as 2 large relationships drove the increase in nonaccrual loans, of which we believe we are adequately reserved. One of the loans was a long-term bank and wealth client who has experienced the credit issues and the other was an acquired CRE loan originated in 2021 that was identified as higher risk marked in diligence.

Credit migration has come from the a category, and we do not -- we have not backfilled despite continuously reviewing our portfolio through annual review, independent internal and external loan views. Charge-offs to average loans remained low for the quarter at 4 basis points and reserves to loans was stable at 1.29%.

I will cover the margin in more detail, but I won't shy away from the reality of the magnitude of it. We did take a step back to 2023 after a much anticipated step forward last quarter. Our long-term guidance remains intact. The NIM was impacted by the continued pricing pressure on deposits. We have consistently discussed the impact of deposit competition in our market, where many banks face high loan-to-deposit ratios and a reliance on brokered funds. The competition remains fierce and we are focused here again on the long-term retention and doing what's right. We have evaluated all exception price deposits on an account by account level, and we will be adjusting incentives to correlate with volume and pricing.

Also, always the highlight for Alerus is our wealth management division, which has consistently grown top line revenue for many years. Our advisers are the best in the business and our wealth business is deeply embedded in our business lines with over 40% of our client works from part of our retirement focus business and 20% of our wealth clients take personal or commercial bank relationships. We know how special our wealth business is and we are completely committed to continuing to invest in the business.

We recently signed to move to a new technology platform that will transform the client experience and greatly improve the processes for our advisers and their support teams. This technology upgrade will

help build on our established success in recruiting advisors as we offer a great user experience and the exceptional synergies that advisors are able to leverage from our retirement business.

Speaking of our retirement business and our ultimate differentiator when it comes to value creation, given the recurring nature of the business with minimal capital allocation. Here, too, we have new leadership, new team members and enhanced structure. The team had a record quarter of new revenue, and we see continued positive growth trends in plans and participants, which is where the majority of our new fees are sourced. National partnerships are one of the key initiatives in building our business, and we are pleased with the progress and the momentum we are seeing so far. We will continue to invest in this business with key talent additions and technology to improve efficiency, increase automation and strengthen our margins in the business.

Year-over-year core nonmarket-related revenues are up 5%. We are very bullish on the commentary in our business and view the recent legislation of Secure Act 2.0 as a key catalyst in continuing our trend of improving organic growth.

Moving on to expenses during the quarter, which trended upwards due to a few factors: the addition of key hires and the correlated severance and retirement-related packages in addition to M&A-related expenses, which were \$1.7 million. We had some lumpiness between the quarters related to FDIC insurance, and we had some increases in professional fees, which I would characterize as operational but not recurring.

We believe each of our revenue producing hires will contribute to an improving fee with higher levels of production and more profitable business. The platform and technology changes in our wealth and retirement business will also create greatly improve our processes, which will lead to efficiencies, all of which will allow us to continue to effectively manage headcount in the company.

In regards to capital levels, they bounced back closer to core with the payoff of BTFP and we grew book value by 4.6%. Our book value continues to include \$63 million of AOCI that will be casually recaptured over the coming years. We believe in maintaining a fortress balance sheet and remain committed to our long history of delivering dividends to support returns to our shareholders. We have not been active in repurchases due to the recently closed acquisition and our priorities remain focused on organic growth, but we absolutely understand the value of the sum of the parts of our business and will be active as deep disconnects on value present themselves.

With that, I will turn it over to AI for specifics on the quarter.

Alan A. Villalon
Executive VP & CFO

Thanks, Katie. I'll start my commentary on Page 11 of our investor deck as posted on the Investor Relations part of our website. Let's start on our key revenue drivers. On a reported basis, net income decreased 6.1% over the prior quarter, while fee income grew 3.6%. The decrease in net interest income was driven primarily by lower purchase accounting accretion for the Metro Phoenix Bank acquisition, an increase in nonaccruals and higher interest expense due to mix shift from noninterest-bearing deposits due to interest-bearing deposits. Growth in fee income was primarily driven by an increase in overall asset base fees within our wealth, retirement business line and from a gain recognized in the sale of one of our offices.

Turning to Page 12 in the third quarter. We can dive into interest income a little more closely. Net interest income decreased to \$22.5 million and our core net interest margin decreased partly due to 3 factors. The first one being lower purchase accounting accretion for Metro Phoenix as you can see above decrease from 10 basis points to 2, less net interest income due to higher nonaccruals and higher interest expense from an increase in interest-bearing deposits.

At the end of the quarter, we repaid our borrowings from the BTFP as the Fed recently reduced interest rates. So going forward, our reported net interest margin no longer reflect the drag from these low interest earning assets. We continue to see a path to our net interest margin reaching 3%. The path will not be linear as each quarter will have the different factors affecting net interest margin. For the migration of noninterest-bearing deposits to interest-bearing would drive our cost of funds higher.

Turning to Page 13 to talk about earning assets. Since acquisition of Metro Phoenix Bank, we had our eighth consecutive quarter on growth as loans grew 4% over the prior quarter. We continue to let our loan investment portfolio run down as we mix low-yielding securities to higher-yielding loans.

Turning to Page 14. On a period-end basis, our costs increased 0.8% from the prior quarter. While we saw seasonal outflow from our public funds, we continue to drive or get deposit growth to offset these outflows. Given the 2.7% growth in interest-bearing deposits and 6.3% decline in noninterest-bearing deposits, noninterest-bearing deposits are now 19.8% of total deposits versus 21.3% in the prior quarter. Given the stable deposit level overall, our loan-to-deposit ratio was 91.2%, which is well below our target level of 95%. We continue to not utilize any broker deposits for funding needs.

Turning to Page 15. I will now talk about our banking segment, which also includes our mortgage business. I'll focus on the fee income components now since interest income was pre-discussed. Overall, noninterest income from banking was up \$600,000 or over 12% from the prior quarter. Most of the increase was from the gain recognized in the sale of one of our offices in Minneapolis Metro Market. For the fourth quarter, we expect overall level of noninterest income to decrease from third quarter levels as we expect mortgage revenue to slow on the back of a seasonal slowdown in originations.

On Page 16, I'll provide some highlights on our retirement business. Our total revenue from the business increased 0.4%, while assets under management increased 4.7%, mainly as equity and bond markets continue to improve. Participants within retirement grew 1.5% during the quarter. New business production continues to be strong as over 500 opportunities were won this year. For the fourth quarter, we continue to expect fee income for our retirement business to be stable.

Turning to Page 17, you can see some highlights from our wealth management business. On a linked quarter basis, revenues increased 5.1%, while our end of quarter assets under management increased 5.4% due to continued improvement in economy bond markets. For the fourth quarter, excluding any market impact, we expect fee income from our wealth business to be up slightly.

Page 18 provides an overview of our noninterest expense. Third quarter noninterest expense increased 9.5%. During the quarter, we did incur \$1.7 million of onetime merger-related expenses related to the recently completed acquisition of HMN Financial. Excluding these merger expenses, core noninterest expense increased 7.6%. Compensation and benefits saw an increase due to the onboarding of the equipment finance team, additional key hires and from an increase in employee benefits. We also saw an \$800,000 increase in professional fees, excluding M&A-related activity due to increased examination and audit expenses. For the fourth quarter, reported expenses will increase due to merger and acquisition expenses related to the Home Federal deal. For 2026 -- 2025, we are still committed to achieving 30% cost saves announced in the Home Federal acquisition.

Turning to Page 19, you can see our credit metrics. As Katie covered a lot of this in her prepared remarks, I will go the next slide. I will discuss our capital liquidity on Page 20. We continue to remain very well capitalized as a common equity Tier 1 capital to risk-weighted assets is 11.1%. Our tangible common equity ratio also improved 85 basis points to 8.11% as we saw an improvement in unrealized losses and we repaid the BTFP.

Post the acquisition of Home Federal now have an outstanding share of over \$25.3 million, which is in line with our original deal assumptions. Additionally, we also added over \$868 million of loans and \$952 million of deposits. On the bottom right, you'll see the breakdown in the sources of our \$2.2 billion of potential liquidity. Overall, we continue to remain well positioned from both the liquidity and capital standpoint to support future growth or whether any uncertainty.

On Page 21, we continue to see strong organic loan growth, which offset any seasonal outflows. We continue to see positive momentum in our retirement and wealth businesses, while seasonal capital levels remain strong to weather any economic uncertainty. With that, I will now open up for Q&A.

Question and Answer

Operator

[Operator Instructions]. And our first question comes from the line of Jeff Rulis from D.A. Davidson & Co.

Jeffrey Allen Rulis

D.A. Davidson & Co., Research Division

Question on the larger credit, I guess, on nonaccrual, as you extend were to potentially put yourself in a good position there. I guess, is that capped the extension of credit to that the construction item? Or is there more to come to kind of get it over to completion? And then I guess, secondarily, could you just remind us kind of where that is located and the time line on resolution?

Karin M. Taylor

Executive VP and Chief Risk & Operating Officer

Sure, Jeff, this is Karin. Yes. We continue to evaluate a number of options with regard to this particular credit. If you recall from last time, the borrower has been proactive in injecting equity into the project to cover overruns. It went to nonaccrual because additional equity injections were delayed. They continue to try and source additional update. That said, we will look at a range of options as we determine how to best resolve the credit.

It is here in the in cities market. It's on the east side of the cities, relatively close to both downtown. St. Paul and downtown Minneapolis. It's well located to entertainment, to public transportation, it's a Class A property in a preferable location. So we continue to feel good about the market dynamics and the market ability to support that property. It is about 87% complete at this point, and we're looking at early 2025 for completion. Obviously, we're doing everything we can to resolve as quickly as possible, but I don't have a firm time line for you.

Jeffrey Allen Rulis

D.A. Davidson & Co., Research Division

Okay. I appreciate it. On the expense side, Katie, I think you have, I guess, I'm interested in those areas that aren't necessarily -- that were operational, but maybe not recurring. We can carve out the one-timers, but I guess of the areas that were elevated trying to get a sense for the comp line? Are those hires fully baked in and then maybe professional services, just some areas that you may see maybe tail off potentially that aren't recurring, if you will.

Katie A. Lorenson

President, CEO & Director

Sure. Yes. In regards to the professional fees. I would expect to see more normalization if you take the run rate for the past couple of quarters ex the M&A. There's some lumpiness in between the second quarter and third quarter I would say for both the compensation line as well as the professional fees line item.

Jeffrey Allen Rulis

D.A. Davidson & Co., Research Division

Okay. I guess on a core basis to Al's commentary, I mean, ex the added platform, you're bringing on legacy expenses, can we expect flat to down? Trying to get a sense for what the trend is there?

Alan A. Villalon

Executive VP & CFO

So Jeff, you're going to see just on a reported basis, so our expenses, we are going to combine mergers. But on a standalone basis, if you were just to look at us, we are committed to getting that down. But from a combined entity because we're now 2 companies getting combined up, you will see reported expenses,

of course, go up. We're committed to the 30% cost saves -- 30-plus percent cost saves that we detailed out in our original performance for the deal.

Jeffrey Allen Rulis

D.A. Davidson & Co., Research Division

Yes. I guess I'm trying to get a sense for -- we could track the expenses on HMN side and what that potentially could add. We can carve out cost saves in '25. But just the run rate for legacy that's the key I'm trying to nail down.

Alan A. Villalon

Executive VP & CFO

Yes. Yes, you would expect that to come down.

Jeffrey Allen Rulis

D.A. Davidson & Co., Research Division

Okay. Yes. Got you. Maybe just one last one then on the loan growth. Really strong growth, Katie. I appreciate the tilted towards the market share gains to the degree of -- I guess, does that suggest that the market overall, maybe the pie is not growing, you're just taking a bigger piece of that? Or question really is just on the underlying business trends and activity. Is that improving some, but you're executing well on taking share. I just wanted to kind of wade into that discussion a little bit more.

Jim R. Collins

Executive VP and Chief Banking & Revenue Officer

Jeff, this is Jim. That is taking market share. We brought in a lot of talent over the last 18 months. Those non-solicits are up. So a lot of the relationships that are moving over, and we're seeing that in the growth. Our relationships that have been known to a lot of the employees here now that have come over for a long time. So it is market share in some of the other banks that are probably resting on the laurels a little bit.

Jeffrey Allen Rulis

D.A. Davidson & Co., Research Division

Okay. And Jim, your pulse on the activity, generally speaking, of the market from demand, what would that be?

Jim R. Collins

Executive VP and Chief Banking & Revenue Officer

I think all the markets that we're currently in are in pretty good economic shape. There's not a ton of robust growth, I would say, but pretty average. So I don't think there's a lot of growth exponentially, but there's enough growth for us as other banks are still not overly active in the marketplace. I think our activities are going to generate a lot as the market competition comes back. Our activities now are going to be more fruitful in the '25 to '26 just because they haven't -- a lot of the banks haven't been in the market as much as we have been.

Operator

Our next question that comes from David Feaster with Raymond James.

David Pipkin Feaster

Raymond James & Associates, Inc., Research Division

I wanted to dig into the margin for a second. Look, there's a lot of moving parts in here. I was hoping you could just help us think through maybe like a core margin what's a good starting point? Look, we've unwound the BTFP. You got HMNF in the fold. Just thinking through the trajectory, again, you got the nonaccrual reversal in the last quarter. Just how do you think about a good core margin starting point, the trajectory going forward as your liability sensitivity had improved. And if you had any updated expectations for accretion just on rate marks now the deals closed.

Alan A. Villalon*Executive VP & CFO*

Thanks, David. So with September on a legacy portfolio with an interest margin of around 2.41%. When you think about the acquired portfolio, HMN portfolio, their net interest margin is around 2.8% for the third quarter, okay? So those are both quarter-to-quarter, no deal marks, of course.

Now on a going forward basis, we did indicate about a \$54.2 million mark, on the loan book. We're still waiting back on the final valuation there, but we do expect that \$54.2 million on original deal assumptions to be a little bit less given where the rates have moved since our announcement in May. So we'll have less income accretion -- purchase account accretion to net interest income for next year in terms of deal accretion, but we also will have less goodwill because of the marks.

David Pipkin Feaster*Raymond James & Associates, Inc., Research Division*

Okay. Okay. And then just how do you think about deposit betas on the way down? You talked a lot about the competitive landscape in your market for deposits. That's obviously well on the margin. How do you think about the competitive landscape maybe impacting your ability to reprice deposits on the way down? I mean is that going to make it maybe a bit more difficult to do that? And just curious how you think about that and some of the assumptions in your outlook?

Alan A. Villalon*Executive VP & CFO*

Yes. We've been pretty conservative in our assumptions in terms of deposit betas. We do expect deposit betas -- I mean our deposit pricing to lag a little bit on the way down because given how many banks are still north of 100% loan-to-deposit ratio and still continued. Again, in this quarter, we saw migration from noninterest-bearing to interest-bearing too, which increased our cost of funds.

So in terms of the betas, now we are seeing some rationalization though, because we did see in all our markets CD rates pull back some. So that is encouraging to see some of that now. We're not seeing stuff in the high 5s or 6s anymore. We're now seeing things come back, especially with the Fed cut. But I do think deposit betas on the way down will be a little bit slower to realize than probably take another 50 to 100 basis points before we start seeing meaningful shift in deposit costs.

David Pipkin Feaster*Raymond James & Associates, Inc., Research Division*

So that just kind of putting that all together, your margin trajectory is probably going to be more back half weighted for the expansion side. Is that a fair characterization?

Alan A. Villalon*Executive VP & CFO*

Yes, that's correct. That's correct. I think when we still look at our ALM modeling, based on what we're seeing still though, and I'm not talking about any deal marks, we're looking on a legacy book right now because we're still importing a lot of stuff in understanding the HMN portfolio. When we look at our legacy Alerus book, we still see a path to 3% with even that lag effect coming in. So nothing has changed right with no rate cuts, we still get to 3% in 2026.

And on the to add there, too, that David, just the last thing I'll add to is on a down 100 basis point scenario, we still see our NII increasing in the legacy book about mid-single digits.

David Pipkin Feaster*Raymond James & Associates, Inc., Research Division*

Okay. Good point. That's a good point. And then just last one. You've had a lot of success in the retirement and wealth businesses. I appreciate some of the commentary that you had. You talked about some successes on national partners. I'm just curious where you're seeing success in those lines of business?

And then just following up on the commentary about improving efficiency. I mean profitability has come down pretty much in those businesses. I'm just kind of curious when do think that that's going to start manifesting itself? And how do you think about the profitability profile of those businesses?

Forrest R. Wilson

Executive Vice President & Chief Retirement Services Officer

Yes, I can take that. This is Forrest. I can take that for the retirement business. One of the other benefits to this business is it's very steady business, but we do anticipate margins to improve really in response to the groundwork that we're laying in 3 areas: in efficiency, increased revenue and reduced client turnover.

As Katie mentioned some of that in her opening comments, but we're moving forward with multiple efforts in each of these areas, including upgrading some technology that we're very excited about working on process improvement and forming new partnerships, which you specifically mentioned, I think there's about 10-plus states now that have state-mandated retirement plans and a lot of private companies do not want to go with the state plan, and it's definitely -- there's a groundswell of startup plans, which with our [path are] pooled employer plan model, we're taking advantage of, and that's leading to some significant partnerships, one that we could highlight is our partnership with Mass Mutual financial advisors that has yielded north of 150 new retirement plan clients in the last 14 months or so. So as far as margins go, we anticipate expanding margins through these various efforts, but it's going to be steady over time.

Operator

And the next question comes from Brendan Nosal from Hovde.

Brendan Jeffrey Nosal

Hovde Group, LLC, Research Division

Maybe just to unpack like this quarter's margin before we get into the outlook here, could you help us understand some of the drivers of the loan and earning asset yield pressure? I guess, one, how much of a drag came to nonaccrual piece? And is that recurring as long as those loans may not accrual and then two, was there any impact from the swap maturity in this quarter.

Alan A. Villalon

Executive VP & CFO

Yes. Thanks, Brendan. So nothing on the swap maturity when it comes to the nonaccruals, you could see that about roughly around 7 to 8 basis points was from the nonaccruals.

Brendan Jeffrey Nosal

Hovde Group, LLC, Research Division

And does that drag stick around as long as those bonds are on nonaccrual? Or is that more of an interest reversal?

Alan A. Villalon

Executive VP & CFO

There will be a reversal.

Brendan Jeffrey Nosal

Hovde Group, LLC, Research Division

So that 8 basis point drag will not be present in the fourth quarter, just to make sure I understand completely clearly.

Alan A. Villalon

Executive VP & CFO

Yes, that should not be there. Correct.

Brendan Jeffrey Nosal

Hovde Group, LLC, Research Division

Okay. Got it. Okay. And then as the rest of the swap book rolls off, as it is pertaining to timing versus where the terms of those stats are versus where Fed funds is? Is there any kind of intermediate impact one way or the other as those fall off the...

Alan A. Villalon
Executive VP & CFO

No. I mean what we're anticipating in this quarter is a slight decrease in our -- on the legacy interest expense. But we should start seeing margin improvement going forward because the swaps, we had \$200 million rolling off here in January. Then we only have another \$200 million left from January 2026. So there will be a very minor impact left from the remaining swap.

Brendan Jeffrey Nosal
Hovde Group, LLC, Research Division

Okay. Okay. Perfect. And then maybe last one on mortgage. I know you've kind of offered the guidance for the fourth quarter there. I mean, for this quarter, it seemed like things were better than I was thinking, even though originations were down kind of the core gain on sale was quite a bit stronger quarter-over-quarter. Just wondering if there's anything that was kind of worth calling out for the third quarter performance.

Alan A. Villalon
Executive VP & CFO

No, we did disciplined pricing in that area is what really helped in the mortgage area. Hence why you saw the better gain on sale.

Operator

[Operator Instructions]. And our next question comes from Nathan Race with Piper Sandler.

Nathan James Race
Piper Sandler & Co., Research Division

Just put all the pieces together on the margin outlook and just the impact from Home Federal. Al, can you just help us with kind of a 4Q NII starting point, both on a core and reported basis?

Alan A. Villalon
Executive VP & CFO

Yes. So I would look at it, it's like Home Federal at 2.8% take 20% of that and then 80% as around 2.4%, you're going to get to somewhere in the mid-2s like 2.5-ish.

Nathan James Race
Piper Sandler & Co., Research Division

So you're talking margin, I was referring to NII.

Alan A. Villalon
Executive VP & CFO

I'm sorry, for NII, my bad. Sorry. When we talk about NII, we're looking at right now, let me just get that number up for you.

Because we're doing about, I'm going to say, around \$32 million to \$33 million in total for NII.

Nathan James Race
Piper Sandler & Co., Research Division

That's kind of the starting 4Q with Home Federal?

Alan A. Villalon
Executive VP & CFO

Yes. without any deal marks.

Nathan James Race
Piper Sandler & Co., Research Division

Right, right. And just thinking about the opportunity to maybe deleverage the balance sheet at Home Federal. Any other balance sheet optimization initiatives that could come to fruition with that deal? Just curious to hear any thoughts as it relates to your loan sales or just securities portfolio restructuring that could help that margin outlook as we get through the integration into early 2025?

Alan A. Villalon
Executive VP & CFO

Yes. So we already looked at doing some loan sales for that, we're contemplating laying off options on the loan front. On the securities front, you can expect that we're going to make -- we've done some stuff on that front to help with NII. But the lift from the securities book because they only had about \$190 million worth of securities is going to be very small.

Nathan James Race
Piper Sandler & Co., Research Division

Okay. Perfect. Very helpful. And then just in terms of just the rate sensitivity of the combined franchise going forward. I think we talked about the liabilities since the position of the balance sheet previously. You have some swaps going off next year. So just curious how you're kind of thinking about just the static margin or NII impact from each 25 basis points going forward.

Alan A. Villalon
Executive VP & CFO

Yes. We're still working through that right now as we get our 2 systems merged in place. But what we could see from the surface right now is that they're liability sensitive, so that's just going to add to liability sensitivity that we have.

Nathan James Race
Piper Sandler & Co., Research Division

Got it. Switching gears, maybe a question for Karin. Curious if you could just touch on what you saw in terms of criticized classified loan trends in the quarter?

Karin M. Taylor
Executive VP and Chief Risk & Operating Officer

Sure. We did see those increase again. What I would say about that is that while we've been experiencing increases, overall levels are fairly consistent with what we saw pre-pandemic. And so the nonperforming obviously, are higher, and those are being driven over half of that by that one loan. So those are higher than what we've experienced in the past. But generally speaking, the criticized and classified levels are more consistent with pre-pandemic.

And when you look past these few credits that Katie pointed out in her comments, there's they're really made up of all different segments. Even the asset classes within the commercial real estate are different and then origination date. Kind of span all the way back actually to mid-2015. And so I think really what we're seeing is we're seeing some continued normalization, which isn't unexpected, but then we've got these couple of big deals that are really bouncing those nonperforming numbers.

Nathan James Race
Piper Sandler & Co., Research Division

Got it. That's very helpful. Maybe one last question for me for Katie. Now that you got Home Federal closed in a pretty timely fashion here in the fourth quarter. I would just love to hear your updated

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perspective in terms of managing excess capital. Obviously, with the profitability improvement with Home Federal, you guys should be accreting excess capital at stronger clips going forward. So just curious how you're thinking about weighing those options and deploying excess capital between additional acquisitions, whether it's on the retirement or wealth side or in terms of whole big acquisitions or perhaps resuming share repurchases just given where the stock is trading.

Katie A. Lorenson

President, CEO & Director

Sure. Yes. Thank you. In regards to capital, our priorities remain consistent with the previous quarters. Organic growth is certainly a key priority to maintain our fortress balance sheet is always #1 in our priority books. Our commitment to our dividend remains consistent with our long history. And as I mentioned in my opening comments, we understand the value embedded in this company. And so having the share repurchase out there from a defensive standpoint, I think, serves us all well.

In regards to M&A, again, there's a couple of catalysts particularly in the retirement space for some scale providers. And we are known and have proven that we are a partner of choice for many of those companies, we'll be highly selective of course, because there's a lot of work that we're doing internally in that business, but we believe we will continue to see opportunities specifically in that retirement as well as in the wealth space.

Operator

The next question comes from Damon DelMonte with KBW.

Damon Paul DelMonte

Keefe, Bruyette, & Woods, Inc., Research Division

First one, just regards to expenses. Al, kind of just wondering what your thoughts are on the combined company here in the fourth quarter. I think you guys mentioned the wealth management platform upgrade you guys are going to be doing. So just trying to get a gauge on kind of what we could expect here in the fourth quarter.

Alan A. Villalon

Executive VP & CFO

Yes. Damon, I'm going to say that fourth quarter is going to be a little messy here because we're going to have a lot of the deal expenses flowing through especially contract terminations and onboarding of new stuff. So I don't have a good guide for you at this moment in terms of the fourth quarter run rate. But what I could say for the '25 run rate is that we are looking once you get pass all the deal costs and everything from a combined basis that we're still on track to meeting all the goals we set for in 2025.

Damon Paul DelMonte

Keefe, Bruyette, & Woods, Inc., Research Division

Okay. Yes. And I understand there'll be a lot of moving parts. But I mean is the simple way of looking at it is -- if you take out the merger this quarter, you're around \$40.8 million today, basically layer on the HMNF expense base and then start to take off some expenses, which would kind of put you in the upper \$47 million, low \$48 million range. Is that ballpark?

Alan A. Villalon

Executive VP & CFO

That's the way to think about it, right, on a core basis. Correct.

Damon Paul DelMonte

Keefe, Bruyette, & Woods, Inc., Research Division

Okay. Great. And then with regards to the 2 new loans that moved into nonaccrual this quarter, Could you just scale a little bit more color, one of them was a large residential relationship. Like how big was it? And what kind of reserves do you have against that?

Karin M. Taylor

Executive VP and Chief Risk & Operating Officer

Yes. Damon, this is Karin. That relationship was about -- is about \$8.5 million. And it's comprised of an owner-occupied property as well as the previous property that's listed for sale. The current reserve on is about 5%, and we will be getting updated valuations on both of those properties.

Damon Paul DelMonte

Keefe, Bruyette, & Woods, Inc., Research Division

Okay. Great. Great. So both of those were to one borrower. One part of it was residential and one was owner-occupied?

Karin M. Taylor

Executive VP and Chief Risk & Operating Officer

It's a long-term banking and wealth client, as Kate mentioned, and he had a primary residence, constructed a new residents, which we financed. And so both of those residents are single-family residences. And he is in the new home now and the previous homes listed for sale.

Damon Paul DelMonte

Keefe, Bruyette, & Woods, Inc., Research Division

Got it. Okay. And then with regard to the construction loan, this may have been asked before, so I apologize. But is there any additional funds to be released to this borrower to help complete the project? Or are you at full exposure right now?

Karin M. Taylor

Executive VP and Chief Risk & Operating Officer

We're at full exposure on that deal.

Damon Paul DelMonte

Keefe, Bruyette, & Woods, Inc., Research Division

Okay. And then that's at about how much now 20, is it upper 20s?

Karin M. Taylor

Executive VP and Chief Risk & Operating Officer

I'm sorry, you're talking about the original deal. I thought you were talking about the residential deal. No, I'm sorry.

Damon Paul DelMonte

Keefe, Bruyette, & Woods, Inc., Research Division

I'm talking about the Construction loan, yes. Sorry.

Karin M. Taylor

Executive VP and Chief Risk & Operating Officer

Okay. Yes. That one, we're considering -- we still are considering a number of options on that one, Damon. The borrower is continuing to try to raise equity. They've demonstrated their willingness to inject equity. And so we're supporting that process. But certainly, additional fundings may be on the table as we look at how we can most quickly resolve this.

Damon Paul DelMonte

Keefe, Bruyette, & Woods, Inc., Research Division

Got you. Okay. And have you quantified what the total exposure is to that one particular borrower?

Karin M. Taylor

Executive VP and Chief Risk & Operating Officer

Right as of 9/30, the balance was \$25 million, and the approved -- or they're approved up to just under \$29 million.

Operator

The next question comes from David Feaster with Raymond James.

David Pipkin Feaster

Raymond James & Associates, Inc., Research Division

I just wanted to touch on the hiring front. You got you guys have been really active. You've attracted a lot of new talent. I'm curious, I guess, a, what's your appetite for new hires. And how much of the production -- like how much of the growth that you're seeing from those guys? Or is that kind of still on the come?

Jim R. Collins

Executive VP and Chief Banking & Revenue Officer

David, this is Jim. I will say we're still active on hires, but I do want to note we are -- as we have some individuals leaving the organization, we are repurposing those FTEs for a lot of the new hires. The growth is coming from those new hires because they have capacity and relationships that are new, but we also have a lot of growth coming from our existing traditional portfolios as well.

David Pipkin Feaster

Raymond James & Associates, Inc., Research Division

Okay. Okay. And I guess, as you think about funding growth going forward, we've kind of talked about a mid-90s loan-to-deposit ratio. Is that kind of still the target. And how do you think about funding growth with core deposits in light of the competition that you talked about?

Alan A. Villalon

Executive VP & CFO

Yes. Thanks, David, thank for the question. I mean that is our target is 95%, but we understand too that will drift up above that in certain quarters due to seasonality. So you could see us get up to 97%, 98% and maybe some quarters below 95%. So the average will get to 95% through the cycle. But with that being said, too, though, as we continue to grow, we will probably be utilizing other areas other means to fund those growth if we can get core deposits in the door.

Jim R. Collins

Executive VP and Chief Banking & Revenue Officer

I do want to note, David, we do have some very specific deposit strategies around our homeowners associations around large nonprofits and large specific mid-market clients generate a lot of cash and don't need a lot of loans. So we are very focused on driving those core deposits. And I think we've been fairly successful over the last year, and we will continue to drive those.

David Pipkin Feaster

Raymond James & Associates, Inc., Research Division

And just to be crystal clear, that 2.45% is a core margin that we talked about out, right? Accretion would be on top of that.

Unknown Executive

Correct. That is correct.

Operator

So this does conclude our question-and-answer session. And I would like to turn the conference back over to Katie Lorenson for any closing remarks.

Katie A. Lorenson

President, CEO & Director

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Thank you. Thank you all for joining our call and for your relationships and, of course, for your investments. We acknowledge and take full responsibility for a tough quarter. The path to superior returns is certainly not linear. It does take time for some of these investments we have made to result in top-tier performance. So the sum of the parts of this incredibly valuable company will be recognized with time, and we are transforming from within, and we're making progress every day. We have a best-in-class diversified business model and a company that will deliver superior profitability and tremendous value creation to our shareholders.

I want to say thank you to all of our team members who are part of our journey to get better every day. Have a great day, everyone.

Operator

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

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