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Alerus Financial Corporation

Q4 Earnings Conference Call

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CORPORATE SPEAKERS:

Katie Lorenson

Alerus Financial Corp; President and Chief Executive Officer

Al Villalon

Alerus Financial Corp; Chief Financial Officer

Jim Collins

Alerus Financial Corp; Chief Banking and Revenue Officer

Karin Taylor

Alerus Financial Corp; Chief Risk Management Officer

PARTICIPANTS:

Jeff Rulis

D.A. Davidson & Co.; Analyst

Nathan Race

Piper Sandler; Analyst

Matthew Renck

KBW; Analyst

PRESENTATION:

Operator^ Good morning, afternoon, evening. 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 over to Alerus Financial Corporation President and CEO, Katie Lorenson. Please go ahead.

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

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

Alerus Financial Corporation

Q4 Earnings Conference Call

Jim Collins, our Chief Banking and Revenue Officer. This morning I will provide some commentary on an excellent quarter of execution in key areas of the company.

We've been working with incredible (inaudible) over the past two years to strategically transform the Commercial Wealth Bank. We began with assembling a new executive leadership team, in addition to putting the right people in the right seats across the company.

Over the course of the past 18 months, we have completed five restructurings and added over 120 new team members of the company, while managing to reduce overall head count to nearly 10%. The resulting transformation of our commercial Wealth Bank is evident with exceptional deposit growth supporting high-quality loan growth during the quarter.

In addition, the well-executed balance sheet repositioning in December provided additional flexibility and continued momentum to improve financial performance heading into 2024 and beyond. We believe this quarter marks a normal milestone in turning the corner on our return to top-tier financial performance with improving PPNR.

The ongoing execution of our One Alerus strategy resulted in continued key talent wins, including adding four commercial bankers in Arizona, as well as success in taking market share of well-established commercial businesses in the form of full banking relationships with lending and treasury management throughout all of our footprint. In addition, we decreased leverage on the balance sheet and paid down FHLB advances, our highest cost source of funding as we have yet to tap into any brokered CDs or brokered funds market. We finished the year with a loan-to-deposit ratio ticking down to 89%.

The culmination of the efforts of our team members and our Board's strategic prioritization of bringing long-term value to our shareholders, our clients and communities, led to net interest margin expansion in the quarter. Net interest margin expansion is another milestone and a critical turning point in our return to top-tier performance. Our uniquely diversified revenue mix is a differentiator in the industry with a robust contribution of 54% of total revenue.

During the quarter, we restructured and integrated the stand-alone mortgage division into our private Wealth Banking franchise, and we are already seeing the benefits of the synergies of these teams and backrooms working together to serve clients throughout the Twin Cities, Arizona and North Dakota. Outside of the Mortgage business, the majority of our diversified revenue mix or approximately 90% of our fee income is highly annuitized, recurring and noncyclical revenue with minimal capital allocation or balance sheet risk.

Alerus is top 25 National Retirement Services business delivers most of the fee income. The business ended the year with a record level of sales and new revenue, the retirement business remains highly valuable, and we are committed to extracting this embedded value by achieving net revenue growth in our scaled and highly profitable product lines in this business.

Alerus Financial Corporation

Q4 Earnings Conference Call

The synergies between the Commercial Wealth Bank and the Retirement remain as a source of deposits as well as Wealth Management assets. In the fourth quarter, we commenced a nationwide search for a Chief Retirement Services Officer, and we are incredibly proud of the caliber of deeply experienced professionals we are attracting to this organization. Shifting over to the next highest contributor to our 54% of fee income is our Wealth Management business.

Again, most of our Wealth Management business is full relationship advice-based business, less than 10% of our business is transaction or brokerage. The milestone I would highlight for Wealth Management this quarter is another great one of Alerus success.

This one in our Arizona market in partnerships between the Commercial teams and the Wealth advisers in capturing business owner liquidity opportunities. Moving over to provision expense in the quarter, it was driven by loan growth, as credit quality remains strong with low levels of past dues and nonperforming loans. Alerus experienced another quarter of net recoveries to loan losses remained robust at 1.3% of total loans.

We remain highly selective in our lending and are committed to franchise building full banking relationship. Capital levels also remained robust with TCE of 7.96% and CET1 of 11.81%.

During the quarter, we grew tangible book value 8% and returned \$5.8 million to shareholders through dividends and share repurchases. This was a breakout quarter for the team and the company after implementing significant change throughout the banking division. We are building a stronger-than-ever franchise with the best in the business talent.

We are prudently adding new client relationships and improving profitability through infrastructure right rightsizing and optimization. Each move is purposeful and strategic in positioning Alerus to bring expertise to our clients in a fast, frictionless and highly responsive manner, while delivering value which we believe will directly translate into value creation for our shareholders. With that, I will turn it over to AI to talk about the financial performance for the quarter.

AI Villalon^ Thanks, Katie. I'll start my commentary on Page 14 of our Investor deck that is posted in Investor Relations part of our website. Let's start our key revenue drivers. On a reported basis, net interest income increased 5.7% on a linked quarter basis. The increase was driven primarily by strong organic loan and deposit growth.

Net interest income represented 45.9% of revenues, when excluding the loss on investment securities. Switching to fee income. Noninterest income, excluding the loss on investment securities decreased 10.5% on a linked-quarter basis, primarily driven by a gain recognized by the [profession for] our ESOP trustee business being recognized in the prior quarter. Excluding

Alerus Financial Corporation

Q4 Earnings Conference Call

ESOP trustee gain, noninterest income was relatively stable on a linked quarter basis. I'll go into details on each of our fee income statements in later slides.

Turning to Page 15. Net interest income was \$21.6 million in the fourth quarter. Net interest margin was 2.37%, an increase of 10 basis points from the prior quarter.

While some of our index liabilities repriced in October, due to last Fed hike in July, we saw the loss quarterly increased interest expense.

During the quarter, we had gradual net interest margin improvement as our balance sheet continues to remix towards higher-yielding assets and strong organic deposit growth helped lower borrowings.

Based on the recent Fed commentary on a potential pause, we do expect our net interest margin to improve even without any rate cuts. Should Fed cuts -- should the Fed cut rates later in the year, we anticipate our net interest margin to continue to improve faster. Any increase in funding costs will be related to competition and a shift from noninterest-bearing to interest-bearing. Let's turn to Page 15 to talk about the Loan portfolio. Total loans grew 5.7% from the prior quarter, driven by organic growth in commercial real estate C&I and residential real estate.

Excluding the impact of PPP, this was one of the highest organic loan growth that we have experienced. Growth across the Board was driven by newly onboarded talent and legacy producers as well. We continue to attract high-quality talent in our growth markets and they have been able to drive growth quickly for Alerus. For 2024, we continue to expect to see modest Loan growth. Turn to Page 17.

On a period-ending basis, our deposits increased 7.8% from the prior quarter. Just like Loans, this is one of the highest organic deposit growth for Alerus. Noninterest-bearing deposits balances increased 1.4% and represented 24% of total deposits. Client retention remains very high, and we continue to attract new clients, especially in the mid-market commercial space. For 2024, we expect the [deposit loans] to remain stable.

We also expect the usual seasonality in deposits with public fund outflows occurring in the second and third quarters. Turning to Page 18, you can see a further breakdown of our strong deposit base. Our synergistic deposits, those are in sourced from our Wealth and Retirement businesses grew 23% over the prior year and 11.5% from the prior quarter. The continued growth in synergistic deposits was driven mainly by strong organic client growth within our Retirement and Wealth segments. Synergistic deposits sourced from Retirement, Wealth businesses now account for over 27% of our deposit base.

As you can see here, continued growth on our synergistic deposits shows the strength of our unique and differentiated business model. Turn to Page 19. You'll see details about our

Alerus Financial Corporation

Q4 Earnings Conference Call

investment portfolio. Currently, almost 62% of our securities are available for sale versus approximately 38% in health to maturity. Excluding the loss rate, we did see improvement in unrealized losses, as the bond markets rallied given recent Fed commentary.

We continue to remix the balance sheet towards commercial lending relationships that will add higher-yielding loans and treasury management relationships. On Page 20, I'll start talking about our fee income businesses. On this page, I'll provide some highlights on our Retirement business. Excluding the impact of the ESOP Trust services gain and nonrecurring ESOP trustee revenues in the prior quarter, revenues increased 1.6%. End of quarter assets under management and administration increased 6.2%, mainly due to improved equity in bond markets.

Participants within retirement have grown 4.4% over the prior year. For the first quarter of 2024, excluding any market impact, we expect fee income for our Retirement business to be stable. Turning to Page 21. You can see highlights for our Wealth Management business. On a linked quarter basis, revenues increased 12.7%, while end-of-quarter assets under management increased 7.9%, again due to improved equity and bond markets.

Over 83% of revenues in the segment are asset-based fees. For the first quarter, excluding any market impact, we do expect our fee income from our Wealth business to be up slightly. Turning to Page 22, I'll talk about our Mortgage business. Mortgage revenues decreased 49% from the prior quarter as originations decreased 41%. We saw our usual seasonal decline in Mortgage production given that most of our production comes from the twin cities.

For the first quarter, we expect Mortgage originations to decrease 40% from the prior quarter, as we enter again another seasonally weaker quarter for our Mortgage business. Page 23 provides an overview of noninterest expense.

During the quarter, noninterest expense increased 3.7%. Excluding onetime items, onetime items such as severance and a donation to Minnesota housing noninterest expense grew 2.4%. The increase in expenses was mainly due to inflationary pressures, experienced in our technology contract renewals and due to the higher audit examination fees.

As we continue to deal with deflationary pressures, we do expect our overall expenses for 2024 to grow low single digits on a reported basis. Turning to Page 24, Credit continues to remain very strong. We had net recoveries of 4 basis points in the quarter. Our nonperforming assets percentage was 22 basis points, compared 23 basis points in the prior quarter. Our allowance for credit losses on loans to total loans was 1.3%.

We had a provision during the quarter, mainly due to strong Loan growth and unfunded commitments. I'll discuss our capital and liquidity on Page 25.

Alerus Financial Corporation

Q4 Earnings Conference Call

During the quarter, we repurchased \$2.1 million of outstanding stock at an average price of \$17.65. Our capital remains well above regulatory minimum levels, which is well above the 6.5% minimum threshold. On the bottom right, you'll see the breakdown of our sources of over \$2 billion in potential liquidity.

Overall, we continue to remain well positioned from both a liquidity and capital standpoint for future growth or whether any economic uncertainty. To summarize on Page 26, we ended the year on a very strong note with great momentum going into the new year. We saw strong organic Loan and Deposit growth, the high since -- the highest in our history. Our net interest margin improved as the Fed [falling] paused and strong organic production helped continue to remix the balance sheet. We expect continued improvement in our net interest margin going forward.

Our Fee businesses, which continue to be a differentiator for us, as over 54% of our revenues are non-spread base. Our capital remains strong and we remain committed to returning capital prudently. With that, I will now open it up for Q&A.

Operator^ (Operator Instructions) The first question today comes from Jeff Rulis of D.A. Davidson & Co.

Jeff Rulis^ Just a question on the Loan to Deposit growth, just really strong, and I wanted to get a sense for -- is there was anything kind of lumpy towards the end and/or did you pull forward -- looking at kind of a little more muted growth in '24. Did you sort of cannibalize some activity? Just a really strong quarter. I wanted to see if there was some production that may be pulled into the Q4 versus what was maybe going to book in '24?

Jim Collins^ Jeff, this is Jim Collins. No. I would say we didn't pull anything forward. The real loan growth and deposit growth, specifically in the fourth quarter was just the buildup of the talent that we acquired throughout 2023, and their pipeline is coming forward into production. I anticipate that those pipelines will continue through 2024. Typically, we will see a strong second quarter, strong third quarter.

First quarter will be a little light. And then fourth quarter, generally, is a little light. So it usually goes second quarter, third quarter, first quarter and fourth quarter. So I do anticipate that those pipelines will continue. And there wasn't anything lumpy necessarily, all of what was getting booked are stronger mid-market C&I loans and again, our continued growth in commercial real estate.

But the focus still is mid-market C&I, and we're pulling in the full relationship. And that's what I anticipate for the rest of 2024.

Alerus Financial Corporation

Q4 Earnings Conference Call

Jeff Rulis^ And just the -- was that growth also pretty even through the quarter, kind of thinking about margin and if it was sort of back-end loaded on the Loan side? Or was it pretty steady throughout fourth quarter?

Al Villalon^ Hey Jeff, we did see a little bit more pickup after October. So I'd say that was probably more when activity came as prior, after October, November, December related.

Jeff Rulis^ Got it. And Al, just to kind of circle back on the margin. I reminded of the coiled spring reference. And just wanted to see if that's kind of the beginning of this releasing. And so that's Part A.

And Part B is when we do see those rate cuts, I don't know if you've got sensitivity on either NII or margin bump per each 25 basis point cut, should we get this?

Al Villalon^ Yes. So Jeff, thanks for that. I mean this is the beginning of our net interest margin to improve. So we're very optimistic here about the trajectory of our net interest margin, given the pause now on the Fed and potential rate cuts with the -- in terms of sensitivity, one thing you'll notice on the disclosures, if you look at our last 10-Q that you did see a little bit of that liability sensitivity decrease because we did put into effect a little bit of balance sheet swaps last year. Those swaps will be rolling off during the course of 2024 and the liability sensitivity will begin to increase again.

So you'll see more improvement in our net interest margin probably towards the back half of next year. So with that being said, though, I might have you look at probably our disclosures in terms of net interest margin -- net interest income improvement probably mid to high single digits, which is drive to what our 10-K was last year prior to the swaps we put on the balance sheet.

Jeff Rulis^ Okay. So just to your comments of you think in Q1, steady state sees margin improvement, but cuts should accelerate that improvement.

Al Villalon^ That is correct.

Jeff Rulis^ And maybe last one. One final one on -- go ahead. I'm sorry, go ahead.

Al Villalon^ No. The rate of -- also the rate of the improvement also be dictated by the deposits as well because we did have very strong deposits in the fourth quarter. So as we know there's a pretty much strong deposit demand out there right now, we continue to keep deposits stable to also dictate how much improvement we see.

Jeff Rulis^ Okay. And Katie, the -- just wanted to check in on capital and the buyback appetite, you had pretty strong growth, but maybe if that ebbs, so that front, but also I did hunting around

Alerus Financial Corporation

Q4 Earnings Conference Call

on the M&A side. You mentioned looking for an individual retirements front, but would you also consider kind of M&A on the retirement side as well?

Katie Lorenson^ Yes, absolutely. So from a capital prioritization standpoint, they remain consistent in terms of our priorities. And so first and foremost, prudent and disciplined organic growth is our number one priority, being selective, but taking market share at a time as we're adding talent in our growth markets is the number one priority. Returns to our shareholders remains a top priority. As you saw with the activity this quarter with share buybacks and continued dividends.

But continuing to also be as we have in our history, very opportunistic with strategic lift outs, market expansion, as well as acquisitions in both the Commercial and Wealth space, as well as on the Retirement side.

Operator^ Our next question today is from the line of Nathan Race of Piper Sandler.

Nathan Race^ I just want to clarify one question to your early response to Jeff's item on NII growth for this year, that mid- to high single-digit trajectory, that I think you described, AI, does that include maybe two or three rate cuts in the back half of this year?

AI Villalon^ Yes. Thanks for clarifying for that. That is on the plus 100 scenario that we're -- I'm sorry, the minus 100 scenario, really clarify at the minus 100 scenario that we had in the 10-K, last year.

Nathan Race^ Got you. And perhaps supporting that outlook with rate cuts, is the plan with some of the liquidity that you guys built with the repositioning in the fourth quarter. Is the plan to kind of keep borrowings where they're at, just to provide at least a short-term debt where it's at, just to kind of provide that installation to floating rate loans to the extent Fed cuts occurred, do you kind of plan on maybe bringing down wholesale funding to the extent deposit growth remains as strong as it was in the fourth quarter, and loan growth also remains strong, albeit likely not to the level that we saw in the fourth quarter?

AI Villalon^ Right. So from the restructuring we did in the fourth quarter, we did use that predominantly to support loan growth, as you saw that we had very strong loan growth. But on a go-forward basis, as you think about our borrowings, we'd like to decrease that, especially if we have more Deposit growth there. I mean, we'd like to have pretty much eliminate that if we can potentially -- and if we have continued strong deposit growth.

Nathan Race^ Okay. Great. And I apologize, I jumped down somewhat late. But just in terms of kind of the loan growth outlook for this year, could you remind me what you guys are thinking there?

Alerus Financial Corporation

Q4 Earnings Conference Call

Al Villalon^ So we're thinking modest, but I'll let Jim also answer.

Jim Collins^ Yes. I think we will have loan growth. Obviously, with the borrowing situation depends on how much deposit growth we have, but with the talent that we acquired in 2023, some of the processes and procedures that we have streamlined in 2022 and 2023 helps our -- the entire commercial lending group, as well as the rollout of our private banking group, acquiring market share from some of the other banks that are not lending, we will definitely have some good, solid, profitable loan growth. That's my expectation.

Nathan Race^ Got you. In terms of commercial real estate maturities expected this year, is that a meaningful headwind to growth? Net growth that is.

Al Villalon^ We do not have a meaningful amount that will be maturing in the next 18 months to have a headwind in that category.

Nathan Race^ Got it. And just changing gears, Al, I think you mentioned Retirement benefit service revenue should be kind of flat in the first quarter versus the 4Q level. I noticed in the release that retirement plan participants had some nice growth quarter-over-quarter.

So just curious what you guys are seeing from an organic growth perspective, in terms of adding new accounts onto that platform and just kind of how you're thinking about growth in that line this year, assuming equity markets are relatively stable?

Katie Lorensen^ Nate, it's Katie. I'll take that one. From a new sales standpoint, from new plans, new revenue, new participants, it was a record-setting year in 2023. We continue to sustain headwinds, as plans that leave through, they either get acquired or move out for RFPs, continues to be a headwind to that new business. And so considering stable markets, that's where we end up with a fairly flattish outlook for that revenue line item going forward.

Nathan Race^ Okay. Katie, have you noticed just the natural headwind from that line of business in terms of the natural attrition there. That's slowing relative to the past years, just as you guys have launched a number of initiatives and new sales efforts to kind of offset, what occurs with that attrition rate?

Katie Lorensen^ It's slowing incrementally, and we're growing new revenue incrementally, but we think there's continued additional opportunity to improve that net revenue growth year-over-year. And there are initiatives being put in place that contractually will do some things for us.

There's also some efficiencies and some process improvements that will be implemented in 2024, that will continue to help that net revenue pace higher. So I'm confident that we will see incremental continued growth, but it's going to take a little bit of time and looking forward to

Alerus Financial Corporation

Q4 Earnings Conference Call

having the Chief Revenue Services Officer in the executive team, to help us guide through and prioritize some of those changes, as well as help us build out that acquisition opportunity list.

Nathan Race^ Got you. And I know it's been an ongoing initiative for you guys, in terms of increasing the capture rate from the Retirement platform on to Wealth. I was just curious to what extent maybe some progress on that front was evident in the Wealth Management revenue increase in the fourth quarter. Was that just more so a function of some of the private [banking] teams that you've added and also just given that equity markets were higher in the fourth quarter?

Al Villalon^ We actually had one specific large win in that arena from capturing that terminated participant into Wealth in the fourth quarter, it was a sizable number. But we continue to fine-tune and streamline that process and over the years, we will continue to capture more of a percentage. And we will be adding additional Wealth advisers in 2024 and '25 to capture more of that piece of the business.

Nathan Race^ Okay. Great. And Al, just to clarify on the expense growth outlook for this year. The low single-digit expectation that's off \$151 million in reported expenses in '23.

Al Villalon^ Yes also -- yes, also \$150.1 million or \$150.2 million reported expenses.

Nathan Race^ Okay. Got you. Then maybe one last one for Karin. Just curious if there's any additional tail to the recoveries that we saw in 2023? And if you've just seen any major credit issues on the horizon, obviously, is not evident from the numbers that we conclude that you guys reported this quarter, but I'd just be curious on kind of your outlook for charge-offs in 2024. And how you see the reserve trending relative to loans as well?

Karin Taylor^ Sure, Nate. Most of those larger recovery opportunities have been exhausted. And so I expect as credit continues to normalize, we'll start to see some level of charge-off activity. Just in terms of the general outlook for asset quality, I don't see anything significant on the horizon. We're just continuing to see some normalization, no specific patterns, just what we would expect as we return to a more normalized environment.

Nathan Race^ Okay. Great. And just sorry, one last one. Just curious on the uptight for share repurchases continuing at this point. I imagine you guys are going to be fairly opportunistic, but a good amount of excess capital flexibility.

But just curious to what extent you maybe want buybacks to be a kind of more recurring component to your capital return to shareholder story?

Al Villalon^ Yes. This is Al, Nate. In terms of buybacks, the opportunity is a good word for it. We do look at buybacks to make sure that the earn back on those any repurchases is still definitely

Alerus Financial Corporation

Q4 Earnings Conference Call

under three years. So we definitely look at where our stock price is trading relative to our [deferent] back scenario.

Operator^ (Operator Instructions) And our next question today is from the line of Matthew Renck of KBW.

Matthew Renck^ A lot of my questions have been asked and answered. But just as a follow-up to the loan growth discussion, are rate cuts baked into that outlook? Or do you think -- and if they're not, do you think we'll see a meaningful uptick in loan growth in the back half of the year perhaps?

Al Villalon^ I don't -- we didn't anticipate the loan cuts in that loan forecast of growth. Like I said a little bit earlier, we should have a strong second quarter and third quarter. That's fairly natural when you see the business tax returns come in and businesses are planning for events. We had a strong fourth quarter this year, but that had more to do with the talent we brought on in 2023 and them getting their pipeline set and then starting fleshing out their pipeline. That could happen again in 2024.

If we find additional talent, we're going to be very opportunistic to find good, solid mid-market commercial bankers, specifically in Minneapolis and Arizona. So if we do find that in the first half of this year, we might see similar results next year on a stronger fourth quarter than I'm anticipating, but that would be because of talent acquisition, not rate cuts.

Operator^ (Operator Instructions) Okay. It seems we have no further questions in the queue. So this will conclude the question-and-answer session. I would like to turn the conference back over to Katie Lorenson for any closing remarks.

Katie Lorenson^ Great. Thank you, [Harry]. Thank you everyone for the questions. Thank you for everyone listening in today. As you can tell, we feel very confident as we move forward into 2024, about -- in regards to sustaining the momentum that we saw in the fourth quarter.

Our unique strength of this company's diversified business model continues to differentiate our ability to attract and retain clients, as well as talented professionals. We remain absolutely laser focused on our strong and diversified balance sheet.

Our talent investments, fee income, and investments in those key business lines, while optimizing our infrastructure to return this company to our long history of delivering strong profitability, tangible book value growth, and top-tier returns to our shareholders.

Thank you to our investors, our analysts, and to everyone for joining our call today. Have a great day everyone.

Alerus Financial Corporation

Q4 Earnings Conference Call

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