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Earnings Call

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Call Participants

EXECUTIVES

Katie A. Lorenson
President, CEO & Director

Alan A. Villalon
Executive VP & CFO

Karin M. Taylor
Executive VP & COO

Jim R. Collins
Executive VP and Chief Banking & Revenue Officer

Forrest R. Wilson
Executive VP & Chief Retirement Services Officer

ANALYSTS

Brendan Jeffrey Nosal
Hovde Group, LLC, Research Division

Damon Paul DelMonte
Keefe, Bruyette, & Woods, Inc., Research Division

David Joseph Long
Raymond James & Associates, Inc., Research Division

Jeffrey Allen Rulis
D.A. Davidson & Co., Research Division

Nathan James Race
Piper Sandler & Co., Research Division

Presentation

Operator

Good morning, 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's President and CEO, Katie Lorenson. Please go ahead.

Katie A. Lorenson
President, CEO & Director

Thank you. Good morning, and thank you for joining us today. I'm Katie Lorenson, President and CEO, and I'm pleased to be here with our Chief Financial Officer, Al Villalon; our Chief Operating Officer, Karin Taylor, our Chief Banking and Revenue Officer, Jim Collins; and our Chief Retirement Services Officer, Forrest Wilson. Each of these leaders continues to play a crucial role in driving our company's progress to transformational growth and top-tier performance.

This quarter marked a significant step forward in our journey to deliver long-term, sustainable, top-tier performance as we reported an adjusted earnings per diluted share of $0.72, which represents an adjusted return on assets of 1.41%. Our results reflect our efforts to build on the strength of our uniquely diversified business model combining traditional commercial and private banking, with the highly valuable and capital-light fee-based businesses in Wealth Management and Retirement and Benefits. This business model not only differentiates us in the growing communities and client base we serve, it also provides resilience across economic cycles and the ability to outperform traditional banks.

We're seeing encouraging momentum across our core businesses. The transformation in our Commercial Wealth Bank is nearing completion, with our focus turned towards maximizing the capacity in our organization and infrastructure to further enhance profitability. While we continue to see the benefit of purchase accounting, we are replacing this with disciplined pricing on renewals of the core client base.

During the quarter, deposit outflows were as expected from public funds and tax payments, while client retention in legacy Alerus, and the recently acquired Home Federal portfolio remained at high levels. We see robust opportunities in our lending pipeline, but we'll continue to be highly selective with our team focused on deposit-rich opportunities and prioritizing full C&I relationships.

We also took proactive steps to optimize our balance sheet, including the strategic sale of $60 million in nonowner-occupied CRE hospitality loans, which resulted in a net $2 million gain during the quarter. As a result of the sale, we were able to reverse related reserves on the portfolio, which allowed us to record no provision for the quarter. Reserve levels remained robust at 1.47% of loans, and notably net charge-offs were limited to 7 basis points when excluding the accounting entries of the hospitality loan sale.

Industry-leading fee income of more than 42% will be the ultimate differentiator of our valuation. The cornerstone of our top-tier fee income levels is our Retirement and Benefits business. Our talented team continues to execute on several key strategic initiatives to grow our business, secure meaningful partnerships, and make impactful operational improvements. We remain bullish on this business given the tailwinds of SECURE Act 2.0, in addition to growing opportunities for M&A.

The value of the Retirement Business is multifaceted due to the stability and durability it brings to our company's earnings, with minimal capital allocation and balance sheet risk in addition to the tangible synergies we leverage in deposits and the capture of wealth business.

Similarly, our Wealth business has strong momentum, and we're investing in talent and technology to deepen client relationships and expand our reach. As an enhancement to the business, we upgraded our wealth management platform, which will allow us to continue to progress on our long-term goal of doubling the number of wealth advisers, and growing our assets under management at the same pace as our banking assets. A shout out to all of our team members and wealth advisers who made this conversion seamless for our clients.

Results of our team's focus on expense management are evident with another quarter of improvement in our efficiency ratio. We continue to balance our investments in talent and technology with long-term and sustainable improvements while optimizing everywhere.

In short, we're making significant progress. This quarter's results were excellent, and I want to thank our team members for their continued efforts to return Alerus to top-tier performance. We know this path is not linear and requires an unwavering focus on constant improvement and expense management. Our guidance for the year remains consistent with prior quarter's communication with the ultimate goal of achieving this quarter's level of performance consistently. The foundation is solid. The strategy is clear and the opportunity ahead is compelling.

Thank you again for your continued support. And I'll turn it over to Al to walk through the financials in more detail.

Alan A. Villalon
Executive VP & CFO

Thanks, Katie. Turning to Page 11 of our investor deck that is posted in the Investor Relations part of our website. On a reported basis, net interest income increased 4.6% over the prior quarter, while fee income increased 15%. The increase in net interest income was primarily driven by remixing of maturing loans being replaced by organic loan growth at higher spreads, while interest expense remained relatively stable. Our fee income remains over 40% of revenues and well above the industry average of 19%. Let's dive into the drivers of net interest income on the next slide.

Turning to Page 12. In the second quarter, net interest income continued to reach new heights at $43 million, and our reported net interest margin increased another 10 basis points to 3.51%. Our net interest margin continues to show improvement. Our total cost of funds remained stable at 2.33%. We had 45 basis points of purchase accounting accretion in the quarter. Of those 45 basis points, 9 basis points were from early payoffs.

We remain disciplined in pricing as we continue to not price on the inversion of the yield curve for loans. In the second quarter, we continue to see strong spreads, which contributed to core net interest margin expansion, as average rate on loan portfolio during the quarter increased 8 basis points from the quarter -- from the end of the first quarter.

Let's turn to Page 13 to talk about our earning assets. At the end of the second quarter we either sold, or classified as held for sale over $60 million of hospitality loans. Net gain from the sale of all these loans was over $2 million. Excluding the loan sale and reclassification, loan growth was approximately 0.5% over the prior quarter, with the most growth in C&I and owner-occupied CRE.

We remain focused on full relationships within the middle market and business banking space. For the remainder of 2025, we expect over $271 million of loan contractual maturities, which is almost 7% of total loans. Our Investment portfolio declined to $807 million, or just around 16% of earning assets. AOCI improved an unrealized loss of under $60 million. For the remainder of 2025, we expect over $45 million, or close to 6% of the total portfolio, of principal paydowns with a yield in the low 2% range. We will continue to let the balance sheet remix from low-yielding investments to higher-yielding loans.

Turning to Page 14. On a period-ending basis, our deposits shrank 3.3% as we saw expected seasonal outflow from public funds, and our clients using liquidity to meet tax obligations. Since 2010, the median decrease in deposits from 1Q to 2Q has been over 5%. We do expect the seasonal volatility to continue to increase as our average deposit account size has grown over 20% since the end of 2019, due to our focused efforts to grow in the commercial space. Lastly, since the close of the acquisition of Home Federal, our net retention rate remains close to 97%.

Turning to Page 15. I'll now talk about our banking segment, which also includes our Mortgage business. I'll focus on the fee income components now since net interest income was previously discussed. Overall, noninterest income from banking was $8.4 million for the second quarter. The quarter included a $2.1 million gain related to the sale of hospitality loans. Mortgage revenues also improved $2.1 million from the first quarter as we saw our seasonal uptick in the business. We also saw very little swap income this quarter, which tends to be lumpy from quarter-to-quarter.

On Page 16, I'll provide some highlights on our Retirement business. Total revenue from this business was relatively stable at over $16 million. Retirement services continues to be a stable and reliable source of fee income and is not a capital-intensive segment. Assets under administration and management increased 6.3%, mainly due to market performance. We continue to see solid new business production with over -- through the first half of 2025.

Turning to Page 17, you can see highlights for our Wealth Management business. On a linked quarter basis, revenues increased 6.6%, while end-of-quarter assets under management increased 2.5%, mainly due to market performance. During the quarter, we transitioned to a new platform that will deliver a better experience for both clients and financial advisors. With a new and highly regarded system, we not only provide the unique value proposition to our clients, but we also are able to differentiate ourselves, and our recruiting efforts, to add more wealth advisors.

Page 18 provides an overview of our noninterest expense. During the quarter, noninterest expense decreased 3.8% due to the seasonal decrease in benefits, less acquisition expenses in the quarter on a reported basis, and due to an insurance reimbursement. Our adjusted efficiency ratio was 62.4%, versus 66.9% in the prior quarter. Most of the improvement in our adjusted efficiency ratio was driven by both core expense and revenue improvements.

Turning to Page 19, you can see our credit metrics. During the quarter, adjusted net charge-offs were only 7 basis points, which excludes the impact of the hospitality loan sale. Nonperforming assets remained stable at 98 basis points compared to the prior quarter. We continue to have close to $7.8 million in reserves related to the CECL double count, and approximately $50 million of fair value marks related to the Home Federal acquisition.

I'll discuss our capital liquidity on Page 20. We continue to remain well capitalized as our common equity Tier 1 capital ratio to risk-weighted assets is at 10.5%, our tangible common equity ratio improved 44 basis points to 7.87%. On the bottom right, you'll see a breakdown in sources of $2.7 billion in potential liquidity. We did utilize some broker deposits in the quarter to optimize our funding structure. Although we continue to remain well positioned from both a liquidity and capital standpoint to support future growth.

Turning to Page 29 -- 21, I will now update you on our guidance for 2025. Our guidance for the year remains consistent with prior quarters and has not materially changed. While we continue to make improvement, given the seasonality we experienced in our businesses, improvement is never linear from quarter-to-quarter. We are still expecting loan growth of mid-single digits for 2025, excluding the loans moved to held for sale. Deposit growth of low single digits remains the same. For the third quarter, though, we will see continued seasonal deposit outflows from our public funds.

Net interest margin of 3.25% to 3.35%. Within this guidance, we're assuming several things. First, we are expecting less purchase accounting accretion in the back half of the year. We're expecting less in purchase accounting accretion for the remaining quarter due to accelerated payoffs already recognized. Currently, we're expecting 27 basis points of purchase accounting accretion in the third quarter, which is an 18 basis point reduction compared to the second quarter. For the fourth quarter, we had only expected 22 basis points of accretion. Both accretion numbers are based on contractual payoff data.

Second, we are not expecting any early payoffs, which has averaged over 8 basis points over the past 3 quarters since the closing of the Home Federal acquisition. Lastly, we're expecting an increase in deposit costs by 8 to 10 basis points due to mix shift in deposits and continued competition. We expect our noninterest income for the year to be up low single digits now on a reported basis due to the gain on loan sale recognized in the first half.

On the mortgage side, we expect mortgage to ease a little in the third quarter and have a seasonal downturn in the fourth quarter. We expect our adjusted efficiency ratio, excluding onetime items to be below 68% for the 2025 as we continue to realize cost saves from Home Federal. In the upcoming third quarter, we expect our core expenses to be around $49 million to $50 million as we recognize investments made in our core business lines in talent and technology.

Summarized on Page 22, we continue to build on the momentum we saw in the first quarter. Adjusted pre-provision net revenue grew 23.2% over the prior quarter. Our current adjusted ROA of 1.41%, and adjusted ROTCE of over 21% are definitely in the top quartile of the banking industry. We see this as another solid quarter in the line of more to come.
With that, I will now open up for Q&A.

Question and Answer

Operator

[Operator Instructions] The first question comes from Jeff Rulis with D.A. Davidson.

Jeffrey Allen Rulis
D.A. Davidson & Co., Research Division

Al, I just wanted to circle back on -- I missed the margin piece there, or components of it. It sounds like accretion was running a little high. Could you repeat -- did you outline third quarter accretion expectations and fourth?

Alan A. Villalon
Executive VP & CFO

Yes, I did. So Jeff, for the third quarter, we're expecting 27 basis points of purchase accounting accretion, and for the fourth we're expecting 22. Neither of those numbers have any early payoffs embedded in it.

Jeffrey Allen Rulis
D.A. Davidson & Co., Research Division

Okay. And I guess if we kind of unpack on a core basis expectations for -- on the core side in the second half?

Alan A. Villalon
Executive VP & CFO

Yes. In the second half, we still expect at the end of the year to have core margin improvement as we continue to see spreads on both loans and deposits to be above our core net interest margin.

Jeffrey Allen Rulis
D.A. Davidson & Co., Research Division

Got you. And then the -- I think the noninterest income guide of -- you said that up low single digits is inclusive of the gains this quarter?

Alan A. Villalon
Executive VP & CFO

That is correct, Jeff.

Jeffrey Allen Rulis
D.A. Davidson & Co., Research Division

Okay. Got it. Just I guess hopping over to the credit side, I wanted to check back in on the larger construction credit. I think we were headed towards occupancy or listing for sale this summer, June or July. So I just wanted to check back in to see where the status of that is?

Karin M. Taylor
Executive VP & COO

Sure, Jeff. This is Karin. The final certificate of occupancy was issued and the property was listed for sale in the second quarter. That's a soft listing. The project continues to lease up. It's currently at 57%. And as that progresses, obviously, it will become better positioned for sale. There's just some minor work left on the outside to complete. So it's in line with our expectations.

Jeffrey Allen Rulis
D.A. Davidson & Co., Research Division

Okay. Great. And the -- I guess on the CRE side, just the acquired -- could you recall what -- remind us what deal was that? And then are more cleanup in that segment contemplated?

Karin M. Taylor
Executive VP & COO

Are you referring to the loan sale, or to this particular construction project?

Jeffrey Allen Rulis
D.A. Davidson & Co., Research Division

The loan sale, I apologize, in the hospitality side.

Karin M. Taylor
Executive VP & COO

The hospitality loan sale as part of the Home Federal portfolio. We saw an opportunity on that particular portfolio, the underwriting standards were a little bit more liberal than ours, and we had those well marked, and there was a market for those loans.

So it was a good opportunity. We'll continue to look for those opportunities to reduce risk in our balance sheet, and make sure that our resources are aligned with our strategic objectives.

Jeffrey Allen Rulis
D.A. Davidson & Co., Research Division

Okay. I mean, I guess, the question of do you think you've ring-fenced the areas that -- where that underwriting was a little more liberal? Have you kind of attack that piece? Or is it a case by case?

Karin M. Taylor
Executive VP & COO

No, we addressed that with our identification of purchase credit deteriorated loans. And certainly, this particular group of loans was in that category.

Operator

Your next question comes from Brendan Nosal with of Hovde Group.

Brendan Jeffrey Nosal
Hovde Group, LLC, Research Division

Maybe just starting off on the loan sale piece. For the piece that closed in this quarter, you recorded a nice gain on that sale. Just kind of curious for the $50 million you sold in July, any line of sight to a potential gain there?

Alan A. Villalon
Executive VP & CFO

No. Actually, there was just a very, very minimal loss on that one.

Brendan Jeffrey Nosal
Hovde Group, LLC, Research Division

Okay. Got it. Got it. Maybe moving over to capital then. You folks created a fair bit of capital this quarter. Just with levels getting up to higher levels. Just kind of curious how you think about deployment for the rest of this year and maybe your thoughts on the M&A landscape?

Katie A. Lorenson
President, CEO & Director

Sure. Our capital priorities remain consistent, and as we've discussed in the prior quarters. Growing 44 basis points in Q2, consistent with where we had pro forma levels at post Home Federal. We are targeting to get to that 8% or higher TCE. But priorities are organic balance sheet growth with franchise accretive clients, as well as maintaining our dividend history, and M&A on the retirement side of the business, which is typically more of the bite-sized cash deals.

Brendan Jeffrey Nosal
Hovde Group, LLC, Research Division

Okay. Perfect. I'm just going to sneak one more in here, on the Retirement business. Revenues were fairly flat for the quarter. But Al you noted nice AUA growth, but it looks like participants were down a little bit.

Maybe just talk about which of these two AUA versus participants had a bigger impact on revenues for this business this quarter?

Alan A. Villalon
Executive VP & CFO

Forrest, I'm going to let you take that one.

Forrest R. Wilson
Executive VP & Chief Retirement Services Officer

Yes. So can you -- sorry, can you repeat that question really quick. It was the participants versus the AUA in terms of revenue?

Brendan Jeffrey Nosal
Hovde Group, LLC, Research Division

Yes.

Forrest R. Wilson
Executive VP & Chief Retirement Services Officer

Yes, we had some onetime effects on participants that affected us this quarter. We did some clean out in our HSA business that was very impactful to us in a negative way in terms of participant count. With that said, these were zero balance participants that we weren't making any revenue off of. So in the future, you can expect participant account -- participant numbers to be going up as they have in the past and to see that trend continue. But there were some one-off events this quarter that led to that decline.

Operator

We now have Damon DelMonte with KBW.

Damon Paul DelMonte
Keefe, Bruyette, & Woods, Inc., Research Division

First question on the loan growth and kind of the outlook that's supporting that.

Are you seeing more demand across your footprint in the way of like new credits and new customers coming on board? Or is this the growth opportunities more from kind of leveraging your current client base?

Jim R. Collins
Executive VP and Chief Banking & Revenue Officer

It's leveraging the current client base, and it's taking market share. We're still not seeing a really solid, robust new generation of loans with clients and prospects necessarily. It's still the staff that we brought in all markets. It's really stealing market share from some of the other banks and increasing with our current client base.

Damon Paul DelMonte
Keefe, Bruyette, & Woods, Inc., Research Division

Got it. And is there any areas, any segments that are stronger than others that have better opportunity for the growth?

Jim R. Collins
Executive VP and Chief Banking & Revenue Officer

No. We're sticking to full C&I and really focused on that lower mid-market. So we're still really focused on manufacturing, wholesaling and distributing. So that's really where we're focused.

There's opportunities across the board in a lot of different segments. But with the team that is really zeroing in on that lower mid-market, that's where we're going to find most of our growth.

Damon Paul DelMonte
Keefe, Bruyette, & Woods, Inc., Research Division

Got it. Okay. I appreciate that. And then, Al, with regard to the full year margin outlook of the 3.25% to 3.35%, is that like on a reported basis? So including like the benefit you guys got from the kind of the accelerated fair value accretion?

Alan A. Villalon
Executive VP & CFO

Yes, that is on a reported basis.

Operator

We now have Nathan Race with Piper Sandler.

Nathan James Race
Piper Sandler & Co., Research Division

In your prepared remarks, you referenced some technology upgrades and platform transition. So just curious, maybe, Katie, if you can kind of speak to how some of these technology initiatives could increase, kind of the capture rate across new clients within the Alerus franchise? And just how you see opportunities to also increase existing client wallet share with all these upgrades as well?

Katie A. Lorenson
President, CEO & Director

Sure. I'll start and then Jim can add on where I miss.

So we did a full conversion of our Wealth Management business that was completed in the second quarter. It went very well. This platform really improves the client experience, as well as the advisor experience, and the operational experience. And so we believe besides our differentiated recruiting proposition that we have to advisors, this platform allows them to kind of level set in terms of their experience, in addition to the opportunities that they have within our organization because of the retirement synergies.

Jim R. Collins
Executive VP and Chief Banking & Revenue Officer

Yes. I would say, Katie is right on. The new platform on the wealth side will allow us to leverage our current staff and then allow us to recruit better, and it will be a better client experience. It will also allow us better analytics to dive into that synergistic relationship and see where we can help our clients in the other areas that we have in Alerus.

The other piece is we have a very solid treasury management group to grow our C&I and we're putting on a new online retail and commercial online system, which acts the same way as the wealth platform. Better customer experience, better analytics and speed to market will be better.

Nathan James Race
Piper Sandler & Co., Research Division

Okay. Great. That's helpful. And then just turn to credit. Your nonperformers are still almost 2x that of peers on a relative basis when you just look at the percentage of loans. So maybe, Karin, just curious to get some thoughts on kind of the outlook for some larger resolutions, or just opportunities to bring down nonperformers going forward?

Karin M. Taylor
Executive VP & COO

Yes. Nate, the numbers are really being driven by the same two large relationships that we've been talking about the last couple of quarters. And so as I mentioned earlier, the construction deal is performing as expected in terms of meeting time lines. Realistically, that's probably an early 2026 resolution.

The other one is that large residential relationship, and we have -- we are pursuing legal action on that. And I would expect that would also be a first half 2026 resolution.

Nathan James Race
Piper Sandler & Co., Research Division

Okay. Great. And then maybe, Al, I appreciate all the commentary on the margin outlook, but can you just maybe update us in terms of the balance sheet sensitivity to a 25 basis point fed cut?

Alan A. Villalon
Executive VP & CFO

Yes. Nate, on a 25 basis point Fed cut, we do expect our NIM to improve about 5 basis points. As a reminder, though, our guidance does not have any rate cuts embedded in it.

Operator

We now have David Long with Raymond James.

David Joseph Long
Raymond James & Associates, Inc., Research Division

Al, I just want to confirm on the deposit outlook, deposit cost outlook. Did you say up 8 basis points in the third quarter?

And then as a follow-up, I just wanted to get a better understanding of what your assumptions are tied to that? And then also maybe some color on overall deposit competition?

Alan A. Villalon
Executive VP & CFO

David, what we're -- what I guided to was about 8 to 10 basis points of deposit cost increase in the third quarter, and then stable from there going forward. Jim, do you want to take on the deposit outlook?

Jim R. Collins
Executive VP and Chief Banking & Revenue Officer

Yes. The deposit competition is tough, right? We have staffed up with a couple of seasoned commercial deposit bankers. And obviously, I think I talked about earlier, we have a solid treasury management group. So our strategy is still focused on full relationships of mid-market C&I and business banking. I think we have the pieces in place. But the competition is tough and deposits are always hard to forecast, but we're sticking to our strategy.

Alan A. Villalon
Executive VP & CFO

And just to finish on that, David, too. I mean, if you're thinking about not -- what Jim just said in competition being tough, we are expecting some mix shift from noninterest-bearing to interest-bearing that's going to put that pressure. That's part of the 8 to 10 basis points increase that we're guiding to.

Operator

We now have a follow-up from Brendan Nosal with Hovde Group.

Brendan Jeffrey Nosal
Hovde Group, LLC, Research Division

Apologies. I just wanted to circle back to the fee income outlook. Because it looks like year-to-date you've got quite a bit of momentum. I think core fees are up, I don't know, 10 or so percent year-over-year through the first half.

So just kind of help me square up the [indiscernible] progress you've made year-to-date versus that relatively stable fee outlook you after all of this year?

Alan A. Villalon
Executive VP & CFO

Right. Part of it, too, Brendan, is that, one, we're not forecasting any market outlook for the remainder of the year. Number two, we are expecting a seasonal downturn in our mortgage business. So the fourth quarter typically is one of our weaker ones for us, and now put some pressure on the fee income as well. And then we're expecting a little bit of a pullback maybe too in the third quarter in mortgage.

Operator

We have another follow-up from the line of Nathan Race with Piper Sandler.

Nathan James Race
Piper Sandler & Co., Research Division

It seems like there's been a good amount of M&A-related disruption in the Twin Cities lately. So just curious maybe what the appetite is to hire some additional producers, maybe on the commercial or private wealth side? Or you think some of those share gains are possible just with the existing teams capacity?

Jim R. Collins
Executive VP and Chief Banking & Revenue Officer

I would say at this point, we have capacity with our existing team, but we are always opportunistic. So if there comes a situation where we find the right person that could come into our culture and add some benefits to us right away, we would look at that. But right now, I would say we're pretty set with the team we have.

Operator

I can confirm 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

Yes. Thank you. Thank you, everyone, for taking the time to listen and for your investment in Alerus. Thank you to our team members who continue to make Alerus better every day.

While the macroeconomic uncertainty and competitive pressures remain, we're staying disciplined and focused on getting better and bigger. Managing credit risk proactively, maintaining strong capital and reserve levels, and investing in areas that align with our long-term strategy. While we acknowledge there's more work to do, we're confident in the path we're on, and we're proud of the incredibly talented team we have in place. Thank you, everyone. Have a great day.

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