

Alerus Financial Corp.

Q3 2021 Earnings Conference Call

Thursday, October 28, 2021, 10:00 A.M.  
Eastern

**CORPORATE PARTICIPANTS**

**Randy Newman** – *Chairman, President, and Chief Executive Officer*

**Katie Lorenson** – *Chief Financial Officer*

**Karin Taylor** – *Chief Risk Officer*

## **PRESENTATION**

### **Operator**

Good morning and welcome to the Alerus Financial Corporation earnings conference call. All participants will be in listen-only mode. Should you need assistance, please signal a conference specialist by pressing the star (\*) key, followed by zero (0). After today's presentation, there will be an opportunity to ask questions. 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 Chairman, President, and CEO, Randy Newman. Please go ahead.

### **Randy Newman**

Thank you. Good morning and welcome to everyone who is joining our call today. Today, I'm joined by Karin Taylor, our chief risk officer; and Katie Lorensen, our current CFO, and as we recently announced, our future President and CEO. In addition to announcing the transition of leadership to Katie in 2022, we also announced the addition of three new corporate directors to our board: Janet Estep, Jill Schurtz, and Mary Zimmer.

Alerus' ability to attract and retain talent from the boardroom to the entry level professional is a key differentiator in our ability to grow and execute our strategic plan. The third quarter was another quarter of impressive financial results. Our diversified business model continues to drive strong financial performance as we ended the third quarter with a return on tangible common equity of over 18%. We generated \$57.2 million of revenue through continued momentum in our retirement, wealth management, and mortgage businesses while net interest income and loan growth, excluding paycheck protection program or PPP loan, showed incremental improvement with average total earning assets growing 10.6% year-over-year.

Credit quality was better than expected with another net recovery quarter driving a negative provision for the quarter. Tangible book value grew over 7% from a year ago, which includes the intangibles recognized in the December 2020 acquisition of the Denver-based 24HourFlex RPS. During the quarter, we converted 24HourFlex clients to Alerus, and we are pleased to see exceptional client retention and growth. We greatly appreciate all of our employees for their continued hard work, remarkable ongoing client engagement and dedication to serving our clients, and their ability to help us produce strong returns for our shareholders.

I am so proud of the company's historical and current levels of performance. Next April 2022 is the 25th anniversary of the devastating flood and fire in Grand Forks, North Dakota that created a crisis situation for both the community and for our company. I'm famous for the line that I use when I state that while I'm immensely proud of the financial performance of Alerus, the non-financial achievements of Alerus define and separate us from our competitors and I believe will drive this company to continued outperformance of our peers well into the future. Alerus is a purpose-driven company that performs exceptionally well and is blessed with enormous professional talents that have a strong pride and passion in what we do and how well we focus on client success and satisfaction.

Before I turn it over to Katie and Karin, I'd like to just say that over the past several years, Alerus and our board successfully became a public company and significantly improved the leadership

of our company. This seamless transition occurred during a pandemic and has not interfered with our -- with record earnings the past several years. In 2016, we created the Alerus leadership council, which includes our top 20 product staff market leaders in addition to our C suite executives. As needed, we also successfully recruited and brought in new leadership to supplement our internal talent, and in every case, we were able to attract our number 1 candidate. In addition, and as I mentioned earlier, we are adding three high quality industry experienced corporate directors to our leadership team, and finally, the board decided to name Katie Lorenson as my successor.

I'm very proud of how the board followed the process to identify candidates based upon performance and cultural fit and ultimately chose Katie. No one has contributed more to Alerus' success than Katie over the past several years. I didn't think that we would ever find anyone who mirrored my pride and passion in Alerus, but we have found that person in Katie. The response from advisors, investors, and employees to the announcement of Katie has been overwhelmingly positive and has reinforced the decision of the board.

Alerus is making these leadership changes during a position of strength, and Katie has Karin Taylor, Ann McConn, experienced and engaged corporate directors, and a very talented and experienced Alerus leadership council to call upon as she builds her team and focuses on executing strategies to keep Alerus successful in the future and to meet the never-ending challenges of our industry. I strongly support the decision of the board and I couldn't be happier for Katie or for Alerus. I have the greatest confidence in her abilities, and she has my unequivocally support.

She is the right person at the right time. I will now turn it over to Katie, currently our chief financial officer and our new chief executive officer on January 1, 2022. Katie?

### **Katie Lorenson**

Well, thank you, Randy, and thank you for your many, many years of leading this exceptional company. I will spend just a couple of minutes today touching on the highlights of another excellent quarter of results and the continued momentum that we have building within Alerus today. First, I'll spotlight the incredible efforts of our revenue-generating team members. Our business advisors and financial guides continue to put up impressive numbers and pipelines remain strong across all product offerings.

I believe we have turned the corner on loan growth, ending the quarter with balances up for the first time this year. The SBA team continues to be a welcomed addition to our company. With our significant commercial base of clients and the expertise and experience of this team, we believe this product offering will continue to help differentiate Alerus and the value we bring to our business clients. The team has integrated so quickly and so well into our organization. We've closed a couple of deals already and we have a solid pipeline and good opportunity flow.

Our business model continues to prove out with client expansion opportunities growing and upsell of treasury management and synergistic product sales in our retirement business remaining strong. Within our consumer segment, our wealth management business had another strong quarter and new revenue for the quarter kept pace with last quarter both at exceptional level. We rolled out a wealth management digital account opening, which has not only provided a big efficiency lift for our team members but has delivered a seamless and simplified process for our clients.

Our mortgage unit had another great quarter serving over 1,200 consumer clients. Our business continues to evolve back to our historical mix with purchase volume averaging approximately 67% of the production in the quarter. As expected, we did see the continued unwinding of the value of the hedge this quarter, a revenue headwind of about \$1.8 million. We estimate a seasonal drop in volume of about 20% in the fourth quarter and the hedge to unwind an additional \$1.7 million.

Briefly on the margin, we saw more of the same with stimulus driven liquidity remaining heightened. Our deposit balances have consistently held at \$2.7 billion for the first nine months of 2021, an incredible 48% increase from pre-COVID Q3 2019 ending balances. We did see net interest income ex-PPP increase this quarter, a trend we expect to continue as we've built a billion-dollar investment portfolio and continue to put on loan growth. We've seen some significant deposit balance inflow in October with some big clients this -- and this could lead to further pressure on the margin.

Once we see outflow of these funds, we expect to be -- which we expect to be intra-quarter, we would expect to stabilize and in the longer term improve from here as we shift investments into loan growth.

Last but not least, expense management from an expense standpoint, our execution in controlling costs continues and we delivered another solid quarter of managed expenses. We continue to extract efficiencies and processes, operations, and facility closures while growing our client base and engaging clients in our digital technology investments. All of this while employee satisfaction scores and recognitions continue to distinguish Alerus as an employer of choice.

That's a wrap for my remarks. I'll turn it over to Karin for some brief comments on credit and the allowance.

### **Karin Taylor**

Thank you, Katie, and good morning, everyone. Our COVID-related lending programs continued to wind down during the quarter. As of October 25th, we've received forgiveness on approximately \$396 million or 83% of our PPP loans, just \$19 million of first round loans remain on the books. Remaining loan balances on deferral total \$3.4 million comprised primarily of eight residential real estate loans.

Asset quality remained strong during the quarter. Non-performing assets to total assets were 23 basis points excluding PPP loans. We recorded net recoveries of \$302,000 for the quarter. This is the fourth quarter out of the last five in which we recorded a net recovery. That combined with continued strong credit metrics and improving economic conditions in all of our markets resulted in a reserve release of \$2 million during the quarter. As of 9/30, the ratio of the allowance to total loans was 1.89%, excluding PPP loans; and the ratio of the allowance to non-performing loans was 515%. That concludes our prepared comments, and we will now open it up for questions.

## **QUESTIONS AND ANSWERS**

### **Operator**

We will now begin the question-and-answer session. To ask a question, you may press star (\*), then one (1) on your touchtone phone. If you are using a speaker phone, please pick up your handset before pressing the keys. To withdraw your question, please press star (\*), then two (2). We will pause momentarily to assemble our roster. The first question will come from Nathan Race of Piper Sandler. Please go ahead.

**Nathan Race**

Yes. Hi, everyone. Good morning.

**Katie Lorenson**

Good morning, Nate.

**Karin Taylor**

Good morning.

**Nathan Race**

Maybe just to start off on just kind of the overall balance sheet growth expectations, you guys like most others in the industry have had a lot of positive flows over the last several quarters but I suppose I could argue that some of your deposit gathering is a function more so of what you guys are doing across the – one Alerus strategy. So just curious, as we kind of look out to next year and into the fourth quarter as well, how we should kind of think about just the overall balance sheet growing from here. Do you expect any kind of deposit outflows or should we kind of assume kind of low single-digit growth in the overall earning asset base and that of loans as well?

**Katie Lorenson**

Good question, Nate. I believe that is a sound assumption in that regard. We are not at this point anticipating significant declines in the deposit base, and what we do believe will flow out, we will replace with continued growth on the treasury management side and in synergistic deposits.

**Nathan Race**

Great, it's very helpful, and then I appreciate your thoughts on the decline in mortgage volumes expected for the third quarter. How should we kind of think about the -- also potential compression you're getting on sale margin. I think it held up relatively well, as indicated on the slide deck. Are you seeing that pressure accelerate thus far in the fourth quarter? How should we be kind of be thinking about that component of the mortgage banking revenue line near term?

**Katie Lorenson**

We do expect to see those margins compressed from -- we have held very well obviously, but we would expect them to settle in somewhere between 2.80 and 3.

**Nathan Race**

Okay, great. Very helpful, and maybe just last one on fees. Wealth management and retirement and benefits services revenue continue to increase in the quarter, perhaps a little bit above kind of what we were expecting and perhaps what you may be guided to, particularly on the RB&S line last quarter. How are you kind of thinking about the trajectory of that -- of those business lines into the fourth quarter and 2022 as well?

**Katie Lorenson**

It's a good question but we did have some accelerated doc restatement fees in the quarter, which we disclosed in the earnings release and so that that helped pull the numbers up a little bit for the quarter. I would expect for the fourth quarter to be similar to where we ended up this quarter.

In the run rate for 2022, we will have this -- we'll end 2021 with about \$2 million of document restatements revenue, and that's recurring revenue but not on an annual basis, so that'll be a bit of a headwind for us into 2022. As we think about -- assuming the market is at historical levels, we would expect revenue for the year to look fairly consistent with where -- where we land in 2021.

**Nathan Race**

Okay. Got it, and I think you mentioned also in the release around expenses that there were some perhaps onetime costs in the quarter around some investments in automated processing and integration. Was that a significant dollar amount in the quarter? And kind of what do those investments perhaps generate in terms of additional efficiency improvement or cost saves as well over the near to intermediate term?

**Katie Lorenson**

Yeah, those expenses relate to pulling in some consultants to help with some of -- with our technical -- technology investments, and so it's really just the shift in expenses from 2022 to 2021.

**Nathan Race**

Okay. Great. I will step back for now and congrats again, Katie, on the promotion. Thanks, everyone.

**Katie Lorenson**

Thank you.

**Operator**

The next question is from Jeff Rulis of D.A. Davidson. Please go ahead.

**Jeff Rulis**

Thanks. Good morning. The question on the loan growth outlook -- I just want to -- in terms of the payoffs, are you seeing anything -- was that higher in the quarter and you -- and maybe even expectations for the coming year?

**Katie Lorenson**

We did have a couple of significant payoffs this quarter, \$25 million in one of our markets. For the fourth quarter loan growth, we would expect to look similar to the third quarter, but with the pipelines and the momentum that we're seeing building, we would expect to return to mid to upper single digits of growth next year.

**Jeff Rulis**

Got you, and, Katie, I may have missed the spread income comment. In terms of management of investment securities, did you say that you think NII can stay up here or what was that expectation?

**Katie Lorenson**

Yes, we do expect that NII will continue -- without PPP will continue to grow on a quarterly and annual basis.

**Jeff Rulis**

Got it. Okay, and last one, just on the M&A landscape and maybe even other capital plan, it's been a bit since the last transaction and just interested in those discussions and thoughts about where you stand on being opportunistic on any -- anything that's out there strategically.

**Katie Lorenson**

Yes. Yes, we like where we're at today in regard to the stage of the conversations that we're having and we continue to focus on building those pipelines and really through various sources

that we've touched upon before, but really establishing relationships wherever it makes sense and across business units as well as across geographies.

**Jeff Rulis**

Got it. Randy, all the best in retirement. You've been a great ambassador and certainly looking forward to Katie's leadership. So, thank you.

**Katie Lorenson**

Thank you, Jeff.

**Randy Newman**

Thanks, Jeff.

**Operator**

The next question comes from William Wallace of Raymond James. Please go ahead.

**William Wallace**

Yes. Hi. I was hoping to maybe circle back on the expense commentary. It sounded like you were suggesting that you pulled forward some expenses in the quarter. We've been hearing a lot about wage inflation and pressures on the expense base maybe not being so transitory. I'm just kind of curious if you could help us think about where you think a run rate expense might be going into next year and then what kind of inflation you might -- you might anticipate on the base relative to the commentary that you've pulled some expense forward.

**Katie Lorenson**

Right. It's a good question. Obviously, a big piece of our expense run rate is variable with mortgage volume, which we do expect to trend down next year. We -- if you apply the industry - - what the industry is saying about what's going to happen next year with purchase and refi volume, that would pull down our business about 30%. We absolutely believe we will do much better than the industry but that certainly impacts our expense side, and so, we do expect compensation related to mortgages to turn down but we believe that that won't hit the bottom line as we continue to invest in our current talent as well as recruiting new talent in the revenue-producing side of the business, and so our outlook today from an expense from an expense side is probably within the \$42 million or so run rate on average, give or take a couple million on either side depending on what happens with mortgage and unforeseen items.

**William Wallace**

So that \$42 million run rate is -- that contemplates that your variable compensation related to mortgage will be declining, but it's not by 30%.

**Katie Lorenson**

Right.

**William Wallace**

Okay, and then I think I misunderstood or misheard what you're talking about on the fee -- on the fee income side. Were you suggesting that investments, like for the sample in the SBA platform and then what you're seeing in play business etc., you think will offset any mortgage pressures?

**Katie Lorenson**

What I would say is that we believe our mortgage business will do better than the industry and we don't anticipate the headwind that we have in mortgage this year in regard to the hedge unwinding,

which we think it'll probably be about an \$8 million year-to-date headwind in mortgage. That is not something that we will be having to deal with next year and we expect continued growth in wealth, and so as we look at just net revenue, I believe that we will be able to stay pretty close to where we were this year.

**William Wallace**

Okay, and then on net interest margin, understanding that obviously liquidity is pressuring the reported NIM, can you just talk about what pressures you're seeing loan pricing and whether or not you feel like if we were to just keep liquidity flat and not worry -- not worrying about debt improving or continuing to pressure NIM, what would you think kind of a core NIM trajectory would be? You think you've got stability in pricing, or do you think we still have pressures on the pricing side from the loan portfolio that will be a pressure?

**Katie Lorenson**

No, I think we've got some stability --

**Karin Taylor**

Katie.

**Katie Lorenson**

Oh, go ahead, Karin.

**Karin Taylor**

Yeah, I would -- I was just going to say that we continue to see pressure certainly on pricing, but it has been fairly stable over the quarter.

**William Wallace**

Okay. That's all I had. I really appreciate your time and I'll echo all the other sentiment. Katie, it's exciting working with you, and Randy, I hope you're able to enjoy your free time.

**Katie Lorenson**

Thanks, Wally.

**Randy Newman**

Thanks, Wally.

**Operator**

And this concludes our question-and-answer session. I would now like to turn the conference back over to Randy Newman for any closing remarks.

**CONCLUSION**

**Randy Newman**

All right. Thank you to everyone for joining our call this morning. Thank you for listening and also asking questions. Our performance through the first nine months continues to position us well for future success.

Our diversified business model and significant client base continues to create opportunities to grow and outperform our peers. We are a purpose-driven organization, which differentiates our ability to attract and retain our talented professionals. We have made significant investments in sales training and technology, which has led to a high level of engagement within our team and

is driving production and new business across all product lines. We remain focused on our culture, our communities, and our clients.

We are very pleased with our performance year to date and thank all of you and all of our shareholders for their investments and our team members, who work daily to positively impact our client's financial potential. We thank you for your continued support and interest in our company, and again thank you for joining and listening to today's call.

**Operator**

The conference is now concluded. Thank you all for attending today's presentation. You may now disconnect your lines. Have a great day.