

# Alerus Financial Corporation

## Q4 and Year-End 2020 Earnings Conference Call

Thursday, January 28, 2021 at 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*

**Ryan Goldberg** - *Chief Revenue 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. 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 Chairman, President, and CEO, Randy Newman. Please go ahead.

### **Randy Newman**

Thank you, Grant, and good morning, everyone. This is our sixth earning call since our IPO in September of 2019. This morning we intend to discuss our fourth quarter 2020 and year-end financial results and also to give a current impact of the COVID-19 pandemic. Today I'm joined by our Chief Financial Officer, Katie Lorenson; our Chief Risk Officer, Karin Taylor; and our Chief Revenue Officer, Ryan Goldberg. As always, we appreciate your interest in our company and invite your questions at the end of our introductory remarks.

Let me first begin by recognizing and thanking all of our almost 850 employees of Alerus. Our significant achievements in 2020 were a result of their dedicated efforts and reflect their pride and passion that they have in Alerus. Alerus is a purpose-driven organization with very strong ethics, principles, values, and performance standards, all centered on a guiding principle to do the right thing always and to help our clients and customers achieve their financial goals.

During the fourth quarter of 2020, we continued to ensure that our employees are safe and that we meet the needs of our clients during this period of uncertainty. Our focus and efforts remained the same in the fourth quarter as they have throughout 2020. Katie and Karin will give more specifics in their reports.

I would like to focus on a brief summary of 2020. We, like everyone else, did not anticipate COVID and its impact as we began 2020. It did, it has, and it will continue to have an impact on us going forward. That being said, and despite this disruption and uncertainty, Alerus achieved record financial results for 2020, continued to execute our organic and inorganic growth strategies by proactively meeting the needs of our employees and clients. We successfully completed our 14<sup>th</sup> fee-income acquisition, and we continuously continued — or continue to build upon our very strong financial foundation as we head into 2021.

I'm very pleased to announce that Alerus achieved this record financial performance in 2020 that consisted of record net income totaling \$44,675,000, fully diluted earnings per share of \$2.52 per share, return on equity of 14.41 percent, and return on tangible capital of 17.74 percent, respectively, and an ROA of 1.61 percent for the year.

Our stock price increased significantly throughout 2020, from \$22.50 per share on January 1, 2020, to a low of \$15.26 on April 1, 2020, reflecting the concern that the industry had for credit quality in the pandemic, and finished at year-end at \$27.37 a share.

Achievements in 2020 included record financial performance, proactively protecting the safety of our employees in meeting the needs of our clients, being named to the Piper Sandler Allstar List for 2020 for small cap financial institutions, being named one of the 85 best banks to work for in 2020 by *American Banker*, and successfully closing on another fee-income acquisition in the Rocky Mountain Region of Colorado.

At this time, I'll turn it over to Katie Lorenson and follow up with some concluding remarks at the end of today's presentation. Katie?

### **Katie Lorenson**

Thank you, Randy. Good morning, everyone. Thank you for joining our call today. What an incredible quarter and a year, indeed. We are of course very proud of our financial results but even more proud of how we got there and all of our amazing Alerus team members. So, I'll briefly walk through some of the highlights of the quarter, and then I'll hand it off to Karin, who will provide an update on credit-related matters, PPP, and provisioning.

The trends of the fourth quarter picked up being right where the third quarter left off, and I'll go right into mortgage, which was, again, a highlight this time, with originations flowing right past last quarter's record, surpassing \$600 million to end the year at nearly \$1.8 billion of originations. I've mentioned it before, but I think it's worthy of noting again that this unprecedented volume would not have been possible without those long-term investments we've made in technology and digital. Although our originations are typically rated towards the purchase side, the mix shifted as expected in 2020 to a 55% total originations in the refi space. Purchase volume did remain strong in 2020, and our mortgage loan officers [unintelligible] average over \$55 million in 2020. Our capital markets and our operations teams shined with continued strong margins and a nearly 90 percent pull-through rate on mandatory delivery.

We ended the year with almost 6,000 clients purchasing or refinancing their home with Alerus. We are grateful and proud of our team members within the division and across the company who helped make these results possible.

As the mortgage application volume came down from its record levels, the valuation of the forward pipeline decreased \$2.3 million in the quarter, ending the year at a mark-to-market gain just over \$8.8 million of the nearly \$62 million of mortgage revenue reported. We expect the first quarter volume for 2021 to be higher than usual for a first quarter, but down from the record levels of the fourth quarter volume.

Sticking with the fee-income theme, which comprised over 64% of total revenue in 2020, retirement revenue finished in line with expectations. Assets in the division jumped up to \$34 billion, driven by strong market conditions and the closing of the 24HourFlex RPS transaction in mid-December. From the first conversations with the leaders of RPS, we believed these companies had a strong culture fit, and we are seeing the teams integrating well and focusing on client retention and conversion.

Wealth management finished the year strong, with overall production exceeding our expectations, certainly impressive given the volatile environment of 2020. On the balance sheets, which ballooned over the \$3 billion mark in total assets at the end of the year, we continued to build the investment portfolio, adding another \$100 million in the quarter from cash with both short- and long-term purchases. But despite these ongoing efforts the cash levels remained in the \$200-million range consistent with most of 2020. With loans held for sale at

historic highs and 122 — of \$122 million and PPP forgiveness continuing, it appears the liquidity levels will be higher and remain longer than we anticipated.

From a net interest margin standpoint, the increase on a linked-quarter basis was due to the PPP loan forgiveness. On a core basis, the net interest margin dropped to 3.03 from a Q3 core of 3.10. Cost of funds decreased another 9 basis points, while average deposits grew nearly 5% on a linked-quarter basis. Excess cash continues to weigh a heavy burden on the NIM despite these ongoing efforts to reduce the cost of deposits.

Last, but not least, expenses. Expenses for the quarter did have a few outliers. First and foremost, the compensation rose in conjunction with the increase in mortgage volume and an increase in accruals for total loans originated, not just sold. In addition, one-time adjustments to year-end accruals were made relating to the outstanding financial performance of the company. During the quarter, we also made the decision to exit another four locations, bringing our total office closures for the year to six — six of our — or a quarter — over 25 percent of our physical footprint. The impact to the financials for Q4 was over \$700,000.

In the technology and business services line, we included some one-time expenses related to the permanent transition of some of our employees to a home office. In addition, we accelerated a few projects into 2020. Professional services included merger-related expenses for the acquisition we closed during the quarter, and we expect the 2021 expense run rate to normalize in the \$40-million-per-quarter range.

As a final point, we are pleased to see our investments in our ONE ALERUS culture. Our talents and technology translate into results. Our teams are working with urgency to identify additional opportunities to expand relationships and grow our client base as well as increase efficiencies and reduce expenses. Although uncertainty remains for 2021, it is clear the enterprise value of our company is strong and resilient to incredible challenges.

I will now turn it over to Karin Taylor, our Chief Risk Officer.

### **Karin Taylor**

Thank you, Katie, and good morning, everyone. First, a brief update on our banking markets. North Dakota and Minnesota both experienced a significant surge in cases through much of November and December. North Dakota remained open for business, while Minnesota increased restrictions on businesses during that time. Those restrictions were listed earlier this month, and Minnesota case numbers decreased. Arizona's surge came later, and they continue to experience an elevated number of cases. We are serving clients in all markets, virtually, digitally, and in person, based on market needs and conditions.

Loans increased by \$258 million since December of 2019. This is attributable to an increase of \$212.7 million in C&I loans, driven by PPP, and an increase of \$68.3 million in commercial real estate loans. This growth was offset by a decrease in consumer loans of \$41 million.

Commercial line utilization remained low at the end of the year at 21%. This compares to a utilization rate of 34% at year-end 2019. Increased borrower liquidity due to various relief programs, including the PPP, is contributing to that lower utilization rate.

As you know, we successfully executed on the first round of the PPP, securing over 1600 loans for our clients totaling \$364 million. As of January 25<sup>th</sup>, we had submitted 763 forgiveness applications to the SBA, totaling approximately \$205 million. We had received approval from the SBA for 671 of those applications, totaling \$115 million. We are accepting applications for round two of the PPP, and through January 25<sup>th</sup>, we had received 212 applications for \$26 million.

With respect to deferrals, we have granted some type of deferral on about \$154 million in balances, or 9% of the portfolio. Requests for payment relief remained low during the fourth quarter. Most were one-month deferral requests on consumer loans. Requests on commercial loans were extremely limited. As of year-end, about \$12 million in loan balances remained on deferral, or about 0.7% of outstanding and guaranteed loan balances. \$3.7 million of those loans are in an initial deferral period, and \$8.4 million are in a second deferral period. Balances on second deferral were almost entirely in our one-to-four-family residential portfolio.

Our credit metrics remained strong during the quarter. Non-performing assets to total assets remained at 17 basis points, unchanged from the third quarter. Loans downgraded or moved to non-accrual during the quarter remained at very manageable levels and included loans to borrowers in industries most impacted by the pandemic, including restaurants and hotels.

We reported net recoveries of \$1.5 million for the fourth quarter. This was primarily the result of a \$2.6 million recovery on a commercial loan that was charged off during the second quarter of 2019. The recovery was partially offset by a further write-down on problem — on a problem credit and a charge-off of a small business loan. Both of these loans had weaknesses prior to the pandemic. Our fourth quarter provision expense decreased to \$1.4 million, from \$3.5 million, in the third quarter, primarily a result of the recovery I mentioned. We did increase allocations to all loan segments for current economic conditions as well as to potentially higher-risk portions of the portfolio.

Our ratio of the allowance to total unguaranteed loan balances increased to 2% compared to 1.83% at the end of the third quarter. Our allowance to non-performing loans also increased to 678%.

Our credit is performing better than we had anticipated in the spring of 2020; however, a high degree of uncertainty remains as to whether the additional stimulus will be enough to actually bridge the gap for some businesses. While we expect loan losses to emerge in 2021 and be higher than what we experienced during 2020, we believe our strong credit culture, diverse loan portfolio, and geographic footprint will continue to help us withstand the economic impacts of COVID-19 relatively well.

We expect loan growth will be challenged in 2021, at least through the first half of the year, due to continued high levels of liquidity and hesitancy on the part of some borrowers to make investments while there is still so much uncertainty. Our business advisors continue to build their pipelines, and we are finding opportunities and extending credit that meets our lending standards.

That concludes our prepared comments. 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 1 on your touchtone phone. If you are using a speakerphone, please pick up your handset before pressing the keys. To withdraw your question, please press star, then 2. At this time, we will pause momentarily to assemble our roster.

Our first question will come from Jeff Rulis with DA Davidson. Please go ahead.

**Jeff Rulis**

Thank you. Good morning.

**Karin Taylor**

Good morning, Jeff.

**Jeff Rulis**

Appreciate the comments on expenses tracking back towards the low-\$40 million range. [Unintelligible] in the fee income side, I — a big piece of that is the mortgage unit. Any thoughts on the outlook for the — you mentioned expectations for production in the first quarter, but net revenues there and/or just absolute fee income? I'd imagine it's a tough quarter or a tough year to replicate, but any thoughts on the fee-income side?

**Katie Lorenson**

Sure. Morning, Jeff. Thank you for the question. So, on the mortgage side, as I mentioned, we do expect the first quarter to be relatively high compared to prior years, certainly, and likely the peak quarter for the year, and so we are estimating an overall decline in originations [unintelligible] 30%, which is consistent with the industry.

The other component of that is related to, of course, that pipeline valuation, which ended the year at a positive, almost \$9 million, which we also expect to unwind during the year. So, that should give you a little color on mortgage in regard to the revenue there.

The other components — I'll maybe speak specifically to the retirement side. There, we expect from a legacy-business standpoint, probably fairly flat, maybe incremental core growth in the slower 1 to 2 percentage. Then, of course, with the addition of the acquisition and the RPS 24HourFlex team, overall, we should see — they should add about 8% or so to total revenues in the retirement division, bringing us up to a run rate that's probably closer to the \$17 million — \$17 — \$17.5 million for the year.

**Jeff Rulis**

Great. And it's pretty steady on that wealth management. We kind of factor that. That's good color. Thanks. Maybe one for Randy, just checking in on the capital plan and your priorities of, I imagine, funding organic activities, number one. But you did close on RPS and this pipeline of other opportunities and/or kind of what you can do. You know, do you look at dividend or other on the capital side?

**Randy Newman**

All of what you mentioned there. First of all, we're very, very pleased with the acquisition that we were successfully able to close on. It was a very, very good fit, both from a business perspective as well as a cultural fit to our company. It will really come down as a very good acquisition for Alerus.

Where the Board really turns its attention to now is really to — having gone through the IPO and everything and with the — both the earnings and the build-up of capital is — capital management is something that we continue to discuss on a quarterly basis with our corporate Board, and all of the things you mentioned, just to review the dividend strategy, which I'll make a remark on — I'll save my remarks to the end of the meeting — and also as well as, just putting things in place from a good governance manner to discuss and make sure that we're managing that capital properly going forward.

**Jeff Rulis**

Okay. Thanks. I'll step back.

**Operator**

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

**Nathan Race**

Yes. Hi, everyone. Good morning.

**Katie Lorenson**

Good morning, Nate.

**Nathan Race.**

Yes. Perhaps just continuing on the capital deployment discussion. I'd be curious just to get an update just in terms of how discussions are going with [inaudible] essential — or B&S partners. Are you guys seeing an influx of opportunities post RPS, or is it pretty much a similar state of affairs from what we discussed last quarter?

**Randy Newman**

Katie, do you want to —

**Katie Lorenson**

This is Katie. Yes, absolutely. I would say it's fairly consistent with what we've been seeing in the pipeline since last quarter.

**Nathan Race**

Okay. Got it. And then, just on the core margin outlook — PPP — any thoughts, Katie, on just how that projects from here? I believe you had said it was around 3.03 for the quarter. I know a lot [inaudible] kind of access the liquidity levels and how that trends over the course of this year. But just any thoughts just with kind of the flattish loan growth outlook for the first part of this year as Karin alluded to, how we can kind of think about the core NIM — PPP?

**Katie Lorenson**

Yes, I think, the guidance I've been giving was that scraping for 3, and we're there, and it seems like our liquidity position actually continues to increase. So, I think ex PPP, you know, there's a good possibility without loan growth or without seeing that loan utilization pick up, that we will drop below 3 into the 2.90, potentially as low as 2.80s, if it really takes a long time this year to see any demand on the loan side. So, I do think a sub-3 is going to be a reality before we know it, unfortunately.

**Nathan Race**

Okay. Got it. If I could just ask one last one. Mortgage banking revenue, I think you talked about it being down 30% or so, or at least expectations were down 30% or so in 2021, which is

in line with the industry expectations. Does that include the drop-off that we may see in the unrealized — or the hedge gain that was in 2020?

**Katie Lorenson**

Uh-huh, uh-huh. It does not. So the kind of core revenue we would expect to decline that much, and then, in addition, we would expect to see the headwinds of the hedge on top of that decline.

**Nathan Race**

Okay. Got it. I appreciate all the color. Thanks, everyone.

**Katie Lorenson**

Thank you.

**Operator**

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

**William Wallace**

Thank you. Good morning. Just following onto that last question, what are your thoughts on the mortgage — the gain on sales for the year?

**Katie Lorenson**

Yes, a good question. We are anticipating at this point, that margins will return back to the pre-COVID levels, so the 27 levels.

**William Wallace**

Okay. Thank you. And then on the net interest margin, just following up on that line of questioning, so, we can understand that with all the liquidity that continues to come into the bank balance sheet, that's going to add in pressures. But maybe helping us think about NII dollar growth exclusive of PPP fees, any thoughts on how NII dollars might grow? In other words, are you planning on deploying liquidity into the bond portfolio to kind of supplement flattish loan growth, et cetera, to help drive NII growth?

**Katie Lorenson**

Yes, we certainly are. I think the headwinds will probably continue to still be too strong from that standpoint, but that's the goal, is to at least maintain levels of NII where we were last year ex the PPP. Of course, we made a lot of ground — made up a lot of ground on the expense side of things last year, which will be more difficult to do this year in regards to our ability to continue to lower our cost of funds. But, yes, that's our objective, that's our goal, is to focus on at least maintaining that level or growing it, whichever levers we can.

**William Wallace**

Okay. And if we were to assume that liquidity was not to continue to build, would that prior guidance around the 3% core NIM hold today?

**Katie Lorenson**

That assumes that the liquidity we're seeing, the liquidity we've got, yes, sticks around. And so, a continued build would probably further the tier rate, though I don't anticipate that happening at this point.

**William Wallace**

Yes, okay. Thanks. And then, in prepared remarks, I believe it was stated that the applications so far for round two of PPP were \$26 million received. I'm just curious if you could give us thoughts on where you think your ultimate level of participation in round two or three, whatever you want to call it, might shake out.

**Karin Taylor**

Yes. Sure, Wally. This is Karin.

**William Wallace**

Hi, Karin.

**Karin Taylor**

It's really early for us to tell where it will shake out. We think that most of the applications we've received so far are for second draw applications. We've not seen significant new applications for first draws.

**William Wallace**

Okay. And has the pace of applications already started to slow, or has it remained kind of, obviously, below the first round, but steady?

**Karin Taylor**

Yes. I mean, it's been steady, and, you know, I'll get another update here I think at the end of the week, but we've had — we've certainly had strong applications right at the start.

**William Wallace**

That \$26 million, where was that up through, what day?

**Karin Taylor**

That was through Monday of this week. And, you know, I should clarify too, those are applications received. They're not necessarily approved by SBA. They're at different stages of approval.

**William Wallace**

Yes. Okay. Okay, that's all I had. I'll step out and let somebody else ask a question. Thank you for your time.

**Karin Taylor**

Thanks, Wally.

**Operator**

Again, if you'd like to ask a question, it's star, then 1 — star, then 1 to ask a question. There being no further questions at this time, that will conclude our question-and-answer session.

I would like to turn the conference back over to Randy Newman for any closing remarks.

**CONCLUSION**

**Randy Newman**

All right. Thank you. Let me first extend our appreciation for everyone who joined our call this morning. Thank you for listening, and Jeff, Nate, and Wally, thank you for your questions.

Alerus has a long history of consistently outperforming our peers and we believe providing extraordinary value to our shareholders. This is driven by our high-value professional services business model, our diversified balance sheet and loan portfolio, and our non-margin-dependent revenue lines of business that we believe deliver greater risk-adjusted returns than our peers.

I'd like to mention two long-term highlights of our very strong operating performance. My records go back to the late 1960s and show that Alerus has always paid a cash dividend, but since 1987, we've increased our cash dividend every year for the last 34 years at an average of 10% per year. At the end of 2020, over the past ten years, Alerus has achieved a 337% total shareholder return, which is just shy of a 16% annual return for our shareholders. This compares, for example, to 16%5 total shareholder return for the S&L All Bank Index into the 150% total shareholder return from the S&L SmallCap Bank Index.

We remain confident in our ability to continue to navigate the uncertainties of this downturn, while also continuing to drive value for all of our stakeholders. As we navigate through the remainder of 2021, I am very proud of how our organization has responded to this uncertain and challenging environment. Our company has accomplished so much despite COVID-19, which is a testament to our team, our leaders at all levels, and our business model.

I'd like to again thank all of our employees for their extraordinary efforts during these unprecedented times and for all of your continued support and interest in Alerus. Thanks to all of you for joining today's call.

**Operator**

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