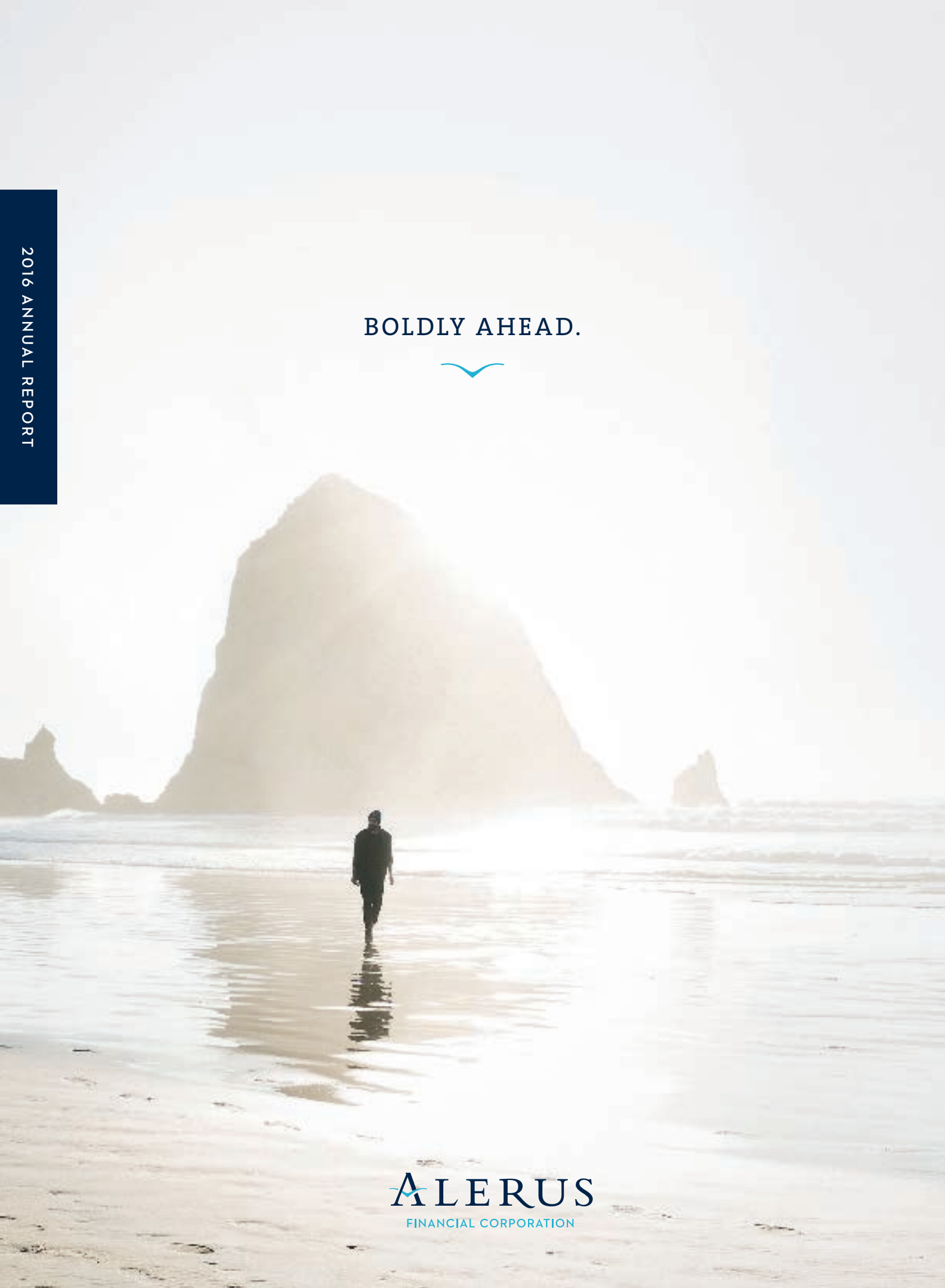


BOLDLY AHEAD.



FROM ENTREPRENEURS TO FAMILY BUSINESSES, FROM FIRST APARTMENTS TO FAMILY HOMES, *wherever people with dreams are found*, THERE YOU WILL FIND ALERUS. OUR STORY IS A COLLECTION OF CUSTOMER STORIES,

### COMPANY PORTFOLIO

Diversified financial services company  
 \$2.0 billion banking assets  
 \$3.4 billion assets under management  
 \$25.0 billion assets under administration  
 \$1.1 billion mortgage loans originated

### CORE STRENGTHS

Strong balance sheet  
 Diversified earnings  
 Relationship-oriented business model  
 Professional service-focused employee base  
 Commitment to business expansion  
 Presence in diversified and growing markets

### CUSTOMER BASE

44,610 consumers  
 10,491 businesses  
 6,000 employer-sponsored retirement plans  
 350,000 employer-sponsored retirement plan participants

### STOCKHOLDER RETURN

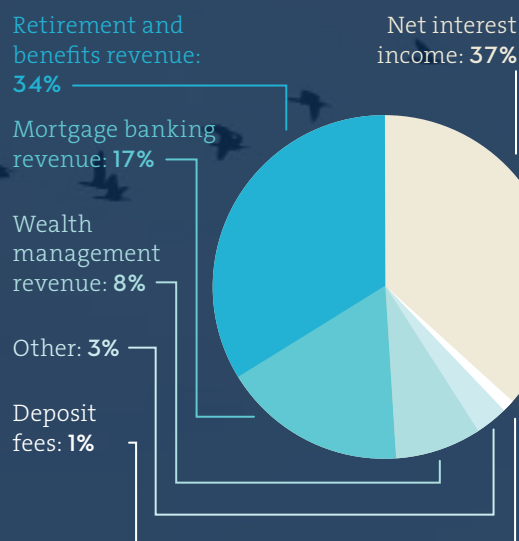
Earnings per common share: \$1.00  
 Dividends per share: \$0.44  
 Stock price range 2016: \$16.20 - \$20.00  
 Last Trade 2016: \$17.00  
 Total stockholder return: -7.7%\*

\* Calculated as Last Trade 2016 minus Last Trade 2015 plus dividends per share divided by Last Trade 2016.

### DIVERSIFIED REVENUE STREAM

\$168 million

- 63% NON-INTEREST INCOME
- 37% NET INTEREST INCOME



SPANNING ACROSS MORE THAN A CENTURY. YET FOR ALL OF THAT HISTORY, *our greatest honor lies ahead*: THE OPPORTUNITY TO ACCOMPANY STILL MORE CUSTOMERS AS THEY NAVIGATE THEIR FINANCIAL LIVES TO ACHIEVE THEIR DREAMS.

### ALERUS TEAM

812 employees

### MARKET PRESENCE

Grand Forks, ND

- Five full-service banking and wealth management offices

Fargo, ND

- Three full-service banking and wealth management offices

Twin Cities, MN

- Six full-service banking and wealth management offices
- Two residential mortgage offices

Duluth, MN

- Two full-service banking and wealth management offices

Scottsdale, AZ

- One full-service banking and wealth management office

### NATIONAL PRESENCE

- Two retirement and benefits offices in Minnesota
- Two retirement and benefits offices in Michigan
- One retirement and benefits office in New Hampshire
- Serve customers in all 50 states through retirement plan services

### CORE BUSINESS LINES

#### BUSINESS BANKING

- Commercial and commercial real estate lending
- Agriculture lending
- Treasury management
- Deposit services

#### CONSUMER BANKING

- Deposit products and services
- Consumer lending
- Private banking

#### MORTGAGE

- Residential mortgage lending
- Purchasing or refinancing
- Residential construction lending
- Home equity/second mortgages

#### WEALTH MANAGEMENT

- Trust and fiduciary services
- Investment management
- Executive insurance
- Financial planning
- Philanthropic giving

#### RETIREMENT AND BENEFITS

- Retirement plan administration
- Retirement plan investment advisory
- ESOP fiduciary services
- Payroll administration services
- Health and welfare administration
- COBRA

### NATIONALLY RECOGNIZED FOR OUR PERFORMANCE

Earned BauerFinancial's highest five-star rating: a distinction for banks excelling in areas of capital adequacy, profitability, and asset quality. *(Sep. 2016)*

Ranked 23rd for number of sponsors, 32nd for number of participants, and 28th for size of plan assets under management by Pension & Investments, which ranks the top recordkeepers nationally by size. *(Sep. 2015)*

Ranked 45th on the 2016 Bank Performance Scorecard within the \$1-5 billion category by Bank Director Magazine, a rating recognizing performance based on profitability, capitalization, and asset quality. *(Aug. 2016)*

Ranked 51st in the Top 200 Publicly Traded Community Banks listing by American Banker. *(Sep. 2016)*

Received an A+ financial health rating from DepositAccounts.com, a bank health monitoring publication. *(Sep. 2016)*



DEAR STOCKHOLDERS, CUSTOMERS, AND FRIENDS, ALERUS IS A COMPANY *built on relationships* — WITH YOU, OUR CUSTOMERS AND COMMUNITIES, AND EACH OTHER. WE OCCUPY A PRIVILEGED POSITION IN THE LIVES OF SO MANY, AND *we are humbled* BY THE OPPORTUNITY TO HELP INDIVIDUALS, FAMILIES, AND BUSINESSES *achieve their dreams*.

### A UNIFYING YEAR

The 2016 story of Alerus may be best told by first taking a moment to reflect back to 2015, when we announced the acquisitions of Beacon Bank and Alliance Benefit Group North Central States, Inc. (ABGNCS). Those franchise-changing transactions, which were made official in January 2016, saw us expand our presence in the Twin Cities; enter Duluth, Minnesota; and greatly broaden the suite of products and services we are able to provide customers nationwide. With the completion of those purchases, we have now concluded 13 strategic acquisitions since 2009, each representing another step toward building the Alerus franchise and establishing ourselves as a strong presence in our chosen markets.

That is rapid growth by any measure, and it has required an extraordinary amount of energy, dedication, and effort from everyone in our company. I am grateful to all employees at Alerus for their incredible contributions.

Experience has taught us that we have only a small window of time to show customers why our institution is the one they should trust. It is our job to prove our value every day, to take nothing for granted. In order to do so, we must ourselves take the time to make these acquisitions work. There was no better time to start this work than the year following the two largest acquisitions in our company's history.

2016 was an exercise in togetherness. Whether it is described as assimilation, integration, or unification, what mattered most to us was ensuring that the Alerus ecosystem could support the people and the products that are now part of our company, and do it without disrupting existing operations. I am proud to say that we were successful in these efforts and will continue to build on these accomplishments moving forward.

### OUR FINANCIAL PERFORMANCE

Every strategic decision we make is done with this question in mind: How can we best provide added value to our customers, and ultimately to our stockholders? At times, the answer to that question includes the need for added expenses and investments in our future that impact earnings in the current year. We planned for 2016 to be that sort of year, and it was. I will touch on a handful of performance indicators in this letter. I strongly encourage you to read the accompanying Management's

Discussion and Analysis for a full explanation of all the factors underlying this year's performance.

Our total revenue increased from \$146.1 million in 2015 to \$168.0 million in 2016. We are pleased with the levels of revenue generated organically, as well as the revenue gained via the Beacon Bank and ABGNCS acquisitions. We are excited about the growth opportunities afforded to us by virtue of our newly expanded menu of products and services, which now includes payroll, health savings accounts, flexible spending accounts, health reimbursement arrangements, and COBRA services. The ability to offer these additional benefits to our customers will play a key role in driving organic growth across the company. Additionally, we returned to stockholders a cash dividend of \$0.44 per share in 2016, a 4.8 percent increase from 2015's \$0.42 per share. We are proud to say our cash dividends have increased roughly 9 percent per year for 36 years.

However, we must acknowledge the decrease in net income and earnings per share in 2016. We earned net income of \$14.0 million in 2016, a decrease of 18.0 percent from 2015 when we earned \$17.1 million. 2016 earnings per common share were \$1.00 compared to \$1.21 in 2015, a decrease of 17.4 percent.

This reduction in performance is attributable to a number of factors. A variety of one-time expenses totaling just over \$4.0 million were necessary to make our transformational acquisitions work smoothly, as were another \$1.5 million in expenses associated with the closure of three branch offices and consolidation of additional offices in order to more efficiently utilize the space we have gained in recent years. Intangible amortization expenses increased from \$4.4 million to \$7.0 million in 2016, which are part of the costs associated with acquisition growth. Operating expenses also rose as we continued to make investments in the people, technology, risk management, and information security tools necessary to enable us to deliver value to our customers. Finally, while interest rates did begin rising in 2016, the pace of the increase was slower than predicted, resulting in less interest income than anticipated.

Alerus has a long history of excellent financial performance. We expect, once our acquisitions are integrated and we begin to realize the revenue benefits from more customers and more services to provide them, our performance to steadily improve.



## OPTIMIZATION

If the last few years have been about building the Alerus franchise – entering new markets, rebranding the company, diversifying our services – the emphasis in this and future years is about optimizing that franchise. In a largely commoditized industry, we won't differentiate ourselves by what we sell or what we do. Rather, our ability to separate ourselves from the competition will depend on how well we do what we do. Key to this will be our effectiveness at showing customers how our company, structured as a high-value professional services firm, can improve some facet of their financial lives.

Fine-tuning the organization to deliver customer value, and in turn stockholder value, is an ongoing and multi-faceted endeavor. We are always exploring and evaluating possible improvements that keep us on a customer-driven track. Everything from delivery methods to technology to the tools that support our employees in serving the customer will be assessed and adjusted as needed.

Of course, in our industry, the pressure to grow is ever present. That means our efforts to optimize must share space with our growth initiatives. Our focus now is on leveraging the breadth and depth of our company, our people, and our facilities to grow from within. This is a time to grow with our customers and to impress upon them the diverse nature of our services and solutions.

## STRIKING A BALANCE

One theme I try to consistently articulate when talking about Alerus is our need to balance growth, risk, return, and infrastructure investment. We have been particularly mindful of this balance because we have been an active acquirer, and every acquisition contains inherent risks, opportunities for growth, and the need for additional infrastructure support. Now, following a lengthy period of planned, opportunistic franchise expansion, we prepare to focus inward, which means the question of balance presents itself in a slightly different posture.

The inward search for balance in 2016 resulted in a number of developments that will better position our company for the future. One example was an initiative called Project Footprint, where we reviewed our entire footprint to determine what locations and space we need now – and into the future – to best serve customers. In closing and consolidating some of our locations, we're able to continue investing in user-friendly technology, which our customers not only prefer, but also expect. In our mortgage area, we performed a thorough review of methodologies and operations, uncovering opportunities to enhance processes and delivery. In our retirement and benefits business, we began a partnership with an outside firm to conduct a thorough analysis of processes and practices throughout the operation. And in 2017, we are redesigning our company to better serve the needs of our customers; many of the changes are reflected in the leadership structure of our company listed on page 17.

These are but a few examples of the decisions we are making on a constant basis in order to achieve the right balance. By continuing to operate with this theme in mind, we believe we are positioning ourselves for long-term success with respect to our customers, our stockholders, and our enterprise.

## FOUR PILLARS OF SUCCESS

We have defined four key components of our business that demand ongoing attention if we are to maintain a steady course. We must focus on meeting customer expectations, supporting our employees, achieving operational excellence, and optimizing our financial performance. We refer to these components as our Pillars of Success, and we have built strategic plans around each of them. This year's Annual Report highlights our accomplishments from 2016 and offers a glimpse into our direction for the future with respect to each pillar.

## FAREWELL TO TWO LEADERS

I must take a moment to acknowledge two people who played crucial roles in the success of our company over the years. John Flesch, who served as executive vice president of our retirement and wealth management areas, retired at the end of 2016. He guided our retirement group through multiple acquisitions and the challenges that came along with them. During John's tenure, our retirement division grew from a relatively localized operation to a nationwide service provider administering \$25.0 billion in assets. Bart Holaday, who has served on our board of directors since 2008, will retire in May 2017. It is safe to say we would not be where we are today as a company without his strong, informed voice in the boardroom. On behalf of everyone at Alerus, I say thank you to these two leaders, for your dedication, your loyalty, and your commitment to making this company better. We will do our best to live up to the high standards you have set for us.

## THANK YOU

As always, thank you to everyone who supports our company. To stockholders and customers, know that we work every day to repay the trust you've placed in Alerus. To our board of directors, your insight, guidance, and support means everything in our quest to become a high-value professional services company. Similarly, to our management team, thank you for displaying the courage and vision needed to take us in new directions. Most of all, to every employee, I extend my deepest and most heartfelt appreciation for everything you do on behalf of Alerus. You are the primary reason Alerus is able to continually excel.



**Randy L. Newman**  
Chairman, President, and CEO

ALERUS HAS BEEN AN *active acquirer* FOR THE PAST DECADE, EXECUTING A SERIES OF STRATEGIC PURCHASES THAT ALLOWED US TO BUILD A DIVERSIFIED FRANCHISE AND *expand into growth markets*. THOSE ACQUISITIONS TRANSFORMED OUR COMPANY INTO A HIGH-VALUE PROFESSIONAL SERVICES

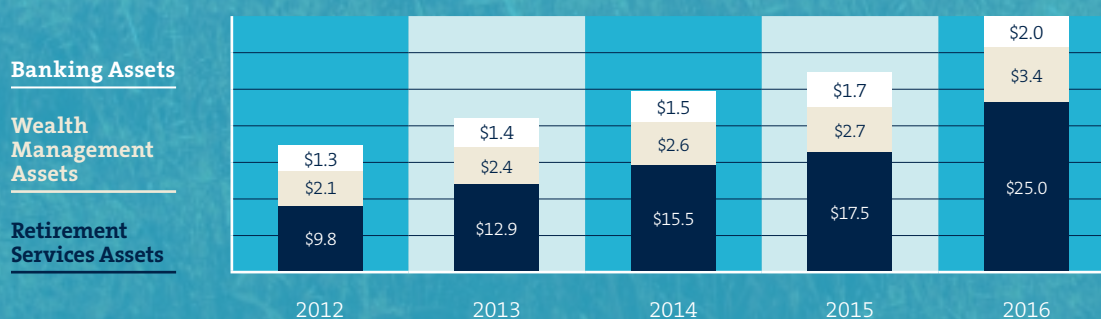
Since 2008 when we took advantage of industry disruption to build the market franchise of Alerus, company revenue has increased from \$66.5 million to \$168.0 million, and our market capitalization has increased from \$100.0 million to more than \$235.0 million. During that time, our common equity has increased from \$82.4 million to more than \$170.0 million, and we have returned \$35.7 million to stockholders in the form of cash dividends. Our stock price has more than doubled since 2012. Looking further back provides more perspective on our performance history: Since 1981, on average we have paid out 29 percent of our earnings to stockholders, retaining the rest to buy back more than \$34.0 million in stock, fund acquisitions, and fuel growth.

Although our track record for increasing stockholder value has been exemplary, 2016 was a different kind of year. As anticipated, we incurred substantial one-time expenses related to the integration of our two largest acquisitions, Beacon Bank and Alliance Benefit Group North Central States, Inc. (ABGNCS). These expenses were planned and necessary to retain customers and employees. Additionally, given our robust history of acquisition activity, we accumulated

significant intangible assets, as is common for acquirers. This resulted in increased amortization expenses (and a decrease in earnings) as we are able to write off or expense most of the purchase price. We expect those amortization expenses to decrease as we move into a period of organic growth. Together these expenses contributed to a decrease in our reported earnings, from \$1.21 per share in 2015 to \$1.00 in 2016. Expenses stemming from the realignment of our facilities contributed as well, as did ongoing investments in technology and infrastructure, all necessary as our industry becomes more and more driven by digital.

The integration and facilities closure expenses were one-time costs that affected our earnings this year, but will not affect earnings in future years. And, intangible amortization expenses carry no cash impact beyond reducing our taxable income. As a result, while the acquisitions led to higher costs that negatively impacted earnings in 2016, these costs will pass through and reveal the growth those transactions provide. The accompanying Management's Discussion and Analysis provides more insight on this topic and our overall financial performance.

#### ASSET GROWTH (IN BILLIONS)

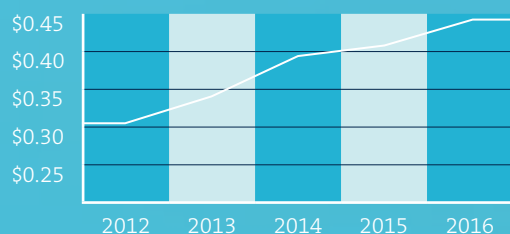




PROVIDER, *increased our revenue and earnings*, AND ALLOWED US TO RETURN MORE VALUE TO YOU, OUR STOCKHOLDERS. TODAY, AS WE PREPARE TO TURN INWARD AND FOCUS ON ORGANIC GROWTH, WE PAUSE TO SHARE A BRIEF SYNOPSIS OF THE VALUE GENERATED *for you* DURING THIS PERIOD OF RAPID CHANGE.

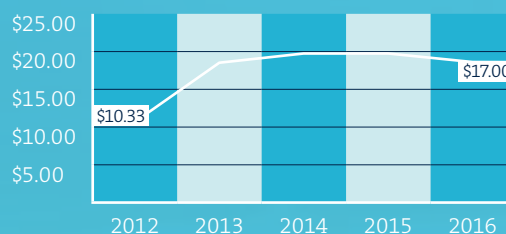
### DIVIDENDS AND EARNINGS PER SHARE

#### Dividends per share (DPS)

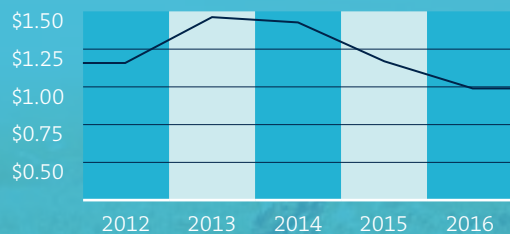


### STOCKHOLDER VALUE

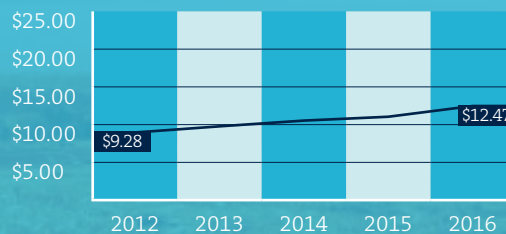
#### Year-end stock price



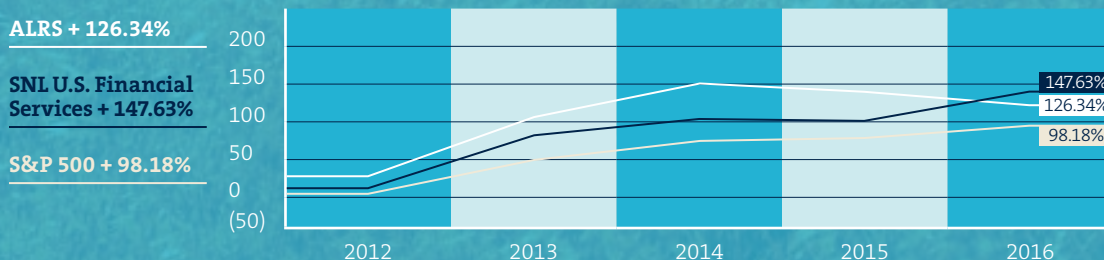
#### Earnings per common share (EPS)



#### Book value per share



### STOCKHOLDER TOTAL RETURN (%) CUMULATIVE



One of the keys to increasing stockholder return is to maximize the revenue and earnings contributions afforded to us through our newly expanded products, services, and customer base. That will be a focal point in our ongoing efforts to deliver stockholder value. As a company, we make calculated decisions about how to grow and conduct our business. Stockholder return will always be a pivotal factor in those calculations.





## FINANCIAL PERFORMANCE\*

Reported net income of \$14.0 million, down 18 percent from 2015.

Cash dividends per share were \$0.44 per share, up 4.8 percent from 2015.

Diluted earnings per share of \$1.00, down 17.4 percent from 2015.

Return on average assets (ROA) of 0.73 percent, down from 1.12 percent in 2015.

Return on equity (ROE) of 8.3 percent, down from 10.51 percent in 2015.

Return on tangible common equity (ROTCE) of 14.88 percent, up from 13.41 percent in 2015.

Company revenue of \$168.0 million, up 15.0 percent from 2015.

- Banking division revenue of \$69.3 million, up 17.4 percent from 2015.
- Mortgage division revenue of \$28.3 million, up 14.9 percent from 2015.
- Retirement services division revenue of \$57.8 million, up 13.2 percent from 2015.
- Wealth management division revenue of \$12.6 million, up 10.7 percent from 2015.

## STRONG CUSTOMER GROWTH

Total loans grew \$240.0 million to \$1.37 billion from 2015.

Total deposits grew \$327.2 million to \$1.79 billion from 2015.

Total assets under administration grew \$7.6 billion to \$25.0 billion from 2015.

Total assets under management grew \$680.0 million to \$3.4 billion from 2015.

## CONTINUED STRONG CREDIT QUALITY

Total nonperforming assets decreased \$2.4 million or 20.3 percent from the fourth quarter of 2015; nonperforming assets to total loans plus other nonperforming assets equaled 0.7 percent at year-end 2016 compared to 1.0 percent at year-end 2015.

Allowance for loan losses to nonperforming loans was 204 percent at year-end 2016, compared to 132 percent at year-end 2015.







### **MAINTAINED STRONG CAPITAL RATIOS, YEAR-END 2016**

Common equity tier 1 ratio of 7.74 percent.  
Tier 1 capital ratio of 8.23 percent.  
Total risk-based capital ratio of 12.29 percent.  
Tier 1 leverage ratio of 6.85 percent.

### **ACQUISITIONS/EXPANSIONS**

Completed the acquisition of Beacon Bank in Minnesota, adding \$350.0 million in banking assets, three new offices in the Twin Cities, and entering a new market with two branches in Duluth. This is the largest bank transaction in company history.

Completed the acquisition of Alliance Benefit Group North Central States, Inc. (ABGNCS) in Eden Prairie and Albert Lea, Minnesota, adding 900 retirement plans, 75,000 participants, \$6.0 billion assets, and new services including payroll, HSA/FSA/HRA, and COBRA. This is the largest retirement transaction in company history.

### **CUSTOMER ENHANCEMENTS**

Introduced updated account platform for retirement plan participants and sponsors.

Issued chip-enabled (EMV) debit cards to improve security for all bank customers.

Introduced mobile deposit capability for business banking customers.

### **COMPANY DEVELOPMENTS**

Realigned company footprint for the future to shift resources from physical branches to digital technology, including closing two bank branches in Fargo and one in the Twin Cities, opening a new operations center in Fargo to bring cross-functional teams together, and remodeling several locations to better utilize space.

Redeemed all Series A SBLF Preferred Stock originally issued in 2011.

Received affirmation of investment-grade ratings from Kroll Bond Rating Agency: BBB+ for senior unsecured debt, BBB for subordinated debt, and K2 for short-term debt.

Assumed \$10 million in trust preferred securities (TRUPS) through the purchase of Beacon Bank.

## HOLDING TRUE TO OUR PURPOSE.

*From the first savings account* TO THE FIRST DAY OF RETIREMENT, AND FROM OPENING A NEW BUSINESS TO SELLING A COMPANY, *we have the opportunity* TO ACCOMPANY OUR CUSTOMERS THROUGHOUT THEIR FINANCIAL JOURNEY. WITH THAT OPPORTUNITY COMES RESPONSIBILITY *to do what is right for customers*, TO SAFEGUARD THEIR INFORMATION, AND TO SERVE IN THEIR BEST INTEREST EVERY DAY.

### ONE CHANCE TO MAKE A FIRST IMPRESSION

With the acquisitions of Beacon Bank and Alliance Benefit Group North Central States, Inc. (ABGNCS) came thousands of new banking customers, tens of thousands of new retirement plan participants, and many new advisor relationships. It is true that such an expansion of our customer base presents exciting opportunities for future growth and the creation of deep relationships with these new clients. But it is likewise true that the availability of those opportunities over the long term depends in large part on our ability to make a strong, positive impression in the short run.

One way to measure that short-run success is through customer retention. We are pleased to report that, thanks to the commitment and skill of teams from across our company, we exceeded our goals for customer retention for both of the acquisitions. Incorporating the lessons learned from more than a dozen previous acquisition experiences, we focused more than ever on proactively communicating with our new customers, keeping them informed of overall progress, notifying them of changes that may impact their day-to-day interactions with us, and impressing upon them our desire and ability to guide them through this period of change.

We are confident in saying that we succeeded in making the kind of first impression that will lead our new customers to view Alerus as a partner on whom they can rely. Our ability to validate that viewpoint will be critical as we move forward with showcasing the diversity and strength of our company to customers, both new and existing.

### BUILT TO BENEFIT CUSTOMERS

Our organizational model – Alerus as a high-value professional services company delivering solutions in the context of a real relationship – is about continually finding ways to do things more effectively for our customers. There are certainly larger institutions offering all the products that we do, but we believe our customer-first philosophy and approach adds value to a customer's bottom line in ways that cannot be replicated through other means.

2016 provided an opportunity to begin showcasing the benefits of our model to the customers we welcomed as part of the acquisitions. This effort is still in its early stages, but we are already beginning to see exciting examples of customers taking advantage of the value we can provide. For instance, former Beacon Bank customers now have convenient access to wealth management, mortgage, and retirement services, all from Alerus, and all provided to the customer through one primary point of contact who helps simplify the experience.

This illustrates how the diversified nature of our company, coupled with our customer-centric approach, has us poised to grow along with our customers. Expanding our relationships with customers the right way, by providing the right solution at the right time, is key to organic growth and building stockholder value. You will surely notice the repeated use of the word “right” here. It is meant to convey that our company culture prioritizes the interests of the customer. Our reputation and prosperity as a company depend on one asset: the trust of our customers. And that is an asset we will never risk.





## ENHANCING THE CUSTOMER EXPERIENCE

We constantly search for ways to improve our delivery, create more meaningful customer touchpoints, and make it easier for customers to interact with us. This year was certainly no exception as we rolled out a variety of enhancements designed to benefit customers across the company.

In the retirement area, we launched a redesigned account platform that improves the user experience for plan participants and plan sponsors who log in to their accounts online. With a more modern interface, more tools, and an improved structure, participants and sponsors can now accomplish their tasks more efficiently and find the information they desire more easily.

Customers received new debit cards featuring chip-protected EMV technology. The added security provided by these cards is another layer of protection in the ever-evolving fight against fraud and identity theft. For business banking customers, we introduced a convenient mobile deposit feature, making it possible for these customers to make deposits from the mobile app. Mobile deposit reduces the need to travel to a branch, freeing up precious time for business owners who never have enough hours in the day.

These are but a few of the steps we took during 2016 to provide added benefits to customers. There are others, such as continual information security enhancements, that the customer may never see, but which bolster our ability to protect their critical information. We look forward to implementing future enhancements, some very visible, others in the background, that will allow us to continue to meet rising expectations. The alignment of our company with new technology will be crucial to those efforts.

## GOING WHERE CUSTOMERS LEAD

A strong case could be made that the digital empowerment of consumers has been the overriding business trend of this decade. We now live in a world where it is possible, for example, to order products online or through apps and have them delivered in a matter of hours or even faster – by drone. The existence of these services reflects the high expectations and demands for immediacy of today's consumer. The financial services industry feels those demands as well, as more and more customers adopt technology as their primary means of interacting with their institutions.

Recognizing the shift to digital in our own customer base, and understanding that the pace of the shift is only expected to accelerate, we made the decision to close three of our physical branches in November, two in Fargo and one in the Twin Cities. Upon careful consideration of the investments we must make in order to provide customers the service they expect and deserve, we are convinced that providing user-friendly technology is the best way to adapt to changing customer behavior.

## THE INTERESTS OF CUSTOMERS AND STOCKHOLDERS ALIGN

To deliver stockholder value over the long run, we must be fully committed to meeting customers where they are and proactively taking steps to delight them, earn their trust, and earn their business. We will continue taking the steps and making the investments needed to provide the kinds of outstanding customer experiences that translate to added stockholder value.

Likewise, we will continue searching for opportunities to reach more new customers and for the chance to demonstrate to them the distinctive qualities that make Alerus special.



## DELIVERING ON PROMISES.

A COMPANY LABELING ITSELF A *professional services provider*, AS WE DO, MUST TAKE CARE TO BUILD AND NURTURE A *professional culture*. AFTER ALL IT IS OUR EMPLOYEES, AS THE PUBLIC FACES OF THAT CULTURE, WHO PROVIDE THE SERVICE THAT ULTIMATELY DETERMINES WHETHER CUSTOMERS ARE SATISFIED THAT WE *deliver on our promises*. EMPLOYEES ARE THE LIFEBLOOD OF ALERUS, AND THEIR PURSUIT OF PERSONAL AND TEAM EXCELLENCE SUSTAINS US.

### INTEGRATING NEW EMPLOYEES

With the acquisitions of Beacon Bank and Alliance Benefit Group North Central States, Inc. (ABGNCS) at the beginning of the year, our talent pool grew larger and deeper. More than 150 new employees joined our organization, and from the beginning they showed a genuine desire to understand our company and assimilate into our culture. Going into the acquisitions, we knew both companies had cultures that were compatible with ours, but the enthusiasm the employees showed and the way they embraced change exceeded even our greatest expectations.

The credit for the smooth transition belongs to all of our employees, who went far above and beyond in working to bring us all together as one Alerus. Much of the leadership from both Beacon and ABGNCS agreed to join our company, bringing with them decades' worth of institutional knowledge and experience that greatly benefited us during the integration process. It was undoubtedly challenging for these key people to go through a period of such fundamental change after enjoying success at their own companies, but they showed nothing but excitement at being part of Alerus.

Our existing leadership executed a variety of programs and events that helped show our new colleagues what we mean when we say that Alerus values an environment of professionalism. In February, about a month following the close of both acquisitions, we held an all-employee gathering where new and existing employees were able to gather together to celebrate the evolution of our growing company. In the subsequent months, Alerus team members provided training on everything from our organizational structure to how to accomplish their day-to-day tasks within our systems and processes. And all of these efforts helped reinforce the message that we are a high-value professional services company, and a place where professionals can thrive.

The conversion process is never easy, and we sincerely thank everyone, from individual contributors to senior executives, for the hard work and determination they showed in moving us forward, together.

### CULTIVATING LEADERS

Recognizing that our current and future prosperity hinges in large part on the strength and vision of leaders, we continue to build on our internal leadership programs. Our programs take would-be leaders on a journey from self-leadership to executive leadership with a series of intermediate steps along the way.

Each phase of the process pushes the employee to cultivate new skills and adopt new behaviors befitting leaders in positions of increasing responsibility. In this fashion we are building a pipeline of future leaders capable of maintaining and improving upon the success we have enjoyed so far.



### **RANDY NEWMAN NAMED ENTREPRENEUR OF THE YEAR**

In June, Alerus Chairman, President, and CEO Randy Newman was named 2016 Ernst & Young Entrepreneur Of The Year® Upper Midwest. Upon receiving the award Randy stated, "Banking may not always be the first profession that comes to mind when you think of entrepreneurs, but we encourage all of our employees to work with an entrepreneurial spirit and take ownership of their roles. I share this award with the entire Alerus team."

### **STAYING CONNECTED**

One of the results of our growth in recent years is that we now have employees located around the country. With offices from New Hampshire to Arizona, as well as remote employees, staying connected with each other and maximizing the effectiveness of our teams requires more than just emails and phone calls. That is why we partnered with a world-class provider in 2016 to launch our new corporate intranet, Concourse, in June.

Concourse has opened up the communication lines more than ever, allowing management to deliver messages to employees and employees to engage with each other more easily. The platform, which takes some cues from social media tools like Facebook and LinkedIn, fosters collaboration and a sense of belonging, no matter where an employee may be physically located. It helps centralize information about Alerus, making training easier and onboarding new employees more efficient. We expect Concourse to play an integral role in helping all of us stay connected, no matter where we are at a given moment.

### **MAKING A MARK ON OUR COMMUNITIES**

Community involvement is part of our company culture; we consider it a privilege to be a part of each community in which we operate, and we support a number of organizations across our markets through financial contributions and employee volunteerism. In 2016, Alerus donated over \$950,000 to a wide range of recipients, including community events like the Grand Forks Wild Hog Marathon, important community initiatives such as the Jeremiah Program in Fargo and Duluth LISC (Local Initiatives Support Corporation), and other organizations working to improve our communities, including the United Way, YMCA, Second Harvest Heartland, and American Red Cross. These are only a handful of the difference-making organizations we supported throughout the year.

Our commitment to communities is more than financial; Alerus employees collectively donated thousands of hours of their time to the causes they cherish. We encourage this charitable spirit by providing every employee paid time off each year to volunteer at nonprofits of their choosing. We are humbled that we as a company are able to extend our hands and open our hearts to those who need it the most.

## DEFINING THE FUTURE.

TO KEEP ALERUS ON THE RIGHT COURSE, WE *continually strengthen* OUR OPERATIONS TEAMS, TOOLS, AND PROCESSES SO WE ARE PREPARED TO TAKE ADVANTAGE OF *opportunities* AND OVERCOME OBSTACLES AS THEY ARISE.

### CYBERSECURITY AT THE FOREFRONT

The security of sensitive information remains of paramount concern in an environment in which outside threats to electronic financial data are more numerous and harbor more damaging potential than ever before. Cybercriminals and hackers continue growing bolder; in 2016 the nation witnessed security breaches of government systems at the IRS and the Office of Management and Budget, and in the private sector at globally recognized companies like Yahoo and LinkedIn.

Alerus continues to proactively develop processes and programs that enhance the safety of our customer and company information. This year we augmented our vulnerability management procedures, allowing us to more quickly identify, understand, and remediate vulnerabilities as they become known. We also implemented upgraded controls around data loss prevention, providing even more protection for customer data. Finally, we continually tested our defenses against ransomware – the malicious code, delivered through emails or compromised websites, which can prevent a company from accessing its own data until the company accedes to the demands of the cybercriminal who deployed the code. Ransomware was responsible for a number of notable attacks on core banking systems, hospitals, and other businesses around the world this year.

The acquisitions of Beacon Bank and Alliance Benefit Group North Central States, Inc. (ABGNCS) each demanded their own security assessments. We engaged in large-scale efforts to ensure that as we integrated the systems of those companies into our own, we were able to strengthen the security posture of our company as a whole. Those efforts included expanding our infrastructure to accommodate the additional customer data, evaluating policies and procedures and strengthening them where needed, and retiring systems when appropriate.

Alerus is committed to protecting customer information from cyberattacks and cyber fraud. We continue to marshal and deploy people, policies, and systems necessary to protect customers, the company, and ultimately, our stockholders. Securing our customers and our company against cyber risks will be one of the most critical and taxing aspects of financial services for many years to come. We are confronting these issues head-on and working diligently to protect customer information.

### ENTERPRISE RISK MANAGEMENT

Effective risk management is central to the continued prosperity of our company. The job of managing risk is never finished, and indeed, grows more demanding with time. In recognition of that fact, we continually adopt measures to ensure that our resources are properly aligned to meet ever-increasing demands.

We must ensure that we are viewing the company's risk profile holistically and taking action in the context of a coordinated effort rather than in silos. In order for that to happen, a company of our size and complexity must live at the confluence of people and technology.

With respect to the latter, we implemented a proven software program that helps us get the most out of our governance, risk, and compliance (GRC) approach. The program provides our leaders with more clarity about, for example, how a risk position taken in one part of the company impacts the rest of the enterprise. Further, we continue to put in place the human resources that will continue to drive our efforts forward. All of this is done to ensure we understand our environment, make decisions based on the evidence we gather, and remain proactive as we move across an evolving business landscape.



A woman with curly hair is smiling and looking down at her smartphone. She is wearing a dark top and a necklace. The background is a soft, out-of-focus light blue and white. The text is overlaid on the left side of the image.

## INTEGRATING PEOPLE AND PROCESS

The addition of an entirely new business line – payroll and health and welfare services – upon the acquisition of ABGNCS introduced a whole new spectrum of operational considerations. For the first time, we became a company administering health savings accounts, handling COBRA and state continuation, and providing payroll and human resources information systems. What could have been a steep learning curve was eased by the fact that we were able to retain so many of the experienced and skilled employees from ABGNCS who had developed expertise in these areas.

The compliance, privacy, and risk aspects of this new business line were carefully evaluated, documented, and ultimately, accounted for within the context of our operational structure. ABGNCS had established policies and procedures over the years that in some cases we imported to Alerus, and in other cases modified and then incorporated. The integration of the new business line is a good example of the strength and flexibility of our operations framework, as well as a testament to the dedication of the employees from ABGNCS who joined our company this year. Thanks to the success of these integration efforts, we are in position to fulfill our potential as a broad-based financial services company.


As we think about the future, our focus is on optimizing our operations to achieve more efficiencies and improve delivery to customers. Everything from hardware and servers to project management systems to teams of employees will be fine-tuned. This is an open-ended process that demands continued attention and revision in response to competitive pressures, rising customer expectations, and rapid industry change.

## THE FUTURE OF THE CUSTOMER.

FINANCIAL SERVICE COMPANIES HAVE LONG CLAIMED TO PLACE *customers* AT THE CENTER OF THEIR PHILOSOPHIES, OPERATIONS, AND SERVICE MODELS. THE EXTENT TO WHICH THOSE CLAIMS REFLECTED INDUSTRY REALITY COULD BE DEBATED. BUT WHAT IS NOT ARGUABLE IS THAT *customer expectations are rising*, AND TECHNOLOGY IS EQUIPPING CUSTOMERS NOW MORE THAN EVER WITH THE ABILITY TO ALIGN THEMSELVES WITH THE INSTITUTIONS THAT BEST *deliver on their promises*.







Customers across demographic groups are expressing a desire for more digital and technological interaction, but at the same time they are voicing their need for financial advice provided by professionals, in person. Creating a solution that meets these seemingly disparate preferences is not easy, but one does exist: Mold the organization into a customer experience-focused one, driven by what the customer wants rather than what the company traditionally provides.

The future prosperity of Alerus will hinge largely on how effectively we deliver – and differentiate ourselves – on both fronts, digital and personal. Our relationship-oriented business model allows us to start from a position of strength, particularly with respect to providing financial advice tailored to each customer. On the digital front, we continue

to make investments in technologies that will increase our effectiveness and remove friction from the customer experience. We are exploring ways to work with fintech firms to create integrated systems and platforms that simplify and enhance the ways customers interact with us on their favorite devices.

“Customer experience” is, for us, much more than a phrase. It encompasses everything from how we answer phones to how we gain the trust of every individual customer through each interaction. It permeates throughout our company and influences the choices we make. And most of all it is a commitment made by every employee to every customer and stockholder that we seek ways to provide value at every turn.

## IN CLOSING

2016 will be remembered as an outstanding expression of our company culture and philosophies in practice. We were able to bring together customers and employees from our two largest-ever acquisitions – Beacon Bank and ABGNCS – within a single, high-value financial services organization that acts responsibly and with customer welfare at the forefront. Thanks to the commitment of our stockholders, the support of our board, and the dedication of our employees, we are prepared to improve upon our strong performance and use the power and capabilities of our diverse organization to help customers realize their financial potential. That, after all, remains our core purpose.



## ALERUS LEADERSHIP

### SENIOR EXECUTIVE TEAM



**RANDY L. NEWMAN**  
Chairman, President, and  
Chief Executive Officer  
*36 years with Alerus*



**KRIS COMPTON**  
Executive Vice President and  
Chief Strategy Officer  
*42 years with Alerus*



**DAN J. CHEEVER**  
Executive Vice President and  
Chief Financial Officer  
*2 years with Alerus*



**ANN MCCONN**  
Executive Vice President and  
Chief Business Officer  
*15 years with Alerus*

### ALERUS LEADERSHIP COUNCIL

- Karl Bollingberg**  
Director of Lending
- Jan Fitzer**  
President of Alerus Mortgage
- Jon Hendry**  
Chief Information Officer
- Missy Keney**  
Director of Customer  
Experience and Corporate  
Communications
- Karna Loyland**  
Director of Deposits
- Chip Norris**  
Group President, Director  
of Sales and Service
- Brian Overby**  
President of Alerus  
Retirement and Benefits
- Brian Schumacher**  
Director of Wealth  
Management
- Teresa Wasvick**  
Director of Human Resources

### TWIN CITIES ADVISORY BOARD

- Dick Enrico** 2<sup>nd</sup> Shade Patio Furniture
- Larry Gamst** DS+B CPAs and Business Advisors
- Lisa Meyer** Marketing and Management Executive
- Dennis Monroe** Monroe Moxness Berg PA
- Julie Gilbert Newrai** PreciouStatus
- James Nichols** James L. Nichols CPA, LLC
- Michael Opat** Hennepin County Commissioner
- David Waldo** Banking Executive
- Bob Weiss** Banking Executive



## BOARD OF DIRECTORS

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Former Chief Administrative Officer, Piper Jaffray Companies  
Former Chief Executive Officer, Piper Trust Company, Edina, MN

### **Lloyd G. Case**

Past President and CEO of Forum Communications Company  
Board of Directors, Forum Communications, Fargo, ND

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Former Chairman and CEO, Howe Barnes Hoefler & Arnett, Chicago, IL

### **Harold A. Gershman**

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Chairman and President, Happy Harry's Bottle Shops, Grand Forks, ND

### **A. Bart Holaday**

Retired Managing Director, Brinson Partners and UBS Asset Management, Colorado Springs, CO, Grand Forks, ND

### **James J. Karley**

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### **Kevin D. Lemke**

President, Virtual Systems, Inc., Grand Forks, ND

### **Sally Smith**

President and Chief Executive Officer, Buffalo Wild Wings, Inc., Minneapolis, MN

### **Galen G. Vetter**

Retired Global Chief Financial Officer, Franklin Templeton Investments  
Former Partner-In-Charge, Upper Midwest Region, McGladrey, Minneapolis, MN

## BUSINESS LEADERS

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**Dan Doeden**, Fargo

**Sara Ausman**, Twin Cities

**Deb Otto**, Duluth

**Rob Schwister**, Phoenix

### CUSTOMER SEGMENT MANAGEMENT

#### **Jon Handy**

Consumer, Business, and Small Business

#### **Sara Ausman**

Professional Services and Private Banking

**Brad Costello**, Agriculture

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#### **Dan Jacobson**

Chief Lending Officer

#### **Randi Adams**

Chief Credit Officer

### MORTGAGE

#### **Kim Onnen**

Vice President, Operations

### RETIREMENT AND BENEFITS

#### **Laura Tiemann**

Retirement Plan Services

#### **Steve Pulley**

Benefit Services

#### **Lee Kliebert**, Retirement

Plan Advisory Services

#### **Nels Carlson**

ESOP Fiduciary Services

### WEALTH MANAGEMENT

#### **Sunil Swami**, Chief

Investment Officer

#### **Doug Carpenter**

Alerus Investment and Fiduciary Services

#### **Brian Kraft**

Alerus Securities

### CORPORATE STAFF

#### **Chad Johnson**

Audit Management

**Bonnie Upham**, Compliance

**Scott Fenske**, Legal

**Mark Nelson**, Enterprise

Risk Management

#### **Kyle Hendrickson**

Information Security

**Jerrod Hanson**, Accounting

**Travis Ingebrigtsen**, Finance

#### **A.J. Zielike**

Branch Operations

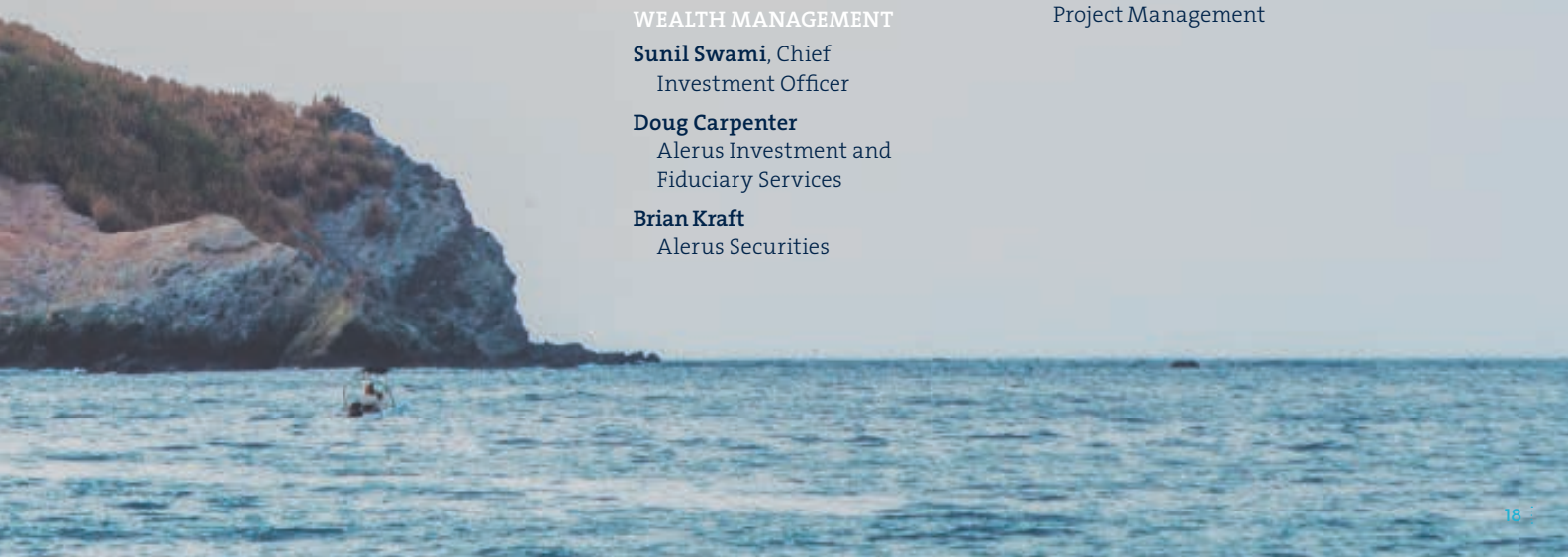
**Kara Fosse**, Marketing

#### **Chris Dunnigan**

Information Technology

#### **Tammy Schmitz**

Project Management



## A SPIRIT OF INNOVATION.

- 1879** Founded as the Bank of Grand Forks, one of the first chartered in the Dakota Territory.
- 1933** First National Bank in Grand Forks opened its doors in Grand Forks, North Dakota.
- 1985** Acquired Northwood State Bank in Northwood, North Dakota.
- 1986** Created Employee Stock Ownership Plan for our employees.
- 1987** Entered the Fargo market by purchasing West Fargo State Bank in West Fargo, North Dakota.
- 1989** Purchased Dakota Bank in Grand Forks.
- 1991** First National Bank in Grand Forks purchased the North Dakota branches of First Federal Savings & Loan in Fargo, consolidated its banks, and changed its name to First National Bank North Dakota.
- 1997** Historic flood and fire devastated Grand Forks and First National Bank North Dakota's buildings.
- 2000** First National Bank North Dakota changed its name to Alerus Financial to reflect the evolution from a traditional bank to a diversified financial services company.
- 2002** Acquired a branch of BNC National Bank in Fargo.
- 2003** Purchased Pension Solutions, Inc., a retirement plan services company located in St. Paul, Minnesota.
- 2006** Opened a trust and investment office in the Twin Cities; purchased Stanton Trust Company in Minneapolis, Minnesota.
- 2007** Opened a business banking office in Minnetonka, Minnesota; purchased the retirement recordkeeping services unit of Acclaim Benefits, Inc. in Minneapolis; acquired Stanton Investment Advisors, Inc., a Minneapolis-based investment advisory firm.
- 2009** Expanded into Phoenix, Arizona, through the purchase of a bank branch from Meridian Bank Arizona; purchased the retirement plan practice of Eide Bailly, LLP, in Minneapolis, Minnesota; acquired deposits from BankFirst in Minneapolis, Minnesota; acquired Prosperan Bank in Oakdale, Maplewood, and Minnetonka, Minnesota; acquired Residential Mortgage Group in Minnetonka and Arden Hills, Minnesota.
- 2011** Acquired selected loans and deposits from BNC National Bank in Minnesota and Arizona, and a branch of BNC in Scottsdale, Arizona.
- 2012** Purchased PensionTrend Inc. and PensionTrend Investment Advisors, LLC, in Okemos, Michigan.
- 2013** Purchased Tegrit Administrators, LLC.
- 2014** Purchased Private Bank Minnesota in Minneapolis, Minnesota; purchased Retirement Alliance, Inc., in Manchester, New Hampshire.
- 2015** Purchased Interactive Retirement Systems, LTD, in Bloomington, Minnesota.
- 2016** Purchased Beacon Bank in Shorewood, Excelsior, Eden Prairie, and Duluth, Minnesota; purchased Alliance Benefit Group North Central States, Inc., in Albert Lea and Eden Prairie, Minnesota.

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**ALERUS**

BANKING :: MORTGAGE :: RETIREMENT :: WEALTH MANAGEMENT

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# FINANCIAL REPORT



**TABLE 1 – SELECTED FINANCIAL DATA**
*Year ended December 31,*
*(dollars in thousands, except per share amounts)*

	2016	2015	2014	2013	2012
<b>Income Statement Data:</b>					
Interest income	\$ 69,942	\$ 56,328	\$ 54,394	\$ 50,510	\$ 52,852
Interest expense	7,002	3,458	3,316	3,712	4,586
Net interest income	62,940	52,870	51,078	46,798	48,266
Provision for credit losses	3,060	4,200	(400)	1,200	833
Net interest income, after provision for credit losses	59,880	48,670	51,478	45,598	47,433
Non-interest income	105,081	93,255	78,406	79,269	79,115
Non-interest expense	143,792	118,134	100,115	92,913	100,834
Income before income taxes	21,169	23,791	29,769	31,954	25,714
Income tax expense	7,138	6,683	8,999	11,417	9,109
Net income	\$ 14,031	\$ 17,108	\$ 20,770	\$ 20,537	\$ 16,605
Diluted earnings per common share	\$ 1.00	\$ 1.21	\$ 1.48	\$ 1.48	\$ 1.20
<b>Performance Ratios:</b>					
Net interest margin	3.63%	3.81%	3.97%	3.94%	4.52%
Return on average total assets	0.73%	1.12%	1.45%	1.57%	1.39%
Return on average common equity	8.30%	10.51%	14.26%	15.60%	13.94%
Return on average tangible common equity	14.88%	13.41%	17.11%	18.23%	17.14%
Efficiency ratio	85.58%	80.84%	77.32%	73.70%	79.16%
<b>Balance Sheet Data:</b>					
Cash and due from banks	\$ 207,367	\$ 266,159	\$ 45,526	\$ 72,544	\$ 123,679
Investment securities	278,911	192,343	206,101	279,672	263,659
Mortgages held for sale	35,063	48,642	35,042	30,254	77,432
Loans	1,366,952	1,126,921	1,095,458	914,564	770,778
Allowance for loan and lease losses	(15,615)	(14,688)	(17,063)	(16,838)	(15,101)
Goodwill	27,329	3,683	3,264	664	664
Other intangible assets	37,506	21,751	22,442	15,014	15,251
Total assets	2,050,579	1,744,863	1,487,732	1,381,727	1,323,087
Deposits	1,785,209	1,458,021	1,262,168	1,182,603	1,115,750
Long-term debt	58,813	70,744	21,494	21,630	21,755
Total liabilities	1,881,794	1,562,042	1,316,646	1,228,416	1,181,806
Stockholders' equity	168,785	182,821	171,086	153,311	141,281
<b>Capital:</b>					
Common equity tier 1 ratio	7.7%	10.9%	N/A	N/A	N/A
Tier 1 capital ratio	8.2%	12.3%	11.8%	12.8%	12.8%
Total capital ratio	12.3%	17.0%	13.0%	14.1%	14.1%
Tier 1 leverage ratio	6.9%	10.9%	10.1%	10.6%	9.9%
Tangible common equity / tangible assets	5.5%	8.2%	8.8%	8.8%	9.2%
<b>Asset Quality:</b>					
Nonperforming assets	\$ 9,581	\$ 12,028	\$ 6,484	\$ 10,265	\$ 16,326
OREO	1,721	842	2,478	4,877	9,387
Nonperforming assets / loans and other real estate	0.70%	1.07%	0.59%	1.12%	2.09%
Net charge-offs (recoveries) / average total loans	0.16%	0.58%	-0.06%	-0.06%	-0.20%
Allowance for loan and lease losses / total loans	1.14%	1.30%	1.56%	1.84%	1.96%
Allowance for loan and lease losses / nonperforming loans	203.74%	131.72%	427.11%	313.15%	218.22%
<b>Other:</b>					
Assets under management	\$ 3,379,787	\$ 2,734,850	\$ 2,583,808	\$ 2,424,642	\$ 1,991,841
Assets under administration	25,028,090	17,459,308	15,518,303	12,860,780	9,762,247
Mortgage originations	1,065,132	986,979	729,913	1,028,208	1,174,514

# ABOUT ALERUS FINANCIAL CORPORATION

Alerus Financial Corporation (the “Company”) is a diversified financial services firm with \$2.0 billion in banking assets, \$3.4 billion of assets under management and \$25.0 billion of assets under administration. The Company, through its subsidiaries Alerus Financial, N.A. (the “Bank”) and Alerus Securities Corporation, offers business and consumer banking products and services, residential mortgage financing, employer-sponsored retirement plan administration and employer sponsored services including payroll, health savings accounts, flexible spending accounts, health reimbursement arrangements, and COBRA administration, and wealth management services including trust, brokerage, executive insurance, and asset management. The Company’s banking and wealth management offices are located in Grand Forks and Fargo, North Dakota, the Minneapolis-St. Paul and Duluth, Minnesota metropolitan areas, and Scottsdale, Arizona. Alerus Retirement and Benefits administers plans in all 50 states through offices located in St. Paul and Albert Lea, Minnesota, East Lansing and Troy, Michigan, and Manchester, New Hampshire. The common stock of the Company trades on the OTCQX market under the symbol ALRS.

## RECENT EVENTS

### ACQUISITIONS

During the two years ended December 31, 2016, the Company completed the following acquisitions:

#### **Beacon Bank**

On January 15, 2016, the Company acquired Beacon Bank and its five branches, three located in the southwestern suburbs of Minneapolis, Minnesota and two in Duluth, Minnesota. The Company assumed \$325.5 million of deposits and other liabilities, including \$7.8 million of trust preferred securities, and purchased \$352.6 million in cash, securities, loans, and other assets at fair value. As part of the transaction, the Company allocated \$18.8 million to goodwill and \$3.8 million to a core deposit intangible. The core deposit intangible is being amortized over the estimated life of five years, resulting in an annualized intangible amortization expense of \$759 thousand, while the goodwill is not subject to amortization.

#### **Alliance Benefit Group North Central States, Inc. (ABGNCS)**

On January 1, 2016, the Company acquired Alliance Benefit Group North Central States, Inc. (ABGNCS), with locations in Albert Lea and Eden Prairie, Minnesota. The purchase, consisting of approximately 900 retirement plans with more than 75,000 retirement participants, grew the Company’s retirement division by \$6.0 billion in retirement and individual asset managed accounts. As part of the transaction, \$4.8 million was allocated to goodwill and \$17.9 million to an identified customer intangible, based on the estimated value as of the acquisition date. The identified customer intangible is being amortized over the estimated life of ten years, resulting in an annualized intangible amortization expense of \$1.8 million, while the goodwill is not subject to amortization.

#### **Interactive Retirement Systems, LTD**

On January 2, 2015, the Company acquired Interactive Retirement Systems, LTD, located in Bloomington, Minnesota. The purchase, consisting of approximately 160 retirement plans with more than 16,200 retirement participants, grew the Company’s retirement division by \$1.3 billion in retirement and individual asset managed accounts. As part of the transaction, \$3.8 million was allocated to an identified customer intangible and \$420 thousand to goodwill, based on the estimated value as of the acquisition date. The identified customer intangible is being amortized over a 10-year period, resulting in an annualized intangible amortization expense of \$378 thousand, while the goodwill is not subject to amortization.

### SUBORDINATED NOTES OFFERING

On December 17, 2015, Alerus issued \$50 million of subordinated notes maturing December 30, 2025. The Kroll Bond Rating Agency assigned a rating of BBB+ on the Company’s senior unsecured debt and BBB on its subordinated debt, and a rating of A- on the senior unsecured debt of the Bank. The notes bear a fixed rate of interest at 5.75%, through December 30, 2020, and then convert to floating rate notes that reset quarterly to an interest rate equal to three month LIBOR plus 412 basis points. Through December 30, 2020, interest is payable semi-annually on June 30 and December 30, and thereafter interest is paid quarterly on March 30, June 30, September 30, and December 30. The subordinated notes qualify as Tier 2 capital for regulatory purposes. The proceeds were utilized primarily to retire the Small Business Lending Fund preferred stock of \$20.0 million and for the acquisitions of ABGNCS and Beacon Bank. In December of 2016, the Kroll Bond Rating Agency affirmed the ratings on the Company.

### SMALL BUSINESS LENDING FUND PREFERRED STOCK

On February 16, 2016, Alerus redeemed \$20.0 million of Small Business Lending Fund (SBLF) preferred stock, which had been outstanding since August 8, 2011. The SBLF had a dividend rate of 1.0 percent that was scheduled to reset to 9.0 percent on February 18, 2016. The SBLF qualified as Tier 1 capital for regulatory purposes.

### BRANCH AND FACILITIES CONSOLIDATIONS

In August 2016, the Company announced the closure and consolidation of three branch offices, two in Fargo, North Dakota, and one in Maplewood, Minnesota, effective November 23, 2016. The loans and deposits of the branches were consolidated into other Bank offices within those markets. The cost of closing these facilities was \$1.5 million and was recorded in 2016, with the benefits to be realized in future periods. The Company has continued to consolidate other facilities, either acquired through acquisitions or leased by the Company, to reduce operating expenses and improve efficiencies. During 2016, the Company vacated three leased facilities, consolidating operations units into other locations. In the first quarter of 2017, two additional locations were also vacated as leases expired.



## **COVERED ASSET AND RELATED FDIC LOSS-SHARE INDEMNIFICATION ASSET**

Effective January 1, 2015, the losses on commercial-related loans (commercial, commercial real estate, and construction real estate) acquired in the FDIC-assisted acquisition of Prosperan Bank ceased being covered under the loss-share agreement. The carrying amount of those loans was \$10.7 million as of December 31, 2014. Any recoveries, net of expenses, received on commercial-related loans on which losses were incurred prior to January 1, 2015, will continue to be covered by the loss-share agreement (and any such net recoveries must be shared with the FDIC) through December 31, 2017. Losses and recoveries on single-family related loans acquired in connection with the Prosperan Bank transaction will continue to be covered under the loss-share agreement through December 31, 2019.

In connection with the Prosperan Bank acquisition in 2009, the Bank agreed to pay the FDIC, if the estimated losses on the acquired loan portfolios as well as servicing fees earned on the acquired loan portfolios fail to satisfy certain thresholds set forth in the loss sharing agreements (the “true-up liability”). This contingent consideration is classified as a liability within other liabilities on the Consolidated Balance Sheet and is re-measured at fair value each reporting date until the contingency is resolved. The changes in fair value are recognized in non-interest income or expense. The fair value of the true-up liability associated with the Prosperan Bank acquisition was \$2.9 million and \$2.8 million as of December 31, 2016, and 2015, respectively.

## **TAX**

In 2015, Alerus made two contributions, totaling \$1.0 million, to housing-related projects in North Dakota, sponsored by the North Dakota Housing Incentive Fund, for which the Company received a State of North Dakota

income tax credit of \$1.0 million. The contributions are tax deductible for Federal Income tax purposes, and increased other operating expenses by \$1.0 million, but reduced North Dakota state income tax expense by the same amount. The full tax credit was not utilized in 2015, resulting in a deferred tax asset, which was utilized in 2016 and will continue to be utilized in future years.

## **NEW ACCOUNTING GUIDANCE**

In March 2016, the Financial Accounting Standards Board (FASB) issued ASU 2016-09, “Compensation – Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting,” an update that changes the accounting for certain aspects of share-based payments to employees. The updated guidance requires excess tax benefits and tax deficiencies to be recorded in the income statement when the awards vest or are settled. Previously, excess tax benefits and certain tax deficiencies were recorded in additional paid-in capital. In addition, cash flows related to excess tax benefits will no longer be separately classified as a financing activity. The update also allows entities to repurchase more of an employee’s shares for tax withholding purposes without triggering liability accounting, clarifies that all cash payments made on an employee’s behalf for withheld shares should be presented as a financing activity on its cash flows statement, and provides an accounting policy election to account for forfeitures as they occur. The update is effective for fiscal years beginning after December 15, 2016, including interim periods within those fiscal years. Early adoption is permitted in any interim or annual period. The Company adopted the updated guidance effective January 1, 2016, and adjusted the financial presentation affecting prior periods’ retained earnings and net income by immaterial amounts.

# FINANCIAL PERFORMANCE

The following is management's discussion and analysis of the significant changes in the results of operations, capital resources, and liquidity presented in the accompanying consolidated financial statements. The Company's consolidated balance sheet and income statement are comprised primarily of the financial condition and results of operations of the Bank. Current performance does not guarantee, and may not be indicative of, similar performance in the future. For more information on the factors that could affect performance, see "Forward Looking Statements."

## EARNINGS SUMMARY

Net income was \$14.0 million or \$1.00 diluted earnings per common share in 2016, compared to \$17.1 million or \$1.21 diluted per share for 2015, and \$20.8 million or \$1.48 diluted per share for 2014. The Company's financial performance in 2016 includes \$6.7 million of nonrecurring expenses, \$4.0 million incurred in the acquisitions of ABGNCS and Beacon Bank, \$1.5 million related to the closure of three branch offices, \$0.4 million for prepayment fees on FHLB advances and \$0.8 million of other expenses. The Company's 2016 earnings also reflect \$7.0 million of amortization of identified intangibles from acquisitions, which lower earnings per share, net of taxes, by \$0.30, compared to \$4.4 million or \$0.19 per share in 2015. The net income and earnings per share over the last five years are illustrated in **Charts A** and **B**, respectively.

Revenue, the sum of net interest income and non-interest income, was \$168.0 million in 2016, compared with \$146.1 million in 2015, and \$129.5 million in 2014. The Company's diversified revenue model continues to generate strong core earnings, reflecting revenue growth in all business lines: banking, mortgage, retirement and benefit services, and wealth management. The increase in revenue for 2016 compared to 2015 was predominantly due to the acquisitions of Beacon Bank and ABGNCS, and higher mortgage originations. Retirement services revenue increased by 13.2% as a result of the acquisition of ABGNCS on January 1, 2016, as well as organic growth in the business. The increased level of mortgage originations during 2016 (\$1.1 billion vs. \$987 million in 2015) increased mortgage banking revenue by 14.9%. In 2016, non-interest income of \$105.1 million represented 63% of revenue, compared with \$93.3 million (64%) in 2015, and \$78.4 million (61%) in 2014.

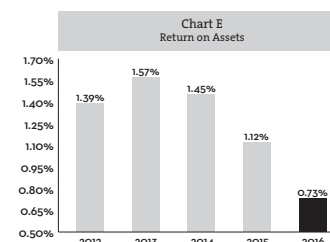
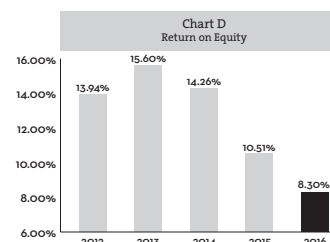
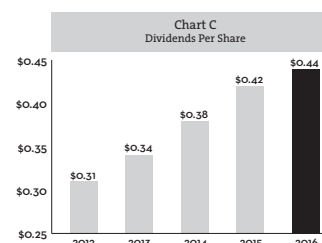
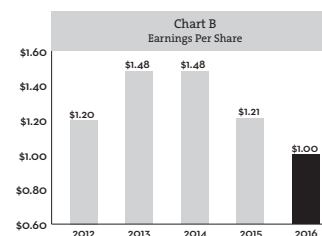
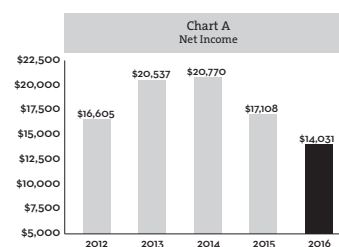
Net interest income was \$62.9 million in 2016, representing 37% of revenue, compared to \$52.9 million, or 36% of revenue, in 2015, and \$51.1 million, or 39% of revenue, in 2014. The net interest income increase in 2016 was primarily due to the acquisition of Beacon Bank in January 2016.

Non-interest expense was \$143.8 million in 2016, compared with \$118.1 million in 2015, and \$100.1 million in 2014. The increase in non-interest expense in 2016, compared to 2015, reflected higher personnel, occupancy, intangible amortization, and other operating expenses resulting from the acquisitions of ABGNCS and Beacon Bank, higher personnel expenses relating to increase mortgage origination volumes, and added infrastructure investments.

Cash dividends per common share were \$0.44 in 2016, compared to \$0.42 in 2015, and \$0.38 in 2014. The growth in cash dividends per share over the last five years is illustrated in **Chart C**.

Return on Average Common Equity (ROE) is net income stated as a percentage of average common stockholders' equity. ROE was 8.30% in 2016, compared to 10.51% in 2015, and 14.26% in 2014, as further illustrated in **Chart D**. The average ROE over the past five years is 12.52%.

Return on Average Assets (ROA) is net income stated as a percentage of average total assets. As **Chart E** illustrates, ROA was 0.73% in 2016, compared to 1.12% in 2015, and 1.45% in 2014. The average ROA over the past five years is 1.25%.



## NET INTEREST INCOME

Net interest income is the interest earned on investment securities, loans (including yield-related loan fees) and other interest-earning assets minus the interest paid for deposits, short-term borrowings, and long-term debt. Net interest margin is the average yield on earning assets minus the average interest rate paid for deposits and other sources of funding. Net interest income and net interest margin are presented on a taxable-equivalent basis in **Table 2** to consistently reflect income from taxable and tax-exempt loans and securities based on a 35.5% federal statutory rate.

While the Company believes that it has the ability to increase net interest income over time, net interest income and net interest margin in any one period can be significantly affected by a variety of factors, including the mix and overall size of our earning asset portfolio and the cost of funding those assets. Net interest income growth has been challenged during the prolonged low interest rate environment as higher yielding loans and securities runoff have been replaced with lower yielding assets.

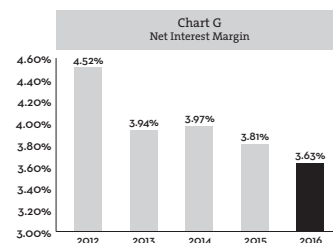
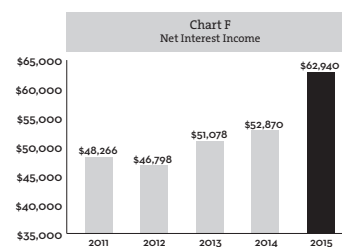
Interest income was \$69.9 million in 2016, an increase of \$13.6 million, or 24.2%, from the \$56.3 million reported in 2015 and the \$54.4 million in 2014. The increase in interest income for 2016, compared with 2015, was largely driven by higher average loans outstanding, \$1.3 billion versus \$1.1 billion at a higher average rate: 4.65% versus 4.48%. The acquisition of Beacon Bank increased both the loans outstanding and average rate on the portfolio. Average earning assets increased by \$350.5 million to \$1.75 billion in 2016; however the average rate decreased to 4.03% from 4.06% in 2015 as a result of a larger investment portfolio at lower yields.

In 2016 the average interest bearing liabilities increased by \$289.1 million to \$1.3 billion, with an average rate of 0.54%, as compared to 0.34% in 2015, as a result of the increase in long-term debt utilized to fund the acquisitions of ABGNCS and Beacon Bank. Average non-interest bearing deposits increased to \$443.5 million in 2016, from \$327.7 million in 2015.

Core deposits are an important low-cost source of funding and affect both net interest income and net interest margin. Core deposits include non-interest-bearing deposits, interest-bearing checking, certificates of deposit less than \$250 thousand, and money market savings deposits. Core deposits rose to \$1.8 billion at December 31, 2016, an increase of \$322 million from the \$1.4 billion in 2015. Net interest margin was 3.63% in 2016, down 18 basis points from 3.81% in 2015, and 3.97% in 2014 as a result of lower yields on average earning assets and higher borrowing costs.

**Chart F** illustrates net interest income on a tax equivalent basis for the past five years.

**Chart G** illustrates net interest margin for the past five years.





**TABLE 2 – AVERAGE BALANCE SHEETS AND AVERAGE RATES**  
*Year ended December 31,*  
*(dollars in thousands)*

	2016			2015			2014		
	Average Balance	Average Rate	Interest	Average Balance	Average Rate	Interest	Average Balance	Average Rate	Interest
<b>Assets</b>									
Interest bearing deposits with banks	\$ 84,667	0.51%	\$ 429	\$ 48,273	0.25%	\$ 123	\$ 19,787	0.26%	\$ 52
Federal funds sold	654	0.15%	1	95	0.00%	-	17	0.00%	-
Investment securities (a)	279,992	2.31%	5,868	183,103	2.69%	4,474	258,705	2.68%	6,496
Mortgages held for sale	39,583	2.91%	1,152	43,515	3.24%	1,409	27,090	3.46%	936
Loans									
Commercial:									
Commercial and industrial (a)	444,637	4.56%	20,268	383,098	4.58%	17,526	341,516	4.43%	15,109
Real estate mortgage	364,134	4.93%	17,958	257,110	4.65%	11,963	260,907	5.21%	13,590
Construction and land development	39,423	5.06%	1,996	34,772	4.15%	1,442	18,846	5.41%	1,019
Farmland and agricultural	50,375	4.19%	2,109	55,067	4.18%	2,300	51,338	4.39%	2,252
Total commercial (a)	898,569	4.71%	42,331	730,047	4.55%	33,231	672,607	4.76%	31,970
Consumer:									
Real estate 1-4 family first mortgage	182,038	4.34%	7,899	155,137	4.42%	6,862	128,123	4.46%	5,713
Real estate 1-4 family junior lien mortgage	177,431	5.03%	8,922	159,772	4.82%	7,700	125,180	4.88%	6,110
Automobile	59,832	3.06%	1,833	59,982	2.92%	1,753	50,340	4.11%	2,068
Other revolving and installment	27,339	5.51%	1,507	19,663	3.95%	776	17,797	5.89%	1,049
Total consumer	446,640	4.51%	20,161	394,554	4.33%	17,091	321,440	4.65%	14,940
Total loans (a)	1,345,209	4.65%	62,492	1,124,601	4.48%	50,322	994,047	4.72%	46,910
<b>Total earning assets (a)</b>	<b>1,750,105</b>	<b>4.03%</b>	<b>69,942</b>	<b>1,399,587</b>	<b>4.06%</b>	<b>56,328</b>	<b>1,299,646</b>	<b>4.22%</b>	<b>54,394</b>
Cash and due from banks	28,186			23,676			23,408		
Allowance for loan and lease losses	(15,937)			(17,218)			(16,792)		
Goodwill & other intangibles	64,111			28,093			18,271		
Bank premises and equipment	25,519			21,375			22,174		
Other	82,211			77,884			77,624		
<b>Total assets</b>	<b>\$1,934,195</b>			<b>\$1,533,397</b>			<b>\$1,424,331</b>		
<b>Liabilities and Stockholders' Equity</b>									
Savings, checking, and money market deposits	\$ 971,979	0.18%	\$1,767	\$ 743,237	0.15%	\$ 1,106	\$ 690,898	0.15%	\$ 1,023
Certificates of deposit	251,359	0.64%	1,618	225,096	0.73%	1,652	222,943	0.74%	1,650
Short term borrowings	5,059	0.42%	21	12,599	0.25%	32	29,007	0.29%	83
Long term debt	65,102	5.52%	3,596	23,480	2.84%	668	21,562	2.60%	560
<b>Total interest bearing liabilities</b>	<b>1,293,499</b>	<b>0.54%</b>	<b>7,002</b>	<b>1,004,412</b>	<b>0.34%</b>	<b>3,458</b>	<b>964,410</b>	<b>0.34%</b>	<b>3,316</b>
Non-interest bearing deposits	443,453			327,654			278,005		
Other liabilities	28,501			20,400			17,713		
Stockholders' equity	168,742			180,931			164,203		
<b>Total liabilities and stockholders' equity</b>	<b>\$1,934,195</b>			<b>\$1,533,397</b>			<b>\$1,424,331</b>		
<b>Net interest margin/income (a)</b>		<b>3.63%</b>	<b>\$62,940</b>		<b>3.81%</b>	<b>\$52,870</b>		<b>3.97%</b>	<b>\$51,078</b>
Interest rate spread (a)		3.49%			3.71%			3.88%	

(a) Taxable equivalent adjustment was calculated utilizing a marginal income tax rate of 35.5 percent.

The Company manages the balance sheet to be interest rate neutral to slightly asset sensitive, defined as allowing assets on the balance sheet to reprice faster than the liabilities that fund them. Financial institutions will feel additional pressure on net interest margin the longer short-term rates remain at lower levels since there is limited opportunity to reprice deposits and fixed-rate loans mature or renew at lower rates. The Company actively implements risk management strategies as detailed in the "Interest Rate Risk" discussion to minimize the effects of interest rate volatility.

**Table 2** presents detailed information as to average balances, interest income and expense, and rates earned and paid by major balance sheet categories for the years 2014 through 2016. **Table 3** provides an analysis of the change in net interest income that is attributable to changes in volume of interest-earning assets or interest-bearing liabilities, and to changes in rates earned and paid.

**TABLE 3 – VOLUME AND RATE VARIANCE ANALYSIS**  
(dollars in thousands)

Increase(decrease) in:	Change from 2016 to 2015			Change from 2015 to 2014		
	Volume	Rate	Total	Volume	Rate	Total
<b>Interest income:</b>						
Interest bearing deposits with banks	\$ 93	\$ 213	\$ 306	\$ 75	\$ (4)	\$ 71
Federal funds sold	-	1	1	-	-	-
Investment securities	2,602	(1,208)	1,394	(2,030)	8	(2,022)
Mortgages held for sale	(127)	(130)	(257)	568	(95)	473
Loans						
Commercial:						
Commercial and industrial	2,819	(77)	2,742	1,844	573	2,417
Real estate mortgage	4,980	1,015	5,995	(198)	(1,429)	(1,627)
Construction and land development	193	361	554	861	(438)	423
Farmland and agricultural	(196)	5	(191)	164	(116)	48
Total commercial	7,796	1,304	9,100	2,671	(1,410)	1,261
Consumer:						
Real estate 1-4 family first mortgage	1,190	(153)	1,037	1,205	(56)	1,149
Real estate 1-4 family junior lien mortgage	851	371	1,222	1,688	(98)	1,590
Automobile	(4)	84	80	396	(711)	(315)
Other revolving and installment	303	428	731	110	(383)	(273)
Total consumer	2,340	730	3,070	3,399	(1,248)	2,151
Total loans	10,136	2,034	12,170	6,070	(2,658)	3,412
<b>Total interest income</b>	<b>12,704</b>	<b>910</b>	<b>13,614</b>	<b>4,683</b>	<b>(2,749)</b>	<b>1,934</b>
<b>Interest expense:</b>						
Savings, checking, and money market deposits	340	321	661	77	6	83
Certificates of deposit	193	(227)	(34)	16	(14)	2
Short term borrowings	(19)	8	(11)	(47)	(4)	(51)
Long term debt	1,184	1,744	2,928	50	58	108
<b>Total interest expense</b>	<b>1,698</b>	<b>1,846</b>	<b>3,544</b>	<b>96</b>	<b>46</b>	<b>142</b>
<b>Increase (decrease) in net interest income</b>	<b>\$11,006</b>	<b>\$ (936)</b>	<b>\$10,070</b>	<b>\$4,587</b>	<b>\$(2,795)</b>	<b>\$1,792</b>

### PROVISION FOR CREDIT LOSSES

The allowance for loan and lease losses (allowance) is an estimate of losses inherent in the Company's loan and lease portfolios and is established through a regular provision for credit losses (provision) based on historical losses incurred on similar pools of loans and periodic analysis of the portfolios' credit quality. Provisions are expected in order to maintain the adequacy of the total allowance after loan losses and recoveries, loan growth, and changes in management's assessment of credit quality and estimates of probable loan losses. Loan losses are charged-off against the allowance when the Company determines the loan balance to be uncollectible. Cash received on previously charged-off amounts is recorded as a recovery to the allowance. Annual fluctuations in the provision result from management's regular assessment of the adequacy of the allowance based on the factors described above.

The provision for 2016 was \$3.1 million compared to \$4.2 million during 2015, increasing the allowance from \$14.7 million in 2015 to \$15.6 million in 2016, net of charges to the allowance. In the acquisition of Beacon Bank, all assets and liabilities were marked to fair value when recorded on the Company's financial statements. The loan portfolio was marked to market for both credit and interest

rates resulting in a discount of \$1.9 million and no allowance was recorded. Asset quality has continued to improve, with nonperforming assets decreasing from \$12.0 million in 2015 to \$9.6 million in 2016. The ratio of nonperforming assets to loans and other real estate at year-end 2016 was 0.70%, compared to 1.07% in 2015. The ratio of the end-of-year balance of the allowance to end-of-year loans was 1.14% for 2016, compared to 1.30% for 2015. Average loans and leases were \$1.3 billion in 2016, an increase of \$220.6 million, or 19.6%, from the \$1.1 billion reported in 2015. The amount of provision to be taken in future periods will depend on management's assessment of the adequacy of the allowance in relation to the loss experience of the entire loan portfolio and periodic analysis of the portfolio's credit quality.

The Company's banking assets are distributed across eastern North Dakota, Minneapolis-St. Paul, and Duluth, Minnesota, and the Phoenix, Arizona metropolitan area, with minimal exposure to the western North Dakota oil-related areas. The bank has less than 0.3% of its loan and lease portfolio in oil and gas related credits and less than 2.2% in loans in western North Dakota and believes the allowance is adequate to cover any losses in the portfolio.

## NON-INTEREST INCOME

The Company continues to expand non-interest income associated with the Company's banking, mortgage, retirement and benefit services, and wealth management divisions. The Company's primary sources of non-interest income consist of retirement plan and recordkeeping services, trust services, service charges on deposit accounts, loan fees, and net gains on mortgage loan origination/sales activities. Non-interest income of \$105.1 million represented 63% of revenue for 2016 compared with \$93.3 million, or 64% of revenue, for 2015, and \$78.4 million, or 61% of revenue, for 2014. The increase in non-interest income in 2016 was primarily due to additional retirement services fee income related to acquisitions and organic growth, as well as increased mortgage banking revenue from higher originations and sales. **Table 4** provides a summary of changes in non-interest income the past three years.

Retirement and benefit services, which includes retirement plan administration, retirement plan investment advisory, payroll, HSA, and other benefit services is the Company's largest source of non-interest income, reporting fees of \$57.8 million in 2016, a \$6.7 million, or 13% increase, from the \$51.0 million reported in 2015. A majority of retirement services fees are transaction or participant based plan fees, with the remainder based on the market value of assets under administration. At December 31, 2016, assets under administration totaled \$25.0 billion, up \$7.6 billion, or 43.3%, from \$17.5 billion at December 31, 2015. The acquisition of ABGNCS, which closed on January 1, 2016, included 900 retirement plans, with more than 75,000 participants, and added \$6.0 billion in assets under administration.

Wealth management income, which includes personal trust services and investment services offered by the Bank and Alerus Securities, was \$12.6 million, a \$1.2 million, or 10.7%, increase from the \$11.4 million reported in 2015. The

Company earns trust, investment, and individual retirement account fees from managing and administering assets, including mutual funds, corporate trusts, personal trusts, and separately managed accounts. Trust and investment fees are primarily based on a tiered scale relative to the market value of the assets under management. At December 31, 2016, assets under management totaled \$3.4 billion, up \$0.6 billion, or 23.6%, from the \$2.7 billion reported in 2015.

Mortgage banking income, consisting of net servicing income and net gains on loan origination/sales activities, totaled \$28.3 million in 2016, a \$3.7 million, or 14.9%, increase from the \$24.6 million reported in 2015. The Company's mortgage division originated \$1.1 billion in loans in 2016, a \$78.1 million, or 7.9%, increase from the \$987.0 million in loans originated in 2015. The Company's mix of refinance and home purchase mortgage originations remained the same from 2015 to 2016 with 32% refinance and 68% purchase.

## NON-INTEREST EXPENSE

Total non-interest expense was \$143.8 million in 2016, a \$25.7 million, or 21.7%, increase from the \$118.1 million reported in 2015. Operating expenses increased in 2016 as a result of several factors, including increased personnel, benefits, and facilities costs due to the additional employees and locations acquired in the mergers; acquisition expenses; higher mortgage loan origination compensation expense due to higher volumes; increased intangible amortization expenses; and investments in the Company's infrastructure to support growth. In 2016, the Company incurred \$6.7 million of nonrecurring operating expenses related to the acquisitions of ABGNCS and Beacon Bank, closure of three branches, the prepayment of FHLB advances, and other expenses.

**TABLE 4 – NON-INTEREST INCOME**

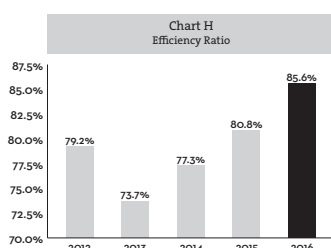
*Year ended December 31,  
(dollars in thousands)*

	<u>2016</u>	<u>2015</u>	<u>2014</u>	<u>% Increase/ decrease 2016/2015</u>	<u>% Increase/ decrease 2015/2014</u>
Retirement services	\$ 57,804	\$51,059	\$41,058	13.21%	24.36%
Wealth management	12,640	11,418	11,119	10.70%	2.69%
Mortgage banking	28,296	24,630	18,435	14.88%	33.60%
Service charges on deposit accounts	1,916	1,611	1,626	18.93%	-0.92%
Investment security gains (losses)	(24)	(17)	2,179	-41.18%	-100.78%
Other non-interest income	4,449	4,554	3,989	-2.31%	14.16%
<b>Total non-interest income</b>	<b><u>\$105,081</u></b>	<b><u>\$93,255</u></b>	<b><u>\$78,406</u></b>	<b><u>12.68%</u></b>	<b><u>18.94%</u></b>



The Company's efficiency ratio, defined as the percent of non-interest expense to total revenue, increased to 85.6% in 2016, compared to 80.8% in 2015.

Chart H illustrates the trend in the efficiency ratio over the last five years.



While control of non-interest expense is a priority for management, the higher-than-average efficiency ratio is partially due to the Company generating 63% of total revenue from non-interest income sources. The efficiency ratio for a business comprised primarily of net interest margin income is generally lower than a business comprised primarily of asset management and administration income and mortgage origination income.

Personnel expenses, which include salaries, commissions, incentive compensation, and employee benefits, are the largest expense component for the Company, representing 60% of non-interest expenses in both 2016 and 2015. Salary expense was \$70.7 million in 2016 as compared to \$59.1 million in 2015, an increase of \$11.8 million or 19.7% over 2015. Employee benefit costs were \$16.0 million in 2016, a \$3.2 million, or 24.8%, increase from the \$12.8 million reported in 2015. The increase in salary and employee benefit costs was influenced by increased staffing associated with acquisitions completed in 2016 and 2015, which added over 136 full-time equivalents (FTEs), as well as to support the infrastructure of the Company, and in variable commissions associated with increased mortgage origination activity, which increased 8% in 2016.

Occupancy expense was \$6.4 million in 2016, a \$1.2 million, or 23.7%, increase from the \$5.2 million reported in 2015. Furniture and equipment expense was \$6.0 million in 2016, reflecting a 19.9% increase from the \$5.0 million reported in 2015. The increase in occupancy and furniture and equipment expenses is primarily the result of the additional facilities associated with acquisitions completed in 2016 and 2015.

The Company has acquired 18 companies since 2002 for an aggregate premium of \$88.1 million in excess of book value, creating identified intangible assets of \$60.7 million and \$27.3 million in goodwill on the balance sheet. The identified intangible assets amortize for book purposes and are reported in other non-interest expense. Goodwill does not amortize for book purposes. The amortization schedules vary based on the type and quality of the acquisition. The aggregate unamortized intangible balance as of December 31, 2016, is \$32.7 million, which will fully amortize by December 31, 2025. The intangible amortization expense for 2016 was \$7.0 million, compared to \$4.4 million in 2015, a 60.1% increase.

Marketing, business development, and public relations expenses were \$3.2 million in 2016, a \$0.7 million decrease from 2015. In 2015 the Company contributed \$1.0 million to projects of the North Dakota Housing Incentive Fund, which provided \$1.0 million of North Dakota state income tax credits; no similar contributions were made in 2016. The contributions are deductible for federal income tax purposes and provide a dollar-for-dollar tax credit for North Dakota state income tax purposes. The Company's income tax expense was reduced for these credits, which were utilized in 2015 and 2016.

Correspondent and other service fees increased 36.9% to \$12.9 million in 2016, from \$9.4 million in 2015, primarily as a result of expenditures for information technology, in conjunction with the acquisitions and to support the growth of the Company. Table 5 provides a summary of changes in non-interest expenses for the past three years.

**TABLE 5 – NON-INTEREST EXPENSE**

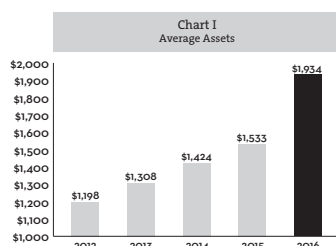
*Year ended December 31,  
(dollars in thousands)*

	<u>2016</u>	<u>2015</u>	<u>2014</u>	<u>% Increase/ decrease 2016/2015</u>	<u>% Increase/ decrease 2015/2014</u>
Salaries	\$ 70,739	\$ 59,122	\$ 48,839	19.65%	21.05%
Employee benefits	15,975	12,804	11,580	24.77%	10.57%
Occupancy expense	6,437	5,203	4,424	23.72%	17.61%
Furniture and equipment expense	6,018	5,018	4,658	19.93%	7.73%
Intangible amortization expense	7,005	4,361	4,196	60.63%	3.93%
Marketing, business development and public relations	3,239	3,907	2,745	-17.10%	42.33%
Supplies, telephone and postage	5,538	4,404	3,838	25.75%	14.75%
FDIC insurance	1,458	1,175	1,040	24.09%	12.98%
Professional fees (legal, audit and consulting)	3,381	2,552	2,667	32.48%	-4.31%
Correspondent and other service fees	12,860	9,394	6,982	36.90%	34.55%
Other non-interest expenses	11,142	10,194	9,146	9.30%	11.46%
<b>Total non-interest expenses</b>	<b><u>\$143,792</u></b>	<b><u>\$118,134</u></b>	<b><u>\$100,115</u></b>	<b><u>21.72%</u></b>	<b><u>18.00%</u></b>

# BALANCE SHEET ANALYSIS

## OVERVIEW

At December 31, 2016, total assets were \$2.0 billion, up \$305.7 million from December 31, 2015, primarily as a result of the acquisition of Beacon Bank. Cash and due from banks decreased by \$58.8 million from December 31, 2015, when the Company had increased liquidity from the issuance of the subordinated debt, for the acquisitions of Alliance Benefit Group North Central States, Inc. (ABGNCS) and Beacon Bank, that were completed in January 2016. Total average assets of the Company were \$1.9 billion in 2016, a \$400.8 million, or 26.1%, increase from the \$1.5 billion reported in 2015. **Chart I** illustrates average total assets for the past five years. Average earning assets were \$1.8 billion in 2016, an increase of \$350.5 million, or 25.0%, from the \$1.5 billion reported in 2015. Average earning assets represent 90.5% of average total assets in 2016, compared to 91.3% in 2015. Average interest-bearing liabilities represented 73.9% of average earning assets in 2016, compared to 71.8% in 2015.



## INVESTMENT SECURITIES

The Company uses its investment securities portfolio to manage enterprise interest rate risk, provide liquidity (including the ability to meet proposed regulatory requirements), generate interest and dividend income, and as collateral for public funds. While the Company intends to hold its investment securities to maturity, it may sell available-for-sale securities in response to structural changes in interest rate risks and to meet liquidity requirements, among other factors.

At December 31, 2016, investment securities totaled \$278.9 million, compared to \$192.3 million at December 31, 2015, representing an increase of \$86.6 million, or 45.0%. The weighted average tax equivalent yield was 2.31% at December 31, 2016, compared with a weighted average tax equivalent yield of 2.69% at December 31, 2015. The increase, net of principal payments, purchases, and sales, was primarily the result of the acquisition of Beacon Bank in January 2016, which included \$113.9 million of investment securities. The combined investment securities portfolio has been managed to meet the Company's investment portfolio guidelines for yield and duration.

The Company's available-for-sale securities are carried at fair value with changes in fair value reflected in other comprehensive income (loss) unless a security is deemed to be other-than-temporarily impaired. At December 31, 2016, the Company's gross unrealized gains on the available-for-sale securities were \$1.3 million, compared with \$2.7 million at December 31, 2015. Gross unrealizable losses on available-for-sale securities totaled \$4.4 million at December 31, 2016, compared with \$1.1 million at December 31, 2015.

The Company conducts a regular assessment of its investment portfolio to determine whether any securities are other-than-temporarily impaired. When assessing unrealized losses for other-than-temporary impairment, the Company considers the nature of the investment, the financial condition of the issuer, the extent and duration of the unrealized loss, and expected cash flows of the underlying assets and market conditions. On December 31, 2016, the Company held certain investments having continuous unrealized loss positions for more than 12 months. As of December 31, 2016, the unrealized losses on these securities totaled \$129 thousand. Substantially all of these losses were in equity securities. During the year ended December 31, 2016, the Company evaluated all of its debt securities for credit impairment and determined there were no credit losses evident. At December 31, 2016, the Company had no plans to sell securities with unrealized losses and believes it is likely that it would not be required to sell such securities before a recovery of their amortized cost.

## LOANS

Total loans were \$1.4 billion at December 31, 2016, a \$240.0 million increase from December 31, 2015. The increase was primarily the result of the acquisition of Beacon Bank, which had \$205.1 million in loans at the time of acquisition, and organic growth. **Table 6** sets forth the composition of the loan portfolio, both in terms of dollars and percentage for the past five years. Average loans were \$1.3 billion in 2016, a \$220.6 million, or 19.6%, increase from the \$1.1 billion reported in 2015. The increase in average loans was driven by the acquisition of Beacon Bank. The average loan to deposit ratio decreased to 80.7% for 2016, compared to 86.8% for 2015.

The Company periodically sells loans to a participation network to manage concentration risk and reduce credit exposure. The sold loan portfolio was \$625.4 million on December 31, 2016, a \$53.3 million, or 9.3%, increase from the \$572.1 million reported at December 31, 2015. The Company also had \$35.1 million of mortgages held for sale at December 31, 2016, a \$13.6 million, or 27.9%, decrease from the \$48.6 million reported at December 31, 2015. Mortgages held for sale are all single-family residential mortgage loans that will be sold to the secondary market, usually within 30 days of origination.

**TABLE 6 – LOANS AND LEASES**
*As of December 31,  
(dollars in thousands)*

	<u>2016</u>	<u>2015</u>	<u>2014</u>	<u>2013</u>	<u>2012</u>
Commercial:					
Commercial and industrial	\$ 435,798	\$ 379,914	\$ 351,460	\$328,183	\$261,974
Real estate mortgage	380,045	261,345	256,281	259,681	244,994
Construction and land development	34,654	16,780	20,544	8,260	15,574
Farmland and agricultural	48,659	53,514	62,340	54,245	46,670
Total commercial	<u>899,156</u>	<u>711,553</u>	<u>690,625</u>	<u>650,369</u>	<u>569,212</u>
Consumer:					
Real estate 1-4 family first mortgage	202,217	170,397	167,177	108,682	75,628
Real estate 1-4 family junior lien mortgage	178,795	162,295	157,921	95,348	76,476
Automobile	58,332	62,509	57,214	46,150	33,414
Other revolving and installment	28,452	20,167	22,521	14,015	16,048
Total consumer	<u>467,796</u>	<u>415,368</u>	<u>404,833</u>	<u>264,195</u>	<u>201,566</u>
<b>Total loans and leases</b>	<b><u><u>\$1,366,952</u></u></b>	<b><u><u>\$1,126,921</u></u></b>	<b><u><u>\$1,095,458</u></u></b>	<b><u><u>\$914,564</u></u></b>	<b><u><u>\$770,778</u></u></b>
<b>Percent Of Loans By Type</b>					
Commercial:					
Commercial and industrial	31.9%	33.7%	32.1%	35.9%	34.0%
Real estate mortgage	27.8%	23.2%	23.4%	28.4%	31.8%
Construction and land development	2.5%	1.5%	1.9%	0.9%	2.0%
Farmland and agricultural	3.6%	4.7%	5.7%	5.9%	6.1%
Total commercial	<u>65.8%</u>	<u>63.1%</u>	<u>63.0%</u>	<u>71.1%</u>	<u>73.8%</u>
Consumer:					
Real estate 1-4 family first mortgage	14.8%	15.1%	15.3%	11.9%	9.8%
Real estate 1-4 family junior lien mortgage	13.1%	14.4%	14.4%	10.4%	9.9%
Automobile	4.3%	5.5%	5.2%	5.0%	4.3%
Other revolving and installment	2.1%	1.8%	2.1%	1.5%	2.1%
Total consumer	<u>34.2%</u>	<u>36.9%</u>	<u>37.0%</u>	<u>28.9%</u>	<u>26.2%</u>
<b>Total loans and leases</b>	<b><u><u>100.0%</u></u></b>	<b><u><u>100.0%</u></u></b>	<b><u><u>100.0%</u></u></b>	<b><u><u>100.0%</u></u></b>	<b><u><u>100.0%</u></u></b>

## DEPOSITS

Deposits totaled \$1.8 billion at December 31, 2016, compared with \$1.5 billion at December 31, 2015, representing an increase of \$327.2 million, or 22.4%. Core deposits provide the Company's major source of funds from individuals, businesses, and local government units. Core deposits include non-interest-bearing deposits, interest-bearing checking, certificates of deposit less than \$250 thousand, and money market saving deposits. Core deposits funded 85.6% and 82.1% of total assets at December 31, 2016, and 2015, respectively. Average deposits were \$1.7 billion in 2016, a \$370.8 million, or 28.6%, increase, primarily as a result of the acquisition of Beacon Bank, compared with the \$1.3 billion reported in 2015.

Non-interest-bearing deposits were \$554.5 million at December 31, 2016, a \$128.9 million, or 30.3%, increase from the \$425.6 million reported at December 31, 2015. Average non-interest-bearing deposits were \$443.5 million in 2016, a \$115.8 million, or 35.3%, increase compared with \$327.7 million in 2015.

Interest-bearing non-maturity deposits totaled \$990.2 million at December 31, 2016, a \$174.2 million, or 21.3%, increase from the \$816.0 million reported at December 31, 2015. Average interest-bearing non-maturity deposits were \$972.0 million in 2016, a \$228.7 million, or 30.8%, increase compared with \$743.2 million in 2015. Interest-bearing time deposits were \$240.5 million at

December 31, 2016, a \$24.1 million, or 11.1%, increase from the \$216.5 million reported at December 31, 2015. Average interest-bearing time deposits were \$251.4 million in 2016, a \$26.3 million, or 11.7%, increase compared with \$225.1 million reported in 2015. Time certificates of deposit are largely viewed as purchased funds and are managed to levels deemed appropriate given alternative funding sources. **Table 7** provides a summary of changes in deposits for the past five years.

## BORROWINGS

The Company utilizes both short-term and long-term borrowings as part of its asset/liability management and funding strategies. Short-term borrowings, as of December 31, 2016, totaled \$0.7 million, compared to \$0 million reported at December 31, 2015. Short-term borrowings consists of repurchase agreements on securities owned by the Company.

The Company utilizes long-term debt to fund longer term assets and as a source of regulatory capital. Long-term debt was \$58.8 million as of December 31, 2016, compared with \$70.7 million as of December 31, 2015, a 16.9% decrease. Long-term debt at December 31, 2016, included subordinated notes, trust preferred securities, and a capital lease obligation on the Corporate Center office located in Grand Forks, North Dakota. At December 31, 2015, long-term debt included subordinated notes, Federal Home Loan Bank advances, and the capital lease obligation.



**TABLE 7 – DEPOSITS**  
*As of December 31,*  
*(dollars in thousands)*

	<u>2016</u>	<u>2015</u>	<u>2014</u>	<u>2013</u>	<u>2012</u>
Non-interest-bearing deposits	\$ 554,490	\$ 425,608	\$ 330,218	\$ 305,042	\$ 267,208
Interest bearing deposits:					
Savings	48,371	37,798	30,397	24,750	20,168
Checking	325,474	291,979	243,334	186,916	188,995
Money market deposit	616,341	486,181	447,346	439,946	386,089
Certificates of deposits of \$250,000 and less	210,312	191,568	182,099	190,767	213,187
Certificates of deposits in excess of \$250,000	30,221	24,887	28,774	35,182	40,103
<b>Total deposits</b>	<b><u>\$1,785,209</u></b>	<b><u>\$1,458,021</u></b>	<b><u>\$1,262,168</u></b>	<b><u>\$1,182,603</u></b>	<b><u>\$1,115,750</u></b>
<b>Percent Of Deposits By Type</b>					
Non-interest bearing deposits	31.1%	29.2%	26.2%	25.8%	23.9%
Interest bearing deposits:					
Savings	2.7%	2.6%	2.4%	2.1%	1.8%
Checking	18.2%	20.0%	19.3%	15.8%	16.9%
Money market deposit	34.5%	33.3%	35.4%	37.2%	34.6%
Certificates of deposits of \$250,000 and less	11.8%	13.1%	14.4%	16.1%	19.1%
Certificates of deposits in excess of \$250,000	1.7%	1.7%	2.3%	3.0%	3.6%
<b>Total deposits</b>	<b><u>100.0%</u></b>	<b><u>100.0%</u></b>	<b><u>100.0%</u></b>	<b><u>100.0%</u></b>	<b><u>100.0%</u></b>

On December 17, 2015, the Company issued \$50 million of subordinated notes with a maturity date of December 30, 2025. The notes bear a fixed rate of interest at 5.75%, through December 30, 2020, and then convert to floating-rate notes that reset quarterly to an interest rate equal to three month LIBOR plus 412 basis points. Through December 30, 2020, interest is payable semi-annually on June 30 and December 30, and thereafter interest is paid quarterly on March 30, June 30, September 30, and December 30. The subordinated notes qualify as Tier 2 capital for regulatory purposes. The proceeds were utilized for the acquisitions of ABGNCS and Beacon Bank in January 2016 and to retire the \$20.0 million of SBLF preferred stock in February 2016.

In January 2016, the Company acquired Beacon Bank and assumed \$10.0 million of trust preferred securities, junior subordinated debentures, in two trusts. Trust I was formed in 2003 and issued \$4.0 million of floating rate notes that bear interest at three-month LIBOR plus 3.10%, and reset quarterly. Trust II was formed in 2006 and issued \$6.0 million of floating rate notes that bear interest at three-month LIBOR plus 1.80%, and reset quarterly. The Trust I securities mature on June 26, 2033, and Trust II securities mature on September 15, 2036. Both are redeemable with the approval of the Federal Reserve Board, in whole or in part, at the Company's option at any time upon the occurrence of certain events affecting their tax or regulatory capital treatment. The trust preferred securities were marked to market at the time of the Beacon Bank acquisition and are reported on the balance sheet at \$8.2 million, as of December 31, 2016.

## CAPITAL RESOURCES

The Company is committed to managing capital for maximum stockholder benefit and maintaining strong protection for depositors and creditors. The Company continually assesses its business risk and capital position.

The Company also manages its capital to exceed regulatory capital requirements for well-capitalized bank holding companies. Total common stockholders' equity was \$168.8 million at December 31, 2016, a \$6.0 million, or 3.7%, increase from the \$162.8 million reported at December 31, 2015. The increase is the result of current year's earnings less dividend payments to preferred and common stockholders, and the market value change in the investment portfolio.

In 2012 the Company applied for and received approval for \$20 million in SBLF at an initial interest rate of 1%. The Company viewed the SBLF as an intermediate source of capital and redeemed the preferred stock in February 2016 utilizing a portion of the proceeds from the subordinated note issuance. The SBLF preferred stock interest rate was scheduled to increase to 9% in February 2016.

The Company paid dividends of \$0.44 during 2016, representing a \$0.02, or 4.8%, increase over the \$0.42 paid during 2015. Dividends per share data was adjusted for a 3-for-1 stock split completed in the third quarter of 2014. The Company's dividend policy is influenced by the belief that most stockholders are interested in long-term appreciation as well as current yield. The current dividend yield is considered reasonable given the Company's present cash flow position, level of earnings, and the strength of its capital.

Banking industry regulators define minimum capital and well capitalized standards for banks and holding companies (see The Company and Bank Required Capital Levels section of this report). The Company's and the Bank's regulatory capital ratios, as of December 31, for the past five years are set forth in **Table 8** and exceeded all minimum capital and well capitalized standards. The acquisitions that closed in January 2016 utilized a substantial amount of the Company's excess capital, and significantly increased the asset base of the Company, which reduced regulatory capital ratios.

The Basel III regulatory capital reforms (the “Basel III Rule”), effective beginning January 1, 2015, contain provisions which require certain adjustments and deductions from common equity Tier 1 capital, including goodwill and other intangible assets (excluding mortgage servicing rights). The Basel III Rule provided for a phase-in period for certain deductions from capital that requires deductions of 40% in 2015, 60% in 2016, 80% in 2017, and 100% thereafter of the deduction. The Company’s deduction for goodwill and

identifiable intangible assets, net of deferred tax liabilities, represents goodwill of \$26.4 million and identifiable intangible assets of \$19.7 million (60% of \$32.7 million) as of December 31, 2016, and goodwill of \$3.5 million and identifiable intangible assets of \$7.0 million (40% of \$17.5 million) as of December 31, 2015. As a result of the acquisitions of ABGNCS and Beacon Bank and the phase-in rules, these amounts significantly increased in 2016, net of intangible amortization.

**TABLE 8 – REGULATORY CAPITAL**  
*As of December 31,*

	Well Capitalized	2016	2015	2014	2013	2012
<b>Alerus Financial Corporation</b>						
Common equity tier 1 ratio	N/A	7.7%	10.9%	N/A	N/A	N/A
Tier 1 capital ratio	8.0%	8.2%	12.3%	11.8%	12.8%	12.8%
Total capital ratio	10.0%	12.3%	17.0%	13.0%	14.1%	14.1%
Tier 1 leverage ratio	N/A	6.9%	10.9%	10.1%	10.6%	9.9%
<b>Alerus Financial, NA</b>						
Common equity tier 1 ratio	6.5%	11.1%	14.4%	N/A	N/A	N/A
Tier 1 capital ratio	8.0%	11.1%	14.4%	11.3%	12.3%	12.6%
Total capital ratio	10.0%	12.1%	15.4%	12.5%	13.5%	13.9%
Tier 1 leverage ratio	5.0%	9.3%	12.6%	9.6%	10.1%	9.7%

## RISK ANALYSIS

### ASSET QUALITY RISK

Management believes its ability to identify and assess the risk and return characteristics of the Company’s loan portfolio is critical for profitability and growth. It is in the best interest of stockholders, regional communities, customers, and the Company to follow a credit policy that carefully balances risk and return, and ensures that potential credit problems are closely monitored.

The Company’s strategy for credit risk management includes well-defined, centralized credit policies; uniform underwriting criteria; and ongoing risk monitoring and review processes for all commercial and consumer credit exposures. The strategy also emphasizes diversification on a geographic, industry, and customer level; regular credit examinations; and management reviews of loans experiencing deterioration of credit quality. The Company strives to identify potential problem loans early, take necessary charge-offs promptly, and maintain adequate reserve levels for probable loan losses inherent in the portfolio. Management performs ongoing, internal reviews of any problem credits and continually assesses the adequacy of the allowance. The Company utilizes an internal lending division, Special Credit Services, to develop and implement strategies for the management of individual non-performing loans.

The allowance provides coverage for probable and estimable losses inherent in the Company’s loan and lease portfolios. Management evaluates the allowance each quarter to determine if it is adequate to cover inherent losses. The evaluation of each element and the overall allowance is based on a continuing assessment of problem loans and related off-balance sheet items, historic loss experience, and other factors including regulatory guidance and economic conditions.

At December 31, 2016, non-performing assets were \$9.6 million, compared to \$12.0 million in 2015, and \$6.5 million in 2014. Non-performing assets represented 0.70% of total loans and other real estate in 2016, compared to 1.07% in 2015, and 0.59% in 2014. **Table 9** provides a summary of non-performing assets for the past five years.

At December 31, 2016, the allowance for loan and leases losses was \$15.6 million, or 1.14%, of total loans compared with \$14.7 million, or 1.30%, at December 31, 2015, and \$17.1 million, or 1.56%, at December 31, 2014. The provision for credit losses was \$3.1 million in 2016, as compared to \$4.2 million in 2015 and a net recovery of \$0.4 million in 2014. Net charge-offs in 2016 were \$2.1 million, or 0.16%, of average total loans, compared to \$6.6 million, or 0.58%, in 2015, and net recoveries of \$0.6 million, or (0.06%), in 2014. The Company considers its allowance of \$15.6 million adequate to cover losses inherent in loans, commitments to extend credit, and standby letters of credit at December 31, 2016. **Table 10** provides a summary of the credit loss experience for the past five years.

The Company’s liquidity risk management process is designed to identify, measure, and manage the Company’s funding and liquidity risk to meet its daily funding needs and to address expected and unexpected changes in its funding requirements. The Asset/Liability Committee (“ALCO”) establishes policies, as well as analyzes and manages the Company’s liquidity to ensure adequate funds are always available at reasonable rates to meet normal operating requirements in addition to unexpected customer demands for funds, such as high levels of deposit withdrawals or loan demand, in a timely and cost effective manner. Liquidity needs are provided for on both the asset and liability side of the balance sheet. Asset liquidity is provided by regular maturities of loans and maintaining

**TABLE 9 – NONPERFORMING ASSETS**
*As of December 31,  
(dollars in thousands)*

	<u>2016</u>	<u>2015</u>	<u>2014</u>	<u>2013</u>	<u>2012</u>
Nonperforming loans					
Commercial:					
Commercial and industrial	\$ 2,418	\$ 6,011	\$ 572	\$ 1,437	\$ 1,769
Real estate mortgage	149	2,634	1,844	3,091	3,468
Construction and land development	751	-	-	-	1,152
Farmland and agricultural	448	158	-	108	8
<b>Total commercial</b>	<b>3,766</b>	<b>8,803</b>	<b>2,416</b>	<b>4,636</b>	<b>6,397</b>
Consumer:					
Real estate 1-4 family first mortgage	1,135	1,501	144	277	96
Real estate 1-4 family junior lien mortgage	2,590	825	1,400	455	427
Automobile	64	-	35	9	-
Other revolving and installment	109	22	-	-	-
<b>Total consumer</b>	<b>3,898</b>	<b>2,348</b>	<b>1,579</b>	<b>741</b>	<b>523</b>
Total nonperforming loans	7,664	11,151	3,995	5,377	6,920
Foreclosed assets	196	35	11	11	19
Other real estate owned	1,721	842	2,478	4,877	9,387
<b>Total nonperforming assets</b>	<b>\$ 9,581</b>	<b>\$ 12,028</b>	<b>\$ 6,484</b>	<b>\$ 10,265</b>	<b>\$ 16,326</b>
Nonperforming assets / loans and other real estate	0.70%	1.07%	0.59%	1.12%	2.09%
Allowance for loan and lease losses / nonperforming loans	203.74%	131.72%	427.11%	313.15%	218.22%

**TABLE 10 – SUMMARY OF CREDIT LOSS EXPERIENCE**
*As of December 31,  
(dollars in thousands)*

	<u>2016</u>	<u>2015</u>	<u>2014</u>	<u>2013</u>	<u>2012</u>
Average loans and leases	\$1,345,209	\$1,124,601	\$ 994,047	\$ 832,445	\$718,650
Allowance for loan and lease losses:					
Balance at beginning of year	\$ 14,688	\$ 17,063	\$ 16,838	\$ 15,101	\$ 12,826
Charge-offs:					
Commercial:					
Commercial and industrial	1,405	6,797	408	538	593
Real estate mortgage	43	400	79	16	924
Construction and land development	1,655	-	4	2	41
Farmland and agricultural	224	109	73	-	22
Total commercial	3,327	7,306	564	556	1,580
Consumer:					
Real estate 1-4 family first mortgage	-	5	1	10	80
Real estate 1-4 family junior lien mortgage	829	596	267	146	146
Automobile	97	155	128	148	41
Other revolving and installment	183	115	60	225	215
Total consumer	1,109	871	456	529	482
<b>Total charge-offs</b>	<b>4,436</b>	<b>8,177</b>	<b>1,020</b>	<b>1,085</b>	<b>2,062</b>
Recoveries:					
Commercial:					
Commercial and industrial	1,055	230	968	1,187	325
Real estate mortgage	188	166	201	75	1,552
Construction and land development	587	697	128	200	1,515
Farmland and agricultural	29	3	20	19	2
Total commercial	1,859	1,096	1,317	1,481	3,394
Consumer:					
Real estate 1-4 family first mortgage	211	10	70	6	17
Real estate 1-4 family junior lien mortgage	94	287	113	36	-
Automobile	54	93	55	15	23
Other revolving and installment	85	116	90	84	70
Total consumer	444	506	328	141	110
<b>Total recoveries</b>	<b>2,303</b>	<b>1,602</b>	<b>1,645</b>	<b>1,622</b>	<b>3,504</b>
Net (charge-offs)/recoveries	(2,133)	(6,575)	625	537	1,442
Provision for credit losses	3,060	4,200	(400)	1,200	833
<b>Balance at end of year</b>	<b>\$ 15,615</b>	<b>\$ 14,688</b>	<b>\$ 17,063</b>	<b>\$ 16,838</b>	<b>\$ 15,101</b>



relatively short-term, marketable investments and federal funds. As of December 31, 2016, the Company had \$85.8 million of un-pledged, available-for-sale securities. Liability liquidity is provided through short-term federal fund borrowings and borrowing capacity at the Federal Home Loan Bank. As of December 31, 2016, the Company had \$87.0 million of unsecured lines of credit for federal funds that may be drawn as needed and borrowing capacity at the Federal Home Loan Bank of \$317.0 million.

### INTEREST RATE RISK

The Company's major market risk exposure is to changes in interest rates. To minimize the volatility of net interest income and exposure to economic loss, the Company manages its exposure to interest rate risk through asset/liability management activities within the guidelines established by ALCO.

Interest rate risk can be broken down into the following four components: 1) repricing risk results from the difference in the timing of rate changes and the timing of cash flows that occur in the pricing and maturity of the bank's assets and liabilities, 2) basis risk occurs when market rates for different financial instruments, or the indices used to price assets and liabilities change at different times or by different amounts, 3) option risk occurs when customers have the right to alter the level and/or timing of the cash flows of an asset or a liability, and 4) term structure risk occurs from variations in the movement of interest rates across maturity spectrums. Interest rate risk is managed within an overall asset/liability framework for the Company. The Company positions the balance sheet to be

interest rate neutral to slightly asset sensitive, defined as allowing assets on the balance sheet to reprice faster than the liabilities. The Company chooses to manage the balance sheet to be slightly asset sensitive to take advantage of a normally upward sloping yield curve.

The Company employs a sensitivity analysis in the form of a net interest income simulation to help quantify the existing interest rate risk embedded in the Company's balance sheet and to help identify ways to minimize the risk. The monthly analysis incorporates substantially all of the Company's assets and liabilities and off-balance sheet instruments, together with forecasted changes in the balance sheet and assumptions that reflect the current interest rate environment. The simulation model is used to measure the impact on net interest income, relative to a base case scenario, of interest rates increasing or decreasing 100, 200, and 300 basis points over the next 12 months. The simulation run at December 31, 2016, illustrates a negative 0.62% change in net interest income for a 100 basis point decline in interest rates, and a positive 5.08% change in net interest income for a 100 basis point rise in interest rates. The base case interest rates for the simulation included the prime rate at 3.75% and the federal funds rate at 0.75%.

The Company has successfully implemented interest rate floors in a substantial number of underlying loan contracts at rates above market indications. These interest rate floors have preserved net interest rate margin in the current environment but will cause slight interest rate compression as interest rates rise since these loans will not reprice until the floor rate is surpassed.

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## REGULATORY CHANGES

Financial institutions, their holding companies and their affiliates, along with securities broker dealers, registered investment advisors, and insurance agencies, are extensively regulated under federal and state law. As a result, the growth and earnings performance of the Company may be affected not only by management decisions and general economic conditions, but also by requirements of federal and state statutes and by the regulations and policies of various bank regulatory agencies, including the Office of the Comptroller of the Currency (the "OCC"), the Board of Governors of the Federal Reserve System (the "Federal Reserve"), the Federal Deposit Insurance Corporation (the "FDIC"), and the Bureau of Consumer Financial Protection (the "CFPB"). Furthermore, taxation laws administered by the Internal Revenue Service and state taxing authorities, accounting rules developed by the Financial Accounting Standards Board (the "FASB"), and securities laws administered by the Securities and Exchange Commission (the "SEC") and state securities authorities have an impact on the business of the Company. The effect of these statutes, regulations, regulatory policies, and accounting rules are significant to the operations and results of the Company, the Bank, and its indirect subsidiary, Alerus Securities Corporation.

Federal and state banking laws impose a comprehensive system of supervision, regulation, and enforcement on the operations of financial institutions, their holding companies, and affiliates that is intended primarily for the protection of the FDIC-insured deposits and depositors of banks, rather than stockholders. These federal and state laws, and the regulations of the bank regulatory agencies issued under them, affect, among other things, the scope of business, the kinds and amounts of investments banks may make, reserve requirements, capital levels relative to operations, the nature and amount of collateral for loans, the establishment of branches, the ability to merge, consolidate and acquire, dealings with insiders and affiliates, and the payment of dividends. Federal and state securities and insurance laws impose a comprehensive system of supervision, regulation, and enforcement on the operations of securities broker dealers, registered investment advisors, and insurance agencies' financial institutions, that is intended primarily for the protection of customers, rather than stockholders.

The following is a summary of the material elements of the supervisory and regulatory framework applicable to the Company and the Bank. It does not describe all of the statutes, regulations, and regulatory policies that apply, nor does it restate all of the requirements of those that are described. The descriptions are qualified in their entirety by reference to the particular statutory and regulatory provision.

## FINANCIAL REGULATORY REFORM

On July 21, 2010, former President Barack Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) into law. The Dodd-Frank Act represented a sweeping reform of the U.S. supervisory and regulatory framework applicable to financial institutions and capital markets in the wake of the global financial crisis. In particular, and among other things, the Dodd-Frank Act: (i) created a Financial Stability Oversight Council as part of a regulatory structure for identifying emerging systemic risks and improving interagency cooperation; (ii) created the CFPB, which is authorized to regulate providers of consumer credit, savings, payment, and other consumer financial products and services; (iii) narrowed the scope of federal preemption of state consumer laws enjoyed by national banks and federal savings associations and expanded the authority of state attorneys general to bring actions to enforce federal consumer protection legislation; (iv) imposed more stringent capital requirements on bank holding companies and subjected certain activities, including interstate mergers and acquisitions, to heightened capital conditions; (v) with respect to mortgage lending, (a) significantly expanded requirements applicable to loans secured by 1-4 family residential real property, (b) imposed strict rules on mortgage servicing, and (c) required the originator of a securitized loan, or the sponsor of a securitization, to retain at least 5% of the credit risk of securitized exposures unless the underlying exposures are qualified residential mortgages or meet certain underwriting standards; (vi) repealed the prohibition on the payment of interest on business checking accounts; (vii) restricted the interchange fees payable on debit card transactions for issuers with \$10 billion in assets or greater; (viii) in the so-called “Volcker Rule,” subject to numerous exceptions, prohibited depository institutions and affiliates from certain investments in, and sponsorship of, hedge funds and private equity funds and from engaging in proprietary trading; (ix) provided for enhanced regulation of advisers to private funds and of the derivatives markets; (x) enhanced oversight of credit rating agencies; and (xi) prohibited banking agency requirements tied to credit ratings. These statutory changes shifted the regulatory framework for financial institutions and impacted the way in which they do business.

## THE INCREASING REGULATORY EMPHASIS ON CAPITAL

Regulatory capital represents the net assets of a financial institution available to absorb losses. Because of the risks attendant to their businesses, depository institutions are generally required to hold more capital than other businesses, which directly affects returns on equity. Certain provisions of the Dodd-Frank Act and the Basel III Rule establish strengthened capital standards for banks and bank holding companies, require more capital to be held in the form of common stock, and disallow certain funds from being included in capital determinations. Once fully implemented, these standards will represent regulatory capital requirements that are meaningfully more stringent than those in place historically.

## THE COMPANY AND BANK REQUIRED CAPITAL LEVELS

The Company and the Bank are subject to various regulatory capital adequacy requirements administered by the Federal Reserve and the OCC. Bank holding companies have historically had to comply with less stringent capital standards than their bank subsidiaries and were able to raise capital with hybrid instruments such as trust preferred securities and subordinated debentures. The Dodd-Frank Act mandated the Federal Reserve to establish minimum capital levels for bank holding companies on a consolidated basis that are as stringent as those required for insured depository institutions. Additionally, after an extended rulemaking process, the U.S. federal banking agencies approved the implementation of the Basel III Rule, and, at the same time, promulgated rules effecting certain changes required by the Dodd-Frank Act, effective beginning January 1, 2015.

The Basel III Rule not only increased most of the required minimum capital ratios, but it also introduced the concept of Common Equity Tier 1 Capital (CET1), which consists primarily of common stock, related surplus (net of treasury stock), retained earnings, and CET1 minority interests subject to certain regulatory adjustments. The Basel III Rule also expanded the definition of capital by establishing more stringent criteria that instruments must meet to be considered Additional Tier 1 Capital (Tier 1 Capital in addition to Common Equity) and Tier 2 Capital. A number of instruments that previously qualified as Tier 1 Capital do not qualify, or their qualifications changed. For example, cumulative preferred stock and certain hybrid capital instruments, including trust preferred securities, no longer qualify as Tier 1 Capital of any kind, with the exception, subject to certain restrictions, of such instruments issued before May 10, 2010, by bank holding companies with total consolidated assets of less than \$15 billion as of December 31, 2009. For those institutions, trust preferred securities and other non-qualifying capital instruments previously included in consolidated Tier 1 Capital are permanently grandfathered under the Basel III Rule, subject to certain restrictions. Qualifying trust preferred securities may also be assumed in conjunction with a bank acquisition without impairing their grandfathered Tier 1 capital status. Noncumulative perpetual preferred stock, which qualified as simple Tier 1 Capital, does not qualify as CET1, but does qualify as Additional Tier 1 Capital. The Basel III Rule also constrains the inclusion of minority interests, mortgage-servicing assets, and deferred tax assets in capital and requires deductions from CET1 in the event such assets exceed a certain percentage of a bank's CET1.

The Basel III Rule contains provisions which require certain adjustments and deductions from common equity Tier 1 capital, including goodwill and other intangible assets (excluding mortgage servicing rights). The Basel III Rule provided for a phase-in period for certain deductions from capital that requires deductions of 40% in 2015, 60% in 2016, 80% in 2017, and 100% thereafter of the deduction. Identifiable intangible assets that are not deducted during the transitional period are risk weighted.

Under current federal regulations, incorporating the Basel III Rule, the Bank is subject to the following minimum capital standards:

- 4.5% CET1 to risk-weighted assets;
- 6.0% Tier 1 capital (i.e., CET1 plus Additional Tier 1) to risk-weighted assets;
- 8.0% Total capital (i.e., Tier 1 plus Tier 2) to risk-weighted assets; and
- 4.0% Tier 1 capital to average consolidated assets as reported on consolidated financial statements (leverage ratio).

In addition, institutions that seek the freedom to make capital distributions (including for dividends and repurchases of stock) and pay discretionary bonuses to executive officers without restriction must also maintain 2.5% of risk-weighted assets in Common Equity Tier 1 attributable to a capital conservation buffer to be phased-in over three years, beginning in 2016. The purpose of the conservation buffer is to ensure that banks maintain a buffer of capital that can be used to absorb losses during periods of financial and economic stress. Factoring in the fully phased-in conservation buffer increases the minimum ratios depicted above to 7.0% for CET1, 8.5% for Tier 1 Capital, and 10.5% for Total Capital. The leverage ratio is not impacted by the conservation buffer.

The Basel III Rule maintained the general structure of the current prompt corrective action framework, while incorporating the increased requirements. The prompt corrective action guidelines were also revised to add the CET1 Capital ratio. In order to be a “well-capitalized” depository institution under the new regime, a bank and holding company must maintain a CET1 Capital ratio of 6.5% or more, a Tier 1 Capital ratio of 8% or more, a Total Capital ratio of 10% or more, and a leverage ratio of 5% or more. It is possible under the Basel III Rule to be well-capitalized while remaining out of compliance with the capital conservation buffer discussed above.

The Basel III Rule revised a number of the risk weightings (or their methodologies) for bank assets that are used to determine the capital ratios. For nearly every class of assets, the Basel III Rule required a more complex, detailed, and calibrated assessment of credit risk and calculation of risk weightings. Furthermore, there was significant concern noted by the financial industry in connection with the Basel III Rule as to the proposed treatment of accumulated other comprehensive income (“AOCI”). The Basel III Rule requires unrealized gains and losses on available-for-sale securities to flow through to regulatory capital as opposed to the previous treatment, which neutralizes such effects. Recognizing the problem for community banks, the U.S. bank regulatory agencies adopted the Basel III Rule with a

one-time election for smaller institutions like the Company and the Bank to opt out of, including most elements of AOCI in regulatory capital. This opt-out, which was required to be made in the first quarter of 2015, excluded from regulatory capital both unrealized gains and losses on available-for-sale debt securities and accumulated net gains and losses on cash-flow hedges and amounts attributable to defined benefit post-retirement plans. The Company elected to opt-out.

Generally, financial institutions (except for large, internationally active financial institutions) became subject to the new rules on January 1, 2015. However, there are separate phase-in/phase-out periods for: (i) the capital conservation buffer; (ii) regulatory capital adjustments and deductions; (iii) non-qualifying capital instruments; and (iv) changes to the prompt corrective action rules. The phase-in periods commenced on January 1, 2016, and extend until 2019.

### PROMPT CORRECTIVE ACTION

A banking organization’s capital plays an important role in connection with regulatory enforcement as well. Federal law provides the federal banking regulators with broad power to take prompt corrective action to resolve the problems of undercapitalized institutions. The extent of the regulators’ powers depends on whether the institution in question is “adequately capitalized,” “undercapitalized,” “significantly undercapitalized,” or “critically undercapitalized,” in each case as defined by regulation. Depending upon the capital category of an institution that is not adequately capitalized, the regulators’ corrective powers include: (i) requiring the institution to submit a capital restoration plan; (ii) limiting the institution’s asset growth and restricting its activities; (iii) requiring the institution to issue additional capital stock (including additional voting stock) or to be acquired; (iv) restricting transactions between the institution and its affiliates; (v) restricting the interest rate that the institution may pay on deposits; (vi) ordering a new election of directors of the institution; (vii) requiring that senior executive officers or directors be dismissed; (viii) prohibiting the institution from accepting deposits from correspondent banks; (ix) requiring the institution to divest certain subsidiaries; (x) prohibiting the payment of principal or interest on subordinated debt; and (xi) ultimately, appointing a receiver for the institution.

As of December 31, 2016: (i) the Bank exceeded its minimum regulatory capital requirements under OCC capital adequacy guidelines; and (ii) the Bank was “well-capitalized,” as defined by OCC regulations. As of December 31, 2016, the Company had regulatory capital in excess of the Federal Reserve’s requirements and met the Dodd-Frank Act’s capital requirements.



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## THE COMPANY

### GENERAL

The Company, as the sole stockholder of the Bank, is a financial holding company. As a financial holding company, the Company is registered with, and is subject to regulation by, the Federal Reserve under the Bank Holding Company Act of 1956, as amended (the “BHCA”). In accordance with Federal Reserve policy, and as now codified by the Dodd-Frank Act, the Company is legally obligated to act as a source of financial strength to the Bank and to commit resources to support the Bank in circumstances where the Company might not otherwise do so. Under the BHCA, the Company is subject to periodic examination by the Federal Reserve. The Company is required to file with the Federal Reserve periodic reports of the Company’s operations and such additional information regarding the Company and its subsidiaries as the Federal Reserve may require.

### DIVIDEND PAYMENTS

The Company’s ability to pay dividends to its stockholders may be affected by both general corporate law considerations and the policies of the Federal Reserve applicable to bank holding companies. As a Delaware corporation, the Company is subject to Delaware general

corporation law (“DGCL”). DGCL allows the Company to pay dividends only out of its surplus (as defined and computed in accordance with DGCL) or, if the Company has no such surplus, out of its net profits for the fiscal year in which the dividend is declared and/or the preceding fiscal year.

As a general matter, the Federal Reserve has indicated that the board of directors of a financial holding company should eliminate, defer, or significantly reduce dividends to stockholders if: (i) the company’s net income available to stockholders for the past four quarters, net of dividends previously paid during that period, is not sufficient to fully fund the dividends; (ii) the prospective rate of earnings retention is inconsistent with the company’s capital needs and overall current and prospective financial condition; or (iii) the company will not meet, or is in danger of not meeting, its minimum regulatory capital adequacy ratios. The Federal Reserve also possesses enforcement powers over bank holding companies and their nonbank subsidiaries to prevent or remedy actions that represent unsafe or unsound practices or violations of applicable statutes and regulations. Among these powers is the ability to proscribe the payment of dividends by banks and bank holding companies.

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## THE BANK

### GENERAL

The Bank is a national bank, chartered by the OCC under the National Bank Act. The deposit accounts of the Bank are insured by the FDIC’s Deposit Insurance Fund (the “DIF”) to the maximum extent provided under federal law and FDIC regulations, and the Bank is a member of the Federal Reserve System. As a national bank, the Bank is subject to the examination, supervision, reporting, and enforcement requirements of the OCC. The FDIC, as administrator of the DIF, also has regulatory authority over the Bank.

### DEPOSIT INSURANCE

As an FDIC-insured institution, the Bank is required to pay deposit insurance premium assessments to the FDIC. The FDIC has adopted a risk-based assessment system whereby FDIC-insured depository institutions pay insurance premiums at rates based on their risk classification. An institution’s risk classification is assigned based on its capital levels and the level of supervisory concern the institution poses to the regulators.

The Dodd-Frank Act permanently increased the maximum amount of deposit insurance for banks, savings institutions, and credit unions to \$250,000 per insured depositor, retroactive to January 1, 2009.

### BANK DIVIDEND PAYMENTS

The primary source of funds for the Company is dividends from the Bank. Under the National Bank Act, a national bank may pay dividends out of its undivided profits in such

amounts and at such times as the bank’s board of directors deems prudent. Without prior OCC approval, however, a national bank may not pay dividends in any calendar year that, in the aggregate, exceed the bank’s year-to-date net income plus the bank’s retained net income for the two preceding years.

The payment of dividends by any financial institution is affected by the requirement to maintain adequate capital pursuant to applicable capital adequacy guidelines and regulations, and a financial institution generally is prohibited from paying any dividends if, following payment thereof, the institution would be undercapitalized. As described above, the Bank exceeded its minimum capital requirements under applicable guidelines as of December 31, 2016 and 2015. Notwithstanding the availability of funds for dividends, however, the OCC may prohibit the payment of dividends by the Bank if it determines such payment would constitute an unsafe or unsound practice.

### SAFETY AND SOUNDNESS STANDARDS/RISK MANAGEMENT

The federal banking agencies have adopted guidelines that establish operational and managerial standards to promote the safety and soundness of federally insured depository institutions. The guidelines set forth standards for internal controls, information systems, internal audit systems, loan documentation, credit underwriting, interest rate exposure, asset growth, compensation, fees and benefits, asset quality, and earnings.

During the past decade, the bank regulatory agencies have increasingly emphasized the importance of sound risk management processes and strong internal controls when evaluating the activities of the institutions they supervise. Properly managing risks has been identified as critical to the conduct of safe and sound banking activities and has become even more important as new technologies, product innovation, and the size and speed of financial transactions have changed the nature of banking markets. The agencies have identified a spectrum of risks facing a banking institution including, but not limited to, credit, market, liquidity, operational, legal, and reputational risk.

Information security risks for financial institutions have generally increased in recent years in part because of the proliferation of new technologies, the use of the Internet and telecommunications technologies to conduct financial transactions, and the increased sophistication and activities of organized crime, hackers, terrorists, activists, and other

external parties. The Company relies on the secure processing, transmission, and storage of confidential information in our computer systems and networks. Cybersecurity and the continued development and enhancement of the controls, processes, and systems designed to protect our networks, computers, software, and data is a priority for the Company.

## **COMMUNITY REINVESTMENT ACT REQUIREMENTS**

The Community Reinvestment Act requires the Bank to have a continuing and affirmative obligation in a safe and sound manner to help meet the credit needs of its entire community, including low- and moderate- income neighborhoods. Federal regulators regularly assess the Bank's record of meeting the credit needs of its communities. Applications for additional acquisitions would be affected by the evaluation of the Bank's effectiveness in meeting its Community Reinvestment Act requirements.

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## **CONSUMER FINANCIAL SERVICES**

There are numerous developments in federal and state laws regarding consumer financial products and services that impact the Bank's business. Importantly, the current structure of federal consumer protection regulation applicable to all providers of consumer financial products and services changed significantly on July 21, 2011, when the CFPB commenced operations to supervise and enforce consumer protection laws. The CFPB has broad rulemaking authority for a wide range of consumer protection laws that apply to all providers of consumer products and services, including the Bank, as well as the authority to prohibit "unfair, deceptive, or abusive" acts and practices. The CFPB has examination and enforcement authority over providers with more than \$10 billion in assets. Banks and savings institutions with \$10 billion or less in assets, like the Bank, will continue to be examined by their applicable bank regulators. Below are additional recent regulatory developments relating to consumer mortgage lending activities. The Company does not currently expect these provisions to have a significant impact on Bank operations; however, additional compliance resources were added to monitor compliance.

### **ABILITY-TO- REPAY REQUIREMENT AND QUALIFIED MORTGAGE RULE**

The Dodd-Frank Act contains additional provisions that affect consumer mortgage lending. First, it significantly expands underwriting requirements applicable to loans secured by 1-4 family residential real property and augments federal law combating predatory lending

practices. In addition to numerous new disclosure requirements, the Dodd-Frank Act imposes new standards for mortgage loan originations on all lenders, including banks and savings associations, in an effort to strongly encourage lenders to verify a borrower's ability to repay, while also establishing a presumption of compliance for certain "qualified mortgages."

On January 10, 2013, the CFPB issued a final rule, effective January 10, 2014, that implements the Dodd-Frank Act's ability- to-repay requirements and clarifies the presumption of compliance for "qualified mortgages." In assessing a borrower's ability to repay a mortgage-related obligation, lenders generally must consider eight underwriting factors: (i) current or reasonably expected income or assets; (ii) current employment status; (iii) monthly payment on the subject transaction; (iv) monthly payment on any simultaneous loan; (v) monthly payment for all mortgage-related obligations; (vi) current debt obligations, alimony, and child support; (vii) monthly debt-to-income ratio or residual income; and (viii) credit history. Further, the final rule also clarifies that qualified mortgages do not include "no-doc" loans and loans with negative amortization, interest-only payments, balloon payments, terms in excess of 30 years, or points and fees paid by the borrower that exceed 3% of the loan amount, subject to certain exceptions. In addition, for qualified mortgages, the monthly payment must be calculated on the highest payment that will occur in the first five years of the loan, and the borrower's total debt-to-income ratio generally may not be more than 43%.

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## FORWARD-LOOKING STATEMENTS

The following information appears in accordance with the Private Securities Litigation Reform Act of 1995:

This annual report contains forward-looking statements about Alerus Financial Corporation. Statements that are not historical or current facts, including statements about beliefs and expectations, are forward-looking statements and are based on the information available to, and assumptions and estimates made by, management as of the date made. These forward-looking statements cover, among other things, anticipated future revenue and expenses and the future plans and prospects of Alerus Financial Corporation. Forward-looking statements involve inherent risks and uncertainties, and important factors could cause actual results to differ materially from those anticipated. Global and domestic economies could fail to recover from the recent economic downturn or could experience another severe contraction, which could adversely affect Alerus Financial Corporation's revenues and the values of its assets and liabilities. Global financial markets could experience a recurrence of significant turbulence, which could reduce the availability of funding to certain financial institutions and lead to a tightening of credit, a reduction of business activity, and increased market volatility. Alerus Financial Corporation's results could also be adversely affected by continued deterioration in general business and economic conditions; changes in interest rates; deterioration in the

credit quality of its loan portfolios or in the value of the collateral securing those loans; deterioration in the value of securities held in its investment securities portfolio; legal and regulatory developments; increased competition from both banks and non-banks; cyber-attacks; changes in customer behavior and preferences; effects of mergers and acquisitions and related integration; effects of critical accounting policies and judgments; and management's ability to effectively manage credit risk, residual value risk, market risk, operational risk, interest rate risk, liquidity risk, and cybersecurity.

Forward-looking statements speak only as of the date they are made, and Alerus Financial Corporation undertakes no obligation to update them in light of new information or future events.



Executive Vice President and Chief Financial Officer  
Alerus Financial Corporation  
March 3, 2017



ALERUS FINANCIAL CORPORATION AND SUBSIDIARIES  
CONSOLIDATED BALANCE SHEETS  
DECEMBER 31, 2016 AND 2015  
(dollars in thousands, except share and per share amounts)

	2016	2015
<b>Assets</b>		
Cash and cash equivalents	\$ 35,441	\$ 28,482
Interest-bearing deposits	<u>171,926</u>	<u>237,677</u>
Cash and due from banks	207,367	266,159
Investment securities		
Securities held for trading	1,959	1,947
Securities available for sale at fair value (Amortized cost \$280,004 and \$188,743)	276,952	190,396
Mortgages held for sale	35,063	48,642
Loans and leases		
Loans and leases	1,366,952	1,126,921
Less: Allowance for loan and lease losses	<u>(15,615)</u>	<u>(14,688)</u>
Net loans and leases	1,351,337	1,112,233
Premises and equipment, net	24,262	22,419
Accrued interest receivable	5,919	4,830
Bank-owned life insurance	29,139	28,308
Goodwill	27,329	3,683
Other intangible assets, net	37,506	21,751
Deferred tax assets, net	19,521	13,780
Other assets	34,225	30,715
<b>Total assets</b>	<b><u>\$ 2,050,579</u></b>	<b><u>\$ 1,744,863</u></b>
<b>Liabilities and Stockholders' Equity</b>		
<b>Liabilities</b>		
Deposits:		
Noninterest-bearing	\$ 554,490	\$ 425,608
Interest-bearing	<u>1,230,719</u>	<u>1,032,413</u>
Total deposits	1,785,209	1,458,021
Short-term borrowings	729	-
Long-term debt	58,813	70,744
Accrued expenses and other liabilities	<u>37,043</u>	<u>33,277</u>
<b>Total liabilities</b>	<b><u>1,881,794</u></b>	<b><u>1,562,042</u></b>
<b>Stockholders' Equity</b>		
Preferred stock, \$1 par value, 2,000,000 shares authorized; 0 and 20,000 shares issued and outstanding	-	20
Common stock, \$1 par value, 30,000,000 shares authorized; 13,534,375 and 13,433,801 issued and outstanding	13,534	13,434
Additional paid-in capital	23,882	42,617
Retained earnings	133,307	125,701
Accumulated other comprehensive income (loss)	<u>(1,938)</u>	<u>1,049</u>
<b>Total stockholders' equity</b>	<b><u>168,785</u></b>	<b><u>182,821</u></b>
<b>Total liabilities and stockholders' equity</b>	<b><u>\$ 2,050,579</u></b>	<b><u>\$ 1,744,863</u></b>

ALERUS FINANCIAL CORPORATION AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF INCOME  
YEARS ENDED DECEMBER 31, 2016, 2015 AND 2014  
(dollars in thousands, except share and per share amounts)

	2016	2015	2014
<b>Interest Income</b>			
Loans and leases, including fees	\$ 63,644	\$ 51,731	\$ 47,876
Investment securities			
Taxable	4,584	3,496	5,483
Exempt from federal income taxes	1,089	808	817
Other	625	293	218
<b>Total interest income</b>	<b>69,942</b>	<b>56,328</b>	<b>54,394</b>
<b>Interest Expense</b>			
Deposits	3,385	2,758	2,673
Short-term borrowings	11	18	22
Long-term debt	3,606	682	621
<b>Total interest expense</b>	<b>7,002</b>	<b>3,458</b>	<b>3,316</b>
<b>Net interest income</b>	<b>62,940</b>	<b>52,870</b>	<b>51,078</b>
<b>Provision for credit losses</b>	<b>3,060</b>	<b>4,200</b>	<b>(400)</b>
<b>Net interest income, after provision for credit losses</b>	<b>59,880</b>	<b>48,670</b>	<b>51,478</b>
<b>Non-Interest Income</b>			
Retirement services	57,804	51,059	41,058
Wealth management	12,640	11,418	11,119
Mortgage banking	28,296	24,630	18,435
Service charges on deposit accounts	1,916	1,611	1,626
Net gain (loss) on investment securities	(24)	(17)	2,179
Other	4,449	4,554	3,989
<b>Total non-interest income</b>	<b>105,081</b>	<b>93,255</b>	<b>78,406</b>
<b>Non-Interest Expense</b>			
Salaries	70,739	59,122	48,839
Employee benefits	15,975	12,804	11,580
Net occupancy expense	6,437	5,203	4,424
Furniture and equipment expense	6,018	5,018	4,658
Intangible amortization expense	7,005	4,361	4,196
Other	37,618	31,626	26,418
<b>Total non-interest expenses</b>	<b>143,792</b>	<b>118,134</b>	<b>100,115</b>
<b>Income before income tax expense</b>	<b>21,169</b>	<b>23,791</b>	<b>29,769</b>
Income tax expense	7,138	6,683	8,999
<b>Net income</b>	<b>14,031</b>	<b>17,108</b>	<b>20,770</b>
Less preferred stock dividends	25	200	200
<b>Net income applicable to common stock</b>	<b>\$ 14,006</b>	<b>\$ 16,908</b>	<b>\$ 20,570</b>
<b>Per Share Information</b>			
Earnings per common share	\$ 1.04	\$ 1.26	\$ 1.55
Diluted earnings per common share	\$ 1.00	\$ 1.21	\$ 1.48
Dividends declared per common share	\$ 0.44	\$ 0.42	\$ 0.38
Average common shares outstanding	13,494,691	13,412,586	13,289,714
Diluted average common shares outstanding	14,000,332	13,947,136	13,877,344

ALERUS FINANCIAL CORPORATION AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY  
YEARS ENDED DECEMBER 31, 2016, 2015 AND 2014

(dollars in thousands, except share and per share amounts)

	Preferred Stock	Common Stock	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
<b>Balance, December 31, 2013</b>	<b>\$ 20</b>	<b>\$ 4,416</b>	<b>\$ 38,826</b>	<b>\$ 109,840</b>	<b>\$ 209</b>	<b>\$ 153,311</b>
Net income	-	-	-	20,770	-	20,770
Other comprehensive income	-	-	-	-	1,161	1,161
Issued 5,877 shares under stock based compensation plans	-	6	309	-	-	315
Stock dividend 3 for 1	-	8,895	386	(9,281)	-	-
Cash dividend declared preferred – 1.0%	-	-	-	(200)	-	(200)
Cash dividend declared common (\$.38 per share)	-	-	-	(5,332)	-	(5,332)
Income tax benefit equity related items	-	-	539	(539)	-	-
Stock-based compensation expense	-	-	1,061	-	-	1,061
Vesting of 28,872 shares of restricted stock	-	29	(29)	-	-	-
<b>Balance, December 31, 2014</b>	<b>20</b>	<b>13,346</b>	<b>41,092</b>	<b>115,258</b>	<b>1,370</b>	<b>171,086</b>
Net income	-	-	-	17,108	-	17,108
Other comprehensive loss	-	-	-	-	(321)	(321)
Repurchase of 1,009 shares	-	(1)	(26)	-	-	(27)
Issued 16,326 shares under stock based compensation plans	-	16	299	-	-	315
Cash dividend declared preferred – 1.0%	-	-	-	(200)	-	(200)
Cash dividend declared common (\$.42 per share)	-	-	-	(5,859)	-	(5,859)
Income tax benefit equity related items	-	-	606	(606)	-	-
Stock-based compensation expense	-	-	719	-	-	719
Vesting of 72,540 shares of restricted stock	-	73	(73)	-	-	-
<b>Balance, December 31, 2015</b>	<b>20</b>	<b>13,434</b>	<b>42,617</b>	<b>125,701</b>	<b>1,049</b>	<b>182,821</b>
Net income	-	-	-	14,031	-	14,031
Other comprehensive loss	-	-	-	-	(2,987)	(2,987)
Repurchase of 17,565 shares	-	(18)	(102)	(237)	-	(357)
Issued 19,726 shares under stock based compensation plans	-	20	345	-	-	365
Cash dividend declared preferred – 1.0%	-	-	-	(25)	-	(25)
Cash dividend declared common (\$.44 per share)	-	-	-	(6,163)	-	(6,163)
Stock-based compensation expense	-	-	1,100	-	-	1,100
Vesting of 98,413 shares of restricted stock	-	98	(98)	-	-	-
Redemption of 20,000 shares of preferred stock	(20)	-	(19,980)	-	-	(20,000)
<b>Balance, December 31, 2016</b>	<b>\$ -</b>	<b>\$ 13,534</b>	<b>\$ 23,882</b>	<b>\$ 133,307</b>	<b>\$ (1,938)</b>	<b>\$ 168,785</b>



**ALERUS FINANCIAL CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**YEARS ENDED DECEMBER 31, 2016, 2015 AND 2014**  
*(dollars in thousands)*

	<u>2016</u>	<u>2015</u>	<u>2014</u>
<b>Cash Flows From Operating Activities</b>			
Net income	\$ 14,031	\$ 17,108	\$ 20,770
Adjustments to reconcile net income to net cash			
Deferred income taxes	(3,044)	581	(1,726)
Provision for credit losses	3,060	4,200	(400)
Provision for foreclosed asset losses	226	53	-
Depreciation and amortization	11,385	8,727	8,160
Compensation related stock plans	1,465	1,034	1,376
Investment security premium amortization	2,364	636	1,372
Increase in value of bank-owned life insurance	(831)	(824)	(821)
Realized loss (gain) on forward sale derivatives	(81)	(186)	91
Realized loss (gain) on rate lock commitments	135	139	(104)
Realized loss (gain) on sale of premises and equipment	6	-	163
Realized loss (gain) on sale of foreclosed assets	73	540	546
Realized loss (gain) on sale of investment securities	17	-	(2,130)
Realized loss (gain) on servicing rights	(1,293)	(1,178)	(1,045)
Net change in:			
Securities held for trading	(12)	13	(59)
Mortgages held for sale	13,579	(13,600)	(4,788)
Accrued interest receivable	(1,089)	(56)	667
Other assets	313	(2,867)	(6,548)
Accrued expenses and other liabilities	(6,315)	10,039	5,848
Net cash provided by operating activities	<u>33,989</u>	<u>24,359</u>	<u>21,372</u>
<b>Cash Flows From Investing Activities</b>			
Proceeds from sales of securities available for sale	59,910	-	85,549
Proceeds from maturities of securities available for sale	42,806	40,096	21,516
Purchases of securities available for sale	(82,487)	(27,490)	(18,391)
Net (increase) decrease in loans and leases	(38,884)	(38,723)	(88,094)
Payments for business combinations	(45,441)	(4,314)	(10,843)
Proceeds from bank owned life insurance	5,331		
Purchases of bank premises and equipment	(1,684)	(3,906)	(2,101)
Proceeds from sales of bank premises and equipment	404	-	3
Proceeds from sales of foreclosed assets	636	2,126	3,341
Net cash used by investing activities	<u>(59,409)</u>	<u>(32,211)</u>	<u>(9,020)</u>
<b>Cash Flows From Financing Activities</b>			
Net increase (decrease) in deposits	25,020	195,853	(36,359)
Net increase (decrease) in short-term borrowings	(6,847)	(10,532)	2,657
Repayments of notes payable	(25,000)	(125)	(136)
Proceeds from issuance of subordinated debt	-	49,375	-
Cash dividends paid on preferred stock	(25)	(200)	(200)
Cash dividends paid on common stock	(6,163)	(5,859)	(5,332)
Redemption of preferred stock	(20,000)	-	-
Repurchase of common stock	(357)	(27)	-
Net cash provided (used) by financing activities	<u>(33,372)</u>	<u>228,485</u>	<u>(39,370)</u>
<b>Net Change in Cash and Due From Banks</b>	<b>(58,792)</b>	<b>220,633</b>	<b>(27,018)</b>
Cash and due from banks at beginning of year	<u>266,159</u>	<u>45,526</u>	<u>72,544</u>
<b>Cash and Due From Banks</b>	<b><u>\$ 207,367</u></b>	<b><u>\$266,159</u></b>	<b><u>\$ 45,526</u></b>
	<u>2016</u>	<u>2015</u>	<u>2014</u>
<b>Supplemental Cashflow Disclosures</b>			
Loan collateral transferred to foreclosed assets	\$ 1,851	\$ 684	\$ 1,499
Unrealized gain/(loss) on securities available for sale	(2,987)	(321)	1,161
Interest paid for the period	7,263	3,381	3,394
Income tax payments net of refunds received	1,612	10,165	11,257
Acquisitions			
Noncash assets acquired	335,830	4,572	127,650
Liabilities assumed	(328,748)	(258)	(116,807)
Net noncash asset acquired	7,082	4,314	10,843
Cash & cash equivalents acquired	18,748	-	17,690



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## INDEPENDENT AUDITORS' REPORT

Board of Directors and Audit Committee  
Alerus Financial Corporation and Subsidiaries  
Grand Forks, North Dakota

We have audited, in accordance with the auditing standards generally accepted in the United States of America, the consolidated financial statements of Alerus Financial Corporation and Subsidiaries, which comprise the consolidated balance sheets as of December 31, 2016 and 2015, and the related consolidated statements of income, comprehensive income, changes in stockholders' equity and cash flows for years ended December 31, 2016, 2015, and 2014, and the related notes to the consolidated financial statements (not presented herein); and in our report dated March 3, 2017, we expressed an unqualified opinion on those consolidated financial statements.

### **Opinion**

In our opinion, the information set forth in the accompanying consolidated balance sheets, statements of income, changes in stockholders' equity and cash flows is fairly stated, in all material respects, in relation to the consolidated financial statements from which it was derived.

*CliftonLarsonAllen LLP*

**CliftonLarsonAllen LLP**

Minneapolis, Minnesota  
March 16, 2017

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