



Always in
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management's financial review

company profile

Alerus Financial Corporation and its subsidiaries ("the Company") is a bank holding company organized under the laws of Delaware. Through its bank subsidiary, the company engages in commercial and retail banking, retail brokerage, insurance, trust and asset management, retirement plan record keeping activities, and investment advisory services within the Red River Valley in North Dakota, Twin Cities metro area in Minnesota, Scottsdale and Peoria, Arizona, and throughout the country. The bank subsidiary operates 15 customer locations in Grand Forks, Fargo, West Fargo, and Northwood, North Dakota; Minnetonka, Maplewood, and Oakdale, Minnesota; and Peoria and Scottsdale, Arizona.

In addition to the bank subsidiary, Alerus Financial Corporation has established a non-banking subsidiary, Alerus Appraisals, to conduct rural land and farm appraisals. Alerus Appraisals operates business offices in Grand Forks, West Fargo, and Wyndmere, North Dakota.

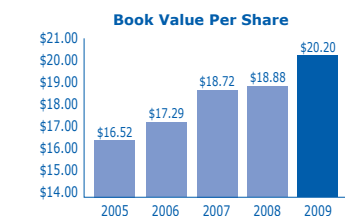
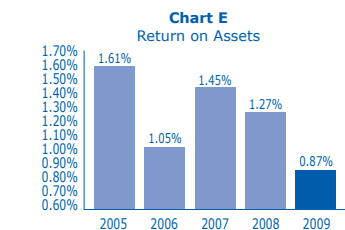
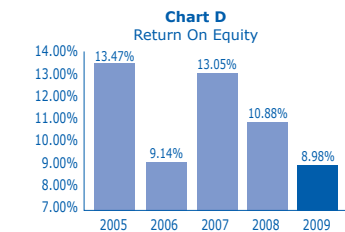
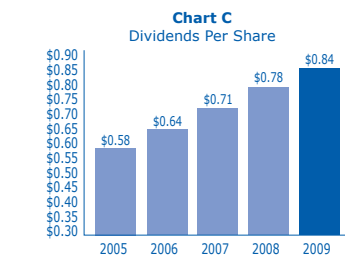
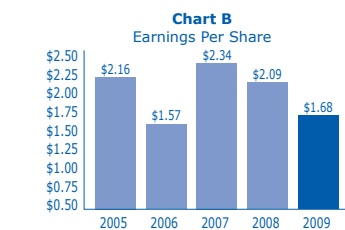
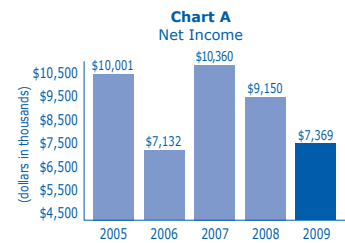
results of operation

earnings summary

For the year ended December 31, 2009, the Company reported net income of \$7,369,000, a decrease of \$1,781,000, or 19.46%, from the \$9,150,000 earned during 2008. Earnings per common share were \$1.68 in 2009, a decrease of \$0.41, or 19.62%, from the \$2.09 earned during 2008. The trend for net income is illustrated in **Chart A**, while the trend for earnings per share is illustrated in **Chart B**. The cash dividend per share was \$0.84 in 2009, compared to \$0.78 in 2008. The trend in cash dividends is illustrated in **Chart C**. Return on Average Equity (ROE) is net income stated as a percentage of the shareholders' investment in the Company. The ROE was 8.98% in 2009 compared to 10.88% in 2008 and 13.05% in 2007, as illustrated in **Chart D**. The average ROE over the past five years is 11.11%. Return on Assets (ROA) is net income stated as a percentage of average total assets of the Company. As **Chart E** illustrates, ROA was 0.87% in 2009 compared to 1.27% in 2008 and 1.45% in 2007. The average ROA over the past five years is 1.25%.

Fiscal year 2009 was a very challenging but rewarding year. Leading economists have called the financial crisis, which came to a head in the fourth quarter of 2008, the worst financial crisis since the Great Depression of the 1930s. It contributed to the failure of key businesses, declines in consumer wealth estimated in the trillions of dollars, substantial financial commitments incurred by governments, and a significant decline in economic activity. The collapse of a global housing bubble caused the values of securities tied to real estate pricing to plummet, damaging financial institutions globally. Questions regarding bank solvency, declines in credit availability, and damaged confidence had an impact on global stock markets.

The challenges of the economy presented a very difficult operating environment in 2009. Initial threats of bank liquidity were offset by the Federal Reserve's economic policy that caused a flight to quality and an increase in the FDIC insurance limit to \$250,000. Loan demand was weak as customers were reluctant to take on more debt in very uncertain times. Equity market values declined more than 50%, causing wealth management fees to severely lag behind plan during the first six months of the year. The Company's increase in provision for credit losses reflected the continuing weak economic conditions and the corresponding impact on commercial, commercial real estate, and consumer loan portfolios as well as stress in the residential real estate



markets. As a result of these economic factors, the Company's non-performing assets as a percent of total loans and other real estate increased to 1.14% at December 31, 2009, from 0.90% at December 31, 2008. The company completed five acquisitions during 2009 which included a Peoria, Arizona branch, the Eide Bailly, LLP retirement line, Residential Mortgage Group, and two FDIC assisted transactions (BankFirst and Prosperan Bank).

acquisitions

On June 1, 2009, Alerus Financial, N.A. acquired the deposits of an Arizona branch of Meridian Bank in Peoria. The company acquired \$11,495,173 in deposits for a purchase price of \$420,000. Of the total purchase price, \$85,000 was allocated to a core deposit premium, and \$335,000 was allocated to an identifiable intangible for the purchase of the Arizona banking charter.

On July 17, 2009, Alerus Financial, N.A. entered into a purchase and assumption agreement with the Federal Deposit Insurance Corporation ("FDIC") to acquire certain assets and assume all of the deposits of BankFirst, Sioux Falls, South Dakota. Alerus Financial, N.A. purchased \$36,554,800 of assets, which was mostly cash and cash equivalents and assumed \$217,513,458 in liabilities. Alerus Financial, N.A. simultaneously sold the \$88,817,132 in deposits located in South Dakota to First Dakota National Bank of Yankton, South Dakota. The purchase price of \$633,100 was paid to the FDIC as receiver for BankFirst. Alerus Financial, N.A. received \$100,000 in consideration for the deposits subsequently sold to First Dakota National Bank. The net balance of \$533,100 was allocated to a core deposit intangible.

On August 1, 2009, Alerus Financial, N.A. acquired the assets of the retirement plan record keeping division of Eide Bailly, LLP. The purchase price has two components that in aggregate will not exceed \$941,918. The two components consist of \$706,438 in cash, which was paid at closing, and a final payment due on October 31, 2010 not to exceed \$235,480. Of the purchase price, \$706,438 was allocated to identifiable intangibles.

On November 6, 2009, the Corporation's bank subsidiary, Alerus Financial, N.A. ("Bank"), entered into a purchase and assumption agreement with the Federal Deposit Insurance Corporation ("FDIC") to acquire certain assets and assume substantially all of the deposits and certain liabilities of Prosperan Bank, a Minnesota state-chartered bank headquartered in Oakdale, Minnesota.

Prosperan Bank operated two branches in Minnesota in the communities of Oakdale and Maplewood. Excluding the effects of purchase accounting adjustments, the Corporation assumed approximately \$175,500,000 of the deposits, purchased approximately \$131,300,000 in loans, \$6,100,000 of other real estate owned ("OREO") and \$8,800,000 of investment securities for a deposit premium of 1.02% on qualifying deposits totaling \$1,714,388 and an asset discount on acquired assets of a negative \$19,290,000. In connection with the acquisition, the Corporation also entered into a loss share agreement with the FDIC. Approximately \$137,400,000 of acquired loans and OREO are covered by loss sharing agreements between the FDIC and the Corporation.

Pursuant to the terms of the loss share agreement, the FDIC's obligation to reimburse the Corporation for losses with respect to the loans and OREO (collectively, "covered assets") begins with the first dollar of loss incurred. The covered assets are subject to a stated threshold of \$66,000,000 that provides for the FDIC to reimburse the Corporation for (1) 80% of losses incurred up to \$66,000,000 and (2) 95% of losses in excess of \$66,000,000. Gains and recoveries on covered assets will offset losses, or be paid to the FDIC at the applicable loss share percentage at the time of recovery.

The loss sharing agreement applicable to single-family residential mortgage loans provides for FDIC loss sharing and Corporation reimbursement, in each case as described above, for 10 years. The loss sharing agreement applicable to commercial loans and other covered assets provides for FDIC loss sharing for five years and Corporation reimbursement to the FDIC for gains and recoveries for a total of eight years, in each case described above.

The loss sharing agreements are subject to certain servicing procedures as specified in the agreements. The expected reimbursement under the loss sharing agreements were recorded as an indemnification asset at their estimated value of \$41,900,000 on the acquisition date.

The Corporation did not immediately acquire the real estate, banking facilities, furniture, or equipment of Prosperan Bank as part of the purchase and assumption agreement. However, the Corporation did exercise an option to purchase the real estate, furniture, and equipment from the FDIC. Acquisition costs of the real estate, furniture, and equipment will be based on the current appraisal and determined at a later date.

The Prosperan Bank acquisition was accounted for under the acquisition method in accordance with FASB ASC 805, Business Combinations. The purchased assets and assumed liabilities were recorded at their respective acquisition date fair values, and identifiable intangible assets were recorded at fair value. Fair values are preliminary and subject to refinement for up to one year after the closing date of a merger as information relative to closing date fair values becomes available. A "bargain purchase option" gain totaling \$7,016,000 resulted from the acquisition and is included as a component of non-interest income on the statement of income. The amount of the gain is equal to the amount by which the fair value of assets purchased exceeded the fair value of liabilities assumed.

On December 31, 2009, Alerus Financial, N.A. acquired the assets of Residential Mortgage Group, Minnetonka, Minnesota. The purchase price of \$330,815 was in consideration for \$280,815 in net book value of fixed assets and \$50,000 in consideration for a deposit on the current lease. There was no value allocated to identifiable intangibles. Residential Mortgage Group provides residential mortgage banking services to Minneapolis and surrounding communities.

TABLE 1 – SELECTED FINANCIAL DATA

For years ended December 31 (dollars in thousands except per share data)

RESULTS OF OPERATIONS	2009	2008	2007	2006	2005	2004	5-Year Compound Growth Rate
Interest income	\$ 39,720	\$ 41,274	\$ 46,589	\$ 43,948	\$ 34,862	\$ 28,711	6.71%
Interest expense	11,196	14,206	20,762	19,242	11,699	7,552	8.19%
Net interest income	28,524	27,068	25,827	24,706	23,163	21,159	6.16%
Taxable equivalent adjustment	442	422	469	388	287	299	8.13%
Taxable equivalent net interest income	28,966	27,490	26,296	25,094	23,450	21,458	6.18%
Non-interest income	42,740	37,755	31,815	25,963	24,207	20,525	15.80%
Net revenue	71,706	65,245	58,111	51,057	47,657	41,983	11.30%
Non-interest expense	52,943	48,027	40,543	34,180	30,785	30,133	11.93%
Provision for loan losses	7,185	2,844	960	5,675	945	83	144.04%
Net income	\$ 7,369	\$ 9,150	\$ 10,360	\$ 7,132	\$ 10,001	\$ 7,411	-0.11%
PER SHARE *(adjusted for a 2-1 stock split in form of a 100% stock dividend)							
Earnings per common share	\$ 1.68	\$ 2.09	\$ 2.34	\$ 1.57	\$ 2.16	\$ 1.60	0.98%
Common dividends declared	0.84	0.78	0.71	0.64	0.58	0.53	9.86%
Book value	\$ 20.20	\$ 18.88	\$ 18.72	\$ 17.29	\$ 16.52	\$ 15.28	5.74%
Weighted average common shares	4,377,517	4,385,685	4,421,633	4,531,220	4,628,227	4,644,770	-1.18%
AVERAGE BALANCES							
Interest-bearing deposits with banks	\$ 261	\$ 168	\$ 1,105	\$ 192	\$ 3,749	\$ 22,919	-59.14%
Federal funds sold	18,905	5,915	10,987	1,640	2,039	5,191	29.50%
Investment securities	151,931	104,846	109,654	110,534	105,223	120,045	4.82%
Loans - excluding covered assets	542,470	537,117	527,851	509,548	453,882	392,511	6.69%
Covered assets	13,354	-	-	-	-	-	-
Total interest-bearing assets	726,921	648,046	649,597	621,914	564,893	540,666	6.10%
Total assets	849,307	723,041	716,186	681,913	621,218	596,449	7.32%
Non-interest-bearing deposits	117,029	104,090	97,654	86,105	91,381	82,655	7.20%
Interest-bearing deposits	606,140	467,427	496,051	461,530	403,800	370,166	10.37%
Total deposits	723,169	571,517	593,705	547,635	495,181	452,821	9.82%
Short-term borrowings	137	27,234	19,971	34,929	30,163	39,275	-67.75%
Other borrowed funds	34,117	31,965	10,280	11,702	12,896	29,323	3.07%
Shareholders' equity	\$82,052	\$ 84,101	\$ 79,404	\$ 78,043	\$ 74,260	\$ 68,601	3.65%
RATIOS							
Return on average assets	0.87%	1.27%	1.45%	1.05%	1.61%	1.24%	
Return on average common equity	8.98%	10.88%	13.05%	9.14%	13.47%	10.80%	
Net interest margin	3.98%	4.24%	4.05%	4.03%	4.15%	3.97%	
Efficiency ratio	74.45%	74.26%	70.58%	66.94%	64.60%	71.77%	
Dividend payout ratio	50.00%	37.32%	30.34%	40.76%	26.85%	32.81%	
Average shareholders' equity to average total assets	9.66%	11.63%	11.09%	11.44%	11.95%	11.50%	

net interest income

Net interest income is one of the Company's primary sources of earnings. Net interest income is calculated as the difference between interest income (which includes yield related loan fees) and interest expense. Net interest income, on a taxable-equivalent basis, expressed as a percentage of average total earning assets is referred to as the net interest margin, which represents the average net effective yield on earning assets. The net interest margin is determined by many variables including the volume, yield, and mix of earning assets and interest-bearing liabilities, the level of non-performing assets, the level of non-interest-bearing liabilities, the general level of interest rates, and the slope of the yield curve.

Net interest income on a taxable-equivalent basis was \$28,966,000 in 2009, an increase of \$1,476,000, or 5.37%, from the \$27,490,000 reported in 2008. The increase in net interest income was primarily due to higher levels of earning assets associated with investing excess liquidity associated with deposits assumed in the BankFirst transaction and lower cost core deposit funding. Average interest-bearing assets were \$726,921,000 in 2009, an increase of \$78,875, or 12.17%, from the \$648,046,000 reported in 2008. Average deposits were \$723,169,000 and \$571,517,000 and funded 85.15% and 79.04% of the Company's average total assets in 2009 and 2008, respectively. **Chart F** illustrates net interest income on a tax equivalent basis for the past five years.

TABLE 2 – AVERAGE BALANCE SHEETS AND AVERAGE RATES

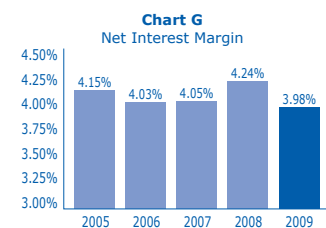
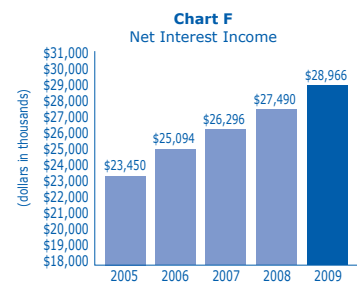
For years ended December 31 (dollars in thousands)

ASSETS	Avg Balance	2009 Avg Rate	Interest	Avg Balance	2008 Avg Rate	Interest	Avg Balance	2007 Avg Rate	Interest
Interest-bearing deposits with banks	\$ 261	0.38%	\$ 1	\$ 168	2.98%	\$ 5	\$ 1,105	3.71%	\$ 41
Federal funds sold	18,905	0.72%	137	5,915	2.32%	137	10,987	4.94%	543
Investment securities (a)	151,931	4.39%	6,673	104,846	5.71%	5,991	109,654	5.68%	6,229
Loans									
Commercial and financial (a)	175,917	5.50%	9,681	182,593	6.87%	12,545	188,040	7.71%	14,489
Agricultural	32,420	5.41%	1,754	32,399	6.03%	1,955	33,838	7.86%	2,659
Real estate	310,178	6.28%	19,465	302,499	6.51%	19,688	287,802	7.14%	20,558
Consumer loans	23,955	6.09%	1,460	19,626	7.01%	1,375	18,171	13.97%	2,539
Total loans -									
Excluding covered assets	542,470	5.97%	32,360	537,117	6.62%	35,563	527,851	7.62%	40,245
Covered assets	13,354	7.42%	991	-	-	-	-	-	-
Total Earning Assets	726,921	5.52%	40,162	648,046	6.43%	41,696	649,597	7.24%	47,058
Cash and due from banks	68,354			19,689			20,923		
Loan loss reserve	(8,954)			(6,988)			(6,224)		
Goodwill & other intangibles	14,817			13,054			8,075		
Bank premises and equipment	14,226			14,737			14,662		
Other	33,943			34,503			29,153		
Total Assets	\$ 849,307			\$723,041			\$716,186		
LIABILITIES AND SHAREHOLDERS' EQUITY									
Savings, NOW, and money market deposits	\$ 357,537	0.88%	3,139	\$256,111	1.56%	4,001	\$255,609	3.44%	8,788
Time deposits	248,603	2.74%	6,823	211,316	3.87%	8,177	240,442	4.19%	10,070
Short-term borrowings	137	11.68%	16	27,234	2.54%	691	19,971	5.55%	1,109
Other borrowed funds	34,117	3.57%	1,218	31,965	4.18%	1,337	10,280	7.73%	795
Total Interest-bearing Liabilities	640,394	1.75%	11,196	526,626	2.70%	14,206	526,302	3.94%	20,762
Non-interest-bearing deposits	117,029			104,090			97,654		
Other liabilities	9,832			8,224			12,826		
Shareholders' equity	82,052			84,101			79,404		
Total Liabilities and Shareholders' Equity	\$ 849,307			\$723,041			\$716,186		
Net Interest Margin/Income		3.98%	\$28,966		4.24%	\$27,490		4.05%	\$26,296
Interest Rate Spread		3.78%			3.74%			3.30%	

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

TABLE 3 – VOLUME/RATE VARIANCE ANALYSIS

(dollars in thousands) Increase (decrease) in:	Change from 2008 to 2009			Change from 2007 to 2008		
	Volume	Rate	Total	Volume	Rate	Total
Interest income:						
Interest-bearing deposits with banks	\$ 2.77	\$ (6.77)	\$ (4.00)	\$ (34.77)	\$ (1.23)	\$ (36.00)
Federal funds sold	300.87	(300.87)	-	(250.67)	(155.33)	(406.00)
Investment securities	2,690.48	(2,008.48)	682.00	(273.12)	35.12	(238.00)
Loans - excluding covered assets						
Commercial and financial	(458.67)	(2,405.33)	(2,864.00)	(419.71)	(1,524.29)	(1,944.00)
Agricultural	1.27	(202.27)	(201.00)	(113.08)	(590.92)	(704.00)
Real estate	499.78	(722.78)	(223.00)	1,049.82	(1,919.82)	(870.00)
Consumer loans	303.29	(218.29)	85.00	203.30	(1,367.30)	(1,164.00)
Total loans excluding covered assets	345.67	(3,548.67)	(3,203.00)	720.34	(5,402.34)	(4,682.00)
Covered assets	-	991.00	991.00	-	-	-
Total Interest Income	3,339.79	(4,873.79)	(1,534.00)	161.79	(5,523.79)	(5,362.00)
Interest expense:						
Savings, NOW, and money market deposits	1,584.49	(2,446.49)	(862.00)	17.26	(4,804.26)	(4,787.00)
Time deposits	1,442.84	(2,796.84)	(1,354.00)	(1,219.83)	(673.17)	(1,893.00)
Short-term borrowings	(687.52)	12.52	(675.00)	403.32	(821.32)	(418.00)
Other borrowed funds	90.01	(209.01)	(119.00)	1,677.00	(1,135.00)	542.00
Total Interest Expense	2,429.82	(5,439.82)	(3,010.00)	877.75	(7,433.75)	(6,556.00)
Net Variance	\$ 909.96	\$ 566.04	\$ 1,476.00	\$(715.96)	\$ 1,909.96	\$ 1,194.00



For 2009, the net interest margin was 3.98%, compared with 4.24% in 2008. In 2009, the Company experienced substantial growth in customer deposits through existing customers increasing their rate of savings and through acquired deposits through FDIC assisted transactions. Demand for loans was relatively weak during 2009, causing excess liquidity to be invested in lower-yielding government guaranteed mortgages and agencies. The change in earning asset mix was the primary cause for the decrease in net interest margin during 2009.

The Company positions the balance sheet to be interest rate neutral to slightly liability sensitive, defined as allowing liabilities on the balance sheet to reprice faster than the assets. The Company chooses to manage the balance sheet to be slightly liability sensitive to take advantage of a normally upward sloping yield curve. The Federal Reserve aggressively took action during 2008, reducing the targeted federal funds rate by 400 basis points in an attempt to unfreeze the credit markets. The current target for federal funds is between 0.00% and 0.25%. A federal funds target at this level makes borrowing more attractive to the majority of customers the Company serves. **Chart G** illustrates net interest margin for the past five years.

Table 2 provides detailed information as to average balances, interest income and expense, and rates earned and paid by major balance sheet category for the years 2007 through 2009. **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.

provision for loan losses

Annual fluctuations in the provision for loan losses result from management's regular assessment of the adequacy of the allowance for loan losses and is maintained at levels considered appropriate by management for probable and estimable incurred losses. The provision for loan losses for 2009 was \$7,185,000, an increase of \$4,341,000, from \$2,844,000 during 2008. This amount of provision was utilized to support growing problem loan volumes and to build the ratio of allowance for loan losses to end of year loans. The ratio of allowance for loan losses to end of year loans was 2.09% for 2009 compared to 1.42% for 2008. Average loans were \$542,470,000 in 2009, an increase of \$5,353,000, or 1.00%, from the \$537,117,000 reported in 2008. The increase in provision for loan losses reflected deterioration in economic conditions during most of the year and the corresponding impact on commercial, commercial real estate, and land development portfolios. The large increase in annual provision expense in 2009 was associated with management's general concern over broader market conditions and the potential for adverse customer impact. The amount of provision to be taken in future periods will depend on management's assessment of the adequacy of the allowance for loan losses in relation to the loss experience of the entire loan portfolio.

non-interest income

The company continues to expand non-interest income associated with the Company's banking and wealth management divisions. Management is working to increase the contribution of non-interest income to operating results by increasing the delivery of financial products and services. The Company's primary sources of non-interest income consist of trust services, retirement plan services, record keeping, service charges on deposit accounts, and loan fees.

Non-interest income is a significant source of revenue for the Company, representing 59.60% of taxable equivalent net revenue in 2009, compared with 57.87% in 2008. Non-interest income was \$42,740,000 in 2009, a \$4,985,000, or 13.20%, increase from the \$37,755,000 reported in 2008. The large increase in non-interest income was due to the recovery in the market values the last six months of the year, a low interest rate environment that was conducive to mortgage originations, and an FDIC assisted transaction that produced a large bargain purchase gain.

Wealth management income, which is the Company's largest source of non-interest income, was \$32,183,000 in 2009, a \$2,378,000, or 6.88% decrease from the \$34,561,000 reported in 2008. The Company collects fees based on the market value of assets managed, record keeping services, consulting, and brokerage and insurance commissions.

Trust and investment advisory fees declined \$1,743,000, or 21.29%, to \$6,445,000, reflecting lower assets under management and the impact of low interest rates on money market investment fees.

Service charges on deposit accounts were \$813,000 in 2009, an \$80,000, or 10.91%, increase from the \$733,000 reported in 2008. The increase in deposit service charges was associated with the commercial services product suite that includes Remote Deposit, Positive Pay, Business On-Line and ACH services. Charges collected on deposit accounts are typically reclassified to loan interest income when the fee collected is associated with an overdraft balance. The dollar amount of deposit service charges reclassified into loan interest income for 2009 was \$1,362,456 compared to \$1,460,917 for 2008.

Mortgage origination and loan servicing fees were \$1,965,000 in 2009, a \$338,000, or 20.77%, increase from the \$1,627,000 reported in 2008. Loan servicing fees and the collection of prepayment premiums on fixed rate loans contributed to the increase in mortgage origination and loan servicing fees. Loan servicing fees were \$432,258 in 2009, a \$64,987, or 17.69%, increase from the \$367,272 reported in 2008. Loan servicing fees increased in 2009 due to the amount of sold loans increasing \$1,231,000 to \$132,006,000. Mortgage origination fees were \$1,172,082, a \$700,240, or 148.41%, increase from the \$471,842 reported in 2008.

The Company incurred \$749,336 in investment losses during 2009. The Company incurred impairment write-downs on a private label mortgage backed with residential real estate. With the heavy losses incurred in the residential real estate sector, credit support in these bonds has accelerated, indicating a high probability of future losses.

	2009	2008	2007	% Increase/ decrease 2009/2008	% Increase/ decrease 2008/2007
Wealth management income:					
Retirement plans	\$ 21,662	\$ 21,595	\$ 17,562	0.31%	22.96%
Property management	1,423	1,483	1,532	-4.05%	-3.20%
Trusts, agencies, wills, estates and other	5,124	5,979	6,401	-14.30%	-6.59%
Brokerage commissions	1,492	1,845	1,765	-19.13%	4.53%
Insurance commissions	1,161	1,450	563	-19.93%	157.55%
Investment advisory fees	1,321	2,209	662	-40.20%	233.69%
Total Wealth Management Income	\$ 32,183	\$ 34,561	\$ 28,485	-6.88%	21.33%
Service charges on deposit accounts	813	733	677	10.91%	8.27%
Mortgage origination and loan servicing fees	1,965	1,627	1,342	20.77%	21.24%
Investment security gains (losses)	(749)	(1,011)	-	-25.91%	0.00%
Gain on acquisition	7,016	-	-	0.00%	0.00%
Other non-interest income	1,512	1,845	1,311	-18.05%	40.73%
Total Non-Interest Income	\$ 42,740	\$ 37,755	\$ 31,815	13.20%	18.67%

The Company recorded a bargain purchase option gain in the amount of \$7,016,000 associated with the acquisition of Prosperan Bank from the FDIC. The transaction was accounted for under the acquisition method in accordance with FASB ASC 805, Business Combinations. The purchased net assets and assumed liabilities were recorded at their respective acquisition date fair values, and the identifiable intangible was recorded at fair value. The amount of the gain is equal to the amount by which the fair value of assets purchased exceeded the fair value of liabilities assumed.

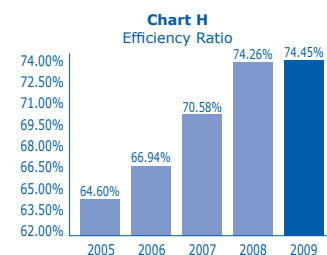
Other non-interest income was \$1,512,000 in 2009, a \$333,000, or 18.05%, decrease from the \$1,845,000 reported in 2008. The large decrease in other non-interest income was associated with VISA, Inc. going private and the receipt of \$482,785 of stock in the company during 2008. **Table 4** provides a summary of changes in non-interest income for the past three years.

non-interest expense

Total non-interest expense was \$52,943,000 in 2009, a \$4,916,000, or 10.24%, increase from the \$48,027,000 reported in 2008. The large increase in non-interest expense in 2009 was associated with the implementation of strategic initiatives, which will have accretive effects to net income in future accounting periods. The strategic initiatives are as follows:

1. Purchase of branch in Peoria, Arizona.
2. Purchase of deposits from BankFirst in an FDIC assisted transaction.
3. Purchase of Eide Bailly, LLP retirement plan administration business.
4. Purchase of Prosperan Bank in an FDIC assisted transaction.
5. Purchase of Residential Mortgage Group in Minneapolis, Minnesota.

The Company's efficiency ratio, defined as the percent of expense to total income, increased to 74.45% in 2009, compared to 74.26% in 2008. **Chart H** illustrates the trend in the efficiency ratio over the last five years. While control of non-interest expense is a top priority of management, the higher than average efficiency ratio is partially due to the Company's goal of generating 50% of total revenue from non-interest income sources.



	2009	2008	2007	% Increase/ decrease 2009/2008	% Increase/ decrease 2008/2007
Salaries	\$ 24,885	\$ 23,770	\$ 19,673	4.69%	20.83%
Employee benefits	6,050	5,481	4,816	10.38%	13.81%
Occupancy expense	3,331	3,195	2,944	4.26%	8.53%
Furniture and equipment expense	2,688	2,405	2,211	11.77%	8.77%
Marketing, business development and public relations	3,312	3,146	2,694	5.28%	16.78%
Supplies, telephone and postage	2,359	2,158	1,958	9.31%	10.21%
FDIC insurance	1,739	251	270	592.83%	-7.04%
Professional fees (legal, audit and consulting)	2,046	1,054	861	94.12%	22.42%
Correspondent and other service fees	3,081	2,867	2,677	7.46%	7.10%
Other non-interest expenses	3,452	3,700	2,439	-6.70%	51.70%
Total Non-Interest Expenses	\$ 52,943	\$ 48,027	\$ 40,543	10.24%	18.46%

The efficiency ratio for a business comprised solely of net interest margin income is dramatically lower than a business comprised solely of asset management income; however, the income generated from asset management has higher risk adjusted returns since the Company does not have to allocate regulatory capital to the assets or carry a credit reserve. Given continued net interest margin pressure in the banking industry today and a competitive market share environment, management is seeking to develop a diversified revenue stream that will be less sensitive to extreme interest rate movements. This diversification will create a higher efficiency ratio when compared to local peers without a similar revenue mix. Management will continue to balance short-term earnings with the long-term competitive development of its resources such as people, facilities, products, and computer systems.

Salary and employee benefit cost is the largest component of total expense for the Company. Salary and employee benefit cost represented 58.43% in 2009 compared to 60.91% in 2008 and 60.40% in 2007. Salary and employee benefit cost was \$30,935,000 in 2009, a \$1,684,000, or 5.76%, increase from the \$29,251,000 reported in 2008. The large increase in salary and employee benefit cost was due to adding 38 employees throughout the year associated with four of the acquisitions. The final acquisition of Residential Mortgage Group was done effective December 31, and added 60 employees.

Occupancy expense was \$3,331,000 in 2009, a \$136,000, or 4.26%, increase from the \$3,195,000 reported in 2008. The Company assumed the lease for the branch in Peoria and had to pay two months of rent for the Minnetonka leased office space acquired from Prosperan. The lease on this space will be cancelled in 2010 and consolidated with the Company's existing Minnetonka location.

FDIC Insurance expense was \$1,739,000 in 2009, a \$1,488,000, or 592.83%, increase from the \$251,000 reported in 2008. The large increase in expense was associated with two separate components. The first was a higher level of assessments for 2009. Our quarterly assessment amount increased from 6 basis points to 12 basis points per quarter. The second was a one-time assessment of 10 basis points payable on June 30, 2009. The amount of the assessment was \$344,125.

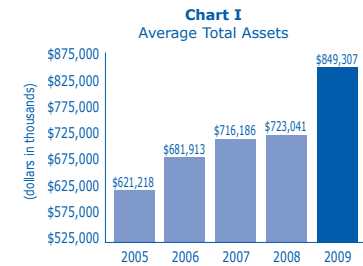
Professional fee expense was \$2,046,000 in 2009, a \$992,000, or 94.12%, increase from the \$1,054,000 reported in 2008. Higher levels of professional fees were incurred with one-time expenses associated with the Prosperan transaction to include investment banking, legal, and loan collection expenses that are 80% reimbursable under the loss share agreement.

Other operating expense was \$14,892,000 in 2009, a \$616,000, or 4.31%, increase from the \$14,276,000 reported in 2008. The Company's acquisitions over the year created additional intangibles that are set up to amortize between five and seven years. Intangible amortization was \$1,464,429 in 2009, an increase of \$521,574, or 55.32%, from the \$942,855 reported in 2008. **Table 5** provides a summary of changes in non-interest expenses for the past three years.

statement of financial condition

overview

Total assets of the Company were \$1,126,846,000 at December 31, 2009, an increase of \$365,840,000, or 48.07%, from the \$761,006,000 reported at December 31, 2008. Total average assets of the Company were \$849,307,000 in 2009, an increase of \$126,266,000, or 17.46%, from the \$723,041,000 reported in 2008. **Chart I** illustrates average total assets for the past five years. Average earning assets were \$726,921,000 in 2009, an increase of \$78,875,000, or 12.17%, from the \$648,046,000 reported in 2008. Average earning assets represent 85.59% of average total assets in 2009 compared to 89.63% in 2008. The increase in average earning assets of \$78,875,000, or 12.17%, was primarily driven by three acquisitions to include the purchase of a Peoria, AZ branch, the assumption of deposits from the failed BankFirst, and the whole bank purchase of Prosperan Bank from the FDIC through an assisted transaction. Average interest-bearing liabilities represented 81.26% of average earning assets in 2009 compared to 88.10% in 2008.



securities

The Company uses its investment securities portfolio for several purposes. It serves as a vehicle to manage interest rate risk and prepayment risk, generates interest and dividend income from the investment of excess funds depending on loan demand, and provides liquidity as is used for collateral for public deposits and wholesale funding sources. While it is the Company's intent to hold its investment securities indefinitely, the Company may take actions in response to structural changes in interest rate risks and to meet liquidity requirements.

At December 31, 2009, investment securities, both available for sale and held to maturity, totaled \$288,487,000, compared with \$92,550,000 at December 31, 2008. The \$195,937,000 year over year increase reflects additional purchases made to absorb excess liquidity. The weighted average yield of the investment portfolio was 4.39% at December 31, 2009 compared with 5.71% at December 31, 2008. At December 31, 2009, the available for sale portfolio included a \$5,255,000 net unrealized loss, compared with a net unrealized loss of \$8,609,000 at December 31, 2008.

The Company periodically evaluates available for sale securities for other than temporary impairment. There is uncertainty concerning the effect of the mortgage crisis and the eventual impact on mortgage collateral being held in private label mortgage backed securities. At December 31, 2009, the Company held \$22,106,000 of private labeled mortgage related securities with a current market value loss of \$6,065,000. It is currently unclear how much price depreciation is associated with the underlying collateral credit quality and how much price depreciation is associated with a lack of market liquidity. A detailed analysis is performed quarterly to determine if any security is other than temporarily impaired by analyzing constant default rates, prepayment speeds, and loss severities. Based on the evaluation for the year ending December 31, 2009, the Company recorded \$750,000 of other than temporary impairment related to five non-investment graded non-agency mortgage backed securities.

loans

Total loans were \$616,896,000 at December 31, 2009, up \$65,989,000, or 11.98%, from the \$550,907,000 reported at December 31, 2008. Average loans were \$555,824,000 in 2009, an increase of \$18,707,000, or 3.48%, compared with \$537,117,000 reported in 2008. The increase in total loans was driven by the purchase of \$131,100,000 of loans associated with the FDIC assisted acquisition of Prosperan Bank. The loans were booked at their fair value of \$87,700,000 and an indemnification asset of \$31,397,000 was established. Window charge-offs totaling \$10,313,000 were assumed as part of the transaction and subsequently charged off. Total non-covered loans were \$529,895,000 at December 31, 2009, down \$21,012,000, or 3.81%, from the \$550,907,000 reported at December 31, 2008. Loan demand was weak as customers were reluctant to take on more debt in very uncertain times. The loan to deposit ratio decreased to 65.20% at December 31, 2009 compared to 87.13% at December 31, 2008, as the Company acquired \$315,692,000 of deposits versus \$87,700,000 of net loans through acquisitions during 2009.

TABLE 6A — LOANS EXCLUDING COVERED ASSETS BY TYPE

As of December 31 (dollars in thousands)

	2009	2008	2007	2006	2005	2004
Commercial and financial	\$ 163,524	\$ 177,246	\$ 189,500	\$ 180,187	\$ 162,115	\$ 145,488
Agricultural	44,806	37,139	35,578	35,778	32,596	29,962
Real estate	298,010	313,320	274,497	289,308	275,190	239,737
Consumer loans	23,555	23,202	19,228	18,546	18,613	23,156
Total Loans	\$ 529,895	\$ 550,907	\$ 518,803	\$ 523,819	\$ 488,514	\$ 438,343
PERCENT OF LOANS BY TYPE						
Commercial and financial	30.86%	32.17%	36.53%	34.40%	33.19%	33.19%
Agricultural	8.46%	6.74%	6.86%	6.83%	6.67%	6.84%
Real estate	56.24%	56.87%	52.91%	55.23%	56.33%	54.69%
Consumer loans	4.45%	4.21%	3.71%	3.54%	3.81%	5.28%
Total Loans	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%
Sold loans:						
Commercial and financial	\$ 51,516	\$ 73,227	\$ 65,706	\$ 48,052	\$ 41,095	\$ 60,959
Agricultural	-	215	500	571	2,905	2,598
Real estate	208,100	110,364	74,133	64,696	48,308	52,060
Consumer loans	-	-	-	-	-	-
Total Sold Loans	\$ 259,616	\$ 183,806	\$ 140,339	\$ 113,319	\$ 92,308	\$ 115,617
Purchased loans:						
Commercial and financial	\$ 15,280	\$ 25,586	\$ 32,765	\$ 39,289	\$ 35,220	\$ 28,634
Agricultural	518	611	691	766	-	884
Real estate	12,104	18,136	16,791	22,271	15,766	14,143
Consumer loans	-	-	-	-	-	-
Total Purchased Loans	\$ 27,902	\$ 44,333	\$ 50,247	\$ 62,326	\$ 50,986	\$ 43,661

The Company periodically sells loans to a participation network to manage concentration risk and reduce credit exposure. The sold loan portfolio was \$259,616,000 on December 31, 2009, an increase of \$75,810,000, or 41.24%, from the \$183,806,000 reported at December 31, 2008. The Company also actively purchases loans through the related participation network. The purchased loan portfolio was \$27,902,000 on December 31, 2009, a decrease of \$16,431,000, or 37.06%, from the \$44,333,000 reported at December 31, 2008. The Company's loan mix excluding covered loans remained relatively constant during 2009. **Table 6A** provides a summary of changes in loans excluding covered assets for the past six years. The covered loan mix is heavily weighted in commercial real estate, which comprises \$72,636,000, or 83.49%, of the \$87,001,000 portfolio. **Table 6B** provides a summary of the loan mix on covered loans.

TABLE 6B — COVERED LOANS BY TYPE

As of December 31 (dollars in thousands)

	2009
Commercial and financial	\$ 13,336
Agricultural	259
Real estate	72,636
Consumer loans	770
Total Covered Loans	\$ 87,001
PERCENT OF LOANS BY TYPE	
Commercial and financial	15.33%
Agricultural	0.30%
Real estate	83.49%
Consumer loans	0.89%
Total Loans	100.00%

TABLE 7 — DEPOSITS BY TYPE*As of December 31 (dollars in thousands)*

	2009	2008	2007	2006	2005	2004
Non-interest-bearing deposits	\$ 130,442	\$ 116,189	\$ 97,259	\$ 108,686	\$ 112,747	\$ 113,329
Interest-bearing deposits:						
Saving accounts	12,173	9,741	10,293	12,203	15,720	20,717
NOW accounts	137,075	118,688	135,530	121,008	120,438	101,046
Money market deposit accounts	346,041	167,291	120,123	109,063	65,555	80,609
Time deposits \$100,000 and over	128,337	87,847	93,395	101,606	99,569	52,639
Time deposits less than \$100,000	192,031	132,520	129,077	139,424	123,766	108,834
Total Deposits	\$ 946,099	\$ 632,276	\$ 585,677	\$ 591,990	\$ 537,795	\$ 477,174
PERCENT OF DEPOSITS BY TYPE						
Non-interest-bearing deposits	13.79%	18.38%	16.61%	18.36%	20.96%	23.75%
Interest-bearing deposits:						
Saving accounts	1.29%	1.54%	1.76%	2.06%	2.92%	4.34%
NOW accounts	14.49%	18.77%	23.14%	20.44%	22.39%	21.18%
Money market deposit accounts	36.58%	26.46%	20.51%	18.42%	12.19%	16.89%
Time deposits \$100,000 and over	13.56%	13.89%	15.95%	17.16%	18.51%	11.03%
Time deposits less than \$100,000	20.30%	20.96%	22.04%	23.55%	23.01%	22.81%
Total Deposits	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%

deposits

Core deposits provide the Company's major source of funds from individuals, businesses, and local government units. Core deposits consist of all local non-interest-bearing deposits, interest-bearing savings and checking accounts, and time deposits of less than \$100,000. Core deposits funded 72.57% and 71.54% of total assets at December 31, 2009 and 2008, respectively.

Total deposits were \$946,099,000 at December 31, 2009, an increase of \$313,823,000, or 49.63%, from the \$632,276,000 reported at December 31, 2008. Average deposits were \$723,169,000 in 2009, an increase of \$151,652,000, or 26.54%, compared with the \$571,517,000 reported in 2008. The large increase in deposits was the result of acquiring \$315,692,000 of deposits through three acquisitions during 2009.

Non-interest-bearing deposits were \$130,442,000 at December 31, 2009, an increase of \$14,253,000, or 12.27%, from the \$116,189,000 reported at December 31, 2008. Average non-interest-bearing deposits were \$117,029,000 in 2009, an increase of \$12,939,000, or 12.43%, compared with \$104,090,000 in 2008. The increase in non-interest-bearing deposits was primarily attributable to acquiring business customers in the BankFirst and Prosperan Bank acquisition.

Interest-bearing savings deposits totaled \$495,289,000 at December 31, 2009, an increase of \$200,019,000, or 67.74%, from the \$295,270,000 reported at December 31, 2008. Average interest-bearing savings deposits were \$357,537,000 in 2009, an increase of \$101,426,000, or 39.60%, compared with \$256,111,000 in 2008. Interest-bearing time deposits were \$320,368,000 at December 31, 2009, an increase of \$100,001,000, or 45.38%, from the \$220,367,000 reported at December 31, 2008. Average interest-bearing time deposits were \$248,603,000 in 2009, an increase of \$37,287,000, or 17.65%, compared with \$211,316,000 in 2008. Time certificates of deposits 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 six years.

other borrowed funds

The Company utilizes both short-term and long-term borrowings to fund growth of earning assets in excess of deposit growth. Other borrowed funds, as of December 31, 2009, were \$42,497,000, an increase of \$9,773,000, or 29.87%, over December 31, 2008. The Company assumed \$10,000,000 of FHLB advances in the acquisition of Prosperan Bank. Other borrowed funds consist of five Federal Home Loan Bank advances totaling \$40,331,033, a \$100,000 note payable to Dakota Property Management, and obligations under capital lease associated with the lease agreement on the Corporate Center located in Grand Forks, ND, of \$2,062,705.

capital resources

The Company is committed to managing capital for maximum shareholder 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. To achieve these capital goals, the Company employs a variety of capital management tools including dividends and common share repurchases. Total shareholders' equity was \$88,342,000 at December 31, 2009, an increase of \$5,857,000, or 7.10% from the \$82,485,000 reported at December 31, 2008. The increase is the result of the current year's earnings less dividend payments to shareholders, common stock repurchases, and the market value change in the investment portfolio.

The Company paid dividends of \$0.84 during 2009, representing a \$0.06 or a 7.69% increase over the \$0.78 paid during 2008. The Company's dividend policy is influenced by the belief that most shareholders are interested in long-term performance 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.

The Company is committed to providing existing shareholders liquidity for their equity investment. The Company repurchased 27,941 shares associated with ESOP (Employee Stock Ownership Plan) participants exercising their option to sell their shares back to the Company at the appraised value of \$28.25 during 2009 for a total of \$789,333. This represents a decrease from the 54,733 shares that were repurchased at a weighted average price of \$33.55 for a total of \$1,836,490 during 2008.

Banking industry regulators define minimum capital requirements for banks and holding companies. The Company's Tier 1 and total risk based capital ratios as of December 31, 2009 amounted to 11.31% and 12.58%, respectively, well above the requirements to be considered well capitalized of 6.00% for Tier 1 and 10.00% for total risk based capital. This compares to Tier 1 and total risk based capital ratios of 11.60% and 12.83% at December 31, 2008. Regulatory authorities also have established a minimum leverage ratio of 5.00%, which is defined as Tier 1 capital to average assets. The Company's leverage ratio was 7.97% in 2009, compared to 10.29% in 2008.

risk analysis**asset quality risk**

Management believes its ability to identify and assess risk and return characteristics of the Company's loan portfolio is critical for profitability and growth. It is in the best interest of shareholders, regional communities, customers, and the Company to follow a credit policy that carefully balances risk/return trade-offs 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 an ongoing, internal review of any problem credits and continually assesses the adequacy of the allowance for possible loan loss. The Company utilizes an independent lending division, Special Credit Services, to develop and implement strategies for the management of individual non-performing loans.

The allowance for credit losses provides coverage for probable and estimable losses inherent in the Company's loan portfolio. Management evaluates the allowance each quarter to determine that 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, recent loss experience, and other factors, including regulatory guidance and economic conditions.

The assets acquired from the FDIC acquisition of Prosperan Bank included non-performing loans and other loans with characteristics indicative of high credit risk including a substantial portion of interest only and home builder and other construction finance. Because these loans are covered under loss share agreements with the FDIC, the Company's financial exposure to losses from these assets is substantially reduced. To the extent actual losses exceed the Company's estimates at acquisition, the Company's financial risk would only be its share of those losses under the loss share agreement.

	2009	2008	2007	2006	2005	2004
Non-accrual Loans						
Commercial and financial	\$ 1,769	\$ 3,161	\$ 756	\$ 536	\$ 115	\$ 26
Agricultural	-	-	-	-	29	-
Real estate	9,105	2,302	318	289	69	249
Consumer loans	-	4	-	491	21	5
Total Non-Accrual Loans	10,874	5,467	1,074	1,316	234	280
Foreclosed assets	6	146	40	408	-	-
Other real estate owned	1,927	1,207	125	-	-	30
Total Non-Performing Assets	\$ 12,807	\$ 6,820	\$ 1,239	\$ 1,724	\$ 234	\$ 310
Loans past due 90 days or more						
Commercial and financial	\$ -	\$ 71	\$ -	\$ -	\$ 122	\$ 69
Agricultural	16	-	-	-	-	-
Real estate	27	16	-	47	68	-
Consumer loans	-	-	-	-	-	7
Total Loans Past Due 90 Days or More	\$ 43	\$ 87	\$ -	\$ 47	\$ 190	\$ 76
Percentage of non-performing loans to loans	2.05%	0.99%	0.21%	0.25%	0.05%	0.06%
Percentage of non-performing assets to assets	1.14%	0.90%	0.18%	0.24%	0.04%	0.05%
Percentage of allowance for loan losses to non-performing loans	101.65%	142.91%	582.12%	442.55%	2349.57%	1730.71%

At December 31, 2009, non-performing assets excluding covered assets were \$12,807,000 compared to \$6,820,000 in 2008 and \$1,239,000 in 2007. Non-performing assets excluding covered assets represented 1.14% of total loans and other non-performing assets in 2009 compared to 0.90% in 2008 and 0.18% in 2007. **Table 8A** provides a summary of the non-performing loan history for the past six years. At December 31, 2009 non-performing covered assets were \$9,415,000. **Table 8B** provides a summary of the non-performing loans on covered assets.

At December 31, 2009, the allowance for loan losses was \$11,053,000, or 2.09%, of total loans excluding covered assets, compared with \$7,813,000, or 1.42%, at December 31, 2008, and \$6,252,000, or 1.21%, at December 31, 2007. The provision for loan losses was \$7,185,000 in 2009, \$2,844,000 in 2008, and \$960,000 in 2007. Net charge-offs in 2009 were \$3,945,000, or 0.73%, of average total loans excluding cover assets, compared with net charge-offs of \$1,283,000, or 0.24%, in 2008, and net charge-offs of \$532,000, or 0.10%, in 2007. The Company considers the allowance for loan losses of \$11,053,000 adequate to cover losses inherent in loans, commitments to extend credit, and standby letters of credit at December 31, 2009. **Table 9** provides a summary of the loan loss experience for the past six years.

liquidity risk

The Asset/Liability Committee ("ALCO") establishes policies, as well as analyzes and manages the Company's liquidity to ensure that 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 relatively short term, marketable investments and federal funds. As of December 31, 2009, the Company had short-term investments in federal funds of \$10,666,000 and \$205,607,000 of unpledged 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, 2009, the Company had \$79,000,000 of unsecured lines of credit for federal funds that may be drawn as needed and borrowing capacity at the Federal Home Loan Bank of \$79,995,000.

interest rate risk

The Company's major market risk exposure is changing 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 the ALCO committee.

	2009
Commercial and financial	\$ 836
Agricultural	-
Real estate	5,270
Consumer loans	-
Total Non-Accrual Loans	6,106
Foreclosed assets	3,224
Other real estate owned	85
Total Non-Performing Covered Assets *	\$ 9,415
Loans past due 90 days or more	
Commercial and financial	\$ -
Agricultural	-
Real estate	92
Consumer loans	-
Total Loans Past Due 90 Days or More	\$ 92

*Exposure on Covered Assets is limited to 20% on the first \$66 million and 5% thereafter

Interest rate risk can be broken down into four components which are as follows: 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.

	2009	2008	2007	2006	2005	2004
Average loans excluding covered assets	\$ 542,470	\$ 537,117	\$ 527,851	\$ 509,548	\$ 453,882	\$ 392,511
Allowance for loan losses:						
Balance at beginning of year	\$ 7,813	\$ 6,252	\$ 5,824	\$ 5,498	\$ 4,846	\$ 4,463
Charge-offs:						
Commercial and financial	(1,975)	(896)	(443)	(4,648)	(147)	(258)
Agricultural	-	-	-	-	(122)	(16)
Real estate	(1,963)	(229)	(68)	(720)	(41)	(19)
Consumer loans	(131)	(332)	(123)	(149)	(124)	(226)
Total Charge-offs	(4,069)	(1,457)	(634)	(5,517)	(434)	(519)
Recoveries:						
Commercial and financial	51	66	16	67	43	419
Agricultural	6	5	4	4	26	12
Real estate	-	26	-	24	6	264
Consumer loans	67	77	82	73	66	124
Total Recoveries	124	174	102	168	141	819
Net charge-offs	(3,945)	(1,283)	(532)	(5,349)	(293)	300
Provision charged to earnings	7,185	2,844	960	5,675	945	83
Balance at end of year	\$11,053	\$ 7,813	\$ 6,252	\$ 5,824	\$ 5,498	\$ 4,846
Ratio of net charge-offs to average loans:						
Commercial and financial	1.09%	0.45%	0.23%	2.71%	0.07%	-0.13%
Agricultural	-0.02%	-0.02%	-0.01%	-0.01%	0.32%	0.01%
Real estate	0.63%	0.07%	0.02%	0.24%	0.01%	-0.12%
Consumer loans	0.27%	1.30%	0.23%	0.41%	0.28%	0.45%
Total Loans	0.73%	0.24%	0.10%	1.05%	0.06%	-0.08%
Ratio of allowance for loan losses to end of year non-covered loans	2.09%	1.42%	1.21%	1.11%	1.13%	1.11%

The Company positions the balance sheet to be interest rate neutral to slightly liability sensitive, defined as allowing liabilities on the balance sheet to reprice faster than the assets. The Company chooses to manage the balance sheet to be slightly liability 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 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, 2009 illustrates a positive 3.28% change in net interest income for a 100 basis point decline in interest rates and a negative 2.22% 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 3.25% and the federal funds rate at 0.25%.

TABLE 10 — CONSOLIDATED AVERAGE BALANCE SHEET

As of December 31 (dollars in thousands)

	2009	2008	2007	2006	2005	2004
ASSETS						
Cash and due from banks	\$ 68,354	\$ 19,689	\$ 20,923	\$ 20,480	\$ 20,548	\$ 19,993
Interest-bearing deposits with banks	261	168	1,105	192	3,749	22,919
Federal funds sold	18,905	5,915	10,987	1,640	2,039	5,191
Investment securities:						
Taxable	131,450	85,267	88,015	93,034	92,001	107,014
Exempt from federal tax	20,481	19,579	21,639	17,500	13,222	13,031
Total Investment Securities	151,931	104,846	109,654	110,534	105,223	120,045
Loans - excluding covered assets						
Commercial and financial	175,917	182,593	188,040	168,866	148,566	128,589
Agricultural	32,420	32,399	33,838	33,407	29,587	28,654
Real estate	310,178	302,499	287,802	288,629	255,033	212,707
Consumer loans	23,955	19,626	18,171	18,646	20,696	22,561
Total Loans	542,470	537,117	527,851	509,548	453,882	392,511
Allowance for loan losses	(8,954)	(6,988)	(6,224)	(5,937)	(5,227)	(4,499)
Net Loans - excluding covered assets	533,516	530,129	521,627	503,611	448,655	388,012
Covered loans	13,354					
Bank premises and equipment	14,226	14,737	14,662	15,127	15,846	17,033
Goodwill & other intangibles	14,817	13,054	8,075	3,989	3,433	3,522
FDIC indemnification asset	4,741	-	-	-	-	-
Interest receivable and other assets	29,202	34,503	29,153	26,340	21,725	19,734
Total Assets	\$ 849,307	\$ 723,041	\$ 716,186	\$ 681,913	\$ 621,218	\$ 596,449
LIABILITIES AND SHAREHOLDERS' EQUITY						
Deposits:						
Non-interest-bearing deposits	\$ 117,029	\$ 104,090	\$ 97,654	\$ 86,105	\$ 91,381	\$ 82,655
Savings, NOW and money market deposits	357,537	256,111	255,609	223,074	207,746	221,141
Time deposits	248,603	211,316	240,442	238,456	196,054	149,025
Total Deposits	723,169	571,517	593,705	547,635	495,181	452,821
Federal funds purchased and other short term borrowings	137	27,234	19,971	34,929	30,163	39,275
Other borrowed funds	34,117	31,965	10,280	11,702	12,896	29,323
Other liabilities	9,832	8,224	12,826	9,604	8,718	6,429
Total Liabilities	767,255	638,940	636,782	603,870	546,958	527,848
Common stock and surplus	18,485	17,753	17,144	16,329	15,877	15,607
Retained earnings	63,567	66,348	62,260	61,714	58,383	52,994
Total Shareholders' Equity	82,052	84,101	79,404	78,043	74,260	68,601
Total Liabilities and Shareholders' Equity	\$ 849,307	\$ 723,041	\$ 716,186	\$ 681,913	\$ 621,218	\$ 596,449

TABLE 11 — CONSOLIDATED STATEMENT OF INCOME

For years ended December 31 (dollars in thousands except per share data)

	2009	2008	2007	2006	2005	2004
INTEREST INCOME						
Deposits with banks	\$ 1	\$ 5	\$ 41	\$ 11	\$ 82	\$ 454
Investment securities:						
Taxable	5,438	4,797	4,907	5,069	4,562	4,932
Exempt from federal income taxes	793	772	853	696	512	510
Total Investment Securities	6,231	5,569	5,760	5,765	5,074	5,442
Federal funds sold	137	137	543	75	53	40
Loans and leases, including fees	33,351	35,563	40,245	38,097	29,653	22,775
Total Interest Income	39,720	41,274	46,589	43,948	34,862	28,711
INTEREST EXPENSE						
Deposits	\$ 9,962	\$ 12,178	\$ 18,858	\$ 16,632	\$ 9,844	\$ 5,654
Federal funds purchased and other short term borrowings	16	691	1,109	1,775	1,047	738
Other borrowed funds	1,218	1,337	795	835	808	1,160
Total Interest Expense	11,196	14,206	20,762	19,242	11,699	7,552
Net interest income	28,524	27,068	25,827	24,706	23,163	21,159
Provision for loan losses	7,185	2,844	960	5,675	945	83
Net Interest Income After Provision for Loan Losses	\$ 21,339	\$ 24,224	\$ 24,867	\$ 19,031	\$ 22,218	\$ 21,076
NON-INTEREST INCOME						
Wealth management income	\$ 28,209	\$ 29,057	\$ 25,342	\$ 20,932	\$ 18,623	\$ 15,437
Services charges on deposit accounts	813	733	677	669	693	797
Other	14,467	8,976	5,796	4,470	4,892	4,286
Investment security gains (losses)	(749)	(1,011)	-	(108)	(1)	5
Total Non-Interest Income	42,740	37,755	31,815	25,963	24,207	20,525
NON-INTEREST EXPENSE						
Salaries and employee benefits	\$ 30,935	\$ 29,251	\$ 24,489	\$ 21,103	\$ 19,048	\$ 18,510
Net occupancy expense	3,331	3,195	2,944	2,779	2,518	2,449
Furniture and equipment expense	2,688	2,405	2,211	2,005	1,788	1,969
Other	15,989	13,176	10,899	8,293	7,431	7,205
Total Non-Interest Expense	52,943	48,027	40,543	34,180	30,785	30,133
Income before income taxes and extraordinary items	11,136	13,952	16,139	10,814	15,640	11,468
Applicable income taxes	3,767	4,802	5,779	3,682	5,639	4,057
Net Income	\$ 7,369	\$ 9,150	\$ 10,360	\$ 7,132	\$ 10,001	\$ 7,411

The Company utilizes derivative instruments for purposes such as asset liability management. These transactions involve both credit and market risk. The principal objective in utilizing derivatives is the management of interest rate related risk. Derivatives such as interest rate swaps, basis swaps, or interest rate options may be utilized as part of the Company's Asset Liability Management process. Derivatives are used to modify maturities of assets and liabilities in the management of the gap position, reduce basis risk, provide price protection, and to offset option related risks in certain products.

The Company has entered into two separate interest rate swap transactions that are the mirror image of each other. The first swap was entered into with a customer of the Company to convert a variable rate interest rate exposure to a fixed rate. The second transaction was entered into with Wells Fargo to convert our fixed rate exposure to variable rate. The notional value of both swap transactions is \$754,000. The market value change of these swaps at December 31, 2009, was \$0.



Eric Carlson, CFA,
Chief Financial Officer
Alerus Financial Corporation

report of independent auditor

We have audited the accompanying consolidated balance sheet of Alerus Financial Corporation and Subsidiaries as of December 31, 2009 and 2008, and the related consolidated statements of income, shareholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2009. These financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Alerus Financial Corporation and Subsidiaries as of December 31, 2009 and 2008, and the results of its operations and its cash flows for each of the years in the three year period ending December 31, 2009, in conformity with accounting principles generally accepted in the United States of America.



Brady, Martz & Associates, P.C.
Grand Forks, North Dakota
March 15, 2010

SUMMARY CONSOLIDATED BALANCE SHEET

As of December 31 (dollars in thousands)

	2009	2008	2007	2006	2005	2004
ASSETS						
Cash and deposits with banks	\$ 94,947	\$ 24,935	\$ 28,446	\$ 27,565	\$ 21,625	\$ 46,931
Investments and federal funds sold	299,153	125,689	106,953	123,391	110,088	113,447
Net loans and leases - non-covered	517,896	543,094	512,551	517,996	483,016	433,497
Covered loans & leases	87,700	-	-	-	-	-
Covered other assets	3,309	-	-	-	-	-
FDIC indemnification asset	31,397	-	-	-	-	-
Bank premises, equipment and other assets	92,444	67,288	59,671	51,161	42,391	40,440
Total Assets	\$ 1,126,846	\$ 761,006	\$ 707,621	\$ 720,113	\$ 657,120	\$ 634,315
LIABILITIES AND SHAREHOLDERS' EQUITY						
Deposits	946,099	632,276	585,677	591,990	537,795	477,174
Federal funds/repo agreements	2,582	-	12,529	-	-	4,552
Other borrowed funds	42,497	32,724	13,754	38,149	32,848	72,940
Interest payable and other liabilities	47,326	13,521	13,372	13,095	10,721	8,767
Total Liabilities	\$ 1,038,504	\$ 678,521	\$ 625,332	\$ 643,234	\$ 581,364	\$ 563,433
Common stock and capital surplus	18,782	18,023	17,264	16,723	15,831	15,867
Retained earnings	72,897	69,928	65,935	60,963	61,161	54,727
Accumulated other comprehensive income	(3,337)	(5,466)	(910)	(807)	(1,236)	288
Total Shareholders' Equity	\$ 88,342	\$ 82,485	\$ 82,289	\$ 76,879	\$ 75,756	\$ 70,882
Total Liabilities and Shareholders' Equity	\$ 1,126,846	\$ 761,006	\$ 707,621	\$ 720,113	\$ 657,120	\$ 634,315

SUMMARY CONSOLIDATED INCOME STATEMENT

For years ended December 31 (dollars in thousands)

	2009	2008	2007	2006	2005	2004
Interest income and expenses						
Interest income	\$ 39,720	\$ 41,274	\$ 46,589	\$ 43,948	\$ 34,862	\$ 28,711
Interest expense	11,196	14,206	20,762	19,242	11,699	7,552
Provision for loan losses	7,185	2,844	960	5,675	945	83
Net Interest Income After Provision for Loan Losses	\$ 21,339	\$ 24,224	\$ 24,867	\$ 19,031	\$ 22,218	\$ 21,076
Other operating income and expense						
Wealth management income	28,209	29,057	25,495	20,932	18,623	15,437
Other income	14,531	8,698	6,320	5,031	5,584	5,088
Other Non-Interest Income	\$ 42,740	\$ 37,755	\$ 31,815	\$ 25,963	\$ 24,207	\$ 20,525
Salaries and employee benefits	30,935	29,251	24,491	21,103	19,048	18,510
Occupancy and equipment expense	6,019	5,600	5,156	4,784	4,306	4,418
Other expenses	15,989	13,176	10,897	8,293	7,431	7,205
Other Operating Expenses	\$ 52,943	\$ 48,027	\$ 40,544	\$ 34,180	\$ 30,785	\$ 30,133
Income before taxes and extraordinary items	11,136	13,952	16,138	10,814	15,640	11,468
Income taxes	3,767	4,802	5,779	3,682	5,639	4,057
Net Income	\$ 7,369	\$ 9,150	\$ 10,359	\$ 7,132	\$ 10,001	\$ 7,411

SUMMARY CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY

As of December 31 (dollars in thousands)

	2009	2008	2007	2006	2005	2004
Balance at January 1	\$ 82,485	\$ 82,289	\$ 76,879	\$ 75,756	\$ 70,882	\$ 66,437
Net income for the year	7,369	9,150	10,360	7,132	10,001	7,411
Cash dividends declared	(3,679)	(3,419)	(3,115)	(2,895)	(2,681)	(2,438)
Increase from stock plans & other adj's	827	857	751	1,480	597	691
Repurchase of stock	(789)	(1,836)	(2,482)	(5,024)	(1,519)	(244)
Comprehensive income	2,129	(4,556)	(104)	430	(1,524)	(975)
Balance at December 31	\$ 88,342	\$ 82,485	\$ 82,289	\$ 76,879	\$ 75,756	\$ 70,882



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