First Defiance Financial Corp.

Third Quarter 2018 Earnings Conference Call

October 16, 2018 at 11:00 a.m. Eastern

CORPORATE PARTICIPANTS

Don Hileman, *President and CEO*

Kevin Thompson, *Vice President and Chief Financial Officer*

Tera Murphy, *Vice President and Marketing Director*

PRESENTATION

Operator
Good morning and welcome to the First Defiance Financial Corp. Third Quarter 2018 Earnings Conference Call. All participants will be in listen-only mode. Should you need assistance, please signal a conference specialist by pressing the star key followed by zero. After today's presentation, there will be an opportunity to ask questions. To ask a question, you may press star, then 1 on your telephone keypad. To withdraw your question, please press star, then 2. Please note that this event is being recorded.

At this time, I would like to turn the conference over to Tera Murphy, Vice President and Marketing Director. Please go ahead, ma'am.

Tera Murphy
Thank you. Good morning, everyone, and thank you for joining us for today's 2018 Third Quarter Earnings Conference Call. This call is also being webcast, and the audio replay will be available at the First Defiance website at fdef.com.

Providing commentary this morning will be Don Hileman, President and CEO of First Defiance, and Kevin Thompson, Executive Vice President and Chief Financial Officer. Following their prepared comments on the company's strategy and performance, they will be available to take your questions.

Before we begin, I'd like to remind you that during the conference call today, including during the question-and-answer period, you may hear forward-looking statements related to future financial results and business operations for First Defiance Financial Corp. Actual results may differ materially from current management forecasts and projections as a result of factors over which the company has no control. Information on these risk factors and additional information on forward-looking statements are included in the news release and in the company's reports on file with the Securities and Exchange Commission.

Now, I'll turn the call over to Mr. Hileman for his comments.

Don Hileman
Thank you and good morning, and welcome to the First Defiance Financial Corporation's Third Quarter Conference Call. At this time, I would like to discuss the third quarter results and give you a look into the remainder of 2018. Joining me on the call this morning to give more detail on the financial performance for the quarter, is our CFO, Kevin Thompson. At the conclusion of our remarks, we will be happy to answer any of your questions.

The third quarter results reflect strong operating performance as we balance growth and profitability. Net income for the third quarter of 2018 on a GAAP basis was $11.3 million, or 55 cents per diluted common share, compared to $9.4 million, or 46 cents per diluted common share, in the third quarter of '17, an increase of 20 percent. We continue the trend to solid core performance, with a return on average assets of 1.47 percent compared to 1.28 percent in the third quarter of '17 and 1.48 on a linked quarter basis.

We are also pleased that our efficiency ratio declined to under 60 percent this quarter, and loan growth picked up in the third quarter to an annualized 12 percent growth rate. This puts us on pace for year-over-year growth of around 8 percent, which is consistent with our overall expectations. We are seeing very competitive rates on some lending deals despite the upward movement in loan rates throughout our footprint and are quite satisfied with the linked quarter increase in net interest margin. In this lending environment filled with rate and structural pressures, we know a balanced approach is necessary to grow our loan portfolio, and we continue to be focused on market and relationship pricing, which is reflected in the upward trend of loan yields.

Overall, we saw an increase in asset yields of 10 basis points on a linked quarter basis and an increase in interest costs on deposits of 9 basis points on a linked quarter basis. Strategically still feel confident in our annual goal of upper-single digit loan growth is achievable with the current solid pipeline from across our footprint and stronger short-term economic confidence.

Non-performing loans were down 28 percent from the third quarter of '17 but increased slightly on a linked quarter basis, while restructured loans are down from third quarter of '17 and also on a linked quarter basis.

We also had an increase in charge-offs, primarily related to one credit experience and a dramatic decline in collateral value. We also saw a slight decline in the 30- to 90-day past dues accounts to a needed 14 basis points of total loans. Kevin will provide more details on non-performing assets and non-performing loans in a few minutes. In this environment, we know we must work hard to see stable and improving asset quality trends across the board in the near term.

In regards to our capital management plans, as disclosed, we recently completed a two-for-one stock split. We felt this was consistent with our overall capital plans and aids in attracting shareholders. We are also pleased to announce a 2018 fourth quarter dividend of 17 cents per share and an annual dividend yield of approximately 2.5 percent.

I will now ask Kevin to provide additional financial details for the quarter before I conclude with an overview. Kevin?

Kevin Thompson
Thank you, Don, and good morning, everyone. As Don stated, net income for the third quarter was $11.3 million, or 55 cents per diluted share. These results favorably compared to prior year third quarter results of $9.4 million, or 46 cents per diluted share. That's an increase of 19.6 percent. Our third quarter 2018 results reflect strong profitability, with an ROA of 1.47 percent and a net interest margin of 4 percent; solid expense control, with an efficiency ratio of 59.22 percent; healthy growth momentum for both loans and deposits; and stable asset quality.

Now to the details behind these highlights. First, we'll turn to the balance sheet, with third quarter total loan growth at $71 million, which is just under 12 percent annualized, and up from $27 million last quarter and $10 million in the first quarter, but more in line with the $73 million in the fourth quarter last year. Year-over-year loan growth at September 30th, stood at 7.9 percent.

On the other side of the ledger, total deposits reflected an increase of $35.3 million, an annualized growth rate of 5.7 percent, and, after being flat last quarter, growing $54 million in the first quarter and $77 million in the fourth quarter last year, year-over-year deposit growth at September 30th was 6.9 percent. The combined loan and deposit growth impact maintained our strong earning asset mix, our low-cost deposit funding, and profitable margin, all of which are expected to continue as we go forward.

Next we'll move to the income statement. Our net interest income for the third quarter 2018 was $27.5 million, up from $26.5 million in the linked quarter and up $2½ million, or 10 percent, from

$25 million in the third quarter of last year. The increase over the prior year is primarily driven by growth but also reflects margin expansion as the loan portfolio yield has increased with the rate hikes over the past year, while total funding costs have been less impacted. As a result, our margin this quarter was 4 percent, up 5 basis points from last quarter and up 9 basis points from 3.91 percent in the third quarter of last year. On a linked quarter basis, our yield on earning assets was up 12 basis points as our loan portfolio yield rose to 4.85 percent for the third quarter 2018. Our cost of interest-bearing liabilities was up 11 basis points on a linked quarter basis, mostly due to marginal rate impacts.

Anticipating additional rate increases from the Fed, along with our balance sheet growth outlook, we are confident that our strong earning asset mix, low-cost core deposit funding base, and balanced exposure to interest rate changes will continue to generate a strong, profitable margin in the 3.95 to 4 percent range and solid growth in net interest income.

Total non-interest income was $9.9 million in the third quarter of 2018, down from $10.2 million in the linked quarter but up from $9.5 million in the third quarter of 2017. The third quarter of 2018 did include $76,000 of securities gains versus $158,000 in the third quarter last year. Excluding the securities gains, quarterly non-interest income was up year over year about $509,000, or 5½ percent, primarily due to increases in mortgage banking and insurance commissions. Regarding mortgage banking, revenues for the third quarter of 2018 were $1.9 million, down just $136,000 from the linked quarter but up $179,000 from the third quarter of 2017. The third quarter mortgage banking originations were $74 million compared to $80.5 million last quarter and $71.8 million in the third quarter of 2017.

Gain-on-sale income was $1.3 million in the third quarter 2018 compared to $1.4 million on the linked quarter basis and $1.2 million in the third quarter last year. In addition, service charges were $3.3 million, up $182,000, or 5.8 percent, over a year ago and insurance commissions, at $3.3 million, up $172,000, or 5.6 percent, from last year. Trust revenues continued to grow at a strong pace, up $28,000, or 5.8 percent. Overall, we've very pleased with the performance of our core fee businesses in the third quarter.

As for non-interest expense, third quarter expenses totaled $22.3 million, down from $22.7 million in the linked quarter but up from $20.4 million in the third quarter of 2017. Compared to the same quarter last year, non-interest expenses were up $1.8 million, or 9 percent. This increase was primarily attributable to costs from our metro market expansion efforts in Fort Wayne, Indiana; Toledo and Columbus, Ohio; and Ann Arbor, Michigan. In addition to reinvesting some of the expected benefits of tax reform, as we have previously indicated, we expected to spend approximately $300,000 of the tax benefit per quarter going forward. Even with the increased expenses, we were pleased to see our efficiency ratio back below 60 percent, coming in at 59.22 percent in the third quarter of 2018 versus 61.24 percent last quarter and 58.7 percent in the third quarter last year.

Regarding provision expense, in the third quarter of 2018, our provision totaled $1.4 million compared to a provision of $423,000 last quarter and $462,000 in the third quarter last year. The provision increase this quarter was due to a higher level of net charge-offs recorded, which came in at about $1.1 million, or about 18 basis points on an annualized basis. Our allowance for loan loss at September 30, 2018, was $27.6 million, up $318,000 versus June 30 and up $1.3 million from $26.3 million a year ago. The allowance-to-loan ratio at September 30, 2018, was 1.13 percent, down 2 basis points from last quarter and down 3 basis points from 1.16 last year.

Going forward, we expect net loan losses to normalize and for provision expense to reduce by about a half million from the third quarter of 2018 level. As for the non-performing balances, non-performing loans were up this quarter to $20.9 million from $18.3 million at last quarter end but were down significantly from $29.2 million at September 30, 2017. On the other hand, our accruing troubled-debt restructured loans this quarter were $12.6 million, down $15.5 million from last quarter and $13 million a year ago. Our OREO balance declined just slightly this quarter to $1.7 million compared to $1.8 million last quarter and $532,000 in the third quarter last year.

In total, non-performing assets, including troubled-debt restructuring, finished the quarter at $35.2 million, down $753,000 from the linked quarter and down $7½ million, or 17.6 percent, from the third quarter last year. As a result of the change in NPAs at quarter end, the allowance coverage for non-performing assets was 122 percent compared to 89 percent at September 30, 2017. We're pleased with our asset quality position but always looking for improvement to further strengthen our growth strategies.

Looking at our capital position, total period-end stockholders' equity finished the quarter at $393.5 million, up from $367.9 million at September 30, 2017. Our capital position remains strong, with quarter-end shareholders' equity to assets up 12.73 percent, up from 12.51 percent last year. The bank's total risk-based capital ratio was approximately 12.7 percent at quarter end, September 30th. Our capital position remains solid in support of our ongoing growth and shareholder value enhancement objectives.

Again, in summary, we are very pleased with our continued strong performance in the third quarter — diluted EPS up 19.6 percent from a year ago, strong balance sheet growth in the quarter. asset quality strong and stable, net interest margin at 4 percent, efficiency ratio at 59.22 percent, return on assets at 1.47 percent, and return on tangible equity at 15.68 percent. Our performance outlook remains very positive.

That completes my financial review, and now I'll turn the call back over to Don.

Don Hileman
Thank you, Kevin. I'm very pleased with the results this quarter and the core earnings improvement. Our steady performance, client-focused values, and engaged employees blend together to deliver strong results to our shareholders. Quarter balance sheet growth, with a focus on loan and deposit growth; overall revenue growth; expense control; and improved asset quality all remain areas of focus in 2018 and are key areas for 2019. This level of strategic focus was evident through our improvements noted in several of these areas during the third quarter. Our metro markets of Toledo and Columbus, Ohio, and Fort Wayne, Indiana, all saw solid growth in the third quarter, and we expect solid growth performance in the coming quarters.

To be a consistently high performing community bank and agency, we know it involves more than numbers on the balance sheet. It means living our Better Together philosophy. We must provide our clients and communities with smart solutions that fit their needs and add value to their lives. This is why we continue to meet the needs of our clients, attract new clients to our bank, and seek opportunities to have a positive impact on the communities we call home. Early this year, our employees rallied behind our new Building Better Communities initiative to share knowledge and resources with current and future homeowners, and now they are pushing our fourth annual Pay it Forward Campaign forward with the same passion. Pay it Forward is a random act of kindness that spurs others to continue the cycle of giving. These acts can be as simple as providing sleeping bags to the homeless, donating school supplies for children in need, or helping to start or complete a community project. On November 14th, each of our 700 employees will receive $10 to perform their own pay it forward.

To further our commitment to better our communities and to inspire others to make a difference, we will also be allocating $10,000 to fund community-generated ideas outlined in project applications submitted on our website now through November 14th. When we pay our organized annual initiatives like these with our ongoing financial literacy, outreach, and leadership development opportunities throughout out footprint, it hits the core of who we are. Our steady performance, client-focused values, and our engaged employees blend together to deliver exceptional results for our shareholders. First Defiance leverages these principles to keep us moving forward, to look to introduce more clients to our community approach, as we expand our branch and agency network through mergers and acquisitions and by deepening relationships and pursuing organic growth within our footprint, especially in our metro markets.

Confidence in achieving a high-single digit growth rate for the year remains as we gain more momentum in our metro markets and increase the civility in the rest of our footprint. While we expanded our branch network to 44 with the opening of our new full-service branch and ATM in downtown Fort Wayne, Indiana, early this month, we know enhancing the customer experience is equally important. Initiatives are in place to continually enhance the digital banking experience identified by customers as critically important to a banking relationship, and new projects have been adopted to monitor customer satisfaction going forward.

We continue to see a migration to more digital and electronic transactions by our retail and commercial clients. Our recent performance and these initiatives drive our performance and lead us to be a consistently high performing community financial service company. Growth in our insurance and wealth management revenues continue to be a focal point in the overall strategic plan. We believe these revenue sources help in our ability to grow non-interest revenue in an environment with added pressure on NSF and other deposit fees. To continue this steady progression in wealth management, we have dedicated resources working to educate employees companywide on our wealth management products and services and build relationships with the team dedicated to providing them to our clients. This education will also allow us to deliver more personalized banking solutions to our clients by enhancing our ability to match client needs and personalized solutions.

Strategic initiatives such as these lead out focus and commitment to our clients and to improving our results relative to our peer group. We are very pleased by our recent financial performance and look to both a performance-driven and people-focused financial partnership. We remain strongly committed to all of our clients and shareholders, and we appreciate the confidence you have placed in us as we work to make First Defiance a company known for providing smart solutions to our customers and communities.

Thank you for your interest in First Defiance Financial Corporation, and we thank you for joining us this morning. We will now be glad to take your questions.

QUESTIONS AND ANSWERS

Operator
Thank you, sir. Ladies and gentlemen, we will now begin the question-and answer-session. To ask a question, you may press star, then 1 on your telephone keypad. If you are using a speakerphone, please pick up your handset before pressing the keys. If your question has been

addressed, you may withdraw from the queue by pressing star, then 2. Again, it is star, 1 to ask a question.

Your first question will come from Nick Cucharale from Sandler O'Neill & Partners. Please go ahead.

Nick Cucharale
Good morning, gentlemen.

Don Hileman
Good morning, Nick.

Kevin Thompson
Good morning.

Nick Cucharale
Much of the sequential growth this quarter was from CRE. Is this where you continue to see opportunity from a segment perspective, or did the pipeline tilt away from CRE at quarter end?

Kevin Thompson
No, that continues to be where we see the opportunity, Nick. It's been where our growth has been traditionally, and it is sort of our core competency probably within our commercial lending group, and so it remains where we see the business going forward as well.

Nick Cucharale
Sounds good. Then on expenses, another sequential decline, as you mentioned. Could you help us think about growth in your expense base for the fourth quarter and then heading into next year?

Kevin Thompson
Well, I can give you a little bit of guidance. I think the fourth quarter, I'm expecting a little more of the same as to what we had here in the third quarter. As we look at our plans for 2019, I don't want to get too far ahead of our budgets, but obviously we will expect some progression in the following year, probably lows to a mid-single digit range increase.

Nick Cucharale
Sounds good. And then in terms of capital, your ratios continue to build, even given the strong growth this quarter. I know you've raised your regular cash dividend a few times recently, but I was wondering your thoughts on capital more generally.

Don Hileman
Yeah, I think we're focused on that. I think when we look at where we want to go, we want to have a strong capital base, but we also look to how we can contribute back to our shareholders. Dividends is one thing we talk about every quarter, where we might want to be. This is the second quarter at this current run rate, and then we'll look at — with some of the contraction in the valuation, we'll also look at if there's an opportunity for buying back some of our stock. All those are still on our plate of what we look at on a quite frequent basis.

Nick Cucharale
Great. Thanks for taking my questions.

Don Hileman
Thank you.

Operator
The next question will come from Damon DelMonte with KBW. Please go ahead.

Damon DelMonte
Hey, good morning, guys, how's it going today?

Don Hileman
Good, Damon.

Kevin Thompson
Good, Damon

Damon DelMonte
Great. Just to follow up on that, the CRE growth this quarter, I think it was around $79 million of end-of-period increase in outstandings. Could you just provide a little color on that gross, in the context of size, location, and types of credit that you've been adding?

Don Hileman
Yeah, it's been pretty diversified. There was some growth in that — in the general commercial, the hotel — there's some hotels this quarter, new construction that came online, some multi-family., We look at it in a granular basis, and there was no one large concentration. It was spread out fairly well, but it also spread out fairly well within the markets.

Kevin Thompson
Right, although our metro markets continue to be the predominant source of production, I think out of the $71 million, about $50 million came from what we would consider our metro markets of Fort Wayne, Columbus, and Toledo.

Damon DelMonte
Okay, great. Then with respect to the credit, were the charge-offs associated with maybe the exiting of some of those restructured credits, or is it from the uptick in non-performing loans?

Kevin Thompson
It's not. Nothing to do with the restructured loans, and it probably is related a little bit to the uptick in non-accruals, one loan in particular, but, really, most of the significant part of the increase really came from one credit, where, as Don indicated, we had a reduction in collateral value on an updated appraisal; it was about 50 percent of the original appraisal and resulted in a loss of about $650,000. That's the one that really stood out.

Damon DelMonte
Gotcha. Okay. Then with respect to the margin, Kevin, I think you said 3.95 to 4 percent —

Kevin Thompson
Yeah.

Damon DelMonte
— closeout this year and adding to next year. Does that include any — are you guys baking in any additional rate increases by the Fed?

Kevin Thompson
We're anticipating a couple. I don't know that I've got four in the book yet or anything like that, but we're still expecting some movement forward. We tend to be a little bit cautious in terms of projecting the rate increases. We've seen our margin continue to perform very well as rates have raised steadily. We're seeing, obviously, our deposit betas catch up a little bit to the loans, or should I say — yeah, pace equally with the loans. I think our margin is going to continue to be very strong as we go forward. I'm not thinking 4 percent is the new norm necessarily, but I think as we do our modeling and sensitivities, the 3.90s, upper 390s is where we're thinking we're at.

Damon DelMonte
Okay, great. Then just lastly, have your commercial customers or any customers for that matter — have you seen any change in their approach with the tariffs, impact from the tariffs?

Don Hileman
We have some clients that are affected by the tariffs. A couple of those have price agreements that automatically adjust upward, so they're not concerned from a pricing standpoint, more concerned what that might do to volume, but I'm not hearing from our commercial team right now that they anticipate a significant impact yet on our business based on the tariffs. It could happen.

Damon DelMonte
Yeah, okay. That's all that I have for now. Thanks.

Don Hileman
Thank you, Damon.

Kevin Thompson
Thanks, Damon.

Operator
As a reminder, if you would like to ask a question, please press star, then 1.

The next question will be from Christopher Marinac of FIG Partners. Please go ahead.

Christopher Marinac
Thanks. Good morning, guys.

Don Hileman
Good morning.

Christopher Marinac
Don, I was wondering about your M&A outlook, just from a perspective of how prices have evolved the last couple of months. Does that make it more interesting for sellers to talk with you, or does it create a headwind as you can see how M&A may play out in the future?

Don Hileman
Good question, and I think it gives a little bit more emphasis, and there's probably a lot more conversations going on there. As you start to look at the pricing environment, where we are today makes it a little bit more challenging, so on the one side, I think there's more opportunities; on the other side, it's a little bit more challenging from price expectations.

Christopher Marinac
Okay, great. Then can you just update us on Columbus, both in terms of new loan and deposit activity there?

Don Hileman
Yeah, most of the activity in Columbus is going to be new loans. It's going to be CRE-driven, and we're still getting a lot of good lifts and good pricing opportunities, relatively speaking, from some of the other markets in Columbus. Deposit growth in Columbus is going to be a little lagging. We do have an office, but that's one of the initiatives as we work through '19. How can we generate a little bit more funding for the loan growth in the Columbus market? It's lagging, the other markets right now, Chris.

Kevin Thompson
Right, I think our footings are up to about $250 million in the loan portfolio, so, again, it's really been a nice progression there. On the deposit side, though, we're still very new to the game, as Don indicated. We really don't have a full retail strategy, and I think our totals are $10 million plus or minus on the deposit side only.

Christopher Marinac
Okay, great. If you juxtapose Michigan as another alternative, you are farther along there, just to compare that versus your core Ohio markets?

Kevin Thompson
Would you repeat that question, Chris? I'm sorry.

Christopher Marinac
I was extending on the deposit side. Your comment on deposits in Columbus, if we compare that with Michigan, and some of your markets now aren't necessarily brand new, but they're newer —

Kevin Thompson
Correct.

Christopher Marinac
— long term, how those are going and versus the core Ohio.

Kevin Thompson
Yeah. Oh, you're right. The legacy market deposit growth [unintelligible] was very good this quarter, and Michigan continues to be a key source of new deposit funding for us. We have a very strong position in the markets that we operate up there and continue to do very well, so that's true.

Christopher Marinac
Can you tell any discernible impact or maybe discernible difference in the rates for new money in some of your rural markets versus your metro markets? I'm just curious if there's a definable difference that you can pinpoint.

Kevin Thompson
I would say there certainly is, and we're pricing accordingly to the market conditions, but certainly the metro markets are much higher priced that we are experiencing in the legacy markets. That's not to say that there isn't competitive pricing in the legacy markets, but it's certainly at a different level.

Christopher Marinac
Okay, great. Thanks, Kevin. Thank you, Don. Appreciate your —

Kevin Thompson
Sure.

Don Hileman
Thank you. Appreciate your interest.

Operator
The next question will be from Daniel Cardenas of Raymond James. Please go ahead.

Daniel Cardenas
Hey, good morning, guys.

Kevin Thompson
Good morning, Dan.

Don Hileman
Good morning, Dan.

Daniel Cardenas
Most of my questions have been asked, just a couple of housekeeping questions here. So, Kevin, on the provision guidance that you gave, you're saying that the number should be approximately half a million lower than the third quarter number from Q4. Is that correct?

Kevin Thompson
That is correct.

Daniel Cardenas
Okay. Then as we think about provisioning on a go-forward basis, is that a good run rate, or can that number potentially come down a little bit?

Kevin Thompson
I think it's in that range, Dan.

Daniel Cardenas
Okay.

Kevin Thompson
Depending upon growth of the quarter, it could be a little less, a little more. It all depends with some of that.

Daniel Cardenas
Fair enough. Then how should I be thinking about your tax rate on a go-forward basis?

Kevin Thompson
Yeah, it came down a little bit this quarter, but when we do our modeling, I think 18½ is still a good number from an effective tax rate.

Daniel Cardenas
Okay, great. Well, that's all I have for right now. Thanks, guys.

Don Hileman
Thanks a lot, Dan.

Kevin Thompson
Thank you.

Operator
Again, if you would like to ask a question, please press star, then 1. And we'll pause just a moment for any additional questions.

In showing no additional questions, we will conclude the question-and-answer session. I would like to hand the conference back over to Tera Murphy for closing remarks.

CONCLUSION

Tera Murphy
Thank you for joining us today as we discussed our quarterly results. We appreciate your time and interest in First Defiance Financial Corp. Have a great day.

Operator
Thank you. Ladies and gentlemen, the conference has concluded. Thank you for attending today's presentation. At this time, you may now disconnect your lines.