First Defiance Financial Corporation

First Quarter 2016 Earnings Conference Call

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CORPORATE PARTICIPANTS

Tera Murphy – *Vice President*

Don Hileman – *President, and Chief Executive Officer*

Kevin Thompson – *Executive Vice President, and Chief Financial Officer*

PRESENTATION

Operator

Good morning. Welcome to the First Defiance First Quarter 2016 Earnings Conference call. All participants will be in listen only mode. Should anyone 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 one on your telephone keypad. To withdraw your question please press star then two. These instructions will be repeated. Please note this event is being recorded.

I would now like to turn the conference over to Tera Murphy, Vice President with First Defiance Financial Corporation. Please go ahead.

Tera Murphy

Thank you. Good morning everyone, and thank you for joining us for today's 2016 First 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 forecasted 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 is included in the news release and in company 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. Good morning, and welcome to the First Defiance Financial Corporation First Quarter conference call. Last night we issued our 2016 first quarter earnings release, and now would like to discuss that release and give you a little look into the remainder of 2016. At the conclusion of our remarks, we will answer any questions you might have. Joining me on the call this morning to give more detail on the financial performance for the quarter is our CFO, Kevin Thompson.

We are very pleased with the continued momentum developed in the latter part of 2015. First quarter 2016 net income on a GAAP basis was $7.1 million or $0.78 per diluted common share, compared to $6.6 million or $0.69 per diluted common share in the first quarter of '15. Our overall core performance this quarter was very strong, creating a good start to the year. We experienced solid year-over-year and linked quarter annualized loan growth of 8.3% and 5.1% respectively.

Our loan growth percentage this quarter was down from a strong 9% annualized level in the fourth quarter; however, first quarter loan growth tends to be seasonally weaker, so we're pleased with the overall growth. Our ability to grow our loan portfolio is a key strategic piece of our plan. The lending environment is very competitive with rate and structure pressures relating to terms and conditions. All institutions are looking for loan growth, and we are seeing more competition from large financial institutions for larger deals.

In some cases, we are seeing very aggressive rates and loosening of terms and conditions. It is encouraging to us to see contributions from across our entire footprint despite this environment, and we ended the first quarter with a solid pipeline which was up from yearend. Our Columbus, Ohio LPL has grown to about $90 million of outstandings, and stronger contributions are expected going forward.

We also saw stronger-than-expected growth in the Toledo market which was offset somewhat by declines in the Ft. Wayne market related to the payoff of a large credit in the quarter. Overall, growth in the Ft. Wayne market is still expected this year. This, coupled with more overall confidence from segments of our clients concerning economic stability and the economic environment leads us to believe we have positioned ourselves for continued disciplined loan growth during the remainder of 2016.

We're also very pleased with our margin improvement this quarter over the fourth quarter of '15 which we feel is a reflection of our disciplined approach to both asset and liability pricing. Loan portfolio growth contributed to the improved earning asset mix, increasing our net interest income. The growth in both our net interest income and our non-interest income revenues on a quarterly basis is a result of contributions from our core business strategies.

We're also pleased with our resilient net interest income growth this quarter of 5.5% over the first quarter of '15. We expect the interest rate environment to be relatively stable at the current levels in the short term but anticipate an increase in market rates in the second half of this year. We continue to measure our interest rate risk position and are managing toward a neutral to slightly positive position.

Growth on the deposit side of the balance sheet was strong this quarter, growing 7.6% on a linked quarter basis and 5.6% year-over-year. On a linked quarter basis, we were able to increase our overall margin to 3.8% from 3.77%. We are very satisfied with this quarterly improvement in today's environment.

Noninterest income, given primarily light service fees, trust income, and other income was offset by a decline in mortgage banking revenue. While down year-over-year, mortgage-banking revenues increased on a linked-quarter basis. Noninterest income grew 4.3% year-over-year. Total noninterest expense decreased slightly from the fourth quarter of '15 and increased 2.2% on a year-over-year basis.

The credit quality metric showed continued overall improvement this quarter from the first quarter of '15. Nonperforming assets declined approximately $6.3 million or 25% year-over-year. Nonperforming loans decreased approximately $1 million or 5% year-over-year to $17.7 million. Approximately 60% of the nonperforming loans continued to make payments. We also had a decrease of $8.3 million or 42% in restructured loans.

We're satisfied with the level of 30-day and 90-day and delinquencies at 0.14% of loans for the first quarter of '16, the same level as the first quarter of '15. Overall, we expect to see stable to improving asset quality trends and across the board. We will continue to focus on the asset quality through reducing the nonperforming and classified asset levels in the future, leading to improvements in our nonperforming asset ratio.

Regarding our capital management plans, we bought back approximately 168,000 shares of our stock in the first quarter. We are also delighted to announce a 2016 second quarter dividend of $0.22, representing a 10% increase in annual dividend yield of approximately 2.3%. We anticipate a continuation of the balanced dividend and stock buyback reflecting our strong earnings trend of and a focus on the utilization of capital.

I will now ask Kevin Thompson 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 first quarter was $7.1 million or $0.78 per diluted share. This compares to prior year results of $6.6 million or $0.69 in the first quarter of 2015. It's always encouraging to start the year with strong results, and we're very pleased with our first quarter financial performance results as well as our outlook for 2016. Starting with growth, our loan and deposit balances both had solid increases in the first quarter, which was a nice continuation after our very strong fourth quarter.

Total loans finished the quarter up $22.8 million from yearend and up $140.4 million or 8.3% from a year ago. First quarter average balances increased $63.7 million on a linked quarter basis, keeping our earning asset base strong and profitable. On the deposit side we saw deposit balances increase $35 million in the quarter and $98.5 million or 5.6% from a year ago, and average deposit balances grew $11.9 million in the first quarter of 2016.

Over the past year, we have generally seen our loan growth outpace our deposit growth and relied a bit more on borrowings to grow our balance sheet. While these sources are a bit more expensive, this has been tempered by a favorable mix in our deposit growth. Over the past year, our $98.5 million of deposit growth includes $55.1 million of growth in noninterest bearing demand balances. Overall, our strong growing balance sheet has continued to generate strong growth in earnings.

Turning to the income statement, our net interest income was $19.2 million for the first quarter of 2016, up from $19 million in the linked quarter and up $1 million from $18.2 million in the first quarter last year. The increase over the prior year was despite last year's benefit of $264,000 of recovered interest. Our margin this quarter was 3.80%, down 8 basis points from 3.88% in the first quarter last year which again benefited on the recovered interest which was about 5 basis point of that, but our margin was up 3 basis points from last quarter. On a linked quarter basis and our yield on earning assets was up 6 basis points is our loan portfolio yield held steady at 4.34%, but our mix improved.

Our cost of interest bearing liabilities was up 3 basis points on a linked quarter basis, impacted both by rate and mix. While our earning asset mix has kept our margin strong and steady as we continue to grow our balance sheet, our interest rate risk position is basically neutral and well balanced for our expectation of a cautious but determined Fed. Our noninterest income was $8.6 million at the first quarter of 2016, up from $7.7 million in the linked quarter and up from $8.3 million in the first quarter of 2015.

The first quarter 2016 includes $131,000 of securities gains plus $317,000 of net gains on the sale of OREO, while the first quarter last year included only $67,000 of net OREO gains. Furthermore, the first quarter's generally when we receive our contingent insurance commissions, which totaled $799,000 this year versus $967,000 a year ago. So, excluding these noncore and seasonal items, our noninterest income was up year-over-year about $143,000 or 2%. Service fees, trust income, and our core insurance commissions were all up while mortgage banking declined versus the first quarter last year.

Regarding mortgage banking, revenues for the first quarter of 2016 were $1.5 million, up $74,000 from the linked quarter, but down 236,000 from the first quarter of 2015. The first quarter banking originations were $51.1 million compared to $56.3 million last quarter and 52.7 million in the first quarter of 2015. Gain on sale income was $994,000 in the first quarter 2016 compared to $836,000 on a linked quarter basis and $1.3 million in the first quarter last year.

In addition, the first quarter included a negative valuation adjustment to the mortgage servicing rights of $21,000 compared to positive adjustments of $75,000 last quarter and $26,000 in the first quarter of 2015. At March 31, 2016, First Defiance had $1.3 billion in loans serviced for others. The mortgage servicing rates associated with those loans had a fair value of $9.2 million or 73 basis points of the outstanding loan balances serviced. Total impairment reserves which are available for recapture in future periods, totaled $666,000 at quarter end.

As for non-interest expense, first-quarter expenses totaled $17.3 million, even with $17.3 million in the linked quarter, but up from $16.9 million in the first quarter of 2015. The increase was primarily in compensation and benefits expense, which in the first quarter 2016 was up $1.3 million from last year, mainly due to higher costs for health benefit plans, incentive compensations, merit increases, and new staff to expand and support our growth strategies.

Other non-interest expense was 2.9 million in the first quarter 2016, down from $3.6 million in the same quarter last year, mainly due to reductions in OREO write-downs which totaled $522,000 in the first quarter last year and only $53,000 in the first quarter of 2016.

Regarding provision expense, the first quarter of 2016 totaled $364,000 compared to $43,000 last quarter and $120,000 in the first quarter last year. The first quarter of 2016 included net charge-offs of 2 basis points compared with net recoveries of 3 basis points last quarter and net recoveries of 10 basis points in the first quarter a year ago.

Our allowance for loan loss at March 31, 2016, was $25.7 million or 1.41% of total loans versus $25.3 million or 1.50% at March 31st last year. The change in the allowance ratio reflects the credit quality improvements achieved during the past year. The allowance coverage of nonperforming loans has increased to 145% at quarter end up from 135% at March 31, 2015. We expect the allowance of loan percentage to continue to reflect strengthening asset quality.

As for the asset quality numbers, nonperforming loans increased slightly this quarter to $17.7 million from $16.3 million on a linked quarter basis but was down from $18.7 million at March 31, 2015. Our OREO balance decreased this quarter to $1.1 million from $1.3 million last quarter and from $6.4 million in the first quarter last year. Overall nonperforming assets ended the quarter at $18.8 million or 0.80% of total assets, down from $25.1 million or 1.14% of total assets at March 31, 2015.

Our troubled debt restructured loans this quarter were $11.3 million, up $106,000 from last quarter but down considerably from $19.6 million a year ago. Looking at our capital position, total period end stockholders equity finish the quarter at $280.4 million up just slightly from $280.2 million at March 31, 2015. During the quarter we repurchased 167,746 shares, leaving approximately 377,500 shares remaining under our current repurchase authorization.

Our capital position remains strong with quarter end shareholders' equity to assets of 12.06% although down from 12.84% last year. The total risk based capital ratios was approximately 13% at quarter end March 31, 2016. Our healthy capital position continues to support our growth strategies as well as enhance shareholder value through share repurchases and dividends.

So in summary, we have a strong balance sheet, solid profitability, and good momentum. 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 core results in the first quarter of 2016 and the important progress we have made to position First Defiance for success for the remainder of 2016. We continue to focus on several key areas that we believe important to improving financial performance and greater shareholder value. These areas include core balance sheet growth with a focus on loan growth and deposit growth, overall revenue growth, expense control and improved asset quality. We look to continue to making steady progress in all these areas throughout 2016.

We're off to a good start with the first quarter asset growth of 3% on a linked quarter basis with solid growth in both loans and deposits this quarter. Overall revenues grew 4% in the first quarter of '16. We do believe improvements in loan demand aided by further improvements in the economic environment will carry throughout 2016.

As we have discussed, we have looked to strategically grow our overall position in the metro markets of Fort Wayne, Indiana and Toledo, Ohio, and increase loan production in Columbus, Ohio. We are seeing strong activity in these areas. As I mentioned previously, some additional expense was added to the quarter, and we expect some degree of additional expense in '16, as reflected in Kevin's comments concerning the compensation and benefits expense.

We still believe that growth rate in the high single digits is appropriate for the remainder of the year. While the lending environment remains very competitive, as previously noted, we feel we can realize loan growth without making significant concessions in rate and other terms through a strong process of relationship building and quality client focused service despite seeing declines in offering rates from some competitors.

We understand it will be challenging to drive growth in loans and maintain the yield management until market rates move higher. We are very focused on relationship management pricing and believe our delivery and service model is effective and is contributing to the strong margin performance. We continue to look to enhance our electronic and mobile capabilities, giving our customers more choices on how they bank with us and are responding to their requests unveiled during our research.

We are seeing a changing pattern in transactions and service on the retail side driven by our customers. The shift in customer demographics will also have an impact on our business model. We have spent both time and resources and gain understanding of the needs of our current clients and potential clients as new client relationships are essential to us. We are looking to better understand the needs and behaviors of millennials as the market research indicates this is an increasingly important segment of the population. This group is distinct in their needs and the use of banking products and services, and we must be prepared to serve this generation.

We are pleased with the increases in activity in both electronic and mobile transactions, including online account opening, mobile deposits, electronic payments, and the use of mobile wallets features. The digital delivery environment is changing at an accelerated pace, and we are committed to providing our clients, both retail and business, a quality choice of products and services. In concert with this we are taking a closer look at how our customers interact with us both inside and outside the branch. As banking behaviors of our clients change, we will focus on adopting our services and sales model for a more convenient, better banking experience for all our customers.

We will continue to focus on growth in our insurance and wealth management revenues as part of our strategic plan. We believe these revenue sources help in our ability to grow revenue in an environment with added pressure on NSF and other deposit fees.

We are pleased by the continued improvement in credit quality reflected by low charge-offs and overall lower nonperforming assets. We are committed to continue improving our results relative to our peer group in this area. We are also very pleased by our recent performance and look to constantly drive our performance through initiatives that will help us obtain our goal of being a consistently high performing community bank.

We understand the headwinds and challenges ahead, including economic, regulatory, and operational factors. We are also working diligently to address the growing issue of cyber security and provide our clients important information to protect their financial information. We believe we can accomplish our goals through a balanced approach and a long-term focus on shareholder value. We remain confident in our strategy and in the people we have dedicated to executing this.

We feel that the performance of the organization reflects our focus on shareholder value and at the same time on our commitment to being a strong community of partners in the areas we serve, not only by donating funds and employee volunteer hours but by creating valuable partnerships with community organizations such as the Toledo Public Schools and the Toledo Zoo to provide educational opportunities by bringing zoo animals into the elementary schools.

We also are very committed to providing financial wellness and additional educational opportunities to the public through our footprint. We remain strongly committed to our customers and our shareholders, and we appreciate the trust you have placed in us because we work to make First Defiance a company to be proud of. Thank you for your interest in First Defiance Financial, and we thank you for joining us this morning.

We would now be happy to answer any of your questions.

QUESTIONS AND ANSWERS

Operator
We will now begin the question-and-answer session. To ask a question, you may press star then one on your telephone keypad. If you're using a speakerphone, please pick up your handset before pressing the keys. To withdraw your question, please press star then two. At this time, we will pause for a moment to assemble our roster.

Our first question this morning comes from Christopher Marinac of FIG partners. Please go ahead.

Christopher Marinac
Thanks, good morning. Don and Kevin, wanted to ask a little bit about your thoughts regarding adding mergers to the bank going forward. Is this something that is possible in the future, and I think more importantly is, can you give us a band about where price expectations may be among sellers and is there a updated tolerance in terms of how much dilution you will or won't accept on any given transaction?

Don Hileman
Well, thanks for the nice simple question there, Chris. I think it's definitely one of our things that we consider. When we look at the environment, I believe the M&A activity is going to increase a little bit. We still think it's important that we match up the culture, both of First Defiance with any potential acquisition client, and so we're fairly selective in that part of it because I think that's a key to the execution. As part of our expectations on where we might be from a pricing standpoint, I think we look at a lot of factors. I don't know if we have one, but I think as far as our buyback and tangible buyback, those are all factors but I don't think at this point we have anything that's really specific. We look at it to make sure it will be an accretive transaction.

Chris Marinac
Okay, great. Thanks for that. Appreciate it. From a standpoint of this current quarter, does the margin get stronger if we see one or two more additional Fed hikes or would that just be a challenge? I know you mentioned in your remarks about moving towards neutral so I was just curious. Is that more of a timing issue, if it happens right away it may be negative but if it happens later in the year it could be an either nonevent or a slight positive?

Kevin Thompson
Yes, Chris, actually I think we really are pretty neutral. Our numbers indicate we maybe have a slightly positive bias to a raise in rates, but I wouldn't look for any kind of windfall impact on our numbers. And in terms of timing I don't know that that's going to make a significant difference. I think though as we look ahead with the Fed, we think, moving on a very measured basis, we think that's probably a pretty good environment for us to operate in as opposed to any significant and swifter movements, if you will, by the Fed. That could be a little more perhaps a volatile impact, but if the Fed moves as we expect, with maybe one or two more increases over the remainder of the year, we think again, we're pretty neutral to that impact with maybe a slight benefit.

Chris Marinac
Okay, thanks, Kevin. I appreciate that. And just this last question, since you had mentioned the cyber topic in the earlier remarks, is cyber covered within your existing budget this year? Are there additional spending you have, and then to what extent does some of your plan go part and parcel with your main systems vendors?

Don Hileman
Yes, that's a good question. It is, and we look at it from two perspectives—my comment's related to more of what we're trying to do to educate our clients and help them navigate cyber securely. We have a lot of businesses and small business clients, and how do we provide them the best information for them to make informed decisions to protect them, themselves? We also have a decent amount of spend in our operating budget for enhancements, if you will, to our core systems and ancillary systems to protect us as best we can. We feel real comfortable with our core system provider and their ability to provide additional protections from a cyber security standpoint, but we continually focus on that because I think we all realize that's a big issue for us today and just will continue to be an issue going forward.

Chris Marinac
Sounds good, guys. Thanks again for all the background here.

Kevin Thompson
Sure.

Don Hileman
Thank you, appreciate it.

Operator
Our next question comes from Damon DelMonte of KBW. Please go ahead.

Damon DelMonte
Hi, good morning guys, how you doing?

Don Hileman

Good morning, Damon.

Damon DelMonte
My first question just relates to expenses and the outlook there. I think you mentioned that there might be some higher expenses in '16 related to compensation costs. Is that correct?

Kevin Thompson
That's correct. We're investing in our growth strategies and are obviously reflecting some elevated expenses versus a year ago. We expect that trend to continue.

Damon DelMonte
Okay, so as we look for a quarterly run rate, I think last quarter you were talking maybe something in the $17.5 million to $18 million range. Is that still a reasonable expectation for the remainder of the year?

Kevin Thompson
Yes, I would think $18 (million) might be pushing it, but I think $17.5 (million) probably isn't a bad number.

Damon DelMonte
Okay. Great. And then the $317,000 in the OREO gain that you had this quarter, was that captured in the other noninterest income line?

Kevin Thompson
That is correct.

Damon DelMonte
Okay. And then do you know what the average price was that you bought back the shares this quarter at?

Kevin Thompson
I don't right off the top of my head, but my best estimate would be about $38.

Damon DelMonte
About $38, okay. Great, and then lastly with respect to the provision expense, with the outlook for continued positive growth in the loan portfolio, should we look at the quarterly run rate on provision to be something similar to this quarter's level?

Kevin Thompson
I think that's probably a reasonable expectation. Our asset quality, again, is a little bit stable or steady, if you will, from fourth quarter to first quarter here, but we're still working hard and expect some continued improvements over the remainder of the year. Our allowance ratio is quite strong so we think with our continued work there that we would expect to keep provision in check despite our growth.

Damon DelMonte
Okay. Great. Okay, that's all that I had. Thank you very much.

Don Hileman
Thank you.

Operator

Again, if you have a question, please press star then one.

Our next question comes from Daniel Cardenas of Raymond James. Please go ahead.

Daniel Cardenas
Hi, good morning, guys

Don Hileman
Good morning, Dan.

Daniel Cardenas
Maybe some quick comments on competitive factors. What are you seeing out there in terms of your large and small competitors in terms of structural weakness if any? I know pricing's very intense, and is that causing you perhaps to tighten your credit underwriting standards, and then if that's the case, do you still think you can hit some high single-digit loan growth numbers given all of that?

Dan Hileman
We still do. We still think we can generate those numbers with our current underwriting standards which we think will serve us well, but the structural issues, we're seeing some compression in margin on variable rate loans. We're seeing still some very aggressive fixed rate, longer-term fixed rate on commercial deals from the rate standpoint. We're still trying to target what we think is the right rate on an extended durational basis, the longer terms, and that's very hard to compete and in some cases we don't want to compete with that.

From a structure standpoint, I think it goes back to I think we've said previously in a call that a couple years ago we were getting a lot more personal guarantees on small business or business loans, and now that's harder to get. A lot of these are going to be project-specific guarantees rather than more global guarantees. We still ask for it, still try to get it, but our percentage is probably a little lower on that, and there's some other things that relate to maybe the strength of the global position versus the project that are a little harder to get than they were a few years ago.

Daniel Cardenas
Okay. And then is that across the board, are you seeing the big banks and small banks do it, and what impact our credit unions having on loan growth, if any?

Dan Hileman
Yes, it's pretty much across the board. I think we've always had if a smaller bank wants some loan growth, they'll go in and structure to get it. I wish I could say this one competitor is our biggest problem we have to deal with and figure out that, but it seems to be across the board on different things. Credit unions are getting to be more of a competitor, especially on the commercial side, and then we still see in our market, still very strong competition on some deals from Farm Credit as well.

Daniel Cardenas
And then as you look at your footprint expectations for the majority of growth to come out of the bigger, the Ft. Wayne, Toledo, Columbus markets?

Dan Hileman
I think that's what we've seen, and that's what we would expect because just if you look at it from a market share standpoint, we have a very small market share in those areas, so the upside to grow it is greater than in some of our legacy markets. We think all of our markets will grow, but clearly a higher opportunity and stronger growth rates will come from some of those metro markets.

Daniel Cardenas
Okay, and then as you talked about fee income and the focus on growing insurance and wealth management, expectations, is the growth is going to be entirely organic or do you see opportunities to make small acquisitions throughout the footprint?

Dan Hileman
I hope, and my plan is it'll be both, to grow organically and supplement it with acquisitions, especially on the insurance side. The wealth management side we clearly would look at a possibility there of accruing that through purchase or acquisition as well, but we think we can still have a good organic growth rate and then supplement that through acquisition.

Daniel Cardenas
And in terms of acquisitions for those two areas, are the pipelines robust or is it, "meh, hit or miss"?

Dan Hileman
Hit or miss; I wouldn't say they're robust at all. I think it's hit or miss. We've had a lot of conversations going on. Some are more interested than others. So it's clearly a hit or miss.

Daniel Cardenas
Okay. And then just on the credit side, the numbers are good, but are you seeing any weakness in any of the predictive indicators that you look at?

Kevin Thompson
I would say no, Dan. Our delinquency continues to run really, really well versus historical comparisons. We've had a loan or two here and there get classified, but the overall trend is still very positive in our portfolio. I don't think we see any concerns on that front in terms of the performance and in terms of our underwriting, as Don said, we're being pretty vigilant and we're still getting good growth. Our pipelines are still strong. We're not going to win every deal, but we're going to win the deals I think that we want to win and continue to be strong in our underwriting standards. So at this point I think we're very favorable in terms of our outlook in that regard.

Daniel Cardenas
Okay, great. Alright, guys, thanks. Good quarter.

Don Hileman
Thank you.

Kevin Thompson
Appreciate it.

CONCLUSION

Operator
This concludes our question-and-answer session. I'd now like to turn the conference back to Tera Murphy for any closing remarks.

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
The conference has now concluded. Thank you for attending today. You may now disconnect your lines.