First Defiance Financial Corp

Fourth Quarter 2017 and Year-End 2017 Earnings Conference Call

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CORPORATE PARTICIPANTS

Don Hileman–*President and Chief Executive Officer*

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

Tera Murphy–*Assistant Vice President*

PRESENTATION

Operator
Good morning everyone, and welcome to the First Defiance Fourth Quarter and Year-End 2017 Earnings Conference Call. All participants will be inlisten-only mode. Should you need assistance, please signal a conference specialist by pressing the star (*) key followed by zero (0). After today's presentation there will be an opportunity to ask questions. To ask a question you may press star (*) then one (1) on your telephone keypad and to withdraw your question please press star (*) then two (2). And please note that this event is being recorded.

I would now like to turn the conference over to Tera Murphy with First Defiance Financial Corp. Please go ahead.

Tera Murphy
Thank you. Good morning, everyone, and thank you for joining us for today's 2017 fourth quarter and year-end 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 forecast 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. And now, I'll turn the call over to Mr. Hileman for his comments.

Don Hileman
Thank you, Tera, and good morning. And welcome to the First Defiance Financial Corporation 2017 fourth quarter and full-year conference call. Joining me on the call this morning to give more detail on financial performance is our CFO, Kevin Thompson. Last night we issued our 2017 fourth quarter and full-year earnings release, and now we would like to discuss that release and give some insight into 2018. At the conclusion of our remarks we will answer any questions that you might have.

I am very pleased that we begin 2018 with great momentum that the fourth quarter provided in growth and financial and strategic performance. Fourth quarter 2017 net income on a GAAP basis was $9.4 million or $0.92 per diluted common share compared to $7.4 million and $0.81 per diluted common share in the fourth quarter of '16. For the year ended December 31, 2017, First Defiance earned $32.3 million or $3.22 per diluted common share compared to $28.8 million or $3.19 per diluted common share for '17. At quarter end, our total assets were $2.993 billion, up 21% from a year ago. We did see some impact in the fourth quarter from the enactment of the new tax law, which Kevin will now discuss, will discuss further. We plan on reinvesting up to $1 million of the expected tax benefit to areas and initiatives that support our strategic objectives. These would include investments in technology, growth initiatives, investments in our people, and other investments in strategic objectives. We look to balance this with a focus on maintaining an efficiency ratio under 60% for the full year of '18. The healthy growth trends for both loans and deposits were positive in the fourth quarter. Total loans at December 31st were up 21% over a year ago and up 13% on a linked quarter basis annualized. Total deposits were up 23% year over year and 13% on a linked quarter annualized basis. The efficiency ratio increased slightly to 59.37% from 58.7% on a linked quarter basis but down from 62.09% at the end of the fourth quarter of 2016.

Our fourth quarter ’17 results reflect strong profitability with an ROA of 1.26 compared to 1.19 in the fourth quarter of ’16. Net charge offs moderated lower in the fourth quarter reflecting a net recovery of $28,000 compared with net charge-offs of $36,000 last quarter and recoveries of $110,000 in the fourth quarter of ’16. We are still expecting to see upper single-digit growth for the full year of 2018. As we look into this year, our continued ability to grow the loan portfolio will be a key focus of our strategic plan. We are very satisfied to see an increase in loans across our footprint even in the face of strong competitive market pressures, particularly in pricing, as all institutions are more aggressively seeking increased loan volume.

While we will look to our legacy markets for a consistent growth rate, our metro markets will focus on growth at an accelerated pace. Total new loans originations in the fourth quarter were put on at a weighted average rate of 4.54% compared to 4.15% in the fourth quarter of ‘16, and 4.67% in the third quarter of ‘17. The overall yield on loans in the fourth quarter of ‘17 was 4.58%, up 20 basis points from the fourth quarter of ‘16. Our core business strategies contributed both growth in our net interest income and a solid performance of our noninterest income revenues on a quarterly basis. This is reflected in our solid increase in our net interest income this year of 22% over last year, driven in part by the acquisition creating balance sheet growth.Net interest income increased 2% on a linked quarter basis.

We expect the interest rate environment to be reflective of continued anticipation of multiple federal rate increases over the course of ‘18. We continue to measure our interest rate risk position and we are managing toward a neutral to slightly asset-sensitive position, and Kevin will provide additional commentary on this in a few moments.We are very satisfied with the consistency of our margin considering the very competitive operating and rate environments. Our net interest margin increased to 3.88% over the fourth quarter of ’16, a margin of 3.76%. We did see a slight compression in the margin in the third quarter of ‘17 of 3 basis points, but we are content with our margin trend, and will continue to balance pricing discipline with growth.The credit quality metrics elevated slightly this quarter from last quarter and are up from year-end ‘16. The majority of the year-over-year increase occurred in the second quarter of ‘17. Our nonperforming assets-to-total assets were 1.08% this quarter, compared to 0.60% in the fourth quarter of ‘16, and 1.01% last quarter.

Our overall capital planning is supported by our ongoing solid performance and capital levels.We are very pleased to announce a 2018 first quarter dividend of $0.30 per share, representing a 20% increase and an annual dividend yield of approximately 2.2%. In the fourth quarter, we did not buy back any company stock. I’m also excited about the addition of three new directors to the board communicated earlier this month. These individuals give us a broader experience base from both a geographic and functional basis. We look forward to their contributions.

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

Kevin Thompson
Okay. Thank you, Don. Good morning, everyone. Don stated net income for the fourth quarter was $9.4 million, or $0.92 per diluted share, and these results favorably compared to prior year fourth quarter results of $7.4 million, or $0.81 per diluted share. That’s an increase of diluted

EPS of 13.6%. The fourth quarter did include a modest impact from the Tax Reform Act, about $154,000, which was more than offset by other non-operating items, securities gains, and a change to accrual accounting for our trust income.Altogether, non-operating items increased earnings about $0.02 per share. The all-in fourth quarter 2017 results reflect strong profitability, with an ROA of 1.26%, ROE of 10.10%, a net interest margin of 3.88%, solid expense control with an efficiency ratio of 59.37%, stable asset quality with net loan recoveries in the quarter, and significantly improved growth momentum for both loans and deposits.

For the details behind these highlights, let's start with the balance sheet. For the fourth quarter, total loan growth was $72.7 million or 12.8% on an annualized basis, and up from $21.6 million last quarter and $16.4 million organically in the second quarter. We expected our loan growth profile to elevate, so we were very pleased with our results in the fourth quarter. Going forward, we expect continued strong upper single-digit growth.On the other side of the ledger, total deposits also had a strong finish to the year, reflecting an increase of $77 million, an annualized growth rate of 13%, and up from last quarter, when we had an increase of $34 million in deposits. So we were even more pleased to have strong growth on both sides of the balance sheet in the quarter. The combined growth impact enabled our healthy earning asset mix and low-cost deposit funding to maintain our profitable margin and provide added lift as we enter 2018, which leads us to the income statement and net interest income.For the fourth quarter of 2017, net interest income was $25.4 million, up from $25 million in the linked quarter, and up $4.9 million or 23.6% from $20.5 million in the fourth quarter last year. The increase over the prior year is primarily driven by growth, which includes the addition of the CSB balances acquired in the first quarter of 2017, but also reflects margin expansion from a year ago, as the loan portfolio yield has increased with the rate hikes over the past year while deposit funding costs have been less impacted. As a result, our margin this quarter was 3.88%, down 3 basis points from last quarter but up 12 basis points from 3.76% in the fourth quarter last year.

On a linked quarter basis, our yield on loans was down 1 basis point to 4.58% for the fourth quarter, while our cost of interest-bearing liabilities was up 1 basis point on a linked quarter basis, mostly due to marginal rate impacts. With balance sheet growth expected and our balanced exposure to interest rate changes, we believe that our margin will continue to perform well considering the anticipated Fed actions. Total non-interest income was $9.9 million in the fourth quarter of 2017, up from $9.5 million in the linked quarter and up from $8.3 million in the fourth quarter of 2016.Fourth quarter 2017 did include $160,000 of securities gains versus $158,000 in gains last quarter, and no gains in the fourth quarter of last year. The fourth quarter also included a change to accrual basis accounting for our trust income, which added an additional $428,000 to revenues this quarter. Excluding the securities gains and the additional trust income, quarterly non-interest income was up year-over-year about $1 million or 12.2%.Other than mortgage banking income and gains on the sale of non-mortgage loans, we had increase in all categories of fee income, primarily from the growth of our Company, which includes contributions from the CSB and Corporate One mergers.

Regarding mortgage banking, revenues for the fourth quarter of 2017 were $1.7 million, up just $40,000 from the linked quarter, but down $190,000 from the fourth quarter of 2016. The fourth quarter mortgage banking originations were $63.8 million compared to $71.8 million last quarter and $77.6 million in the fourth quarter of 2016.Gain on sale income was $1.1 million in the fourth quarter of 2017 compared to $1.2 million on a linked quarter basis and $1.2 million in the fourth quarter last year. Changes to the mortgage servicing rights valuation were a positive $69,000 in the fourth quarter compared to a negative adjustment of $27,000 in the linked quarter and a positive adjustment of $241,000 in the fourth quarter of last year.At December 31, 2017, First Defiance had $1.4 billion in loans serviced for others. Our mortgage servicing rights associated with those loans had a fair value of $9.8 million or 72 basis points of the outstanding loan balances serviced. Total impairment reserves, which are available for recapture in future periods, totaled $432,000 at year-end.As for non-interest expense, fourth quarter expenses totaled $21.1 million, up from $20.4 million in the linked quarter, and up from $18.2 million for the fourth quarter of 2016. Comparing to the same quarter last year, the increase was primarily attributable to additional operating costs from the Commercial Savings Bank and Corporate One Benefits mergers, which were respectively completed in the first and second quarters of this year, but also includes ongoing investments to support our metro market growth strategies.

We remain very pleased with our efficiency ratio, improved by realizing the cost synergies from our mergers. Our efficiency ratio of 59.37% in the fourth quarter of 2017 versus 62.09% in the fourth quarter of last year clearly reflects this benefit despite our expanding growth initiatives.Regarding asset quality, provision expense in the fourth quarter of 2017 totaled $314,000 compared to a provision expense of $462,000 last quarter and a credit provision of $149,000 in the fourth quarter of last year. Provision in the fourth quarter of 2017 was mainly driven by growth in the loan portfolio as the fourth quarter included net recoveries of $28,000 and basically stable asset quality metrics.

Our allowance for loan loss at December 31, 2017 was $26.7 million, up $342,000 versus September 30th and up $799,000 from a year ago. The allowance to total loans ratio at December 31, 2017 was 1.14%, down 2 basis points from last quarter and down from 1.33% at last year end. The decline in the ratio from last year was primarily due to the addition of the acquired CSB loans, which were discounted and recorded at fair value with no allowance. The remaining CSB acquired loans are currently carried at a discount of $3.9 million or 1.9% of balances.

As for the non-performing balances, non-performing loans rose slightly this quarter to $30.7 million from $29.2 million at last quarter-end, but were up from $14.3 million at December 31, 2016. The year-to-year change was primarily due to two large credits downgraded in the second quarter, which we are pleased to say are beginning to show performance improvement that we expected.Our OREO balance increased this quarter to $1.5 million from $532,000 last quarter and $455,000 in the fourth quarter of last year, primarily due to the reclassification of a former bank facility from bank properties. Overall, non-performing assets ended the quarter at $32.2 million or 1.08% of total assets, still up from $14.8 million or 0.60% of total assets at December 31, 2016.Our accruing troubled debt restructured loans this quarter were $13.8 million, up slightly from $13 million last quarter and $10.5 million a year ago. With the change in NPAs over the last year, at year-end 2017 the allowance coverage of non-performing assets was 83%, compared to 175% at December 31, 2016. While the two larger downgrades from the second quarter are still impacting the numbers, we are confident in our overall portfolio strength and asset quality as we continue to pursue our growth strategies.

Looking at our capital position, total period-end stockholders' equity finished the year at $373.3 million, up from $293 million at December 31, 2016. The increase includes the acquisition of Commercial Bancshares.Our capital position remains strong with quarter-end shareholders' equity to assets of 12.44%, up from 11.89% last year. The bank's total risk-based capital ratio is approximately 12.4% at quarter-end, December 31, 2017. Our capital position remains solid in support of our strategic growth and shareholder value enhancement objectives.Regarding our year-to-date results, for the year 2017, net income was a record $32.3 million or $3.22 per diluted share, up from net income of $28.8 million or $3.19 per diluted share for the year 2016. That comparison, however, is impacted by several non-operating items, mostly the acquisition costs from our mergers, but also our wholly restructured transaction in the first quarter, the trust income accrual change, securities transactions, and the impact of tax reform.The non-operating items together reduced earnings about $0.25 per share, so we'd calculate our core earnings are up in 2017 over 2016 between 8% and 9%. Furthermore, earnings for 2017 were impacted by a higher provision expense. We calculate our core pretax pre-provision earnings were up over 13% year-over-year.Overall, we were pleased with the results. And as Don indicated, the Board approved a dividend increase of $0.30 per share this quarter for an increase of 20% over the previous rate.

Finally, we are excited about our outlook for 2018. We expect high single-digit balance sheet growth with a strong margin to drive upper single-digit revenue growth. We also expect growth to require more normalized provisioning and core expense growth in the mid-single digits, maintain a positive operating leverage and keeping our efficiency ratio below 60%, even with some reinvestment of the benefits from lower taxes.As for the lower taxes, we see our core effective rate falling from, say, 30.5% in 2017, to about 18.5% for 2018, so a significant lift to profitability is expected. As I look at today's Street estimates for 2018, there is one low estimate on which we need to follow-up, but the remaining three, ranging from $4.12 to $4.36 per diluted share, I would say, frames our expectations and that the consensus of that group is reasonable to us.

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

Don Hileman
Thank you, Kevin. I'm very pleased with the results in ‘17, as it was another record year for First Defiance. We are pleased with the strong finish to the year and anticipate the growth and momentum of the fourth quarter will carry into ‘18. We continue to focus on several key areas we believe are very important, including the core balance sheet growth, with a focus on the loan and deposit growth; overall revenue growth, expense control, and improved asset quality. We've made good progress in many of these areas in ‘17.Improving asset quality was more challenging, but we feel comfortable with where we are and ended the year at 1.08% of assets, but continue to strive to lower this ratio throughout 2018. We do believe a rise in loan demand aided by a further improvement in economic environment will carry through 2018. We look to grow our position in the metro markets of Fort Wayne, Indiana; Toledo, Ohio; and Columbus, Ohio.

While the lending environment remains very competitive, we feel we can accomplish loan growth without making significant concessions in rate and other terms through a strong process of relationship building and client – quality client-focused service. We understand it will be challenging to drive growth in loans and maintain the yield management until market rates move higher.We are heavily focused on relationship management pricing. Our delivery and service model is effective in helping achieve this balance. We are very focused on deposit growth as well, and look to add several initiatives to overcome challenges in attracting core deposit relationships at a correlated pace with loan growth.To support our ongoing metro market strategy, we have expanded our physical branch presence by opening a branch in Sylvania, Ohio as part of our Toledo metro market. That houses a full-service banking branch and a full-service insurance agency.A third office will expand our commitment to Fort Wayne, Indiana market with both banking and insurance services and a staff as the office in the downtown area is on the horizon. And additionally, we have opened an LPO in Ann Arbor to expand our footprint in Michigan.

Throughout 2018, we will continually look to enhance the customer experience in both in-person and through digital channels. Our customers' expectations, especially pertaining to digital delivery methods, are changing at an accelerated pace and we are committed to providing our clients quality products and services within an environment they prefer.When we look to technology for continuous enhancements of our digital delivery capabilities that are growing in popularity with our client base, we have launched a branch transformation initiative to introduce more technology into our customer service model. The deployment of in-teller units increases efficiency in certain locations, and offers customers additional choices within a traditional branch environment, and we look to expand this initiative in ‘18.It is important to reflect on 2017 as an exceptional year for our Company with notable progress made toward our M&A goals that complement our organic growth strategies. In the first quarter of ‘17, we successfully integrated a bank acquisition and a successful insurance acquisition filed within the second quarter of 2017. We will continue to focus on growth in our wealth management and insurance businesses as part of our strategic plan.

We are very encouraged by our recent performance and look to constantly drive our performance through these initiatives that will help us obtain our goal of consistently being a high-performing community bank. As we look to carry this success forward, we have several key strategic objectives to help us achieve long-term goals. The first is to continue to refine our metro market growth plan and expectations. The second is to use technology to become more efficient and utilize data to better serve our clients and assist in making customer-focused decisions and achieving a better overall client experience. Third is to continue the development of and investment in our human capital. And lastly, we seek to gain a better understanding of the changing customer expectations for products and services in order to meet these expectations in a way that matches our overall risk profile.We remain confident in our strategy and in our ability to overcome obstacles and in our people that are working hard to execute our plans. We feel that the performance of the organization reflects our focus on shareholder value and at the same time, our commitment to being a strong community partner in the areas we serve. We remain dedicated to all of our customers and shareholders, and we appreciate the trust that you continue to place in us as we build the pride in First Defiance.

Thank you for your interest at First Defiance Financial Corp, and we thank you for joining us this morning. We will now be glad to take 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 (1) on your touchtone phone. If you are using a speakerphone, please pick up your handset before pressing the keys. To withdraw your question please press star (*) then two (2). And at this time we will pause for a moment to assemble our roster.

And our first questioner today will be Nick Cucharale with Sandler O'Neill and Partners. Please go ahead.

Nick Cucharale
Good morning gentlemen.

Don Hileman
Good morning, Nick. Welcome.

Nick Cucharale
Thank you. First, this was one of your strongest organic loan growth quarters in a while, as you

were alluding to. I was hoping you could give us some color on the opportunity you're seeing and what geographies contributed to the strong performance in the quarter.

Don Hileman
I'll talk a little bit about geographies first, and then go back to the other part of the question. I think we did see some strong growth in the Columbus market this quarter, but we had significant growth in some of the other metro markets as well. So it was a little bit broader than just one market, which was encouraging to us. So when we start looking at a geographic pattern there, it was somewhat dispersed but probably a little bit more weighted in the Columbus market in the fourth quarter.We expect to be able to have a more accelerated growth pace consistent with the fourth quarter in some of our other metro markets as we go into 2018. And right now, we are encouraged about where we were on a pace in the fourth quarter. Will it continue at that pace? Probably not. But as we said, we're looking for overall upper single digits throughout ‘18.

Nick Cucharale
Great. Thank you. And then I know it may be too early in the process, but I was hoping you could share with us how the new LPO in Ann Arbor's shaping up?

Don Hileman
It's pretty early because it has only been about a month or so but he’s got a pipeline, which is encouraging, to start making the contacts. And we think there's a – there's a good opportunity for us there. But it's very early in the stages. And we haven't booked any loans up there yet.

Nick Cucharale
Okay, great. And then in terms of the expenses, you mentioned the $1 million investment in the company as a result of tax reform. Is that primarily going to be in the first quarter or are you planning to spread that across 2018 with – while keeping the efficiency ratio in that 60% range – or better than 60%, I should say?

Don Hileman
We're planning on, yes, spreading it out. We know we've got a couple of things. We don't have it totally identified, so I would expect there will be some balance throughout the course of the year as we start to look at where those opportunities are.

Nick Cucharale
Okay, great. And then the cost of funds remain constant quarter-to-quarter here. Are you seeing any pressure on the funding front or kind of in the horizon?

Kevin Thompson
Not overwhelming pressure, but there's certainly a little more activity recently in terms of one-off type of offers and things like that. So I would expect that's going to continue and particularly if the Fed continues to move rates up, that will continue. So – but at this point, still, again, not overwhelming.

Nick Cucharale
Okay. And then just lastly, you had mentioned that the origination rate was up year-over-year but down a little bit sequentially. Is that just a mix issue or is it just competitive dynamics kind of burying their head?

Kevin Thompson
Yeah, it was a mix issue. Yeah. We have a lot more large credit that we had a good price on, it

kind of inflated the third quarter a little. We're always going to get it.

Nick Cucharale
Thank you very much.

Don Hileman
Thanks a lot.

Operator
And the next questioner today will be Christopher Marinac with FIG Partners. Please go ahead.

Christopher Marinac
Thanks, good morning. I just wanted to – if you could just reiterate the expense addition that you had this year, and curious if we'll see all of that in the first half of the year?

Don Hileman
Yeah. I don't think we – I think it will be more balanced, Chris.

Christopher Marinac
Okay.

Don Hileman
You know, we're thinking if you take that and you almost divide it by four – as we start to develop that plan. You know, we're early on in trying to figure out the best use of that, whether that's additional growth, cost of people in markets, etcetera. So I would say, for us, we're looking at it balanced throughout the year.

Christopher Marinac
Okay. And Don, what was the amount again? I just want to make sure I was clear on that.

Don Hileman
Of the tax benefit we're anticipating allocating?

Christopher Marinac
Correct.

Don Hileman
That would be about $1 million.

Christopher Marinac
Okay.

Don Hileman
About $1 million. Yes.

Christopher Marinac
Okay. And then again…

Don Hileman
The focus will be, Chris, for us – I'm sorry, will be – we're still very focused on the efficiency ratio. So as we balance things out and look to do some of that spend, we're still going to keep

our eye on that, the efficiency ratio.

Christopher Marinac
Got it. No problem. And that's an annual figure, correct?

Don Hileman
Yes.

Kevin Thompson
Correct.

Christopher Marinac
Okay. And then do you have clarity on the tax rate for this year? Or do you think that will get into better focus as you get another quarter under your belt?

Kevin Thompson
Well, certainly, as we report numbers, it will. But, you know, as we've been putting together our budgets and all, we're seeing our reported effective tax rate, we're expecting in the 18.5% range. If it was on a tax equivalent basis, it's probably more like 19.6%, something like that.

Christopher Marinac
Okay. And then do you have any significant change on the FTE adjustment to the margin, just given the lower tax rate?

Kevin Thompson
Well, there will be, needless to say. Just by definition.

Christopher Marinac
Right. Okay.

Kevin Thompson
It will be about $1 million a year decline, I would say.

Christopher Marinac
Okay, great. Just want to clarify all that. That's great. Super. And then I guess back to the growth question. So to what extent do you think seasonality impacts you both favorably in Q4 and then perhaps, in the first – these sort of slow few months of first quarter? I mean, should we – how much of that can – should we read into just from past years, where it's just a little slower in the first part of the year?

Kevin Thompson
I would say that's our – not an unreasonable expectation. But we do feel overall the momentum has been building and certainly, the fourth quarter, we think, evidenced that build up. While we get some seasonality, we're looking for very strong loan growth in 2018 based upon that overall momentum, Chris. So – but you're right, it will be a little bit slower, probably, in the first part of the year.

Christopher Marinac
Okay, that's great. That's helpful Kevin and Don, thank you so much guys.

Don Hileman

Thanks a lot, Chris. Appreciate it.

Operator
And once again, if you would like to ask a question please press star (*) then one (1). And our next questioner today will be Damon DelMonte with KBW. Please go ahead.

Damon DelMonte
Hey, good morning guys. How is it going today?

Don Hileman
Very good, Damon.

Kevin Thompson
How are you?

Damon DelMonte
Good, good. First question, just could you elaborate maybe a little bit more on the outlook for the provision? I think in your prepared remarks, you alluded that you'd have a little bit more normalized provision in 2018.

Kevin Thompson
Sure. I mean, asset quality has been stable and obviously growth is starting to elevate. And with the growth that we are looking at, probably for next year, we're anticipating – provision is probably approaching $1 million a quarter.

Damon DelMonte
Okay. All right. That's helpful. And then the loans that had gone nonperforming in the second quarter, any update on how those are progressing? Do you think they could be resolved during 2018?

Kevin Thompson
We're certainly hopeful. All of the operating performance that we see on those credits is positive. And that's what we were expecting that we'd see. And so we're seeing that, but we're – we're cautious. We're not going to get ahead of ourselves in terms of upgrading loans until we feel that all the problems are absolutely behind us. So we're hopeful that occurs in 2018, but we feel we're certainly on a positive track and that's the most important thing.

Damon DelMonte
Okay, great. And then just one final one related to the margin, a two-part question here. First part, of the 3.88% this quarter, how much of that was -- included the benefit from accretable yield? And then the second part, is it fair to assume that with the outlook for rising rates in 2018, we should see the margin continue to trend up a couple of basis points per quarter?

Kevin Thompson
Well, we'll start with the accretable yield. Actually, it was only about 4 basis points this quarter, so not that significant, and actually down from about 10 basis points quarter before, so becoming a smaller contributor to margins. Looking ahead, as rates rise, we're cautious there. We manage, as Don said, to be neutral, maybe a slight asset sensitivity. But the experience we've had over the last year on the funding side with bases lagging significantly in terms actual pricing, we're cautious that maybe there's some catch up that's going to come in 2018, maybe a little more this intermediation-type impact as well. So I'm looking more for the margin to be

stable as opposed to expanding in 2018.

Damon DelMonte
Okay, that's helpful. That's all that I had. Thanks a lot.

Don Hileman
Thanks, Damon.

Operator
And this will conclude our question-and-answer session. I would like to turn the conference back over to Tera Murphy for any closing remarks.

CONCLUSION

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

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