first Defiance Financial Corporation

Teleconference January 22, 2008 at 11:00 AM ET

fourth quarter and Full-Year 2007 Conference Call

Official Speakers: Mr. William J. Small, Chairman, President and Chief Executive Officer
Mr. John C. Wahl, Executive Vice President and Chief Financial Officer

CAROL MERRY: Thank you. Good morning everyone and thank you for joining us for today's fourth quarter and Full-Year 2007 Conference Call. The Call is also being Web cast. The replay will be available at the first Defiance Web site at http://www.fdef.com until February 1, 2008. We will begin with comments on the results and the Company's outlook from Bill Small, Chairman, President and Chief Executive Officer for first Defiance and will be followed by a report on the financial performance by Jack Wahl, the Company's Executive Vice President and Chief Financial Officer. Before we begin, I would like to remind you that certain statements made during this Conference Call are "forward-looking" statements within the meaning of the Private Securities Litigations Reform Act of 1995. "Forward-looking" statements such as expectations about the Company's plans, business performance, future initiatives and results as well as market conditions in which the Company may operate are based on information currently available to the management of the Company and are subject to risks and uncertainties. Actual results could vary materially because of factors discussed in yesterday's News Release in the Management's Discussion and Analysis Section of the Company's Form 10-K or in other reports and filings with the Securities and Exchange Commission. first Defiance Financial Corp. assumes no obligation to update any "forward-looking" statements. Now I will turn the call over to Mr. Small for his comments.

WILLIAM J. SMALL: Thank you Carol. Good morning and thank you for joining us for the first Defiance Conference Call to review the fourth quarter and 2007 Year-End Results. It certainly has been an interesting morning as everyone has been busy reacting to the Fed announcement. However, last night, we issued our earnings release for the year-end and also for the fourth quarter results. This morning we would like to discuss that release, reviewing 2007 and looking forward into 2008. At the conclusion of our presentation, we will answer any questions you might have. I would like to begin by giving you an overview of the year and then Jack will give you more financial detail on our performance during the quarter and the year. The challenges of 2007 were formidable and came from several directions. Most notably, was the dramatic impact of sub-prime mortgage lending had on the balance sheet and income statement on many banks across the country. Beyond this direct affect of the now infamous subprime mortgages, residential real estate in general suffered from falling property values and in many areas, a glut of properties on the market. Add to this the fact that the country struggled under an uncertain economic environment, which resulted in attentive consumers and business and industry being cautious throughout the year and especially in the final quarters of 2007. For many banks, this resulted in a decrease in loan demand and other services, adding to the earnings challenge that was already present due to net interest margin compression and higher credit costs. Despite all of this, we finished strong with a solid fourth quarter resulting in net income for 2007 at $13.9 million or $1.94 per diluted share. The fourth quarter net income of $3.6 million or $0.50 per diluted share was a respectable finish to this challenging year. The general economic environment was challenging enough but we also faced some further drag to earnings again in the fourth quarter due to additional expenses related to the August flooding. With these challenges before us, we did see our 2007 net income decline from the 2006 level of $15.6 million or $2.18 per share. The positive note, however, is the fact that earnings per share increased 13.6% in the fourth quarter of 2007 over our third quarter results. This increase, along with quarter-over-quarter improvement in the net interest margin and significant deposit in loan growth gives us a positive feeling going into 2008. Looking at our overall performance in 2007, loan growth, after getting off to a very slow start than the first part of the year saw considerable pickup in the fourth quarter, and this increased volume helped offset the negative impact of the tighter net interest margin. As a result, this quarter we did see the year-over-year increase in net interest income for the first time in 2007. The growth continues to be primarily within our commercial and commercial real estate portfolios and most of this increase comes from new relationships that are being brought into the bank as we continue to develop in many of our newer markets and also benefit from other bank mergers. On the deposit side of the balance sheet, things were no less competitive as we kept our focus on the non-interest bearing commercial and retail DDAs. Our average non-interest bearing deposits for the 2007 fourth quarter increased by 14.4% from last year's fourth quarter and they were up by more than 10% from the 2007 third quarter. Results like that are critical to our success in increasing net interest income in a falling rate environment. The aggressive marketing and strong sales push that have been part of our strategy resulted in this significant growth. The net interest margin even though it is still below the year-end 2006 level did increase in the fourth quarter over our third quarter 2007 results. It certainly was a positive sign and was primarily due to the deposit mix mentioned earlier along with the return to a more normalized yield curve. Better quality numbers were stable compared to our third quarter results with one positive exception. Our net charge-offs annualized as a percent of loans were at 4 basis points for the fourth quarter. This compares to 21 basis points and 30 basis points the last two quarters and 34 basis points in the fourth quarter of 2006. Given the current operating environment, we have been very cautious in determining the appropriate levels for the allowance for loan losses and in analyzing asset values. Our non-accrual loans increased to year-end to $9.2 million from $8.5 million at the end of September, which was the result of one large mortgage loan going 90 days delinquent. The allowance against that loan which we recorded in 2006 will be adequate to cover any short fall that occurs when that loan is resolved. We also recorded additional expense in the 2007 fourth quarter to write-down property and OREO to reflect the general weaknesses in the real estate market. Non-interest income excluding securities gains was up 7% from the 2006 fourth quarter results compared to this year's fourth quarter. For the full-year 2007, non-interest income was up by 12.5% over 2006. Insurance commissions, service fees and mortgage banking income were all up for the year. We continue to look for additional ways to enhance these revenues as growth and non-interest income is going to be important to future earnings. Non-interest expense was up about $1 million dollars in the fourth quarter this year but basically flat compared to the 2007 third quarter. This category was negatively impacted by our additional OREO write-downs and the flood related charges. I will now ask Jack Wahl to give you the financial details for the quarter and the year 2007 before I wrap up with an Overview and a look at what we see developing in 2008. Jack

JOHN C. WAHL: Thank you Bill and good morning everyone. I would like to start this morning by giving you some color on our fourth quarter results and then spend a couple of minutes reviewing some of the highlights for 2007 year-end period. As we have already noted, we earned $3.6 million dollars or $0.50 per diluted share for the 2007 fourth quarter compared to $4 million or $0.55 per share for the fourth quarter of 2006. By comparison, we reported earnings of $3.1 million or $0.44 per diluted share in this year's third quarter. net interest income for the 2007 fourth quarter was $12.5 million compared to $12.2 million in last year's fourth quarter, an increase of 2.3%. Our yield on loans dropped 11 basis points between the two periods to 7.21% in the 2007 quarterly period from 7.32% in 2006 and our cost of interest bearing deposits increased by 4 basis points to 3.69% in 2007 from 3.65% in 2006. We also added $15 million of trust preferred subordinated debt in this year's first quarter. As a result the spread between the yield in our interest earning assets and the costs of our interest bearing liabilities decreased to 3.13% in the 2007 fourth quarter or 3.26% in the 2006 period. This compression in our spread was offset slightly by a 14.4% increase in our non-interest bearing deposits in the 2007 fourth quarter compared to 2006 and $6.4 million dollar increase in average shareholder's equity. As a result of these factors, the net interest margin on a tax equivalent basis for the 2007 fourth quarter was 3.52% compared to 3.61 percent in the 2006 fourth quarter. The '07 quarterly margin was a 5 basis point improvement over the 2007 third quarter where we reported a net interest margin of just 3.47%, our low point for the year. Our overall net interest income increased despite a decline in our margin because of growth and our interest earning assets where our average balance increased $1.43 billion in the 2007 fourth quarter and $1.36 billion in 2006. This morning, 75 basis points drop in the Fed Funds rate will put some pressure on our margin. Our net interest income simulation model shows a 1.5% decline in net interest income when rates drop by a 100 basis points over a twelve-month period. However, we have thus far been successful in dropping deposit rates more aggressively than what we had modeled to offset the reduction in yield in our prime-base loans. We have already met this morning and dropped deposit rates across the board in reaction to the Fed move. Hopefully these rates drops will eventually return the yield curved to a more traditional slope. If that happens, I am optimistic by our ability to successfully manage our net interest margin. We recorded a provision for loan losses of $603,000 in the 2007 fourth quarter compared to the provision of $318,000 in the 2006 quarter. This provision expense was necessary to increase our allowance for loan losses $13.9 million dollars at December 31, 2007. Increased allowance for loan losses reflects heightened concern about the overall economy and credit environment rather than any specific reserves for loans in our portfolio. Our credit quality ratio is generally re-strengthened as of December 31, 2007 as a result of the provision adjustment. In addition to the expenses related to the provision for loan losses, we also wrote-down the value of properties we hold in other real estate owned by $598,000 this quarter. These write-downs reflect the realities of the commercial real estate market. Most of the OREO write-down relates to one large commercial property, which comprises more than half of the OREO balance. We are actively marketing that property and hopefully we will be out of real estate owned by the end of this quarter. Our non-interest expenses overall for the quarter were up by $951,000. The OREO adjustments and expenses that we reported in this quarter for repairs to our two flood damaged properties in Findlay and Ottawa accounted for that increase. Our compensation and benefits costs which is our largest expense item was up only slightly in this quarter compared to last year's fourth quarter primarily because of large adjustments to reduce incentive compensation accruals based on our year-end results. We also continue to have favorable claims experience in our self-funded Medical Plan for the last half of 2007. Our non-interest income in 2007 fourth quarter grew by $346,000 or 7% from the 2006 fourth quarter level. Those results included the recognition of $157,000 death benefit in 2007 related to our Bank-owned Life Insurance Program. Our service fees which include loan fees, overdraft fees on checking accounts and debit-card interchange fees among others increased by $145,000 quarter-over-quarter and our insurance investment income was up by $146,000 primarily the result of the acquisition of a small insurance agency in Bowling Green during the 2007 first quarter. Looking at our annual results, our net income was $13.9 million or $1.94 per diluted share compared to $15.6 million in 2006 or $2.18 per share. Over the year, our net interest income declined to $48.7 million from $49 million despite a $43.5 million dollar increase in our average interest earning assets. Our margin was 2007 was 3.55% compared to 3.68% for the full-year in 2006. The 2007 annual results also included a $550,000 increase in the provision for loan losses compared to 2006 and a $4.3 million dollar or 9.7% increase in Non-Interest expenses. Total flood related costs reported in 2007 were $584,000. These cost increases were partially offset by an increase in our non-interest income, which was $22.1 million in 2007 compared to $19.6 million in 2006. Service fees increased year-over-year by nearly $1.5 million and insurance and investment sales commissions were increased by $747,000. Our effective income tax rate for the 2007 fourth quarter was 29.3% and for the year was 31.8%. That rate was favorably impacted by the Bowling death benefit, which is tax-free income and the reversal of some tax expense following the expiration of one of our tax exposure items. A more appropriate run rate for our effective tax rate excluding these items is 32.5%. That concludes my comments this morning and I will now turn the Call back over to Bill for some closing remarks and then we will try to answer your questions. Bill

WILLIAM J. SMALL

Thank you Jack. There were a number of other initiatives that first Defiance in 2007 that will add to our future growth and strength. In March of 2007 we acquired the Huber, Harger, Welt & Smith insurance agency located in Bowling Green, Ohio. This agency is now part of our insurance unit, first Insurance and Investment. Bowling Green has become a very strong banking market for us and the addition of this insurance office will allow us to better serve all of the financial service needs in that market. This acquisition is also part of our ongoing strategy to develop and grow additional sources of non-interest income. In August, we opened a new banking office in Fort Wayne, Indiana. This is our first entry into the Fort Wayne area with an actual office but this is a market where we have developed a number of solid loan relationships over the years. We felt we needed to establish an office within this market to develop the full customer relationship. In the five months of

2007 the office was open, it generated over $10 million dollars in deposits. We also announced in October that we had signed an agreement to purchase Pavilion Bancorp based in Adrian, Michigan. This transaction is projected to close in the first quarter of 2008. We expect to continue to grow in 2008. Our budget reflects period-end net loans, including the Bank of Lenawee of $1.65 Billion. Most of our growth will be in commercial and commercial real estate loans, which we are budgeting to grow by more than $120 million dollars. We have budgeted year-end deposits to total $1.56 Billion, with $170 million of those being non-interest bearing. Our margin for the year is budgeted to be in the 3.6% range in the first quarter, increasing to near 3.9% by year-end. Part of that increase reflects the improved mix of deposits we'll have following the acquisition. While a lower Fed Funds rate will probably negatively impact that margin, we have thus far been able to offset loan rate decreases with reductions to our deposits. This morning's Fed announcement certainly adds a new dimension to that challenge. Excluding the Bank of Lenawee, our non-interest income is expected to grow by 5%. On the expense side, our Compensation and Benefits will increase by 15% over 2007 levels, excluding the Bank of Lenawee primarily because of staffing increases that were modeled in as part of the acquisition's net cost savings. Bank of Lenawee's compensation expense will reflect offsetting staffing reductions. Overall wages will increase by approximately 4% and we budgeted 10% increase in Group medical costs. We believe that 2008 will be a challenging year for everyone in community banking. Asset quality issues will be everyone's focus and with declining rates, net interest margin will continue to be a challenge. Overall, I believe this environment will offer significant opportunities to companies that stay disciplined in both loan underwriting and in loan and deposit pricing. As we proceed into 2008, there are still many challenges but we feel positive of the way we have positioned our company. I see great potential for us to continue to grow in our new markets as well as make our mark as a leader in providing financial services in our established markets. The banking landscape and a large portion of our footprint has been impacted by mergers and acquisition and we have and will continue to benefit from this activity. We have a tested and proven banking strategy with a "customer first" focus. We will continue to build on this strategy as we strive to become an even higher performing community bank. We thank you for joining us this morning and now I will be happy to take your questions.

CHRISTOPHER MARINAC:

Thanks. Good morning Bill and Jack. (Greeting returned) I want to ask about the credit quality of Pavilion and what you know about how their year finished up and was there any deterioration from where they already were at last quarter?

WILLIAM J. SMALL: We have seen some deterioration there Chris. We have been monitoring that very, very closely, actually trying to make sure that they have everything in place to address those issues. We don't have… I cannot release any you know direct numbers or anything on theirs but we have seen some deterioration. That obviously the state of Michigan, Southeast Michigan certainly has felt a major part of the impact of the slowdown in the economy. However, I still feel very confident about the amount of due diligence that we spent in reviewing credit files prior to reaching the agreement with them as well as the fact that we currently have the firm that does our external loan review is currently onsite doing a thorough loan review for us as we speak and we should have those results here probably within the next week to ten days.

CHRISTOPHER MARINAC:
If you kind of think proforma as to how your allowance and covers looks once they are in your fold, do you want your cover ratios to be similar to where you have it now or are you willing to have those dipped out slightly until you work through some of the issues that you inherit from them?

WILLIAM J. SMALL: I don't think we want to see them dip any lower than where they are right now. I mean we are very, very comfortable with our allowance and all of our ratios right now as we you know stand here today but you know knowing with looking at the portfolio affair and such, I certainly don't think that we are going to want to put ourselves in a position of letting those get any thinner.

CHRISTOPHER MARINAC:
Okay and then two other of my questions. The write-down that Jack mentioned, the $598,000 that is not caused by a charge-off. It is just a write-down to OREO?

WILLIAM J. SMALL: That's correct.

CHRISTOPHER MARINAC:
Okay fair enough and then the last question has to do with a bigger picture. There has been a lot of discussion about the price of farmland possibly coming down or having peaked. Does that have any issues from a collateral perspective to your loans whether it is directly in Ag or just other loans that have collateral of farms or other related properties?

WILLIAM J. SMALL: Well obviously it has been something that you have been watching very closely because we do a fair amount of Ag loans, as does the Bank of Lenawee. I think you know hopefully we have seen these land values peak but at the same time, we are not anticipating any significant drop in those prices anywhere in the near future.

CHRISTOPHER MARINAC:
Okay great. Thank you Bill. Thank you Jack.

WILLIAM J. SMALL: Thanks Chris.

OPERATOR: Our next question comes from Michael Lipman from FTN Midwest Securities. Please go ahead.

MICHAEL LIPMAN: Good morning Bill and Jack. (Greeting returned) I just wondered if one of these guys could touch on the margins a little bit. Obviously, the morning was pretty timely and I guess you guided to 3.6 in the first quarter got it going up to the 3.9 range. Are you still comfortable with that range with this morning's announcement and what goes into those assumptions kind of for your margins guidance?

WILLIAM J. SMALL: That is a good question. I asked Jack the same thing a little while ago. (Laughter)

JOHN C. WAHL: Basically Mike it is right off of our budget for 2008 and it reflects assumptions we made at the time we did the budget which basically was a flat rate environment. Declining rates, as long as we can continue to manage the spread and we have some slope in the yield curve, I think we probably won't be far off for those levels if we have a systematic drop across the board in rates, then it is going to be a real challenge for us to get to those budgeted levels in 2008. I guess following this morning I am probably less optimistic about our ability to hit those numbers than I was three hours ago.

MICHAEL LIPMAN: Gotcha. I guess on the same lines, in this quarter, was the increase in the margins largely driven by the non-interest bearing or are there any other pieces that we should be aware of?

WILLIAM J. SMALL: That was the basic driver Mike; just improve mix on the deposits on the liability side. We had a run off… run off is probably too strong a word. We had a reduction in the balances of some of our higher costs CDs. We had CDs re-pricing at lower levels and we had the nice growth in our non-interest bearing deposits, which were up 10% for the quarter which I think is phenomenal growth.

MICHAEL LIPMAN: Right and in those non-interest bearing numbers, is some of that seasonality or how should I look at that?

WILLIAM J. SMALL: Some of it is seasonality. Those balances typically decline in the first quarter. They don't necessarily peak for us in the fourth quarter. They peak in the second-half of the year but they typically decline because you know commercial customers are making tax payments, consumers are paying their credit card bills and other factors so we do see a drop in those balances in the first quarter and when we do our budgeting and our forecasting. This year, at least, we budgeted some of that seasonality into our numbers.

MICHAEL LIPMAN: And I guess you know banks in a lot of the other parts of the country are not intimately familiar with you know Ohio and other Michigan; it seems like deposit rates are still very sticky and it is kind of difficult to lower them. You guys seem to be much more positive on that side of things. Can you just comment on that I guess and do you feel like with lower rate cuts you can continue to ramp down deposit costs?

WILLIAM J. SMALL: I think there certainly has been and especially as different credit markets have tightened up, we have seen a lot of the banks that have driven up the cost of funds in our market as well as other markets across the country and probably come much more so from the larger banks this time around than what sometimes as you see as periodic irrational pricing on the part of smaller banks. That being said, I think that hopefully we have seen the peak in that. I would certainly have to think that we weren't the only place that was busy this morning reviewing deposit rates and making changes there but we still… we are very much aware that there are special rates out there that are continuing to be advertised by many of our competitors and we just… we have a very active ALCO group that tries to react you know in a proper way through that to prevent you know massive run offs but at the same time, protect our pricing philosophy. I do think again that hopefully we have peaked as far as some of this higher pricing is concerned. Right after the Fed came out with their auction process, we saw some of the larger banks use up a little bit and we hope that is and expect that to continue.

MICHAEL LIPMAN: Great. Were there any buy-backs in the quarter and what is your outlook on buy-backs in general?

JOHN C. WAHL: We had a modest amount of buy-back activity in the quarter. I do have that number here. Bear with me for just a second. We repurchased about 40,000 shares in the quarter. Even though our prices dropped significantly, I've not been successful in getting any. We've got a lot of seller out there and our trading window opens back up on Friday, we'll try to get some stock at this level; probably a comparable amount to what we've bought here in the last several quarters.

MICHAEL LIPMAN: Gotcha and I guess… I don't want to hold up this line forever but bank and the CRE in the commercial side, how are you seeing your pipelines and what's the specific I guess weakness and strength in your different markets going into 2008? Thank you for all of the good answers.

JOHN C. WAHL: We felt that from pretty much the middle of the year on our second-half of the year, our own growth was good. We had a decent Third quarter and our fourth quarter I thought our own growth, again, in this environment was very good. I think that we are definitely benefiting from the Huntington acquisition of Sky. They have been very prevalent throughout our market and I think we can compete against them and in every community that we are in with the exception of one or two and you know without a doubt, we know we've benefited from that. We also benefited from the fact that you know some of the acquisitions that we've done over the last couple of years has put us in some new markets that we've been able to finally start to make some good penetration there. As a resolve right now, we ended the year strong as far as loan growth. Our pipeline going into 2008 looks pretty decent. As long as we can keep everybody you know calm in regards to the economy, I think there is still good potential for us to grow.

MICHAEL LIPMAN: Well thank you very much Bill and Jack.

WILLIAM J. SMALL & JOHN C. WAHL: Thanks Mike.

EILEEN ROONEY: Hi guys! (Greeting returned) I have one quick question. Most of my questions have already been asked. With the 75 basis points cut this morning, how much did you lower deposit rates? Was it half of that or just order of magnitude?

WILLIAM J. SMALL: It depends on what maturity you are looking at and what product. We actually had our outgoing met last weekend. You know like everybody else, we were anticipating some level of rate cut, whether it was going to be 50 or 75 and whether it was going to happen now or next week at the regular meeting so we went ahead at that point and lowered most of our special CD rates by at least 25 basis points. This morning, we basically went up and down the list and you know virtually every item except for the very lowest tiers on our savings accounts which were only paying 25 basis points for now anyway, we lowered a minimum of 25 and most of those, we took down either another 50 from the 25 we lowered last week or we lowered the full 75 today.

EILEEN ROONEY: Okay, all right thank you.

WILLIAM J. SMALL
& JOHN C. WAHL: Thank you, thanks Eileen!

OPERATOR: Our next question comes from Barbara Tomalonis, first Manhattan Investments. Please go ahead.

BARBARA TOMALONIS:
Good morning. (Greeting returned) I just want to ask about the rise in the non-performers you mentioned in the Press Release. It is one large mortgage loan. Could you just tell us what kind of mortgage loan it was?

WILLIAM J. SMALL: The non-performers, the development loan, a land development loan with a (Cross Talk) it is a single family property that is we had set up reserves as we said back in late ’06 and you know actually I think we are going to come out with a pretty good resolution on this the way it looks at this point and time.

BARBARA TOMALONIS:
So you are saying it was a residential mortgage or single family?

WILLIAM J. SMALL: It was one large residential mortgage loan.

BARBARA TOMALONIS:
And that was over a million?

WILLIAM J. SMALL: No

JOHN C. WAHL: The balance increased last quarter by about $650,000 and that one property was $600,000.

BARBARA TOMALONIS:
And how are the Toledo based non-performers, the $4.5 million dollar chunk that is really like the majority of the non-accruals?

JOHN C. WAHL: Those obviously are a hard hit market and everything but that is part of what you know our additional provision and stuff, we felt that overall on an individual basis, we felt that we were pretty well reserved on those as far as specifics but that was part of the reason that we took some of the additional general reserve.

WILLIAM J. SMALL: We are working with that borrower right now too. He is trying to avoid foreclosure and we are probably going to get some deeds in lieu of foreclosure on some of those properties so we expect that we are going to see some movement in that and that movement may be from non-performing to OREO this quarter but we feel like at least we’ve got a plan to get that worked out.

JOHN C. WAHL: I’ll feel better when we are in control of the property in that situation.

BARBARA TOMALONIS:
And at this point, what is the specific reserve against that?

JOHN C. WAHL: (Cross Talk) I am sorry I don’t have that here Barb.

BARBARA TOMALONIS:
Okay thank you very much.

WILLIAM J. SMALL
& JOHN C. WAHL: Thank you!

CAROL MERRY: All right thank you. If there are no other questions, we thank you again for joining us today and this will conclude our Call.

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