First Defiance Financial Corporation

Teleconference: April 22, 2008 at 11:00 AM ET

Event: First Quarter 2008 Earnings Results

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

CAMILLE: Hello and welcome to the First Defiance Financial Corporation's First Quarter 2008 Earnings Conference Call. All participants will be in a listen-only mode. There will be an opportunity for you to ask questions at the end of today's presentation. An Operator will give instructions on how to ask your questions at that time. If you should need assistance during the Conference, please signal an Operator by pressing "*" then "0" on your touchtone phone. Please note this Conference is being recorded. Now I would like to turn the Conference over to Ms. Carol Merry. Ms. Merry, you may begin.

CAROL MERRY: Thank you for joining us for today's First Quarter 2008 Conference Call. This Call is also being Web cast and the audio replay will be available at the First Defiance Web site at http://www.fdf.com until April 30, 2008. This morning, we will begin with comments on the Results and the Company's Outlook from Bill Small, Chairman, President and CEO of First Defiance, 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, including the Question and Answer period, are "forward-looking" statements. Such statements are based on information and assumptions available at this time and are subject to change, risks and uncertainties that may cause actual results to differ materially. First Defiance assumes no obligation to update such statements. For a complete discussion of the risks and uncertainties, please refer to materials filed with the SEC, including the Company's most recent Form 10-K and A.K. filings. 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 Financial Corp. Conference Call to review the 2008 First Quarter results. Last night, we issued our Earnings Release for the First Quarter 2008 Results and this morning, we would like to discuss that Release and look forward to the balance of the year. 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 first three months of 2008 and then Jack will give you more financial detail on the Quarter. First Quarter 2008 net income on a GAAP basis was $3.42 Million dollars, or $0.42 per diluted share. This was down from $3.61 Million and $0.50 per diluted share in the 2007 First Quarter. The 2008 Results include part of the costs associated with our acquisition of Pavilion Bancorp, which closed on March 14, 2008. Excluding the after-tax of those charges, First Defiance had earnings of $3.91 Million, or $0.54 per diluted share for the Quarter ended March 31, 2008. The 2008 First Quarter Results include 17 days of operations of the 8 banking centers acquired in the Pavilion acquisition. In his remarks, Jack will give you additional detail on the numbers related to this transaction. Closing on the Pavilion acquisition and the immediate conversion of their operation and systems over one weekend required a lot of time and energy during the First Quarter. Few people realize all the work and planning required to accomplish this successfully and all that needs to be completed while making sure the existing operation is performing up to its expectations. The skilled and talented group of employees from both Companies, led by Denny Rose, here at First Federal Bank, did an exceptional job to make it all happen. This was our largest acquisition yet and teams throughout the combined organization worked extremely hard to make the transition as smooth as possible for our new customers.

With all the closing and conversion activity going on, it is especially pleasing to see the solid performance that we posted in the 2008 First Quarter; in a Quarter that included a surprising and unprecedented 125 basis point rate cut by the Fed in the last ten days of January, followed by another 75 basis point in mid-March, we had plenty of headwinds. Because of the flexibility that we strive to develop in our Business Plan, combined with the quick reaction to our Management Group, we were able to make virtually an immediate downward adjustments in our deposit rates to help mitigate the results the Fed cuts had on the asset side of the Balance Sheet. As a result, in a period of 200 basis point reductions in Fed rates, we were able to improve our net interest margin by 24 basis points compared to Fourth Quarter 2007. The margin was also favorably impacted by an increase in non-interest bearing deposits and the Pavilion acquisition as Pavilion has historically operated at a higher margin than First Defiance. However, in the 2008 First Quarter, the Pavilion results were included in only the last 17 of the 91 days and was the immediate action on our part to address deposit rates that was the key to improving the margin.

The First Quarter is usually a period of lower loan demand. The loan growth was strong on a relative basis during this Quarter. The January 5th cut had a short-term impact on the 10-year Treasury, which brought residential mortgage rates down and sparked a flurry of refinance activity that kept the mortgage pipeline busy throughout February and March. Commercial loan demand also remained strong throughout the Quarter as we continued to pick up business, especially from the larger regional banks for a variety of reasons, including opportunities created by bank consolidations. On the deposit side, the seasonal runoff of deposits early in the year was in line with expectations as we allowed some higher priced CDs to leave the Bank. The success of our concentrated effort to increase non-interest bearing deposits was very evident again in the First Quarter of 2008 and we continue to see our deposit mix progress closer toward our target levels. The provision for loan losses more than doubled in the 2008 First Quarter compared to the First Quarter of 2007. The significant increase was due primarily to an increase in the loan loss reserve for one loan caused by a reduction in the appraised value of that loan's real estate collateral. Excluding the specific allowance recorded for that one loan, the Company's provision was in line with the level of the provision expense recorded over the last several Quarters. Overall, these are among the toughest credit times this industry has seen in a quite awhile. We certainly are not immune to those difficulties but I think our portfolio has held up well as we look around and see the negative impact others are experiencing.

While are non-performing assets increased $5.2 Million from the end of December, nearly $5.7 Million came on the books with the Pavilion acquisition. Non-performing loans originated by First Federal Bank actually decreased during the 2008 First Quarter while other real estate loan balances on original First Federal loans decreased by $246,000. Although we doubled our loan loss provision compared to last year's First Quarter, the impaired loan that I mentioned earlier that caused most of the increase, is paying as agreed. Our net charge-offs for the Quarter are higher than we like but they still represent only 15 basis points of average loans outstanding, calculated on an annual basis. Our expectation is that the ratio of net charge-offs to average assets will trend higher for the balance of the year, both because of the acquisition and because of our market areas overall economic condition. We are seeing increases in delinquencies and we definitely have to work harder to keep our borrowers from falling past due. Our local economy has remained generally healthy though far from robust. The Southern Michigan counties where the former Pavilion branches are located are probably struggling a bit more than most of the communities where our Ohio branches are located, but we anticipated this going into the acquisition and are prepared to deal with it.

We are seeing a higher level of delinquencies in our Consumer Loan portfolio than what we are accustomed to and we will likely see an increase in charge-offs of this type of loan during the balance of 2008. While we don't have subprime loans on our Balance Sheet, falling housing values in our market area will have a negative impact on our asset quality. Overall, however, I feel comfortable with our level of allowance for loan losses at March 31st. First Defiance's non-interest income for the 2008 First Quarter increased over the First Quarter of 2007, driven primarily by the increase in the mortgage banking activities that I spoke of earlier. Gains from the sale of mortgage loans more than doubled in the First Quarter of 2008. The increase was partially offset by adjustments in mortgage servicing rights. These types of negative adjustments are not uncommon during periods of increases and mortgage loan sales gains related to falling interest rates.

Income from the sale of insurance products increased for the 2008 First Quarter at First Defiance's insurance subsidiary, First Insurance and Investment. The increase is attributable to a full Quarter of revenue from the late February 2007 acquisition of the Huber, Harger, Welt & Smith Agency in Bowling Green, Ohio. The insurance market continues to be soft from a premium standpoint so sales growth needs to come from developing additional new business and our people work hard to accomplish this. First Insurance typically recognizes contingent revenues during the First Quarter of the year. These revenues are bonuses paid by insurance carriers when the agency achieves certain loss ratios or growth targets and the commissions were again higher this year. This is our third consecutive year of very strong contingent commissions. It is reflective of effective management and our relationships with our insurance carriers.

Total non-interest expense for First Defiance increased 14.5% from the non-interest expense recognized in 2007 First Quarter. The 2008 amount includes some of the acquisition related charges. If those costs are excluded, non-interest expense increased by 8.1%. As I mentioned at the start, Jack will give you further detail on the acquisition related cost.

Compensation and benefits increased between the 2007 and 2008 First Quarter due to year-over-year compensation increases and a full three months of compensation associated with the Huber, Harger, Welt & Smith Agency compared to just one month in 2007.

Occupancy expenses increased due to the Pavilion acquisition, as well as the December 2007 opening of First Federal's new Operation Center, the Fort Wayne, Indiana branch opened last August and the Grand Fork, Ohio branch that we opened in February of this year.

I will now ask Jack Wahl to give you the financial details for the Quarter before I wrap up with an Overview and a look at what we see developing for the balance of 2008. Jack…

JOHN C. WAHL: Thank you Bill and good morning everyone. I will start by giving you some detail on the Pavilion acquisition. We paid approximately $28.0 Million in cash and we issued 1,039,000 shares of First Defiance stock to purchase Pavilion. The accounting rules currently in effect require us to issue the shares we issued at the price on the announcement date. In our case, per share value at that time was $26.12 per share and the total value of the acquisition, not counting legal accounting and investment banking fees was $55.16 Million. None of the cash paid, the acquisition added approximately $285.0 Million in assets to our Balance Sheet, including $231.0 Million in loans and approximately $27.0 Million in tangible assets. On a preliminary basis, we have estimated core deposits and customer relationship tangibles totaling $6.6 Million and goodwill of $21.5 Million. We also estimated a positive market value adjustment of $5.3 Million to Pavilion's loan balance, a $1.0 Million positive adjustment to the mortgage servicing rights and a market value adjustment that increased Pavilion's fixed rate deposits by $750,000. All of these purchase accounting adjustments are subject to further revision as final valuations are completed by various consultants and appraisers over the next couple of months.

As Bill noted, our Quarterly Results included only 17 days of operation from the Pavilion acquisition and it is difficult to pinpoint exactly how much impact the acquisition had on our bottom line because of all the moving parts. Based on our 2008 Budget, the estimated impact of the acquisition in March and, therefore, on the First Quarter was between $100,000-$150,000. Bill also noted in his remarks that we recorded $750,000 of acquisition-related costs in the 2008 First Quarter. These costs primarily consisted of a number of long-term contracts that Pavilion had entered into that are no longer necessary. In-stay bonuses paid to Pavilion employees that were not offered jobs with First Defiance, but who were needed through a transition period. Our estimate of remaining acquisition-related costs is $1.125 Million dollars, a substantial reduction from our initial estimate of a total of $3.5 Million of such costs. Our initial estimate of the costs to terminate Pavilion's participation in a multiple-employer defined benefit pension plan was to conservative by approximately $900,000 and we had included certain separation and change of control costs in our initial estimate that were expressed by the Seller prior to the closing. Our estimate is that the majority of the remaining acquisition-related costs will be incurred in our Second Quarter.

While the completion of the acquisition was a big story for the Quarter, an equally important story is the substantial improvement in our net interest margin. As Bill noted, our margin improved by 13 basis points over last year's First Quarter and by 24 basis points from the 2007 Fourth Quarter. In terms of dollars, our net interest income increased by $1.6 Million, or 13.4%. The yield on our interest earning assets declined by 45 basis points from last year's First Quarter and by 26 basis points from the '07 Fourth Quarter. During those same periods, the average costs of our interest bearing liabilities dropped by 59 basis points from last year's First Quarter and by 53 basis points from the Fourth Quarter. Our interest rate spread which was 3.26% in the 2007 First Quarter and 3.13% in the 2007 Fourth Quarter expanded to 3.4%. The average balance of non-interest bearing deposits was $124.6 Million for the 2008 First Quarter compared to $97.9 Million in last year's First Quarter and $114.1 Million in the 2007 Fourth Quarter, which helps our margin. Also, the average balance of our Consolidated Stockholders equity increased by approximately $7.5 Million dollars over the last Quarter, which also had a positive impact on our net interest margin.

I do need to point out though that we closed the Pavilion transaction on March 14th, I was able to hold the cash portion of the funding until March 28th, which had a positive impact on net interest income of approximately $50,000 free tax.

Focusing elsewhere on our Income Statement, Bill has already noted the increases in our vision for loan losses as well as the growth in our net interest income. I will point out that our total mortgage banking income increased $332,000 or 42% in the 2008 First Quarter compared to the same period last year on strong mortgage loan demand. Our gain from sale of loans doubled from $512,000 to $1.1 Million and during the same period, our mortgage servicing rights amortization also more than doubled to $352,000 from $141,000. We also recorded $142,000 of impairment to the value of our mortgage servicing rights based on our March 31, 2008 valuation compared to just $10,000 of impairment recognized in last year's First Quarter. We believe that mortgage gains will remain higher than normal level in the Second Quarter before dropping to more routine levels during the Second Half of 2008.

I also like to point out that total securities losses of $81,000 in the Quarter, which included the recording of $100,000 of expense associated with the impairment of one of our trust-preferred investments, which was deemed to be other than temporary. We have approximately $1.5 Million invested in three separate trust-preferred equity notes. These investments are high yield but also high risk if the underlying banks or insurance companies have difficulties. Some of the reduction in the value of these investments is driven by their lack of liquidity and we intend to continue to hold these investments to the maturity date. However, some of the reduction in value is caused by deferrals of interest payments by one or two banks in the trust-preferred pools. We will continue to monitor these investments for potential additional, other than temporary, impairment charges.

Overall, our non-interest expense for the Quarter was $13.5 Million dollars; $12.75 Million if you exclude the acquisition costs, which is an 8.11% increase over last year. Compensation and benefits expense remains the most significant cost and they were up $572,000 from last year. Approximately $250,000 of the increase is due to normal salary increases over the last 12 months, while the balance relates to a half month compensation for the acquired branches, staffing increases in central operations to serve the larger bank and a full Quarter of expense for the insurance agency we acquired in Bowling Green, Ohio at the end of last February.

I realize our results for this Quarter have a lot of noise in them, primarily from the acquisition. As a result, I am sure it is difficult to estimate what the run rate is for our net income going forward. Our Budget for 2008 Second Quarter is projecting consolidated net income of $4.3 Million dollars, or $0.53 per share, excluding any acquisition-related charges. Actual results may be lower than that targeted level as we are waiving a substantial amount of fees over the first 90 days of operating the former Pavilion branches, as we transition those customers to our systems and fee schedules.

That concludes my analysis of the Financial Results of the Quarter. I will turn the Call back to Bill for his concluding remarks and then we will try to answer your questions.

WILLIAM J. SMALL: Thank you Jack. As we progress through 2008, we will continue to be innovative in our approach to offering relationship banking services and meet our customers' needs and produce the returns expected by our investors. We are working hard to ensure the full integration of our recent acquisition as well as to reach the full potential of our newer and larger markets, such as Findley, Toledo, Lima and Fort Wayne. We are pleased with the early results in Southeast Michigan and with the growth in our new offices in Fort Wayne and Glandorf.

Overall, the economic climate throughout our market area continues to vary from industry to industry. We have experienced some plant closing and layoffs in recent months but on the whole, employment numbers have improved over the previous year. We see many companies, large and small, making capital investments in their facilities and many of our clients express confidence in the balance of 2008. Agriculturally, we are coming off 3 consecutive strong years. Farmers are anxious to start planting and assuming weather conditions are decent, most are expecting another good year based on commodity prices. Obviously, many of our commercial clients are concerned about fuel costs and that will continue to be something that bears watching. We worked hard to execute our strategy in this challenging environment and to adapt to the changes in the business cycles. The strength of this organization shows in the solid performance that we had in the First Quarter of this year, even with the additional challenges of the acquisition and the Feds rate cuts. We are focused on finding and growing revenue sources as well as operating efficiently to step up and meet these challenges. I think we have demonstrated that the Plan and the Team that we have at First Defiance is the right formula to continue to produce successful results. Again, we thank you for joining us this morning and now we would be happy to take your questions.

CAMILLE: Thank you. At this time if you would like to ask a question, please press “*” then “1” on your touchtone phone. You will hear a tone to confirm that you have entered the list. If you decide you want to withdraw your question, please press “*” then “2” to remove yourself from the list. That is, “*” then “1” to ask a question.

Our first question comes from Eileen Rooney from KBW. Please go ahead.

EILEEN ROONEY: Good morning guys, I just had a question on the guidance you gave. Just wondering what sort of margin assumption you had factored into that and also in terms of what you know any further Fed rate moves that you factored in there?

JOHN C. WAHL: Actually that is strictly off our budget, which we prepared in the Fourth Quarter of 2007 and so it hasn’t been adjusted for any Fed rate moves. The margin in that assumption was in the 375 to 380 range, which is consistent with where our margin came in the First Quarter.

EILEEN ROONEY: Okay and then what about terms of credit quality? Does that forecast sort of incorporate what you mentioned in the Press Release about your expectations for delinquencies right now in the Consumer portfolio?

WILLIAM J. SMALL: I think that. We feel that we’ve got everything pretty well scoped out as far as that goes and we are seeing some more deterioration in that, some of our home equity but nothing that is what I would call of an alarming level, but certainly higher than what our historical performance has been.

EILEEN ROONEY: Okay thank you.

WILLIAM J. SMALL: Thank you.

CAMILLE: Again, if you would like to ask a question, please press “*” then “1” on your touchtone phone. You will hear a tone to confirm that you have entered the list.

Our next question comes from Brent Villaume from F.I.G. Partners. Please go ahead.

BRENT VILLAUME: Good morning. (Greeting returned.) Of the increase in net interest margin, could you give a guesstimate of what percentage of that was from Pavilion?

JOHN C. WAHL: We really (Cross Talk) moving parts, it is kind of difficult to break that that out. I will say that through the first two months of the Quarter, our margin was significantly higher than what we had initially forecast. With only 17 days of operating the acquisition, it had a modest impact but most of that increase was due to our own reduction in funding costs.

BRENT VILLAUME: Okay and my other question was regarding the deposits coming from Pavilion, what percentage of those were CDs, specifically Jumbo CDs?

WILLIAM J. SMALL:	I don't have that number. I look at it from the other side and I know their non-interest bearing was right in the 20% level as far as their portfolio mix, Brent, but I don't have right off hand the information on their Jumbo CDs.
BRENT VILLAUME:	Okay well thank you gentlemen.
WILLIAM J. SMALL:	Okay thank you.
CAMILLE:	Our next question comes from Michael Lipman from FTN Midwest Securities. Please go ahead.
MICHAEL LIPMAN:	Good morning Bill and Jack. (Greeting returned.) So pretty margin assumptions, 3.75 to 3.8 – is that a 2008 number, or are you saying the next Quarter or so?
WILLIAM J. SMALL:	That is just the next Quarter.
MICHAEL LIPMAN:	Am I correct, the last Quarter you kind of alluded to 390 margin by year-end, is that still hold up?
WILLIAM J. SMALL:	I hesitate to really answer that just because things are so volatile, really haven't projected beyond next Quarter.
MICHAEL LIPMAN:	Okay
WILLIAM J. SMALL:	Again, we are very pleased with how well our margin has held up so far, but there is a lot of factors that go into that.
MICHAEL LIPMAN:	Okay well I won't push anymore than that. I guess on this one major loan that went into NPA status, can you give me some more details on what kind of loan that is, how big it is, where it is? I assume it is associated with Pavilion, obviously.
JOHN C. WAHL:	Actually, no it is not. It is a First Federal loan and beyond what we have already disclosed, it is a loan in the tweedle market. It had already identified as being impaired because of weaknesses in the credit, although it has always paid as agreed. The collateral value of the underlying collateral when we had an appraisal, the value was substantially lower so we increased our allowance so that our exposure equaled basically the appraised value of the collateral.
MICHAEL LIPMAN:	But it is still performing (Interrupted)
WILLIAM J. SMALL:	It is still performing, yes.
MICHAEL LIPMAN:	Okay, along the lines on the reserves, you moved up to about a 120 reserve now. Are you comfortable at this level? Do you foresee further reserve building if there is further credit deterioration?
WILLIAM J. SMALL:	If we detected there was additional deterioration, we definitely would be addressing that through the reserves. We spend an awful lot of time as we do every Quarter. There will probably be some additional since we did have a new portfolio that came on with the acquisition and making sure that we had everything pretty well scoped out again and while we did go up to the 120 level and we are very comfortable with that based on what

we see right now. As long as we don't have any more deterioration, I would not see us making any significant increase, other than what would just come through our normal growth.

MICHAEL LIPMAN: Okay great and I guess lastly, in the Press Release you say that in Q-2 '08, you are expecting acquisition charges of between $1.0 Million and $2.5 Million. Is that pre-tax or after-tax?

WILLIAM J. SMALL: That is pre-tax.

MICHAEL LIPMAN: Okay great, thank you guys!

WILLIAM J. SMALL: Okay thank you.

CAMILLE: Again, as a reminder, if you would like to ask a question, please press "*" then "1" on your touchtone phone. You will hear a tone to confirm that you have entered the list. If you decide you want to withdraw your question, please press "*" then "2" to remove yourself from the list. That would be "*" then "1" to ask a question or comment.

CAROL MERRY: Are you showing any more?

CAMILLE: There are no questions currently in the queue.

CAROL MERRY: Okay if there are no more questions, we thank everyone for joining us and this will conclude our Call.

CAMILLE: Thank you. That does conclude today's Conference Call. You may disconnect now.

######