First Defiance Financial Corp.

Second Quarter 2018 Earnings Conference Call

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CORPORATE PARTICIPANTS

Tera Murphy – *Investor Relations*

Don Hileman – *President and Chief Executive Officer*

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

PRESENTATION

Operator
Good morning, and welcome to the First Defiance Second Quarter 2018 Earnings Conference Call. All participants will be in listen-only mode. Should you need assistance, please signal a conference specialist by pressing the star key followed by zero. After today's presentation there will be an opportunity to ask questions. To ask a question you may press star then one on your telephone keypad. To withdraw your question, please press star then two. Please note 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 2018 Second Quarter Earnings Conference Call. This call is also being webcast, and the audio replay will be available at the First Defiance website at fdef.com. Providing commentary this morning will be Don Hileman, President and CEO of First Defiance; and Kevin Thompson, Executive Vice President and Chief Financial Officer. Following their prepared comments on the company's strategy and performance, they will be available to take your questions.

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

And now I'll turn the call over to Mr. Hileman for his comments.

Don Hileman
Thank you, Tera. Good morning, and welcome to the First Defiance Financial Corporation's Second Quarter Conference Call. Last night, we issued our 2018 second quarter earnings release, and we would like to discuss the second quarter results and give you a look into the remainder of 2018. Joining me on the call this morning to give more detail on the financial performance for the quarter is our CFO, Kevin Thompson. At the conclusion of our remarks, we will answer any questions you might have.

The second quarter results clearly reflect our expected operating performance, and we continue to be satisfied with the sustained movement toward our strategic goals. Net income for the second quarter of '18 on a GAAP basis was $11.1 million or $0.54 per diluted common share, compared to $8.3 million or $0.41 per diluted common share in the second quarter of 2017.

Our overall core performance this quarter helped to drive a solid return on average assets of 1.48% compared to 1.15% in the second quarter of 2017. While loan growth was somewhat impacted by unexpected payoffs in excess of $30 million this quarter, we still experienced year-over-year and linked quarter annualized quarterly net loan growth of 5.6% and 4.8%, respectively. We are seeing very competitive rates on some lending deals, despite indicators of upward movement in loan rates throughout our footprint. In this lending environment with rate and structure pressures, we know a balanced approach is necessary to grow our loan portfolio, and we will pass on lending relationships that would force overly aggressive pricing. Strategically, we still feel confident of our annual goal of upper single-digit loan growth is achievable with the current solid pipeline from across our footprint and stronger economic confidence.

Improved credit quality metrics have been anticipated, and this quarter's improvement was evident when compared to both the second quarter of '17 and on a linked quarter basis. Kevin will provide details on non-performing assets and non-performing loans in a few moments.

With this positive movement this quarter, we know we must work hard to see stable to improving asset quality trends across the board in the near term.

In regards to our capital management plans, as disclosed, we recently completed a 2-for-1 stock split. We felt this was consistent with our overall capital plans and aids in attracting shareholders. We are also pleased to announce a 2018 third quarter dividend of $0.17 per share, representing a 13% increase and an annual dividend yield of approximately 2.08%.

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

Kevin Thompson
Thank you, Don, and good morning, everyone. As Don indicated, we did complete the 2-for-1 stock split last week, so all of our shared data and results are now reported on a split basis. With that, net income for the second quarter was $11.1 million, or $0.54 per diluted share, up significantly from the prior year results of $8.3 million, or $0.41 in the second quarter of 2017. The year-over-year comparison primarily reflects the net benefit of the lower tax rate and the lower provision expense from a year ago, on top of our continued strong core profitability.

Looking first at the balance sheet, as expected, growth in the second quarter of 2018 was higher than the first quarter but still included a higher-than-normal level of loan payoffs, which held down net loan growth. In total, loans had net growth of about $27 million in the second quarter, up from $10 million last quarter, yet still down from our booming $73 million in the fourth quarter last year.

Our new loan originations in the quarter were $145 million, compared to $137 million last quarter and $146 million in the fourth quarter last year, indicating that our loan production remains very strong.

Looking ahead, we do not anticipate significant additional payoffs in the third or fourth quarters, so we still anticipate our net growth to pick up over the second half of the year, as stated before.

As for deposits, we were basically flat for the quarter after growing a solid $54 million in the first quarter and $77 million in the fourth quarter. As the economy has improved, we have seen customers begin to draw more on balances, and we've seen continued rate increases within our markets, creating a more competitive pricing environment. Nevertheless, we are pleased to be up a solid 7% in deposit balances from a year ago and expect growth to pick back up as we go forward.

Overall, while growth may have been a little light in the first half of the year, we are very pleased with the strength of our balance sheet. Our strong earning asset mix and our low-cost deposit funding continue to generate a very profitable margin, and we look for stronger growth in the second half of the year, which leads me to the income statement.

Our net interest income was $26.5 million for the second quarter of 2018, up from $25.7 million in the linked quarter and up $1.9 million or 7.8% from the $24.6 million in the second quarter last year. The increase over the prior year second quarter was primarily driven by the growth in average balances. It also reflects margin expansion from a year ago, as the loan portfolio yield increase from the past year's rate hikes has been greater than the rise in deposit funding costs.

Our margin this quarter was 3.95%, even with last quarter and up 6 basis points from 3.89% in the second quarter last year. On a linked quarter basis, our yield on earning assets was up about 8 basis points, and our loan portfolio yield rose to 4.75%, while our cost of interest-bearing liabilities was up 9 basis points to 0.74%.

In the current environment and with the expectation of some continued rate increases, we believe that with our strong earning asset mix and deposit funding base and with our balanced exposure to interest rate changes, our margin will continue to perform well considering our growth expectations.

Total non-interest income was $10.2 million in the second quarter of 2018, down from $10.7 million in the linked quarter, primarily due to the contingent insurance commissions included in the first quarter, and up from $10.1 million in the second quarter of 2017, which included $267,000 of securities gains. Excluding the securities gains, non-interest income was up about 3.5% from the second quarter last year.

Regarding mortgage banking, revenues for the second quarter of 2018 were $2 million, up $271,000 from the linked quarter and up $183,000 from the second quarter of 2017. The second quarter mortgage banking originations were $80.5 million, seasonally up compared to the $50.7 million last quarter but also up from $64.2 million in the second quarter of 2017.

Gain on sale income was $1.4 million in the second quarter of 2018, up from $1.1 million in the linked quarter and $1.3 million in the second quarter last year. Beyond mortgage banking, we saw service charges at $3.3 million, up $135,000, or 4.2% over a year ago, and insurance commissions at $3.5 million, up $199,000 or 6% from last year. Trust revenues continue to grow at a strong pace, up $58,000, or 12.5%. In addition, the BOLI income increase included a $168,000 death benefit, while the decrease in other income reflects both a $200,000 loss impact in 2018 versus a $183,000 OREO gain in 2017. We were quite pleased with the performance of our core fee businesses in the second quarter.

As for non-interest expense, second quarter expenses totaled $22.7 million, down from $23.3 million in the linked quarter, but up from $20.6 million in the second quarter of 2017. The first quarter 2018, as you may recall, included $544,000 in other expenses for OREO write-downs, while the second quarter 2017 included some expenses attributable to the merger and conversion of CSB, which totaled $310,000, primarily in other expenses.

Excluding non-recurring items, non-interest expenses would be up $2 million, or 9.9% over the same quarter last year. This increase reflects costs for our Metro market expansion efforts in Fort Wayne, Indiana; Toledo and Columbus, Ohio; and Ann Arbor, Michigan. In addition to reinvesting some of the expected benefits of tax reform, as we indicated last quarter, we expect to spend approximately $300,000 of the tax benefit per quarter going forward.

As for provision expense, with net charge-offs for the second quarter totaling $369,000, about 6 basis points annualized, the modest loan growth and the improved asset quality, this resulted in a provision expense of $423,000 in the second quarter of 2018, while last year's second quarter reflected $2 million in net loan charge-offs and a provision expense of $2.1 million.

Regarding income tax expense, comparing year-to-year, the second quarter 2018 reflects the benefits of the new lower corporate tax rate of 21% compared to the higher rate in the second quarter last year. Based on our earnings for the quarter, the change in rate provided a benefit to earnings of about $0.08, but again, our reinvestment of those benefits and expenses for growth reduced that by about $0.01. Our effective tax rate going forward is still about 8.5% to maybe 8.75%.

All of the above contributed to strong earnings performance in the second quarter: diluted EPS up 32%

from a year ago; return on assets of 1.48% versus 1.15% last year; and return on tangible equity of 16.06% versus 13.15% a year ago.

As for asset quality, we saw continued improvement in the second quarter 2018. Non-performing assets declined, allowance coverage ratios improved, and losses remained low. Of the two large loans downgraded in the second quarter of last year, one was paid off with a large recovery in the first quarter of 2018, and now the other was upgraded based on performance in the second quarter of 2018. As a result, non-performing loans declined this quarter to $18.3 million from $27.9 million last quarter-end and $30.4 million at June 30, 2017. We are pleased to report the performance improvement that we expected.

Our OREO balance did increase slightly this quarter to $1.8 million from $1.4 million last quarter and was up from $672,000 in the second quarter last year. Overall, non-performing assets ended the quarter at $20.1 million, or 0.66% of total assets, much improved from $31 million or 1.07% of total assets at June 30, 2017.

Our accruing troubled debt restructured loans this quarter were $15.8 million, up from $13.7 million last quarter and $10.5 million a year ago. Our allowance for loan loss at June 30, 2018 was $27.3 million, up versus $25.9 million at June 30 last year, with the change primarily driven by the growth in loans, as the allowance to total loans ratio at June 30, 2018, was 1.15%, compared to 1.16% last quarter and 1.15% a year ago.

With the change in non-performing assets at quarter-end, the allowance coverage of non-performers was 136% compared to 83% at December 31, 2017, and 84% a year ago. We've been very pleased with the continuation of asset quality improvement in the quarter and believe we are now even better positioned as we pursue our growth strategies.

Looking at our capital position, total period-end stockholders' equity finished the quarter at $386.9 million, up from $361.4 million at June 30, 2017. Our capital position remains strong, with quarter-end shareholders' equity to assets of 12.63%, up from 12.29% last year, and the bank's total risk-based capital ratio was approximately 12.7% at quarter-end June 30, 2018. Our capital position remains healthy in support of our strategies for growth and shareholder value enhancement.

So in summary, the second quarter continued our very good start to 2018. Our balance sheet remains strong. Our margin is performing well. Our operating profitability is high. Our asset quality has improved. Our capital position is solid, and our outlook for the year continues to be very positive.

That completes my review. I'll turn it back to Don.

Don Hileman
Thank you, Kevin. I'm very pleased with the results this quarter and the core earnings improvement. Core balance sheet growth was a focus on loan and deposit growth. Overall revenue growth, expense control and improved asset quality all remain areas of focus for the remainder of 2018. This level of strategic focus was evident through our improvements noted in several of these areas during the second quarter.

Our Metro markets of Toledo, Columbus and Fort Wayne are supported by restructured key leadership positions that were placed in effect earlier this year. These changes helped drive loan growth within these markets during the second quarter and will aid in supporting the anticipated rising loan demand throughout the remainder of the year.

To be a consistently high-performing community bank and agency, we know it involves more than numbers on the balance sheet, it means living our better together philosophy. We must provide our clients and communities with smart solutions that fit their needs and add value to their lives. This was the premise of our recent Building Better Communities initiative in celebration of National Homeowners Month, observed annually in June. We wanted to create a life-changing experience for families, inspire others to take action and to share knowledge and resources with current and future homeowners.

While we know our monetary donation will have immediate impact by allowing a non-profit organization to purchase one home and renovate two additional homes in Metro Toledo, we believe our employees can have an equally powerful influence in the communities we call home. Our employees, from executive level to part-time, rose to the challenge of accumulating 500 hours of community service during the month of June to benefit homeowners, so much so that they exceeded the goal, with 633 hours supporting 25 non-profit organizations throughout our footprint.

The engagement of our teams and communities was evident through social media, surpassing all previous internal campaign benchmarks, and exceeding industry standards in some instances. We look forward to building upon what will now become an annual event, and the building together community initiative hits the core of who we are.

Our steady performance, client-focused values and our engaged employees blend together to deliver exceptional results to our shareholders. First Defiance leverages these principles to keep us moving forward and we look to introduce more clients through our community approach as we expand our branch and agency network through mergers and acquisitions and by deepening relationships and pursuing organic growth within our footprints, especially in our Metro markets.

Confidence in achieving a high single-digit growth rate for the year remains as our branch in Sylvania, Ohio gains momentum and as we anticipate opening a full-service office. Initiatives are in place to improve the digital banking experience identified by customers as critically important to a banking relationship, and new projects have been adopted to monitor customer satisfaction going forward. Our recent performance in these initiatives drive our performance and lead us to a consistently high-performing community financial services company.

Growth in our insurance and wealth management revenues continues to be a focal point in our overall strategic plan. We believe these revenue sources help in our ability to grow non-interest revenue in an environment with added pressure on asset fees and other deposit fees. To continue this steady progression in wealth management, we have dedicated resources working to educate employees across our footprint on wealth management products and services and to build relationships with the team dedicated to providing them to our clients. This education will allow us to deliver more personalized banking solutions to our clients by enhancing our ability to match client needs to personalize solutions. Strategic initiatives such as these lead our focus and our commitment to our clients and to improving our results relative to our peer group.

We are very pleased by our recent financial performance and look to both a performance-driven and people-focused financial partner. We remain strongly committed to our clients and our shareholders, and we appreciate the confidence you have placed in us as we work to make First Defiance a company known for providing smart solutions to our customers and our communities.

Thank you for your interest in 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
Thank you. 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 momentarily to assemble our roster.

The first question comes today from Nick Cucharale with Sandler O'Neill. Please go ahead.

Nick Cucharale
Hi, guys. Good morning.

Don Hileman
Good morning, Nick.

Nick Cucharale
First, I appreciate your commentary on the margin, it's stable NIM this quarter, and funding costs finally started to move up a little bit more than we've seen in the past few quarters. Would you mind sharing where you're seeing the pressure on the funding front and how you expect the margin to play out in the back half of the year?

Kevin Thompson
Well, I don't know that there's a big spearhead of pressure anywhere, but it's across the board. As rates have risen, obviously, customers are more inclined to seek yield, and we're seeing it across the board. Like I say, competitive pricing in terms of CD rates certainly has moved up, but even at that, most of those rates are still not badly positioned in the market, if you will, versus alternative funding costs. So we continue to be, I think, pretty effective competing there.

Beyond that, the non-maturity deposits, a lot of the standard product offerings haven't changed a whole lot, but there's more competition on the invitation-only type offers out there, so there's a broader front, if you will, as rates have moved up. So I think we're going to continue to see that probably in the current environment as we go forward, that's what we're expecting. The key is, obviously managing the others—we've got two sides of the balance sheet, and keeping our loan pricing discipline in line. As you saw this quarter, we're pretty much able to continue to maneuver to keep the margin at a very strong position at 3.95%, and it all depends how far you want to look ahead, but I would say certainly looking over the next quarter, we don't think that relationship is going to change considerably.

Nick Cucharale
Okay, great. And then Kevin, I just wanted to make sure I heard you correctly, the expected effective tax rate 18.5% to 18.75%. Is that correct?

Kevin Thompson
Yes, it moved up a little bit this quarter, and as we do a lot of our forecasting, it's right in that neck of the woods.

Nick Cucharale
Okay, great. And then I'm curious, with your multiple increasing quite a bit since the end of the year, are you guys having more M&A discussions compared to prior quarters?

Don Hileman
I would say the answer to that is yes. As we become more attractive financially as an acquirer, I think we would like to continue to grow the number of conversations and opportunities.

Nick Cucharale
Okay. And then just lastly, as it relates to the BOLI line, did you add more BOLI this quarter, or was there a one-time benefit?

Kevin Thompson
Yes, there was a one-time benefit—I thought I mentioned that in my remarks—it was about $168,000.

Nick Cucharale
Okay. I apologize if I missed that. Thanks for taking my questions.

Operator
The next question comes from Damon DelMonte with KBW.

Damon DelMonte
So my first question, just as it relates to maybe an update on the Columbus initiative you guys have going on, I think last quarter you had around $190 million of outstandings in that market. Where does that stand today, and then how does the outlook look for the back half of the year there?

Don Hileman
We're up at about $230 [million] right now at the end of June, so we're growing pretty well down in the Columbus market and look to continue to have strong growth in the remainder of the year down there. The challenge for us is to balance the loan growth with deposit growth, so that's one of the things we're trying to work on the rest of the year.

Damon DelMonte
And what loan categories are driving that growth in that market?

Don Hileman
Most of that is going to be in CRE, a mix between investment and owner-occupied, but mostly CRE.

Damon DelMonte
Okay. And then during the quarter, it looks like the 1 to 4 family portfolio increased around $30 million or so. Is that just a function of you guys portfolio'ing some of the originations, or did you maybe do a bulk purchase? What was the driver of that?

Kevin Thompson
We didn't do a bulk purchase, I do know that. I'm not sure I have a good answer for that, Damon.

Damon DelMonte
Yes. Okay.

Don Hileman
Nothing out of the ordinary strategically did we do there, that might have just been some additional growth, but no purchases, like Kevin said.

Damon DelMonte
Okay. And then you mentioned, I think, Don, in the beginning about $30 million of unexpected loan

payoffs during the quarter. Were those commercial real estate-related, I take it?

Don Hileman
It was a combination of things. But a good chunk of that was a real estate credit. They sold the company again.

Damon DelMonte
Got you, okay. And then lastly, as we look at the provision and we look at the credit trends we've seen here, Kevin, how do we think about the provision going forward? The first half of the year has been pretty low. Do you expect it to maybe normalize in the back half of the year, or do you expect something similar to this quarter's level?

Kevin Thompson
Well, I would say with the growth we're expecting, probably higher than what we saw this quarter. But our asset quality, though, we're not expecting any negative consequences to the provision from that, and if anything, it might be a little more positive. But I would say a couple of hundred thousand higher than where we are. I have an answer—

Damon DelMonte
Okay. All right, that's all I have—

Kevin Thompson
Damon, excuse me, I have an answer on the mortgage loans. We did have a new relationship that we brought into the bank. It was really one relationship, but it was made up of 50 different 1 to 4 family loans, okay? And so that's what the increase was in that category, okay?

Damon DelMonte
Okay. Could you provide a little more color on that? Was it maybe a developer that had multiple properties?

Kevin Thompson
Yes, it's really like one loan supported by 50 different properties.

Damon DelMonte
Got it, okay. That's helpful. That's all that I had. Thank you very much.

Kevin Thompson
Yes.

Operator
Our next question will be from Christopher Marinac with FIG Partners.

Christopher Marinac
Thanks. Good morning. I wanted to ask a little bit about the farm and agricultural business that you see, more from a standpoint of what it could impact you from trade and tariff stuff in the second half of the year. Is any of that bothering your customers? Is there any read-through on that business, Don or Kevin, that you see?

Don Hileman
Yes, good question, Chris. There's a lot of conversation. I don't think there's, right now, an anticipation, at least in our borrowers, and that's not a big piece of our business, as you know, that are overly

concerned with that. There's a lot of talk and still trying to figure out how some of those will actually play through, but we're not anticipating any kind of large impact on that. Our impact might be more of weather than we think in the short term and the remainder of the year on the tariffs.

Christopher Marinac
Okay. Then, did you see anything unique from a deposit pricing standpoint from maybe your competitors, or again just anticipating how the next few quarters may play out in the environment.

Kevin Thompson
I'm sorry, I didn't quite catch that part. Do we expect or see anything what?

Christopher Marinac
From a deposit pricing from either your markets or competitors just changing in the next few quarters.

Kevin Thompson
Again, I think it's certainly getting more competitive there. I think that's going to remain probably pretty constant on a go-forward basis, but we're not seeing crazy pricing. There's an occasional offer that's out there, but on a day in/out basis, I think we're still seeing pretty rational pricing in the market, given the changes that we've seen in rates.

So, I think it's something that we all have expected would probably elevate some as the persistence in the rise in rates, and I think that's what we're seeing. As we model our margin and we look ahead in our forecasting and we stress our sensitivities, we're always bearish on the margin. We don't take anything for granted. We're always expecting our betas to be strong on the deposit side because I think that as rates continue to rise we're more likely to see that than not. But we still feel our margin is very well positioned for where the market is today and the anticipated increases, as the market expects.

Christopher Marinac
Great. That's helpful, guys. And then just a quick follow-up on expenses. The success you continue to have on just leveraging your expense base, is there anything that either gets in the way of that in the next few quarters and the next year, just thinking of investments or other ideas that might be on the table.

Kevin Thompson
I don't know that there's any new investments. We've been focused on some of our Metro market growth strategy, we've added resources there, we've opened up facilities, Don mentioned, in Sylvania, we've got a new location in downtown Fort Wayne, but I don't think there's anything new in the offing in the next several quarters. I think we have made some investments, I think we're very pleased so far with the progress we're seeing from them. We're looking for better results obviously as we go forward, as we're expecting growth to pick up, but I don't see anything new on that front. As much as we've been investing there, expenses are something that we're working hard on every day here because we want to be able to afford the investments that we think are going to make a difference in our growth in the future, so we're always looking at the other side of the equation every day.

Christopher Marinac
Sounds great. Thank you very much for taking the questions.

Don Hileman
Thanks, Chris.

Operator
Once again, if you’d like to ask a question, please press star then one. The next question will be from

Daniel Cardenas with Raymond James. Please go ahead.

Daniel Cardenas
Good morning, guys.

Kevin Thompson
Good morning, Dan.

Don Hileman
Good morning, Dan.

Daniel Cardenas
Just a couple of quick questions here. On the mortgage banking side, what do the pipelines look like coming into 3Q, and maybe a little bit of color as to what you're seeing in your markets in terms of housing inventory and then maybe just kind of what you're seeing on the margins on the mortgage banking side as well?

Don Hileman
Well, I think we're fairly consistent with what we expect in the third as the second. Inventory is still going to be an issue. We don't see—and don't anticipate—a lot of inventory build here in the third quarter. Hopefully, that will come as some of the projects that some people have for development will come online and we'll start to see more available inventory. But that's still going to be a problem in most of our markets. A little less on the residential side in some of the Metro markets and some of the suburbs that are growing at a faster pace than some of our legacy markets, but that will still be a challenge. We expect still pretty decent opportunities and growth and volume in that for the remainder of the year, Dan, on the mortgage banking side.

Daniel Cardenas
Okay. Great. And then maybe, Kevin, an update, if you can provide it, on where you guys stand in terms of seasonal [ph] preparation?

Kevin Thompson
We have an active project underway, we've been at it now for several quarters. Our plan is to have, basically, our work complete by the end of the year and monitor on a parallel basis throughout 2019 and be fully ready for 2020.

Daniel Cardenas
Perfect. Great. Alright, guys, thanks a lot.

Kevin Thompson
Yes.

Don Hileman
Thanks, Dan.

CONCLUSION

Operator
Ladies and gentlemen, this concludes our question-and-answer session. I would like to turn the conference back over 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
Thank you. The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.