First Defiance Financial Corp

Third Quarter 2014 Earnings Conference Call

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CORPORATE PARTICIPANTS

Tera Murphy – *Marketing Specialist, First Federal Bank of the Midwest*

Donald Hileman – *President, Chief Executive Officer and Chief Financial Officer*

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

James Rohrs – *Executive Vice President, Director; President and Chief Executive Officer of the Bank*

PRESENTATION

Operator
Good morning, and welcome to the First Defiance Third Quarter Earnings Conference Call. All participants will be in listen-only mode. Should you need assistance, please signal a conference specialist by pressing the * key followed by 0. After today's presentation, there will be an opportunity to ask questions. To ask a question, you may press * then 1 on a touchtone phone; to withdraw your question, please press * then 2. Please note, this event is being recorded.

I would now like to turn the conference call over to Ms. Tera Murphy with First Defiance Financial Corp. Ms. Murphy, the floor is yours, ma'am.

Tera Murphy
Thank you. Good morning, everyone, and thank you for joining us for today's 2014 Third 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.

Donald Hileman
Thank you and good morning, and welcome to the First Defiance Financial Corporation Third Quarter 2014 Conference call. Last night, we issued our 2014 third quarter earnings release and we'd now like to discuss the results, and give you our outlook for the remainder of 2014. At the conclusion of our remarks, we will answer any questions you may have.

Joining me on the call this morning to discuss the details of the financial performance for the third quarter is Kevin Thompson, CFO. And also joining us to answer questions is Jim Rohrs, President and CEO of First Federal Bank. This will be Jim's last earnings call, since he is retiring at the end of the year, and I'd like to personally thank Jim for his service and dedication to the company, and we wish him well on his retirement, but not to the first of the year. So, thanks Jim.

In our third quarter earnings release, we announced net income on a GAAP basis of $7.1 million, or a $0.71 per diluted common share, compared to $5.5 million, or $0.54 per diluted common share, in the third quarter of 2013. We are very pleased with our overall performance this quarter and the continued improvement in core operating results. We are encouraged by the year-over-year and linked quarter growth. This was driven both by increased activity from existing customers and new lending relationships.

Loan demand was robust this quarter, with solid growth in each of our market areas, including our new

Columbus, Ohio higher loan production office. The growth in the loan portfolio enabled us to improve our earning asset mix, leading to increased net interest margin and net interest income. The growth in both our net interest income and non-interest income revenues reflect contributions from our core business strategies over the past quarter and last year. We are pleased with our strong net interest income growth this quarter of 3% over the third quarter of last year. The primary factor for growth this quarter was the beneficial change in the earning asset mix.

The competitive loan rate environment remains very challenging, as the industry focuses on growth. We expect the interest rate environment to be relatively stable at current levels in the near-term, as more sustainable growth is built into the overall economy.

In addition, the deposit side of the balance sheet continued to show strong growth over last year. Non-interest bearing and interest bearing demand deposits have been the primary growth areas. We did experience decline on a linked quarter basis in non-interest bearing and interest bearing balances. On a linked quarter basis we were able to increase our margin to 3.73%, from 3.62%.

Non-interest income showed growth both on a GAAP and core operating basis. We believe that several of the strategic initiatives put into place the first half of the year are starting to show results. Included in these are increases in insurance revenues on both the year-over-year and a linked quarter basis, and interest income, which is up on both the year-over-year and a linked quarter basis. Service fees and other account related charges also reflect a similar growth pattern.

Mortgage banking income continued to decline on a year-over-year basis, as mortgage loan production in the third quarter of 2014 declined 15% from the third quarter of 2013. More significantly, mortgage revenues remained at the same level as last year.

Total non-interest expense increased $671,000 from the third quarter of 2013 and also increased on a linked quarter basis, primarily due to variable costs associated with revenue growth.

The credit quality metrics continued showing improvement this quarter. Non-performing assets declined approximately $8.2 million, or 23%, year-over-year. Non-performing loans decreased approximately $8 million, or 26%, year-over-year to $22.8 million at quarter-end, down from $24.9 million on a linked quarter basis.

Approximately 52% of the non-performing loans continue to make payments. Classified loans and non-accrual loans also showed progress in the third quarter of 2014, staying on a downward trend. We are also pleased with the decline from a year ago on the level of 30-day/90 delinquencies to 1.6% of loans for the third quarter are up 2014, compared to 0.20% of loans in the third quarter of 2013. Non-performing and classified assets will remain areas of focus to ensure additional declines in the future.

Regarding our capital management plans, our stock buyback continued in the third quarter with repurchasing of 147,000 shares, and in early October we completed the repurchase of all 489,000 shares authorized last September. The board also authorized a buyback of an additional 469,000 shares. We are also happy to announce a third quarter dividend of $0.175 per share, representing an annual dividend yield of approximately 2.5%. Our outgoing solid performance and capital level support this utilization of capital.

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

Kevin Thompson

Thank you, Don, and good morning, everyone. As Don stated, net income for the third quarter was $7.1 million, or $0.71 per diluted share, and this compares quite favorably to the prior year results of $5.5 million, or $0.54, in the third quarter of 2013. The third quarter of this year did include several nonrecurring-type items that aggregated to about $1.4 million after tax, or about $0.14 per diluted share. These items included securities gains of $299,000 after tax; a tax free bank-owned life insurance benefit of $903,000; a tax free gain realized through a deferred compensation plan trust of $498,000, less an additional net adjustment to income taxes of $250,000, which included the write-off of a portion of unused deferred tax assets. Even with the exclusion of these items, it’s clearly seen we had a very good quarter.

We were very pleased with the overall performance and the continued progress this quarter on almost all fronts. Very strong loan growth improved the earning asset mix, increasing the net interest margin and net interest income. Non-interest revenues also grew on a core basis from a year ago. Operating expenses remained in line, supporting our growth strategies, and credit quality continued to improve.

Looking at the details of the income statement, our net interest income was $17.7 million for the third quarter of 2014, up from $17.1 million in the linked quarter, which had one less accrual day, and up above $507,000 from the $17.2 million in the third quarter last year. For the third quarter of 2014, our margin was 3.73%, up 11 basis points from last quarter, but down from 3.84% in the third quarter last year.

After a slow start to the year, our earning asset mix and margin improved significantly in the third quarter. Growth in loans and securities reduced our excess liquidity position, benefiting both the margin and earnings. Our yield on earning assets is still down 14 basis points from last year, but up 10 basis points on a linked quarter basis. Our cost of interest bearing liabilities was down three basis points from a year ago and was flat on a linked quarter basis.

Total new loans originated in the third quarter were put on at a weighted average rate of 4.12%, a decrease from 4.51% in the second quarter of 2014, but our loan portfolio yield in the third quarter of 4.35% declined only two basis points on a linked quarter basis. We still look to improve our earning asset mix through additional growth in loans and investments going forward, and our margin is expected to improve accordingly. Total non-interest income was $9.4 million in the third quarter of 2014, up from $7.6 million on a linked quarter basis, and up from $7.3 million in the third quarter of 2013.

Again, the third quarter this year included a bank-owned life insurance benefit of $903,000, a gain realized through a deferred compensation plan trust of $498,000 and pretax securities gains of $460,000. Comparatively, the second quarter 2014 had securities gains of $471,000 and the third quarter last year had no securities gains and no significant non-recurring type items.

On a core basis all major categories of non-interest income, except mortgage banking, increased over the third quarter last year. Overall mortgage banking income for the third quarter of 2014 was $1.5 million, which was about even with the linked quarter but down from $1.8 million in the third quarter of 2013.

The third quarter decline in mortgage banking from the prior year was primarily due to the valuation adjustment of mortgage servicing rights, which was a positive $68,000 this year, versus positive $480,000 last year. While mortgage banking originations were still lower compared to the third quarter of last year at $52.2 million in the third quarter this year, compared to $51.6 million last quarter and $61.2 million in the third quarter of 2013, gain on sale income was $973,000 in the third quarter compared to $986,000 on a linked-quarter basis, and actually up from $894,000 in the third quarter last year. At September 30, 2014, First Defiance had $1.4 billion in loan serviced for others. The mortgage servicing rights associated with those loans had a fair value of $9 million, or 71 basis points, of the outstanding loan balances serviced.

Total impairment reserves, which are available for recapture in future periods, totaled $921,000 at quarter end. Service fee income, reflecting some fee and product design changes made this quarter, was $2.7 million in the third quarter of 2014, an increase from $2.5 million in the linked quarter and from $2.6 million in the third quarter last year.

Insurance revenue was nearly $2.4 million in the third quarter of 2014, up from $2.2 million in both the linked quarter and the third quarter of 2013.

Also, our trust income, while a smaller component of revenue, continues to show significant growth from a year ago, totaling $315 million in the third quarter, up 25% from $251,000 in the third quarter last year.

As for non-interest expense, third quarter expenses totaled $16.8 million, up from $16.4 million in the linked quarter and $16.1 million in the third quarter of 2013. The increase was primarily in compensation and benefits expense, which in the third quarter was $569,000, up from last year primarily due to merit increases, higher incentives, increased sales commissions, and higher health plan costs, as well as some staffing additions for our Columbus, Ohio loan production office and our new Fort Wayne, Indiana office, opened in August.

Regarding provision expense, the third quarter of 2014 totaled $406,000, compared to $446,000 last quarter and $476,000 in the third quarter last year. Net charge-offs were 12 basis points of average loans for the third quarter of 2014, compared with 16 basis points last quarter, and 20 basis points in the third quarter a year ago. Our allowance for loan loss at September 30, 2014 was $24.6 million, or 1.50% of total loans, versus $26 million, or 1.66%, at September 30 of last year. The change reflects continued credit quality improvements achieved during the past year such that the allowance coverage of non-performing loans has increased to 109% at quarter end, up from 85% at September 30, 2013. We expect the reserve to loans percentage to continue to track favorably with continued asset quality improvement.

As for the asset quality numbers, non-performing loans decreased again this quarter to $22.5 million, down from $24.9 million on a linked quarter basis, and down 26% from $30.5 million at September 30, 2013. Our OREO balance also decreased to $5.3 million from $5.5 million in both the linked quarter and the third quarter last year.

Overall, non-performing assets ended the quarter at $27.9 million or 1.29% of total assets, down from 1.75% of total assets at September 30, 2013. And total classified loans also declined to $45.1 million at September 30th, compared to $47.6 million on a linked quarter basis, and considerably below the $59.7 million at September 30, 2013.

Moving to the balance sheet, total assets were $2.15 billion at September 30th, virtually flat with last quarter end, but up $92.6 million from last year. Gross loan balances increased $54.3 million during the quarter and are now up $75 million or 4.8% year-over-year. Securities increased $54.2 million from a year ago, while cash and equivalents declined $31 million.

The significant loan growth this past quarter clearly improved our earning asset mix and our loan growth outlook remains very positive.

Total deposits of $1.73 billion at quarter end reflect an increase of $72.2 million from a year ago, but were down $11.2 million on a linked quarter basis. Non-interest bearing deposits have increased to $340.6 million at September 30, 2014 from $300.9 million at September 30, 2013. We are continually pleased with our ability to generate and maintain a solid, low-cost core deposit base.

Looking at our capital position, total period and stockholders' equity finished at September 30 at $278.2 million, up from $269.4 million at September 30, 2013. Our capital position remains strong, with period and shareholders' equity to assets up 12.93% this year, compared to 13.09% last year, and with the banks totaled risk-based capital ratio at approximately 14.9%. Our healthy capital position continues to provide us the opportunities to pursue our growth strategies, as well as enhance shareholder value through dividends and share repurchases, as Don mentioned.

Finally, regarding our year-to-date results, for first nine months of 2014, net income was $17.9 million, or $1.79 per diluted share, versus $17.1 million, or $1.69 per diluted share, for the same period in 2013. That's an increase of $0.10 per share, while overcoming a significant decline in mortgage banking income of about $1.8 million after tax, or $0.18 per share, year-to-date. This year's results have benefited from net non-recurring type items of about $0.12 per share year-to-date, about $0.14 per share this quarter, as I mentioned earlier, about $0.03 per share at last quarter from securities gains while the first quarter included a one-time merger termination charge, which cost us about $0.05 per share. With the exclusion of the mortgage banking decline and the non-recurring items, earnings grew about $0.16 per share. We see this as an indication of success in our core business strategies that will continue to contribute to our improvement in our financial results going forward.

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

Donald Hileman
Thank you, Kevin. I am very delighted with our progress we have made over the course of the year in the position of First Defiance. I anticipate continued strong performance for the remainder of 2014. Our results are beginning to reflect the revenue benefit of our non-interest income initiatives, as pricing and account bundling changes are going into effect with recent statement cycles. We expect that to build throughout the year.

First Defiance is focused on several areas believed to improve financial performance and help drive greater shareholder value. These areas of internal focus are core balance sheet growth, with a focus on loan growth, revenue growth, expense control and improved asset quality. We foresee continued improvement in loan demand for the rest of 2014, and into 2015. The third quarter reflected strong growth, but I would expect a slightly more moderate pace going forward. The size of our current pipeline is reassuring and our lenders say activity is robust within our footprint.

The lending environment remains very competitive, but we believe we can grow our business without making significant concessions in rate and other terms. Our average loan yield declined only two basis points on a linked quarter basis. As we learned from the past several years, we know it is important to maintain our disciplined underwriting during this period and continue our unwillingness to compromise our standards to achieve the loan portfolio growth. Our business banking initiative is underway and balances showed growth during the quarter. Our business bankers in each market area are focusing entirely on this new opportunity, and we expect production volumes to build each quarter. Additional balances were booked as a result of the activity from our Columbus, Ohio loan production office and we expect a further contribution to loan growth in fourth quarter.

Regarding our non-interest revenue initiatives, third quarter changes to our fee schedule and product designs based on relationships and fees for services are beginning to offset changes in customer use patterns, and contribute to the overall service for income growth. We are looking to continue enhancements in our electronic and mobile capabilities, giving our customers more choices on how they interact and bank with us. This environment is rapidly changing and we need to keep pace.

In continuing our conversation on growth, I am also pleased to announce that we opened our second Fort Wayne, Indiana location this quarter. Fort Wayne has been a very good market for us and we look forward to expanding our presence and continued growth in the Fort Wayne market area.

In alignment with our strategic plans for growing revenue, both our insurance and wealth management divisions reflect the growth in our quarterly results. While organic expansion for our insurance revenues is our primary focus, we are continually looking for strategic acquisition opportunities.

We are very uplifted by our recent performance, and look to continue to drive the initiatives we believe will help to obtain our goal of being a consistently high performing community bank we strive to be every day. We remain confident in our strategies and the people we have working hard to execute our plans and looking at our new initiatives as enhancements to our overall strategy. We feel positive about our performance to this point in 2014 and look forward to the remainder of the year.

We are committed to all of our customers and shareholders and appreciate the trust you have placed in us as we work to make First Defiance a high performing community banking organization. Thank you for your interest in First Defiance Financial Corp., and we thank you for joining us this morning. We will be now happy to take your questions.

QUESTIONS AND ANSWERS

Operator
Thank you sir. We will now begin the question-and-answer session. To ask a question, you may press * then 1 on your touchtone phone. If you're using a speakerphone, please pick up your handset before pressing the keys. If at any time your question has been addressed and you would like to withdraw your question, please press * then 2. Again, it is * then 1 to ask a question. At this time, we will just pause momentarily to assemble our roster.

Our first question comes from Christopher Marmiac of FIG Partners. Please go ahead.

Christopher Marmiac
Thanks. Good morning. Don, can you remind us on the number of lenders that you have now, system-wide, and perhaps just talk about seeing some slight increases to the team in the next year?

Donald Hileman
Yes, I think we have got about 25 lenders and we are looking to strategically add to that group in the areas where we think we have an opportunity. We are putting our final plans and the number of that, Chris, as we start our plan for 2015, but right now we are expecting that we will increase our number of loan producers.

Christopher Marmiac
Okay, great. And then just a balance sheet question for either of you, how should we think about the relationship between loans and learning assets? I know it improved this quarter; you mentioned in the release and in your earlier remarks. Is this something that we will see again, or is it more just a catch up, if you will?

Kevin Thompson
Well, I would characterize this certainly probably more of a catch up in a sense, but I think there is still room for us to see the loan mix within earnings assets continue to improve, and that's what we are expecting.

Christopher Marmiac
Okay, great. And then, Kevin, just one more before I go. On the expense side, do you think that the efficiency ratio in general should trend lower? Not asking for a specific guidance per se, just more directionally, if we should expect more operating leverage to come through the company.

Kevin Thompson
Well, we think we have got some very positive movement on the revenue side, and we think our expense controls are in line, so we think that leads to improvement in the efficiency ratio. But you have to spend money to grow revenues a little bit, so it's going to be directionally, I think, improving, but we are focused on maintaining a positive leverage in growing that bottom line.

Christopher Marmiac
Okay, very good. Thank you both for the color.

Donald Hileman
Thanks.

Operator
Next we have Damon DelMonte of KBW.

Damon DelMonte
Hey, good morning, guys. How are you?

Donald Hileman
I am good. How are you, Damon?

Damon DelMonte
Good, thanks. My first question just deals with the margin, could you talk a little bit about your outlook from this level going forward? I know the benefit this quarter is driven in large part by the remixing on the earning assets. Do you think that you are able to sustain this level or would you expect it to trend a little bit lower given where rates are?

Kevin Thompson
Rates are certainly going to be a challenge, Damon, on the loan side, but we still have some opportunity again on the mix. And so when we think at least in the near-term going forward, I am expecting at the margin, I am not expecting the margin to decline, but I don't know that it's going to expand considerably, either, from here.

I think if we can continue to grow the balance sheet and keep the margin where it's at, with perhaps some improvement from an earning asset mix, that's probably what we are trying to do. The rate environment though is a little bit of a wild card, and whether that presents more head-wind, we will just have to see how that plays out.

Damon DelMonte
Yes, and then the yield on the securities portfolio is 3.7% this quarter. Can you just remind us what's in the portfolio to achieve such a yield, and what the duration is?

Kevin Thompson
We have a little bit of a heavier weighting on municipals than most banks, perhaps, but it's, what, about 35% to not quite 40% in municipals, and then the rest is primarily CMOs, and nothing exotic.

Damon DelMonte
Okay. What's the—four to five years?

Kevin Thompson
Yes, something like that, yes.

Damon DelMonte
Okay, all right. And then with respect to the loan growth, I think linked quarter annualized it was probably 9.5% or so. It sounds like you have a lot of momentum going, so you think that as we round out this year and head into 2015, this is a sustainable level?

Donald Hileman
I think there is an opportunity there, but I think it's probably on the high side. And I think when we look out for four quarters, I think that would be pretty high growth rate for us.

Damon DelMonte
Okay. So you think this is a good quarter; you had some build up in the pipeline maybe that, things that came through, and you were able to close them?

Donald Hileman
I think so. I think I look at a little bit more of that than a new sustainable level that we are going to continue with. I would like to if we could, but I am little bit more realistic that that's probably on the high side and we are probably looking at a couple of percentage points lower than that on a more sustainable level.

Damon DelMonte
Okay, great. And then my last question. Can you just refresh us on your M&A thoughts, what your appetite is for size and for location?

Donald Hileman
I think that really hasn't changed. I think our appetite is still in our geographic footprint. We understand the business in our markets, and we think there is still going to be good opportunity in our footprint. Size, I think I'm becoming a little bit more open to different sizes of transactions, but I think, obviously, on the hot top side something like a billion would be a pretty large one for us to swallow. The sweet spot is probably half a billion.

Damon DelMonte
Okay, great. That's all I had. Thank you very much.

Donald Hileman
All right. Thanks a lot.

Operator
Again, as a reminder, to participate in today's Q&A, please press * and then 1 on a touchtone phone. Again, that is * and then 1 to ask a question. Again, we will just pause momentarily to assemble our roster.

We have a follow-up from Damon DelMonte of KBW.

Damon DelMonte
All right. Thanks. Kevin, can you maybe just go over the mortgage banking statistics that you provided? I didn't get all of those. I thought you had said that the originations this quarter were $52.2 –

Kevin Thompson
$52.2 million, yes.

Damon DelMonte
$52.2, okay. And that's last quarter?

Kevin Thompson
Last quarter was $51.6 and the third quarter last year was $61.2.

Damon DelMonte
Okay, and a gain on sales this quarter was $973, correct?

Kevin Thompson
$973, that's correct.

Damon DelMonte
Okay. All right. That's all I had. Thanks.

Donald Hileman
Alright. Thanks, Damon.

Operator
We're showing no further questions at this time. We will then conclude the question-and-answer session. I would now like to turn the conference back over to management for any closing remarks. Ms. Murphy, gentlemen?

Donald Hileman
Thank you very much for joining us the call and have a good day.

Operator
And we thank you, sir, and to the rest of the management team, for your time. You also have a great day. The conference call is now concluded. At this time you may disconnect your lines. Thank you and take care, everyone.