First Defiance Financial Corporation
"First Quarter 2008 Earnings Conference Call"

Tuesday January 20, 2009 11:00 AM Eastern4
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OPERATOR: Hello and welcome to the First Defiance Fourth 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.

If you would like to ask a question during the question and answer session, 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." If you should 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. Good morning everyone and thank you for joining us for today's fourth quarter and full year 2008 conference call. This call is also being webcast and the audio replay will be available at the First Defiance website at fdef.com until February 3, 2009.

With us this morning are Bill Small, Chairman, President and CEO of First Defiance and Don Hileman, Senior Vice President and Interim 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 would like to remind you that certain statements made during this conference call that are not historical, including statements made during the Q&A period, are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Such forward-looking statements are based on the information and assumptions available to management at this time and are subject to change. Actual results may differ materially.

First Defiance assumes no obligation to update such forward-looking statements to reflect the impact of circumstances or events that may arise after the date of the forward-looking statement.

For a complete discussion of the risks and uncertainties that may cause future events to differ from the results discussed in the forward-looking statements, please refer to the earnings release and materials filed with the SEC, including the company's most recent Form 10-K and 8-K. filings.

And now, I will turn the call over to Mr. Small for his comments.

WILLIAM SMALL: Thank you, Carol. Good morning and thank you for joining us for the First Defiance Financial Corp. Conference Call to review the 2008 fourth quarter and year end results.

Last night we issued our 2008 Earnings Release and this morning we would like to discuss that release and look forward into 2009. At the conclusion of our presentation, we will answer any questions you might have.

Before we begin, I would like to let you know that Jack Wahl, our CFO continues to make remarkable progress in his recovery. We wish him well as he continues the recovery process.

Joining me on the call this morning to give more detail on the financial performance for the fourth quarter and the year is Interim CFO, Don Hileman. Also with us this morning to answer questions on credit quality is Jim Rohrs, President and CEO of First Federal Bank.

Fourth quarter 2008 net income on a GAAP basis was $880,000 or $0.09 per diluted common share, down from $3.6 million and $0.50 per diluted common share in the 2007 fourth quarter. For the year ended December 31, 2008, First Defiance earned $7.4 million or $0.91 per diluted common share compared to $13.9 million or $1.94 per diluted common share for the year ended December 31, 2007. The 2008 results included 1.1 million of acquisition related charges associated with the acquisition of Pavilion Bancorp of Adrian, Michigan and its subsidiary, the Bank of Lenawee, which closed near the end of the first quarter in 2008.

2008 presented many challenges to the banking industry as we dealt with unprecedented economic and financial issues and this is reflected in our results. Credit quality remains a challenge as lay offs and business closings continue to mount. In addition, impairment charges, both in the investment portfolio and in mortgage servicing rights had a negative impact on the results for the quarter and the year. However, even in this environment we have confidence in our core operation and with our strong capital levels we've positioned First Defiance to meet these challenges.

Asset quality performance in the fourth quarter was again considerably weaker than our historic performance. All of our credit quality metrics were stressed as we booked $3.8 million of provision expense for the quarter, bringing the provision for the 2008 year upto $12.6 million. Non-performing assets increased significantly in the fourth quarter as more accounts fell 90 days past due and went to non-accrual. Others were classified as troubled debt restructures, therefore putting them in the non-performing category.

At the same time, real estate values have declined and some collateral dependent loans no longer have enough collateral value to support the outstanding balance. This was a major contributor to our higher than normal charge-off rate for the year. We are proactively working to identify all potential problems and mitigate our losses as much as possible.

The impairment charges in the quarter were basically in two different categories with totally different factors. In the fourth quarter, we booked other than temporary impairment in the amount of $599,000 due to the continued deterioration of certain collateralized debt obligations that are not likely to return their full principal investment due to defaults by participants in the pool**.** We ~~have  detailed~~have detailed analysis completed on each of these investments and we will continue to monitor them for any further weaknesses.

The impairment charge on the mortgage servicing rights is a result of the steep decline in mortgage rates during December that produced much higher pre-payment assumptions leading to a reduction in the value of the servicing portfolio. Unlike the other than temporary impairment charge, which you cannot reverse, the mortgage servicing rights possibly could reverse in future quarters.

Despite the disappointing earning results for the quarter, there were several strong performance indicators. One of the significant positive stories in our fourth quarter was that net interest margin remained relatively strong considering the current rate environment. Net interest margin at the end of the quarter was 3.72%, a 20 basis point improvement over the fourth quarter 2007 margin.

Net of the impairment charges mentioned earlier, non-interest income was solid again in the 2008 fourth quarter. With the decrease in residential mortgage rates at the end of the year, our mortgage production has increased dramatically. The gain on sale of mortgage loans in the fourth quarter of 2008 was up considerably over both third quarter 2008 and fourth quarter 2007. We have a significant number of mortgage loans in the pipeline indicating that this trend should continue into 2009.

Commercial loan demand overall is now what would be characterized as strong but there are still opportunities to grow existing relationships as well as to develop new ones. However, we are being more cautious in this environment as we review credit request.

Total deposits at period end were also up only slightly over the September 30, 2008 balances. Customers are continuing to look at CDs to get yield. This flow of funding sources from savings and money market accounts to CDs has had a negative impact on our overall cost of funds but we continue to have success at growing our non-interest bearing deposits to help offset some of this pressure on net interest margin.

Our asset and liability committee is very focused on managing the spread between loans and deposits but there is little room left to lower deposit rates which requires us to be even more disciplined on the lending side.

Total non-interest expense increased year-over-year; however, most of the increase is attributable to the Pavillion acquisition. Year-over-year the efficiency ratio increased 45 basis points on a GAAP basis. Excluding the one-time charges related to the acquisition, we had an 86 basis point drop in this ratio.

I will now ask Don Hileman to give you additional financial details for the quarter and the 2008 year end before I wrap up with an overview and a look at what we see developing for 2009. Don?

DON HILEMAN: Thank you, Bill and good morning everyone. To say the least, it was an interesting quarter on many fronts with several significant items impacting the overall results for the quarter.

Credit quality continues to be a major focus for First Defiance. We saw another quarter in which we had a high level of provision for loan losses. As Bill noted, our provision expense totaled $3.8 million as we increased our allowance for loan losses to $24.6 million. The provision expense was 1.43 times our charge-offs for the quarter and our provision expense for the year at almost $12.6 million is two times the level of our year-to-date charge-offs of $6.1 million.

We are continuously analyzing our loan portfolio and have made decisions to reallocate resources to work with past due clients to determine a course of action that we hope will mitigate potential losses on client relationships. We have added experienced work-out specialists to handle the most complex relationships.

We calculate our allowance for loan losses by analyzing all loans on our watch list and making judgments about the risk of loss based on the cash flow of the borrower, the value of any collateral and the financial strength of any guarantors. Based on those judgments we recorded specific provision for loan losses against each loan we analyzed. We also provided general allowance of 1.05% for any commercial or commercial real estate loans that isn't specifically reserved for.

Residential mortgage loans, we record our allowance equal to 20% of the outstanding loan balance on any mortgage loan and 30% of home equity loans that are 90 days past due at the end of the quarter, and a general allowance of 15 basis points.

Consumer loans are a very small part of our overall loan portfolio and we generally provide 75 basis points for losses on those loans. We are using different loan loss percentages for the loans we acquired from the Bank of Lenawee in March of 2008. The percentages are higher at 1.9% and 1.22% of mortgage and consumer loans respectively, while our percentage for commercial loans is the same at 1.05%.

Overall our allowance for loan losses breaks down to $21.8 million for commercial and commercial real estate loans, $2.4 million for mortgage and home equity loans and $390,000 for everything else.

Our provision for loan losses is the adjustment we make to the allowance for loan losses necessary for the allowance to be adequate based on the losses we estimate to be in the portfolio. The provision expense this quarter reflects expense of $554,000 related to the overall growth in loan balances, $2 million for increases in reserves for classified loan balances and $1.3 million of charge-offs where we did not have adequate reserves.

Net charge-offs was 67 basis points annualized for the quarter compared to 56 basis points last quarter and 4 basis points in the fourth quarter of 2007. At December 31, our allowance for loan losses represented 1.52% of our total loans outstanding, an increase of 5 basis points over last quarter and 71.78% of our non-performing loans with our non-performing assets ending the year at 2.11% of our total assets. While total non-performing loans increased $8.7 million during the quarter, non-accrual loans increased $3.4 million and restructured loans increased $5.3 million.

Restructured loans are considered non-performing because of changes in the original terms granted to borrowers. These loans are still accruing. This is the way we can work with our borrowers who have the ability to repay to mitigate the loss potential. We did see a reduction in the level of 90-day past dues from last quarter in the one-to-four family residential, construction, commercial and consumer loan categories, but we did experience an increase in commercial real estate and home equity.

Another significant item we recorded this quarter was $2.7 million of expense, related to the impairment of our mortgage servicing rights. This is included in our mortgage banking total. At the end of the quarter, we saw a dramatic increase of 40% to 50% in the consensus prepayment speed, which is a major driver of the valuation of mortgage servicing rights. This was driven by a reduction of over 140 basis points in long-term mortgage rates and a corresponding increase in the mortgage refinance applications.

At December 31, First Defiance had $1.1 billion of loans serviced for others. The mortgage servicing rights associated with those loans had a fair value of $6.6 million or 60 basis points of the outstanding loan balances. Total impairment reserves, which are available for recapture in future periods, totaled $2.8 million at the end of 2008.

The difficult economic environment continued to add stress on our investments and trust preferred collateralized debt obligations. The CDOs are made up of pool of investments of the trust preferred securities issued primarily by commercial banks and through us. As the issuing institutions experience financial difficulty, they can defer payments and in many cases we have seen these institutions default on their issue which has a negative impact on the collateral supporting the pooled investments.

The other-than-temporary impairment charge recognized by First Defiance in the fourth quarter of 2008 totaled $599,000. This charge related to three trust-preferred collateralized debt obligation investments with an original cost of $2 million which had been written down to a total value of $419,000.

The company recorded a charge of $489,000 on one CDO investment with an original cost of $1 million in which we do not anticipate receiving the remaining principal and recorded an additional charge of $110,000 on two equity notes in the fourth quarter. At December 31, 2008, the value of those equity note CDOs which had a total original cost of $1 million had been written down to $50,000.

Our net interest income of $16 million for the quarter was a 28% increase over last year's fourth quarter. For the quarter, our margin was 3.72% which was 20 basis points better than last year's fourth quarter.

Falling interest rates continued to impact us on both the asset and liability side. We continually look for opportunities to re-price deposits in line with market rates. This is becoming more challenging at these low levels.

A year ago in the fourth quarter, the average balance on our non-interest bearing deposits was $114 million, which represented 8.1% of our total average deposit balances for the quarter. In the fourth quarter of 2008, our average non-interest bearing deposits were $173 million or 10.1% of total average deposits. We acquired $40.7 million of non-interest bearing deposits in the Pavilion acquisition.

We also continue to have steady growth in our fee income over last year which increased by $722,000 or 26% in the fourth quarter of 2008 over the fourth quarter of 2007. Mortgage banking declined overall in the fourth quarter of 2008 compared to the fourth quarter of 2007 due to the impairment charge mentioned earlier. We also saw an increase of 165% or $989,000 over the fourth quarter of 2007 and a gain on sale of loans, which is a component of mortgage banking.

As previously announced First Defiance elected to participate in the US Treasury Capital Purchase Program in the fourth quarter and received $37 million of equity capital by issuing preferred stock to the US Department of Treasury. Along with our already strong capital position, this helps position us to continue our role as a leader in banking throughout our markets.

That completes my overview for the quarter and I'll turn the call back over to you Bill.

WILLIAM SMALL: Thank you, Don. As we move forward into 2009, we will continue to address the challenges that face all of us. The overall economic climate throughout our market area continues to vary from industry to industry, but we do see signs of continued weakening. Unemployment numbers continue to run higher in this region compared to national numbers as 12 of the 15 counties in our footprint have unemployment rates above the national average. Three of those counties are over 10% unemployment. Contrary to this data however, only three of those 15 counties have a foreclosure rate higher than the national average. I think this is the result of the hard work of our credit people and the core values of the residents of the rural Midwest.

We have expanded our credit monitoring functions even beyond our traditionally strong focus. Additional asset review functions and more delinquent loan reporting requirements have been added to assist in this monitoring. We continually review credit concentrations by the industry and have placed lower limits on lending within certain types of loan categories. We have further segmented our commercial real estate portfolio to track the general performance of these segments to better analyze potential problems earlier. This is a difficult environment to forecast in as conditions are constantly changing. We do anticipate slower growth in 2009 with loan growth being in the mid single digits. Mortgage loan growth could stay strong if treasury yields remain down keeping mortgage rates low, but there is a finite amount of refinancing that can be done and as of yet it does not appear that home purchases are ready to increase significantly to add to the mortgage volume.

Deposit growth should be relatively steady unless the stock market rebounds and funds leave savings instruments falling back into the market. While we saw a net interest margin improvement year-over-year in 2008 versus 2007, we did see some retreat at the end of 2008 as the Fed cut rates to the bone. With this in mind, we feel there is probably going to be some modest downward pressure on the margin throughout 2009 from the year end 2008 level.

It would be nice to think all of those challenges are behind us as we move through 2009, but we all know there are plenty of difficulties still to grapple with. 2008 brought us a continued decline in the housing market with additional foreclosures, bank failures and unprecedented government intervention. The residual effect of all of these events during 2008 made for an extremely difficult banking environment, but I believe it is a time of great opportunity for community banks like ours. We remain well-capitalized with a proven operating strategy and as we move forward through 2009, we will work diligently on the factors within our control to continue to grow even in this economic environment. Those factors beyond our control, we will continue to monitor and be prepared to respond to.

We anticipate many potential opportunities will arrive in these unusual times and we believe we have positioned the company to be able to take advantage of those that offer strategic value.

We thank you for joining us this morning and now, we will be happy to take your questions.

Q&A

OPERATOR: 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." That is "*" then "1" to ask a question.

CAROL MERRY: We are ready to take questions now Camille (Ph).

OPERATOR: Our first question will come from Valerie Taliaferro from FIG Partners. Please go ahead.

VALERIE TALIAFERRO: Hi, good morning.

WILLIAM SMALL: Good morning.

VALERIE TALIAFERRO: I just want to ask, on the $6.3 million in restructured loans you mentioned, could you talk about what type of loans those consisted of?

WILLIAM SMALL: Generally, they are loans for our long standing borrowers where they are struggling due to the softening of the economy where we have granted terms that we wouldn't normally to an average customer, which, you know, typically goes beyond just an interest only period of time. We've reduced interest rates or whatever where we have borrowers that are committed to trying to see this thing through as opposed to cutting and running. So it allows us to be a little bit more patient with them. These loans are then obviously reported as non-performing but we still do accrue interest at the lower interest rate.

VALERIE TALIAFERRO: Okay. Are they mostly like residential mortgages or commercial real estate?

WILLIAM SMALL: The two largest in that group Valerie, one is a golf course and the other is manufacturing.

VALERIE TALIAFERRO: But you haven't taken any losses, it's just changed the terms of the loan?

WILLIAM SMALL: Right. We have reserves against those but we have not taken losses at this point. The borrowers are committed to try to see this thing through and so we are, you know, we are being patient with them.

DON HILEMAN: And they still are accruing interest.

VALERIE TALIAFERRO: Okay. And if I could ask one more question, on your Trust Preferred CDO investments, typically what tranche of these different pools do you own? I mean I saw you mentioned two were equity notes, are all of them equity notes, or do you own different tranches?

DON HILEMAN: We own a variety of tranches we own one B and we own a couple of C's and some D's. The only two equity tranches are the ones I mentioned that we wrote those down.

VALERIE TALIAFERRO: Okay. And how many pools in total do you own?

DON HILEMAN: We own, I think, it's 11 in total.

VALERIE TALIAFERRO: All right, that's it for me. Thank you.

WILLIAM SMALL: Thank you.

OPERATOR: Our next question will come from Jack Ru from Sandler O'Neill Asset Management. Please go ahead.

JACK RU: Yes, hi. Good morning, guys.

WILLIAM SMALL: Good morning.

DON HILEMAN: Good morning.

JACK RU: Just a couple of quick questions. First thing was the compensation expense line item. It seemed a little low this quarter. Was there any type of, you know, reversal or anything in there?

DON HILEMAN: There was. We had some performance based reversals there of bonus compensation and some profit sharing compensation reversals there.

JACK RU: Okay, can you help me quantify that or…

DON HILEMAN: It was probably close to $600,000.

JACK RU: And then, you guys briefly mentioned the increase in kind of delinquencies, home equity and the commercial real estate, can you give me a little more detail or was there any particular concentration, you know, for any particular geographical areas?

WILLIAM SMALL: No particular concentration. One area that we are a little more concerned about and have kind of put a lid on lending is into the residential rental properties, both single family rentals and apartments. That's an area we have seen some increased delinquencies and so we've pretty much put a cap on lending in that particular area.

We keep reading that, you know, the next shoe to drop is retail and we are trying to get out in front of that. We've quantified what we've got in those industries and we are looking at individual credits on those industries to try to get the interim financials and to the extent we can rent rules to get a better handle on how those particular properties are doing.

JACK RU: And I guess on the home equity, you know, the increase was kind of from $2.1 million to $5 million. Was there anything there that is worth mentioning?

WILLIAM SMALL: I don't think anything significant in and of itself with the falling values of residential real estate you are seeing much more pressure on home equities. Typically, everything we've done has been no more than 80% loan-to-value and if it's been higher than that it's been insured. But even at an 80% loan-to-value, we are seeing situations where our home equity loan is in jeopardy.

JACK RU: Okay. And on gain on sale, you guys had a nice increase there. Just kind of want to get a better idea where that was coming from because it looks like it was better than it was in some of the prior quarters?

DON HILEMAN: In the mortgage banking category?

JACK RU: Yes.

DON HILEMAN: Yeah. like we said, we did see a pretty good pick up of that activity primarily in the last month in December and we recorded the value of our locked portfolio at that time which was aiding in that increase.

JACK RU: Okay. That's all I had. Thank you very much.

WILLIAM SMALL: Thank you.

OPERATOR: 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." That is "*" then "1" to ask a question.

We show no further questions at this time. I would like to turn the conference back over to Ms. Merry for any closing remarks.

CAROL MERRY: Thank you, Camille and thank you everyone for joining us today and if there are no more questions, this will conclude our call. Thank you.