First Defiance Financial Corporation

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Third Quarter 2008 Earnings Call

Official Speakers: Mr. William J. Small, Chairman, President and Chief Executive Officer
Mr. Donald P. Hileman, Interim Chief Financial Officer
Mr. James L. Rohrs, President and CEO, First Federal Bank
Ms. Carol Merry, Investor Relations

CAMILLE: Hello and welcome to the First Defiance Financial Corporation's Third 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 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, Camille. Good morning everyone and thank you for joining us for today's Third Quarter 2008 Conference Call. The Call is also being Web cast and the audio replay will be available at the First Defiance Web site at http://www.fdef.com until November 4, 2008. Hosting the Call this morning is Bill Small, Chairman, President and CEO of First Defiance. Following prepared comments on the company's strategy and performance, we 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 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 statements. For a complete discussion of the risks and uncertainties that may cause future events to differ from the results discussed in these "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. 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 Third Quarter results. Last night, we issued our Earnings Release for the Quarter and this morning we would like to discuss that Release and look forward into the balance of 2008. At the conclusion of our presentation, we will answer any questions you might have.

Before we begin, I want to tell you that we issued an 8-K earlier this morning disclosing that Jack Wahl, our CFO, will be off for a period of time for medical reasons. Don Hileman has been appointed Interim CFO in Jack's absence and brings strong experience and thorough knowledge of our operation to this role. Don has served as CEO of our Insurance Unit for the past fifteen months and prior to that he was a Controller at Sky Financial Group for 19 years. Don will be joining me on the Call this morning to give you more financial details on the Quarter. Also present this morning to answer your questions on credit quality is Jim Rohrs, President and CEO of First Federal Bank.

Third Quarter 2008 net income on a GAP basis was $322,000, or $0.04 per diluted share, down from $3.1 Million and $0.44 per diluted share in the 2007 Third Quarter. For the nine-month ended September 30, 2008, First Defiance earned $6.5 Million, or $0.83 per diluted share compared to $10.3 Million, or $1.44 per diluted share for the nine-month period ended September 30, 2007. The 2008 nine-months results included $1.0 Million of acquisition-related charges associated with the March 14, 2008 acquisition of Pavilion Bancorp of Adrian, Michigan and its subsidiary, the Bank of Lenawee. Excluding the after-tax impact of those charges, First Defiance had earnings of $7.1 Million, or $0.91 per diluted share for the nine-months ended September 30, 2008.

2008 continues to present many challenges to the banking industry with the current economic conditions and for our market area, in particular. These challenges are reflected in our results for the Quarter. From a national perspective, we recognize other than temporary impairment in our investment portfolio, when the Federal Government placed Fannie Mae and Freddie Mac into conservatorship in September, we have an investment in Preferred Stock in those government-sponsored enterprises that cost $2.0 Million dollars when purchased, but which declined substantially in value during the year. Those securities were written down to the September 30th market value of $151,000. Also in the 2008 Third Quarter, we recorded a Provision for Loan Losses of $4.9 Million due primarily to the deterioration of a number of large credits in our commercial portfolio.

We have historically taken great pride in our asset quality and I still believe our underwriting standards are sound, however we now have situations where good customers are struggling to make their payments. In some cases, they are in industries that are in the thick of the current downturn and in other cases, health issues or other factors have caused them to fall behind. 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. We are proactively working to identify all potential problems and mitigate our losses as much as possible. At this time, I believe we've provided a conservative level of provision expense for all of the problem loans that we have identified in our portfolio.

Despite the disappointing earning results for the Quarter, there were several strong performance indicators. One of the significant positive stories in our Third Quarter was the strong net interest margin. Net interest margin at the end of the Quarter was 3.81%, a 34 basis point improvement over the Third Quarter 2007 margin. Also, our strong performance in generating non-interest income continued during the Third Quarter, excluding investment security losses due to impairment related charges. Non-interest income for the 2008 Third Quarter improved by 11% over last year's Third Quarter with service fees up by more than 34% between those two periods. Loan demand is softening in some areas, both in commercial lending opportunities and in mortgage lending. The average balance of total loans grew about 2.6% this Quarter due both to the softening and more cautious underwriting. Total deposit balances at period end were also up only slightly over the June 30, 2008 balances. Customers are currently migrating to 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. With the 50 basis point cut in the Fed Funds rate last week, combined with the cost of Funds increase, the possibility of further cuts by the Fed, we anticipate pressure on the margin.

Total non-interest expense for First Defiance increased year-over-year, however most of the increases attributable to the Pavilion acquisition, which closed as I said late in the 2008 First Quarter. Efficiency ratio for 2008 Third Quarter was 66.8% compared to 69.2% in the Third Quarter of 2007.

I will now ask Don Hileman to give you additional 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. Don…

DONALD P. HILEMAN: Thank you, Bill and good morning everyone. In Jack's absence, I will try and give you a little bit more detail on our results for the Quarter and then we will answer your questions.

We had a few significant matters that impacted our overall results for the Quarter and aside from those two items, we had solid results. The first and most significant of those items is the high level of Provision for Loan Losses we recorded this Quarter. As Bill noted, our Provision expense totaled $4.9 Million as we increased our Allowance for Loan Losses to $23.4 Million. The Provision expense was 2.3 times our charge-offs for the Quarter and our Provisioning expense for the year at almost $8.8 Million is 2.5 times the level of our year-to-date net charge-offs of $3.5 Million. 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, the financial strength of any guarantors. Based on those judgments, we record a specific Provision for Loan Losses against each loan that we analyze.

We also provide a General Allowance of 1.05% for any commercial or commercial real estates loans that aren't specifically reserved for. With residential mortgage loans, we record an 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. 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 loans we acquired from the Bank of Lenawee in March of this year. Percentages are higher at 1.9% and 1.22% for mortgage and consumer loans, respectively. Overall, our Allowance for Loan Losses breaks down to $20.2 Million for commercial and commercial real estate loans; $2.7 Million for mortgage and home equity loans and $480,000 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 incurred in the portfolio.

Provision expense this Quarter reflects expense of $624,000 as related with the overall growth in loan balances refund $1.0 Million of increases in reserves for classified loan balances and $1.2 Million of charge-offs where we did not have adequate reserves. Thirty credits accounted for the $3.1 Million of Provision expenses this Quarter.

Net charge-offs were 55 basis points analyzed for the Quarter compared to 21 basis points last Quarter and 21 basis points in the Third Quarter of 2007. At September 30th, our Allowance for Loan Losses represented 1.4% of our total loans outstanding, an increase of 10 basis points over last Quarter and 91.82% of our non-performing loans and our non-performing assets were at 1.58% of total assets.

The second significant item we recorded this Quarter as we want $2.1 Million of expense related to impairment of certain securities in the company's portfolio that management deemed other than temporary. (Cross Talk). The majority of the other than temporary impairment recognized in the Third Quarter is related to $1.9 Million write down on the Preferred Stock issued by Fannie Mae and Freddie Mac. First Defiance invested $1.0 Million in the Preferred Shares of each agency in January of 2008 and wrote those investments down to $87,000 on the Fannie Mae and $64,000 on the Freddie Mac at September 30, 2008.

The company also recorded $150,000 of additional other than temporary impairment of the investment in the equity notes of two trust preferred collateralized debt obligations in the Third Quarter of 2008. Those equity notes bear the initial credit losses when banks that issue trust preferred securities into those pools default. Our net interest income of $16.4 Million for the Quarter was a 36% increase over last year's Quarter. For the Quarter, our margin was 3.81%, which was 34 basis points better than last year's Third Quarter. While interest rates have impacted us both on the asset and liability side, we have been able to drop our liability costs more than our loans have fallen and we have improved the mix of our liabilities. The year ago in the Third Quarter, the average balance of our non-interest bearing deposits was $103.2 Million, which represented 8.8% of our total average deposit balances for the Quarter. In the just completed Quarter, our average non-interest bearing deposits were $169.3 Million, or 11.8% of the 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, which increased by $953,000 or 34% in the Third Quarter of 2008, over the Third Quarter of 2007. In addition, our mortgage banking income increased by $90,000, or 10% in this year's Third Quarter compared to the same period last year.

First Defiance remains well capitalized with the total risk capital at Quarter end of 12.05% compared to the minimum regulatory requirement of 10%. This represents excess regulatory capital of $34.3 Million at September 30, 2008. That completes my overview for the Quarter and I will turn the Call back to you, Bill.

WILLIAM J. SMALL: Thank you, Don. As we progress through 2008, 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. Unemployment numbers continue to run higher in this region compared to national numbers, but seemed to have at least leveled off in recent months. Agriculturally, the dry summer drought has reduced crop yields from the recent strong performance to the lower end of this historic yield. However, even though commodity prices have retreated some from their mid-summer highs, with a combination of price and yield, our farming clients continue to do well.

We have expanded our credit monitoring function and it is 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 continue review credit concentrations by industry and have placed limitations on lending within certain types of loans.

This is the most difficult operating environment that I've experienced in my 30 years in banking. We've worked hard to execute our strategy in this challenging environment and to adapt to the changes in the business cycles. This was a very disappointing Quarter from an earnings performance perspective and certainly not acceptable to us. But I believe it is a time of great opportunity for community banks like ours. We remain well capitalized, with risk base-based capital that is 20% more than the regulatory standard to be considered well capitalized. We have never been involved in the sub-prime lending market, which is at the heart of the recent crisis.

First Federal Bank and First Defiance are positioned to continue following the business plan that has served us well over the years and prepares us for times like this. Our core fundamentals remain strong and the underlying strengths will keep us on course for the future. In addition to working to improve our asset quality, we are focused on finding and growing revenue sources as well as focusing on operating efficiently to step up and meet today's challenges. Needless to say, there are better environments to operate in, but we will continue to work with our customers and offer the best in products and services as we look forward to better times.

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

CAMILLE: 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.

Our first question does come from Brett Villaume of FIG Newton. Please go ahead.

BRETT VILLAUME: Hi, good morning. (Greeting returned). I wanted to ask you on your personal real estate portfolio, what percentage of that is non-owner occupied?

WILLIAM J. SMALL: The commercial real estate that is non-owner occupied, to be honest with you Brett; I don't have that breakdown here with me this morning.

BRETT VILLAUME: Okay

WILLIAM J. SMALL: We can get that for you. I will tell you that the general characteristic of that portfolio really kind of relates back to our thrift roots where we were very comfortable with mortgages. We like real estate as collateral and a large percentage of that are loans to small businesses that includes their real estate and that is not to say that there certainly are some investment properties in there of different types but an awful lot of it. A large percentage of it is owner occupied.

BRETT VILLAUME: If I were to go back and look at last Quarter percentage from regulatory sources, would it probably be about the same?

WILLIAM J. SMALL: Yes

BRETT VALLAUME: Okay great and then on the construction portfolio, do you anticipate that we are going to see a sort of a continuation of that same sort of draw down in the Fourth Quarter? I guess it fell about 9%.

WILLIAM J. SMALL: Yes, I think that would probably be pretty consistent with what we would expect because number one, there is just not a lot of construction activity going on out this way and secondly, we are certainly being very cautious in anything that we look at in that arena.

BRETT VALLAUME: Okay and lastly, I think you may have mentioned it but if you didn't, would you mind repeating the Tier 1 risk-based ratio. You said you had 20% above well-capitalized status and I was wondering if I could have that exact ratio?

WILLIAM J. SMALL: Well that is not. We are doing the final calculations right now. At the end of the Second Quarter, we were at 12.18. We know it is still in excess of 12% but I don't want to give you an exact figure because at this point, I cannot verify or validate that would be absolutely exact. I can tell you that it is in excess at 12.

BRETT VALLAUME: Okay well thank you very much.

CAMILLE: Our next question will come from Eileen Rooney from KBW. Please go ahead.

EILEEN ROONEY: Good morning, guys. (Greeting returned). Just have a question on your Watch List and delinquency trends. Just wondering how those looked in the Third Quarter?

WILLIAM J. SMALL: I am going to let Jim Rohrs, who is the President of the Bank, kind of deal with some of the credit issues on this and so Jim, I'll let you comment on that.

JAMES L. ROHRS: Okay Bill, relative to the delinquencies, we haven't seen a significant increase in the dollar amount of delinquent loans, but we have seen a migration out of the 30 and 60 day into the 90 and 120 day, so we have seen an increase in the more severe delinquencies. That has been a trend that has kind of marched upward over the last four Quarters. Classified credits are also up from the June 30th Quarter end, although not dramatically, but that trend also has been upward over the last several Quarters.

EILEEN ROONEY: Okay and then one unrelated question. In your other Fee line we have a negative number this Quarter and I was just wondering what was included in there?

WILLIAM J. SMALL: That relates to a change in value on a deferred account (inaudible) that we have.

EILEEN ROONEY: Okay, we would expect that to go back up again?

WILLIAM J. SMALL: Yes

EILEEN ROONEY: Great, thank you.

WILLIAM J. SMALL: Okay, thank you.

CAMILLE: Once 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. If you decide you want to withdraw your question, please press "*" then "2". That is "*" then "1" to ask a question.

Our next question will come from Brad Ness from Choral Capital Management. Please go ahead.

BRAD NESS: Hi guys!

WILLIAM J. SMALL: Hi Brad, how are you?

BRAD NESS: Doing fine. I was wondering if you could just discuss (inaudible) what you are considering the top program?

WILLIAM J. SMALL: We certainly have been following it very closely as I am sure people would think that we would be. We are as each piece of it is being released; we are doing a pretty thorough analysis on it. At this point and time, I am not ready to be able to commit exactly what we will be doing, but you can be assured that we have been very actively working through analysis of the different segments as they come out.

BRAD NESS: Okay and… Were you going to say something?

WILLIAM J. SMALL: No, no.

BRAD NESS: Okay, and also how committed are you to your cash dividend right now?

WILLIAM J. SMALL: Again, that is something that is ongoing for us as far as our review and analysis of it. We have a dividend payment that goes out this Friday. Our next dividend is scheduled for January and we will continue to monitor and make determination as they progress.

BRAD NESS: And when you are looking at that determination in front of cash dividends, what are your primary factors in that decision making process?

WILLIAM J. SMALL: Well, we will certainly be watching not only current earnings but our forecast in that regards. We will look at payout ratios and of course, naturally capital needs.

BRAD NESS: Okay, regarding your accruals. You know we saw an increase on the commercial and commercial real estate non-accruals. You know if you had to forecast, what… when would you guess that things peak out?

WILLIAM J. SMALL: Jim, want to take this. (Cross Talk)

JAMES L. ROHR: That is a $64,000 question! The answer to that question depends on what happens with the economy from here on out. As both Bill and Don alluded to in their previous comments, we have a very aggressive and very thorough Watch List process to identify problem loans and then to set reserves for those problem loans. We are very confident that we have identified the problems that are in the portfolio right now and reserve for those, but we can't predict the future.

BRAD NESS: Okay and lastly here, it looks like in your investment securities portfolio; you have 23 or so million in CMOs. One, can you just tell me if these are private label or can you just give me a little bit more color about these CMOs?

DONALD P. HILEMAN: This is Don. Being on the job a day (laughter) gives me a little disadvantage here, but you know I think it is a combination of both. I think there are some private label or (inaudible) of those. It is kind of a mix. We can provide more color on that and there will be more color in our 10-Q filing at a later date, but….

BRAD NESS: Okay, appreciate guys!

WILLIAM J. SMALL: Thank you, Brad.

CAMILLE: This does conclude today's Question and Answer session and I would like to turn the Conference back over to Ms. Merry for any closing remarks.

CAROL MERRY: Well, if indeed there are no more questions, we thank you very much for joining us today and this will conclude our Conference Call. Thank you. Goodbye.

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