First Defiance Financial Corp.

First Quarter 2017 Earnings Conference Call

April 18, 2017 at 11:00 a.m. Eastern

CORPORATE PARTICIPANTS

Don Hileman, *President and CEO*

Kevin Thompson, *Vice President and Chief Financial Officer*

Tera Murphy, *Vice President*

PRESENTATION

Operator
Good morning and welcome to the First Defiance First Quarter 2017 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 1 on your touchtone phone. To withdraw your question, please press star, then 2. Please note this event is being recorded.

I would now like to turn the conference over to Vice President 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 2017 First 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 the 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 and good morning, and welcome to the First Defiance Financial Corp. First Quarter Conference Call. Last night we issued our 2017 first quarter earnings release and now we would like to discuss the first quarter results and give you a look into the remainder of 2017. At the conclusion of our remarks, we will answer any questions you might have. Joining me on the call this morning to give more detail on the financial performance for the quarter, is our CFO, Kevin Thompson.

We are very pleased with the continuing movement toward our strategic goals. In the first quarter, we made notable progress in executing our strategic goals, especially with the close of the Commercial Bancshares transaction, which added $369.5 million in total assets, net of $12.3 million in cash, $285.7 million in total loans, and $308 million in total deposits to First Defiance. We are very pleased with the results of the integration, and I thank all the Commercial Savings Bank and First Federal Bank team members for their hard work and dedication to making the conversion a success.

I am also pleased to announce that in the first part of April, we closed on the addition of a full-service employee benefits consulting organization, Corporate One Benefits, which will add approximately $2.9 million in annual insurance revenues. This acquisition complements First Insurance Group, our agency, and its overall book of business.

As for net income for the first quarter of 2017 on a GAAP basis, it was $5.1 million, or 54 cents per diluted common share after merger-related costs of 27 cents per share, compared to $7.2 million, or 79 cents per diluted common share, in the first quarter of ’16. Our overall core performance this quarter, excluding merger and conversion-related expenses, remains strong and starts the year off on a positive note. We experienced year-over-year and linked quarter annualized core net loan growth of 7.1 percent and 2.7 percent, respectively. However, we are satisfied with the overall growth, as the first quarter growth trends tend to be seasonally weaker. Our ability to grow our loan portfolio is a key piece of our strategic plan. The lending environment is very competitive, with rate and structure pressures relating to terms and conditions and an uncertain economic environment.

We did not see any significant movement in local market rates after the Fed hike. Despite this environment, it is encouraging for us to see contributions from across our entire footprint and end the quarter with a solid pipeline up from year end, and we believe we are on track with our annual goal of upper-single digit loan growth. This, coupled with stronger confidence from segments of our clients concerning economic stability and the economic environment, leads us to believe we have positioned ourselves for continued disciplined loan growth for the remainder of 2017.

We are also very pleased with our margin improvement this quarter over the first quarter of ’16, and on a linked quarter basis. The growth in both our net interest income and our non-interest income revenues on a quarterly basis is a result of contributions from our core business strategies. Non-interest income was driven primarily by BOLI income, insurance revenues, and service fees. Kevin will provide more color on the BOLI income in a few minutes.

We saw a slight increase in year-over-year mortgage banking revenues, while we saw a decrease on a linked quarter basis. Total non-interest expense increased from the fourth quarter of ’16, primarily due to merger and conversion-related costs, but we did see an increase in core compensation and benefits.

The credit quality metrics showed continued overall improvement this quarter from the first quarter of 2016. Non-performing assets declined to .7 percent, from 1.03 percent in the first quarter of ’16. Non-performing loans decreased approximately $2.6 million, or 15 percent year over year, to $15.1 million. Approximately 71 percent of the non-performing loans continue to make scheduled payments.

We also had a decrease of $1.5 million, or 13 percent, of restructured loans. We are also satisfied with the level of 30-day and 90-day delinquencies at .19 percent of loans for the first quarter of 2017. Overall, we expect to see stable-to-improving asset quality trends across the board in the near term. We will continue to focus on asset quality through reducing the non-performing and classified asset levels in the future, leading to improvements in our overall non-performing asset ratio.

In regards to our capital management plans, we are also pleased to announce a 2017 second quarter dividend of 25 cents per share, representing a 14 percent increase and an annual dividend yield of approximately 2 percent.

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

Kevin Thompson
Thank you, Don. Good morning, everyone. Again, as Don stated, net income for the first quarter, $5.1 million, 54 cents per diluted share, and this includes 27 cents per diluted share from an impact of merger and conversion expenses and 2 cents-per-diluted-share reduction resulting from a repositioning in our bank-owned life insurance portfolio. This compares over the result overall, to prior year first quarter results of $7.2 million, or 79 cents per diluted share. When we peel back the numbers, we are very encouraged by our operating results in the first quarter and our outlook for 2017.

Turning to the details and starting with the balance sheet, first quarter growth in our loan and deposit balances was predominantly due to our acquisition of Commercial Savings Bank, or CSB, which added $285.7 million in loans and $308 million in deposits. Organically, loans grew about $13 million and deposits increased about $84 million, which included some run-up right at quarter end that we would expect to moderate growth expectations for the second quarter. Total net loans finished the quarter up 23 percent from a year ago, which included 15.9 percent from CSB and 7.1 percent organic growth, while deposits were up 26.9 percent from the prior year, with 16.5 percent from CSB and 10.4 percent organic growth. First quarter average balances were only impacted by the CSB acquisition for the last five weeks, or about 40 percent of the acquired balances, so we will see an increase in averages again next quarter from the acquisition. And CSB's 93 percent loan-to-deposit ratio combined well with our balance sheet to keep our earning asset mix strong, our deposit costs low, and our margin profitable, which leads me to the income statement.

Our net interest income was $21.6 million for the first quarter of 2017, up from $20.5 million in the linked quarter and up $2½ million from the $19.2 million in the first quarter of last year. The increase over the prior year includes the addition of CSB for the last five weeks of the quarter. Our margin this quarter was 3.81 percent, up 5 basis points from last quarter and up 1 basis point from 3.80 percent in the first quarter of last year. On a linked quarter basis, our yield on earning assets was up 6 basis points, as our loan portfolio yield rose to 4.41 percent, and our overall mix improved with the addition of CSB. Our cost of interest-bearing liabilities was up 1 basis point on a linked quarter basis, impacted slightly by both rate and mix. As stated earlier, with the addition of CSB, our earning asset mix and margin remain strong and steady as we continue to grow our balance sheet, and our interest rate risk remains basically neutral and well balanced for our expectations of continued action by the Fed.

Total non-interest income was $10.5 million in the first quarter of 2017, up from $8.3 million in the linked quarter and up from $8.6 million in the first quarter of 2016. The first quarter 2017 includes a $1.5 million enhancement gain on a BOLI purchase, while first quarter last year included $131,000 of securities gains, plus $317,000 of net gains on the sale of OREO. In addition, the first quarter is generally when we receive our contingent insurance commissions, which were very good this year, totaling $1.2 million versus $799,000 a year ago. So excluding these non-core and seasonal items from each year, non-interest income was up year over year about $460,000, or 6.2 percent. Service fees, trust income, and mortgage banking were all up, while base insurance commissions declined versus the first quarter of last year.

Regarding mortgage banking, revenues for the first quarter of 2017 were $1.7 million, down $190,000 from the linked quarter, but up $199,000 from the first quarter of 2016. The first quarter mortgage banking originations were $48.9 million compared to $63.4 million last quarter and $51.1 million in the first quarter of 2016. Gain on sale income was $1.1 million in the first quarter of 2017 compared to $1.2 million on a linked quarter basis and $994,000 in the first quarter last year. In addition, the first quarter included a positive valuation adjustment to the mortgage servicing rights of $33,000 compared to positive adjustment of $241,000 last quarter and a negative adjustment of -$21,000 in the first quarter of 2016.

At March 31, 2017, First Defiance had $1.3 billion in loan service for others. The mortgage servicing rights associated with those loans had a fair value of $9.7 million, or 72 basis points of the outstanding loan balances serviced. Total impairment reserves, which were available for recapture in future periods, totaled $489,000 at quarter end.

As for non-interest expense, first quarter expenses totaled $23.1 million, up from both $18.2 million in the linked quarter and $17.3 million for the first quarter of 2016. The increase this quarter was mainly due to expenses attributable to the merger and conversion of CSB, which totaled $3.6 million in the first quarter of 2017 and which were primarily in compensation and benefits expense and other expenses.

The first quarter 2017 also included about five weeks of operating expenses for the addition of CSB. Comp and benefits expense in the first quarter 2017 was up $4.2 million from last year, mainly due to $2.8 million of merger costs, plus higher costs for health benefit plans, incentive compensation, merit increases, and new staff primarily as a result of the CSB acquisition as well. Other non-interest expense was $4 million in the first quarter of 2017, up from $2.9 million in the same quarter last year, mainly due to $667,000 of CSB merger expenses.

As for income tax expense, this quarter included $1.7 million expense in connection with the surrender of a BOLI policy. This expense was nearly entirely offset by the $1.5 million enhancement gain on the new BOLI purchased, with the difference being more than made up by the end of the year in improved performance.

Regarding asset quality, provision expense in the first quarter of 2017 totaled $55,000 compared to a credit provision of $149,000 last quarter and $364,000 provision expense in the first quarter last year. The first quarter of 2017 included net charge-offs of 4 basis points compared with net recoveries of 2 basis points last quarter and net charge-offs of 2 basis points in the first quarter a year ago.

Our allowance for loan loss at March 31, 2017, was $25.7 million, up $81,000 versus March 31st last year; however, the allowance-to-total loans ratio at March 31, 2017, was only 1.15 percent compared to 1.33 percent last quarter and 1.41 percent a year ago. The decline in the ratio was primarily due to the addition of the acquired CSB loans, which were discounted and recorded at fair value, with no allowance. Excluding the CSB-acquired loans, the allowance-to-loan ratio would be 1.32 percent, only 1 basis point down from last quarter end. At quarter end, the allowance coverage of non-performing loans was 171 percent, up from 145 percent at March 31, 2016. While impacted by the accounting for purchased loans, we expect the allowance-to-loans percentage to continue to reflect strengthening asset quality.

As for the asset quality numbers, non-performing loans increased slightly this quarter to $15.1 million, from $14.3 million on a linked quarter basis, partially due to the CSB acquisition, but was down from $17.7 million at March 31, 2016. Our OREO balance increased this quarter to $705,000, from $455,000 last quarter but was down from $1.1 million in the first quarter of last year. Overall, non-performing assets ended the quarter at $15.8 million, or .54 percent of total assets, down from $18.8 million, or .80 percent of total assets at March 31, 2016. Our troubled debt restructured loans this quarter were $9.8 million, down from $10.5 million last quarter and $11.3 million a year ago.

Looking at our capital position, total period-end stockholders' equity finished the quarter at $354.2 million, reflecting the acquisition of Commercial Bancshares and thus well up from $280.4 million at March 31, 2016. Our capital positon remains strong, with quarter-end shareholders' equity to assets of 11.9 percent, down just slightly from 12.06 percent last year. The bank's total risk-based capital ratio is approximately 12 percent at the quarter end, March 31, 2017. Our healthy capital positon continues to support our growth and shareholder value enhancement strategies.

So, in summary, we have a solid balance sheet, the acquisition of CSB is in the books and fully integrated, our operating profitability is strong, and our outlook remains very positive. That completes my financial review, and now I'll turn the call back over to Don.

Don Hileman
Thank you, Kevin. The core and overall results in the first quarter of '17 and our important progress has positioned us for success in 2017. We continue to focus on several key areas that we believe are important to improving financial performance and driving greater shareholder value. These areas include core balance sheet growth, with a focus on loan growth and deposit growth; overall revenue growth, expense control, and improved asset quality. We look to make continued and steady progress in all these areas in 2017. Asset growth is off to a good start in the first quarter due to the acquisition and organic growth, and we also anticipate additional growth from the acquired branches and believe improvements in loan demand, aided by further improvements in the economic environment, will carry through to '17.

As we have discussed before, we have looked to strategically grow our overall position in the metro markets of Ft. Wayne, Toledo, and increase loan production in Columbus, Ohio, and we are seeing increased activity in these areas. We still believe the growth rate in the high-single digits is appropriate for the remainder of the year. While the lending environment remains very competitive as previously noted, we feel we can realize loan growth without making significant concessions in rate and other terms through a strong process of relationship building and quality client-focused service. This has been a model that we believe in. We understand it. It will be challenging to drive growth in loans and maintain yield management until market rates move higher, and we see a consistent view to sustainable economic growth. We are very focused on relationship management pricing and believe our delivery and service model is effective and is contributing to the strong margin performance. We are seeing our customers thrive and a changing pattern in transaction and service on the retail side. This shift, along with changing customer demographics, will have an impact on our business model.

We continuously look to enhance our electronic and mobile capabilities, giving our customers more choices on how to bank with us and are responding to their requests unveiled during our research. As a result, we have expanded our smart ATM network and look to further expand our capabilities in 2017. We've spent both time and resources to gain understanding of the needs of our current clients and potential clients as new client relationships are essential.

We are looking to better understand the needs and behaviors of millennials as market research indicates this is an increasingly important segment of the population. This group is distinct in their needs and their use of banking products and services, and we must be prepared to service this generation. In concert with this, we are taking a closer look at how our customers interact with us both inside and outside the branches. We are pleased with the increases in activity in both electronic and mobile transactions, including online account opening, mobile deposits, electronic payments, and the use of Mobile Wallet features, and look to grow this further in 2017. The digital delivery environment is changing at an accelerated pace, and we are committed to providing our clients, retail and business clients, a quality choice of products and services. As the banking behaviors of our clients change, we will focus on adapting our service and sales models for a more convenient, better client baking experience for all of our customers.

We will also have continued focus on growth in our insurance and wealth management revenues as part of our overall strategic plan. This was evidenced by the recent insurance acquisition. We believe these revenue sources will help us in our ability to grow non-interest revenues in an environment with added pressure on NSF and deposit fees.

The ongoing improvement in credit quality is encouraging and reflected by low charge-offs in the overall lower non-performing asset ratios. We are focused on, and committed to, improving our results relative to our peer group. We are very pleased by our recent financial performance and look to constantly drive our performance through initiatives that we believe will help us obtain our goal of being a consistently high-performing community bank. We understand the headwinds and challenges ahead, including economic, regulatory, and operational factors. We believe we can accomplish our goals through a balanced approach and a long-term focus on shareholder value.

We remain confident in our strategy and in the people we have dedicated to executing it. We feel that the performance of the organization reflects our focus on shareholder value and, at the same time, our commitment to be a strong community partner in areas we serve, by not only donating funds and employee volunteer hours, but creating valuable partnerships with community organizations. This, in our minds, is a community bank difference. We remain strongly committed to all of our customers and shareholders, and we appreciate the confidence you have placed in us to make First Defiance a company to be proud of.

Thank you for your interest today, and, at this point, we'll take any questions.

QUESTIONS AND ANSWERS

Operator
We will now begin the question-and answer-session. To ask a question, you may press star, then 1 on your touchtone phone. If you are using a speakerphone, please pick up your handset before pressing the keys. To withdraw your question, please press star, then 2.

Okay, our first question comes from Damen DelMonte from KBW. Please go ahead.

Damon DelMonte
Hey, good morning, guys. How is it going today?

Kevin Thompson
Very good.

Don Hileman
Good morning, Damon.

Damon DelMonte
Morning. My first question is could you just give us a little bit of an update on the merger integration and how that's going as far as system conversions and personnel and signage and things like that? How far along are you in that process?

Don Hileman
We think we're done. We had a very successful system conversion the same weekend it closed. A few little things needed to be cleaned up, but those are all completed at this point. All the personnel adjustments have been completed, signage and all that was done at the close of the transaction, so we're feeling really good about where we are at this point with all that integration behind us, Damon.

Damon DelMonte
Okay, great. And then building on that, as we look at the expense base going forward, I know you didn't have a full quarter of the impacts from the expenses on there, but, Kevin, could you give us a little dive into as to what we could expect for a range for quarterly expenses going forward?

Kevin Thompson
Sure. Obviously, the $23 million that we had this quarter was bloated by the one-time costs which were about $3.6 million, so just taking that down gets you in the mid-$19s [million]. We did have, as Don indicated, a little bit of some higher costs than expected in some of our compensation areas related to some incentive costs. There are strong results, but if you take the operating expectations from adding CSB in now for a full quarter, probably gets you in the $20 [million], $20½ million range.

Damon DelMonte
Okay. That's helpful. All right. And then the margin — it increased this quarter to 381 — I think it was like 376 last quarter — how much of that was related to the accretable yield from the transaction?

Kevin Thompson
Not much at all, Damon. In fact, it would be less than a basis point. I think the overall loan mark on the portfolio was about $5 million, I want to say, the accretable portion — in fact, under $5 million, and it was under $100,000 for the quarter that was recognized.

Damon DelMonte
Okay.

Kevin Thompson
So not a big impact at all.

Damon DelMonte
Okay, great. And then, just lastly, could you just talk a little bit more about the benefits — consulting acquisition that you included in the release? Can you maybe put some color around the size of it and the potential financial impact?

Don Hileman
Yeah, it's an employee benefits consulting group, so they focus on that. That added about 30-some percent to our total revenues for the agency. We're expecting about $2.9 million annualized revenues from that acquisition, so it really fits in well with our overall book of business at the agency and adds some additional stable, we believe, revenues on the non-interest income side. So we're real pleased with it. It's consistent with our pattern, our strategic plan to grow that business, and we were able to bolt this on this quarter.

Damon DelMonte

And then do these guys just focus in Ohio, or are they elsewhere in the Midwest?

Don Hileman
With insurance, they're going to go wherever they can make a sale, but it's primarily going to be in Ohio markets, and we're going to match them up with where our footprint is now. They're located in our market.

Damon DelMonte
Gotcha. Okay, that's all that I had for now. Thanks a lot, appreciate it.

Don Hileman
All right. Thanks, Damon.

Operator
Again, if you have a question, please press star, then 1.

Our next question comes from Daniel Cardenas from Raymond James. Please go ahead.

Daniel Cardenas
Good morning, guys.

Don Hileman
Good morning, Dan.

Daniel Cardenas
Just a couple follow-up questions on the Corporate One Benefits. Can you give us maybe a little bit of color of what the expenses are going to look like for this, and is that built into that $20 [million] to $20½ million quarterly run rate you suggested, Kevin?

Kevin Thompson
Well, it's a good question. As a fresh acquisition here, as I would think about it, that would probably push us certainly to the top end of that and maybe a little bit over. With the $2.9 million in revenues, let's just take a —

Don Hileman
Thirty —

Kevin Thompson
— yeah, 25 percent, 30 percent, an EBITDA-type ratio is going to get you to around $2 million. Divide that by $400,000 or $500,000, so maybe tuck that on top of what I said earlier. That's a good clarification, Dan. Thank you.

Daniel Cardenas
All right. And you've locked up all the key personnel in Corporate One, correct?

Don Hileman
Yes.

Kevin Thompson
Yeah.

Daniel Cardenas
Great.

Don Hileman
We locked them up for a three-year period.

Daniel Cardenas
Okay. And then looking at loan growth, maybe a little bit of color as to the pipelines. I know Q1 can traditionally be soft, but how are the pipelines looking coming into the second quarter?

Don Hileman
Yeah, they've jumped up pretty good, and we're pleased. I think the strongest pipeline might be — well, it's across the South — our southern market as the strongest. I'm just looking at some numbers here we have by our market areas, Dan, and I think the South — Columbus, we expect to be pretty strong, and it looks like we've got some stuff in the Ft. Wayne — and our western market is going to be strong again as well. Probably our weaker market is in the north as we start to build out where we want to — how we want to attack that, but I think our other markets are going to have a pretty strong pipeline going into the second quarter here.

Kevin Thompson
Yeah. Our pipeline from the last couple of quarters is probably up close to 40 percent.

Daniel Cardenas
Okay. That's good. And —

Don Hileman
Yeah, so we're pleased with that.

Daniel Cardenas
And as you look at the categories, is there any one particular category that's dominating the pipelines? Is it C&I, is it CRE?

Kevin Thompson
It is who we are.

Don Hileman
CRE.

Daniel Cardenas
Gotcha. All right. Perfect. And then congrats on the quick integration of your last deal. Does this mean that you guys are ready to do another transaction?

Don Hileman
I'd say if the opportunity's there, I am, and I think our team wants to catch their breath, but I think, organizationally, we think we're ready. Yeah.

Daniel Cardenas
Okay. And then —

Don Hileman

It was a good experience for us. We hadn't done one for quite a while, and I think we've got some lessons learned on how we can do things better, differently, and going forward too.

Daniel Cardenas
Gotcha. Gotcha. Okay. And then tax rate, what's a good tax rate to assume for you guys for the rest of this year, staying where we saw it in Q1?

Kevin Thompson
Well, on a core basis, we're generally probably, I'm thinking, a little over 30 percent; 30½ or so seems to be where I'm thinking. That's not on a tax equivalent basis. That's on just a core basis.

Daniel Cardenas
Gotcha. Okay. Perfect. All right. That'll do me for right now. Thanks, guys.

Kevin Thompson
All right.

Don Hileman
Thanks, Dan, appreciate it.

Operator
Again, if you have a question, please press star, then 1. Okay, this concludes our question-and-answer session. I would like to turn the conference back over to Vice President Tera Murphy for closing remarks.

CONCLUSION

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
The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.