First Defiance Financial Corporation

Teleconference July 22, 2008 at 11:00 AM ET

Event: Second Quarter 2008 Earnings call

Official Speakers: Mr. William J. Small, Chairman, President and Chief Executive Officer
Mr. John C. Wahl, Executive Vice President and Chief Financial Officer
Ms. Carol Merry, Investor Relations

OPERATOR: Hello and welcome to the First Defiance Financial Corporation's Second 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, the floor is yours ma'm.

CAROL MERRY: Thank you. Good morning everyone. Thank you for joining us for today's second Quarter 2008 Conference Call. This 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 July 30, 2008. With us this morning, are Bill Small, Chairman, President and CEO of First Defiance and Jack Wahl, the Company's 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 would like to remind you that certain statements made during this conference call, including during the Q&A period, are "forward-looking" statements and subject to the Safe Harbor found in the First Defiance SEC filings. Such statements are based on information and assumptions available at this time and are subject to change, risks and uncertainties that may cause actual results to differ materially. First Defiance assumes no obligation to update such statements. For a complete discussion of the risks and uncertainties, please refer to the 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 second 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.

I would like to begin by giving you an overview of the quarter and then Jack will give you more financial detail for the period. Second quarter 2008 net income on a GAAP basis was $2.74 Million, or $0.34 per diluted share, down from $3.61 Million and $0.50 per diluted share in the 2007 second quarter. These results include some costs associated with our acquisition of Pavilion Bancorp, which closed on March 14, 2008. Excluding the after-tax impact of those charges, First Defiance had earnings of $2.91 Million, or $0.36 per diluted share for the quarter ended June 30, 2008. 2008 continues to present many challenges to the banking industry with the current economic conditions and, more specifically, with the housing industry. Like many of our peers, our second quarter operating results were negatively impacted by significant provision expense as we continue to address credit issues in our portfolio. A large percentage of those issues are from loans that came on our books through acquisitions and we continue to work at bringing our credit quality numbers more in line with our strong historic performance. I will discuss this in more detail in a moment. In addition to the challenges presented by the economic environment, we also recognized a charge in the second quarter related to losses associated with a former First Defiance investment advisor. While management believes there is a possibility that part of the loss may ultimately be recovered, the expense was recognized in the 2008 second quarter after our claim under the company's Fidelity Bond was denied by the insurance carrier. First Defiance also recognized other than temporary impairment expense on certain investment securities in the 2008 second quarter. Jack will furnish you with the financial details relating to these two items in his remarks.

The second quarter provision expense of $2.8 Million was the difference between a good quarter and the disappointing earning results that we ended with. The soft economy, most notably in Michigan, has resulted in some further deterioration within our loan portfolio. We have continued to focus a lot of energy towards staying on top of this and have taken a very realistic approach to evaluating our credits. We have obtained updated appraisals of collateral on several of the credits, which resulted in further write down being recorded in the second quarter. If you exclude the acquired assets, the company's overall non-performing assets have increased by just $300,000 since beginning of 2008 in this tough economy. That charge-off, that 21 basis points fall slightly higher than the last three quarters were lower than the 30 basis points reported in the second quarter of 2007. Our allowance for loan losses is at 116% to non-performing loans. We believe it is an accurate reflection of the credit risk in our portfolio at this point and time. The current credit environment will continue to present challenges to the banking industry for the foreseeable future and we will be affected along with everyone else. However, our underwriting standards have always been high and we are working hard to identify credit problems early so they can be addressed and minimized. Overall, these are among the toughest credit times this industry has seen in quite awhile. We certainly are not immune to these difficulties but I think our portfolio has held up well as we look around and see the negative impact others are experiencing.

Despite the bottom line quarterly results, I believe there are many positive developments we can take from this quarter. Our core operation remains strong. Our margin improved again this quarter and is up 40 basis points from the margin we reported just six months ago for the 2007 Fourth quarter. Our loan growth continues to be very solid. Our mortgage origination business is steady and our deposit mix continues to improve as non-interest bearing deposits are up to 12.6% of total deposits at June 30th from 10% at December 31, 2007. Also, the integration of the former Bank of Lenawee offices continues to be successful. Overall, our deposit balances in these offices has held steady and our mix there also continues to get stronger, showing we are not having to pay up on CDs to attract or retain deposits in that new market. One of the significant positive stories in our second quarter was the strong net interest margin growth. We anticipated some margin improvement resulting from the Pavilion acquisition, but we also aggressively cut deposit rates as the Federal Reserve reduced the targeted Fed funds rate. We expect pressure on our margin will increase for the balance of the year as Certificates of Deposit rates are rising. We allowed a large number of CDs to run off early in the year rather than match competitor's pricing and has greatly benefited our margin. However, the need to fund our loan growth requires us to be more competitive with those rates. Also, we are starting to see rates on money market and other core saving products creep up. Loan demand, as I said, has been strong throughout the first half of 2008 as the second quarter continued with the momentum from early in the year. On a dollar basis, residential mortgage originations are up almost 70% over the first half of 2007. Commercial loan demand also remained strong throughout the quarter as we continue to pick up business especially from larger regional banks for a variety of reasons, including opportunities created by bank consolidation. Total deposit balances at period end were up only slightly over the March 31, 2008 balances, but the non-interest bearing deposits were up over 7.5% from the First quarter balances. The focus on changing our deposit mix continues to help the margin and has allowed us to be less involved in some of the CD pricing wars in the market. However, as I mentioned earlier, we will most likely need to be more aggressive in CD pricing, as loan demand stays strong.

First Defiance's non-interest income for the 2008 second quarter were increased over the second quarter of 2007, driven primarily by the increase in the mortgage banking activity that I spoke of earlier. Gains from the sale of mortgage loans were up nearly 50% over the second quarter of 2007. Service fee income was up over 25% compared to the June 30, 2007 results. Income from the sale of insurance products was down slightly compared to last year's second quarter. Insurance premium pricing continues to be soft, especially for property and casualty lines, but our agents have worked hard to attract new business to help offset the premium reduction. Total non-interest expense for First Defiance increased year-over-year, however, much of the increase is attributable to the Pavilion acquisition, which closed late in the 2008 First quarter. Results for the 2008 second quarter period also included some more one-time acquisition related charges primarily cost to terminate certain contracts of Pavilion and costs related to adding the former Pavilion employees to our Retiree Medical Plan. Non-interest expense also included the loss recognized in the quarter related to the former investment advisor. As I mentioned previously, this expense was recorded in 2008 second quarter after coverage under the company's Fidelity Bond policy was denied. I will now ask Jack Wahl to give you the 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. Jack…

JOHN C. WAHL: Thank you Bill and good morning everyone. I will give you a little more detail on the results for the quarter and then Bill and I will be happy to answer your questions. We had three matters that impacted our overall results for the quarter and aside from those three items, we had a very respectable quarter. First and most significant of those three items is the high level of provision for loan losses we recorded this quarter. As Bill noted, our provision expense totaled $2.8 Million as we increased our allowance for loan losses to $20.6 Million. Provision expense was more than three times our charge-offs for the quarter and our provision expense for the year at almost $3.9 Million is three times the level of our year-to-date net charge-offs of $1.3 Million. We calculate our allowance for loan losses by analyzing all loans on our watch list in making judgments about the risk of loss based on the cash flow of the borrower value of any collateral in the financial strength of any guarantors. Based on those judgments, we recorded specific provision for loan losses against each loan that we analyze. We also provide a general allowance of 1.05% for any commercial or any commercial real estate 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 or home equity loan that is 90 days past due at the end of the quarter; and a general allowance of .12% on all mortgages that are less than 90 days past due. Consumer loans are a very small part of our overall loan portfolio and we generally provide 75 basis points for loan losses on those loans. We are using different loss percentages for loans we acquired from Bank of Lenawee and percentages are higher at 1.9%, 1.22% for mortgage and consumer loans, respectively, while the percentage for commercial loans is lower at .95%. Overall, our allowance for loan losses breaks down to $17.2 Million for commercial and commercial real estate loans, $2.4 Million for mortgage and home equity loans and $970,000 for everything else. Our provision for loan losses is the adjustment that we make to the allowance for loan losses necessary for that allowance to be adequate based on the losses we estimate to be in the portfolio, including the general provisions described above. Provision for loan losses this quarter reflects expense of $385,000 related to overall growth in loan balances, $1.8 Million dollars of increases in reserves for classified loan balances and $542,000 of charge-offs where we did not have adequate reserves. Ten loans accounted for almost $1.7 Million of the increase in provision expense this quarter. At June 30, our allowance for loan losses represents 1.3% of total loans outstanding and 116% of our non-performing loans.

Our non-performing assets are essentially right at 1% of our total assets. Reported asset quality ratios are negatively impacted by the accounting treatment of impaired loans acquired in an acquisition, which are recorded net of any allowance. These hidden allowances total $3.9 Million at June 30 while our non-performing loans that were reported net of impairment would have been $1.5 Million higher if they were recorded at the gross amount due. Had all of these impaired loans been reported at their gross amounts, the allowance would represent 1.5% of total loans outstanding and 127% of non-performing loans.

The second significant item we recorded this quarter is $752,000 in expense related to losses we incurred associated with one of our former investment advisors. We anticipated that most of those costs would be covered under our Fidelity Bond coverage. When that coverage was denied, we recorded the expense, which amounts to $0.06 per share after tax. We are pursuing recovery of those amounts from a number of potential sources.

The third large adjustment we recorded in our second quarter was $432,000 of impairment expense associated with some securities in our investment portfolio where the decline in market value was deemed to be other than temporary. The vast majority of our portfolio consists of high-grade investments, quality securities; however we reach for yield by investing in the equity notes in a couple of pool trust preferred issuances. Those equity notes bear the initial credit losses when banks that issue trust preferred security into those pools default. At the time we invested, those investments seemed safe and worth the risk. However, two of the recent high profile bank failures have resulted in our recognition of firmament impairment.

If you exclude those three items from our results, we had a very strong quarter. Our net interest income of $16.2 Million for the quarter was a 33% increase over last year's second quarter. Our net interest margin continues to improve. For the quarter, our margin was 3.92%, which was 36 basis points better than last year's second quarter and 40 basis points better than last year's low point in the Fourth quarter. The following interest rates have impacted us both on the asset and liability side, but we've been able to drop our liability costs by more than what our loans have fallen. We have improved our mix of liability. A year ago in the second quarter, the average balance of our non-interest bearing deposits was $101.6 Million, which represented 8.8% of our total average deposit balances for that quarter. In the just completed quarter, our average non-interest bearing deposits were $171.1 Million, or 12% of total average deposits. We acquired $43.8 Million of non-interest bearing deposits in the Pavilion acquisition. If you exclude those from the total, our balance of that type of deposit has increased by $25.7 Million, or 25.3% in the last year. We also continue to have steady growth in our fee income, which increased by $700,000, or 26% quarter-over-quarter in our mortgage banking income which increased by $425,000, or 39% in this year's second quarter compared to the same period last year. We also believe that our expenses are under control. While our reported efficiency ratio was 67.3% for the quarter, if you exclude the $752,000 costs associated with the former investment advisor and $262,000 of one-time acquisition related expenses, our efficiency ratio would have been less than 63% for the quarter.

That completes my overview for the quarter. I'll turn the call back to Bill and look forward to answering your questions.

WILLIAM J. SMALL: Thank you Jack. 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. We have experienced some plant closing and layoffs in recent months, but many of our clients continue to express confidence in the balance of 2008. Agriculturally, we are coming off three consecutive strong years and after some early delays in planting, crops at this point in time are looking very good. Obviously, many of our commercial clients are concerned about fuel costs and that will continue to be something to monitor. We have stepped our credit monitoring functions even beyond our traditionally strong focus. We continually review credit concentrations by industry and have placed limitations on lending within certain types of loans. With loan demand remaining strong, we need to make sure that we stick with our solid underwriting policies and prudent pricing.

We worked hard to execute our strategy in this challenging environment and to adapt to the changes in the business cycles. This was not a strong quarter from an earnings performance and certainly, not up to our standards or expectations. However, the core fundamentals remain strong and the underlying strengths will keep us on course for the future. We are focused on finding and growing revenue sources as well as focusing on operating efficiently to step up and meet these challenges. I think we have demonstrated that the plan and the team that we have at First Defiance gives us the right components to continue to produce successful results.

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

OPERATOR: 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". Again, that is "*" then "1" if you would like to ask a question.

Our first question comes from Christopher Marinac of FIG Partners.

CHRISTOPHER MARINAC:
Hey good morning Bill and Jack. (Greeting returned.) Want to ask you sort of about geographically where the loan demand, the loan pipeline is coming from and to what extent is in your core markets in northwest Ohio versus in the new markets in Michigan?

WILLIAM J. SMALL: Right now in the Findlay area, it has been a real strong area for us. We've seen very good loan growth down that way. The Toledo market continues to pick up for us as our presence there and we've grown that in recent years and starting to get a little bit more traction there. The Michigan market at this point, this early in the game, we haven't seen a lot of new growth there, but we certainly think there is potential. But right now I think Findlay and Toledo probably stand out as probably too as well as you know we opened an office just about a year ago now in Fort Wayne, Indiana. That has been a good strong market for us.

CHRISTOPHER MARINAC:
To what extent does the external changes that have happened in the industry you know some of the questions and a lot of your bigger competitors have played into this pipeline, or is it more just organically blocking and tackling?

WILLIAM J. SMALL: I would like to say that it is all because of our fundamentals that we have in place, but we certainly have benefited I think from number one as I mentioned in my remarks from consolidation. We do know that there has been some tightening of credit, but especially in some of the larger regional banks that we compete with and that actually has probably given us some opportunities that in more normal times we wouldn't necessarily have seen at this point.

CHRISTOPHER MARINAC:
And the last question just has to do I guess with the farm status and sort of where you think land prices shake out in the next year or two and is that all an issue from underwriting those types of loans?

WILLIAM J. SMALL: We certainly have seen land prices as far as farm land gone up over the past year especially it has been kind of a steady increase probably over a longer period of time. We do watch those very carefully and we will continue to be cautious as we review appraisals on any of those credits.

CHRISTOPHER MARINAC: Very well, thanks guys.

WILLIAM J. SMALL: Thanks Chris.

OPERATOR: The next question we have comes from Eileen Rooney with KBW.

EILEEN ROONEY: Good morning guys! I have a question. I am not sure if I missed it in your comments. When you talk about the increased provision, you say 12 loans primarily attributed to that increase, can you just talk a little bit about you know what they were, you know any particular industries or geographic?

WILLIAM J. SMALL: I can give you some color on that. There is really a kind of a spread as far as industries. I do know that probably a little over, between $4.0 Million and $4.5 Million was related to land and land development loans. We did have one in particular outside of that. We had a trucking company that I think was a victim of the fuel prices, but you know outside of those I think it's been pretty well spread throughout some different industries.

EILEEN ROONEY: Okay and just ballpark, what would be the size of those 12 credits? The total?

WILLIAM J. SMALL: You know when I said 10 credits in my comments because the last 2 were relatively small. The largest of those from a provision standpoint was $400,000 and the 12 in total ended up to $1,716,000, but if you take out the smallest 2, it still rounds to $1.7 Million.

EILEEN ROONEY: Okay, but what would the amount of those loans be? I am just trying to get a sense of how much you have written them down?

WILLIAM J. SMALL: Old Granite is a land development and actually was a combination of three different credits is approximately $3.4 Million. That is the largest.

EILEEN ROONEY: Okay and then jumping over to the expenses, I was just wondering if this is a good run rate for the comp and benefit line?

WILLIAM J. SMALL: It is probably a little low because we reversed some senior management executives, or senior management incentive compensation that we accrue each quarter in anticipation of those payouts being significantly lower given the year-to-date results. That was probably $200,000 adjustment that we made. In our expense under our ESOP Plan is those shares have been fully released now for allocation and so that expense is we have reversed a little bit that we over accrued and that was maybe another $100,000, so I think you add that amount back in and you are probably fairly close to the run rate.

EILEEN ROONEY: Okay that's great. Thanks guys!

JOHN W. WAHL

& WILLIAM J. SMALL: Thank you!

OPERATOR: The next question we have comes from Michael Lipman of FTN Midwest Securities.

MICHAEL LIPMAN: Good morning Bill and Jack! (Greeting returned.) I kind of have just a general question for you on credit. How is your feel for the peak of NPAs? I know we have a lot of talk on these different calls about you know being a late 2008 event early in 2009. From your standpoint, what do you kind of think?

JOHN C. WAHL: I would like to sit here and say that I am pretty confident that we are at the peak and again, we've tried to stay on top of this as much as possible and it is such a good environment out there right now. As we sit here today, Mike, I don't see anything that I think is going to jump up and surprise us, but one of the credits just kind of self-destructed on us in less than a three-month period that we had this quarter. So at this point, I am hoping that we are at least by the end of this year; we are going to be through the worst part of this and start seeing improvement after that.

MICHAEL LIPMAN: What… A little further, what part of the loan portfolio kind of constraints you the most at this point?

WILLIAM J. SMALL: I don't know because we really try to watch our concentrations. Obviously, you know fortunately we are not a big, big player in development loans, construction land development loans and we've actually been able to, because of our kind of our foresight I guess for the lack of a better description of it, been able to bring those balances down as we again monitor those levels on an ongoing basis and try to be cognizant certainly of what is going on out there in our environment. The trucking industry you know with fuel costs where they are, we certainly are keeping a very close eye on that. We have several nice size relationships with very… I think very solid organizations in the transportation industry right now so it isn't anything that we are losing sleep over. I think it is just kind of a general keep an eye on everything out there right now.

MICHAEL LIPMAN: But you are still comfortable with a HELOC portfolio this far?

JOHN C. WAHL: Yeah we really are. We've got our over 90's in HELOCs, are just over $400,000 portfolio that is in excess of $100.0 Million. So that is an area that is again we've been over the years, we've been taking a fairly conservative approach to our HELOC lending.

MICHAEL LIPMAN: Gotcha and I guess switching gears, but on these securities impairment, how do you feel about your securities book going forward? Do you think there are any notable risks for further impairment?

JOHN C. WAHL: Yeah there is a little bit, Mike. The specific trust preferred securities that I mentioned you know if there are further bank failures of loans issued into those pools, there is probably another $300,000 of exposure there and we bought last fall when Fannie and Freddie issued their new preferred shares, we bought a Million dollars of each of those and the value of those fall in some sense the end of the quarter, they were actually pretty much in line what we paid for them at quarter end and they have dropped probably 40% since then, so it remains to be seen what will happen with those values between now and the end of the Third quarter.

MICHAEL LIPMAN: Gotcha, okay and I guess on the margin side, how many basis points did Pavilion contribute in the quarter? I don't know if you have that handy per chance.

WILLIAM J. SMALL: I really don't. Once we combine the companies, they kind of lose their separate identities in terms of doing that kind of analysis. (Cross Talk) Certainly had a very positive impact for us.

MICHAEL LIPMAN: Okay and you expect a little bit of margin compression going forward. Can you quantify that at all, or I mean is it just basically all based on the CD pricing going forward?

JOHN C. WAHL: It is based on CD pricing and a continued strong loan growth that is requiring us to maybe use a little more CD funding than what we've had to use to this point of the year, so you know it is probably a few basis points, but I can't really quantify beyond that.

MICHAEL LIPMAN: Gotcha, what would… What would happen to the NIM if we kind of had a rate increases through the end of the year? Before the end of the year?

JOHN C. WAHL: Our simulation shows that if we have like a 100 basis point increase in rates over a 12-month period, that we've got about a Million dollar increase in our net-interest income in that environment.

MICHAEL LIPMAN: Gotcha, okay and lastly, are there any Pavilion related merger costs left on the books or pretty much done with that at this point?

JOHN C. WAHL: Pretty much done. Might be a few small ones that still find their way in there but we are pretty close to being closed on that.

MICHAEL LIPMAN: Great. Thank you Bill and Jack!

WILLIAM J. SMALL & JOHN C. WAHL: Okay thank you very much.

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

CAROL MERRY: All right if there are no other questions, we thank you for having joined us today and this will complete our call.

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

######