FIRST DEFIANCE FINANCIAL CORP.
"2011 First Quarter Earnings Conference Call"

April 26, 2011, 11:00 AM ET
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OPERATOR: Good morning, and welcome to the First Defiance Financial Corp. 2011 first quarter earnings conference call and webcast. 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 a 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 Ms. Mary Beth Weisenburger, Senior Vice President. Please go ahead, ma'am.

MARY BETH WEISENBURGER: Thank you. Good morning, everyone, and thank you for joining us for today's first quarter 2011 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 Bill Small, Chairman, President and CEO of First Defiance, and Don Hileman, Executive Vice President and Chief Financial Officer. Following their prepared comments on the company's strategy and performance, they will be available to take your questions.

Before we begin, I'd like to remind you that during the conference call today, including during the question-and-answer period, you may hear forward-looking statements related to future financial results and business operations for First Defiance Financial Corp. Actual results may differ materially from current management forecasts and projections as a result of factors over which the company has no control. Information on these risk factors and additional information on forward-looking statements are included in the news release and in the company's reports on file with the Securities and Exchange Commission.

And now I'll turn the call over to Mr. Small for his comments.

WILLIAM SMALL: Thank you, Mary Beth. Good morning, and thank you for joining us for the First Defiance Financial Corp conference call to review the 2011 first quarter. Last night we issued our earnings release reporting the first quarter of 2011 results, and this morning we would like to discuss that release and look forward into the balance of 2011. At the conclusion of our presentation, 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 first quarter is CFO Don Hileman. Also with us this morning to answer questions is Jim Rohrs, President and CEO of First Federal Bank.

First quarter 2011 net income on a GAAP basis was $2.7 million, or 25 cents per diluted common share. This compares to net income of $1.5 million and 12 cents per diluted common share in the 2010 first quarter. The 2011 first quarter earning results are an encouraging start to the year. These improved results are a direct reflection of better asset quality performance during the quarter and the bank's ability to maintain its net interest margin. The primary driver on asset quality was a significantly lower provision expense in the first quarter of 2011 compared to last year's first quarter. This helped to offset reduction in non-interest income and an increase in non-interest expense.

Credit quality has been the most significant factor impacting earnings over the past couple of years, and while we are still seeing a degree of stress on certain credits, overall we saw marked improvement in the majority of the loan portfolio. Reduction in classified loans and other real estate owned, along with stabilizing values, contributed to the lower provision. The stabilization of property values resulted in fewer and less severe write-downs of previously identified problem assets.

We are also encouraged by the reduction in non-performing assets for the second consecutive quarter, lower delinquencies, and a reduction in troubled debt restructured. Net charge-offs were also a factor in the improved earnings, as they were down compared to both the linked quarter and the first quarter of 2010. We anticipate the level of charge-offs will be choppy over the next several quarters as more of the problem assets work through the system; however, we are confident we have adequately reserved for these assets.

Loan balances dropped again during the first three months of 2011 in virtually all loan categories. Both normal amortization and pay-downs on lines of credit contributed to the reduction, as loan demand remained soft through most of the quarter. We did start to see a pickup in borrowing requests in the latter part of the quarter, and several significant commitments on the commercial side are waiting to be closed and funded.

Residential mortgage funding is well off the pace of the last half of 2010 but is at more normal historic levels. One positive on the residential side is we are seeing a significantly higher percentage of purchases rather than the refinancing loans that were more prevalent in 2010.

Even with the drop in loan balances, net interest income for the quarter was up slightly over the first quarter 2010 results. Net interest margin was also up 4 basis points over the first quarter of 2010 and flat with the linked quarter. Pricing discipline on both loans and deposits, along with the change in the deposit mix, were positive contributors to the margin performance.

Non-interest-bearing deposit average balances were up 20 percent compared to March 31, 2010. Non-interest income was down in the first quarter of 2011 as lower mortgage income and a reduced fee income caused by recent regulatory changes and changes in consumers' management of their checking accounts were not offset by increases in insurance and wealth management revenue.

The increase in insurance revenue over first quarter 2010 was positively impacted by increases in contingent revenue as well as the increased production resulting from the May 2010 acquisition of the group benefits business from a local agency.

Non-interest expense was basically flat with the linked quarter but up compared to first quarter 2010. The primary difference year over year was in compensated-related categories.

I will now ask Don Hileman 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 2011. Don?

DON HILEMAN: Thank you, Bill, and good morning, everyone. The first quarter saw stronger profitability and progress in improving asset quality metrics as well as higher net interest income. Net income was $2.7 million, or 25 cents per share, compared with $1.5 million, or 12 cents per share, in the first quarter of 2010. The improvement in profitability was driven by an improvement in credit quality and corresponding impact on the provision for loan losses.

Credit-related expenses still remain significant, with a total of $1.4 million in the first quarter of 2011 compared with $1.3 million in the first quarter of 2010 and on a linked-quarter basis. Our markets are persistently showing the effects of the difficult economic environment.

We are pleased with the trend of reducing unemployment rates in our market area but meaningful economic growth is slow in developing. We are encouraged with the overall trend that is indicating improved economic activity; however, it will be irregular and take time to solidly develop, with an extended ramp-up period well into 2011.

We are pleased with the first quarter results and see opportunities to improve further. I will begin with a discussion of credit quality. Our provision expense totaled $2.8 million down from $6.9 million a year ago and down from $5.7 [million] on a linked-quarter basis. Our allowance for loan loss increased to $40.8 million from $39 million at March 31, 2010. The allowance percentage increased to 2.77 percent from 2.47 percent a year ago. The change in the percentage is driven primarily by the lower average loan outstandings.

The overall reserve remained basically flat on a linked-quarter basis. The first quarter provision was $282,000 less than charge-offs for the quarter. The overall reserve level is consistent with our anticipation of higher near-term charge-offs as we continue to work through problem credits. Annualized net charge-offs were 85 basis points for the first quarter of 2011 compared with 114 basis points in the first quarter of 2010 and 158 basis points in the fourth quarter of 2010. Of the total charge-offs, 68 percent related to commercial real estate loans, 16 percent residential, 6 percent home equity and consumer, and 10 percent commercial loans. Of the total commercial real estate charge-offs, 68 percent, or $1.6 million, was due to two credit relationships.

As we see improvements into our asset quality trends as well as in the economy, we will be more confident that asset quality trends have turned the corner towards steady improvement.

Our OREO balance declined on a linked-quarter basis and ended the first quarter at $9.2 million. The OREO balance is made up of $7.2 million of commercial real estate and $1.9 million of residential real estate. We also had additions of $1.8 million in the first quarter of 2011, offset by sales of $1.6 million and valuation adjustments of $573,000. We continue to be active in seeking potential buyers of these properties and are encouraged with the recent activity. We have more buyers of OREO properties and we expect to see some stabilization of values in the near term.

At March 31, our allowance for loan loss was represented at 2.77 percent of total loans outstanding, up form 2.7 on a linked-quarter basis and represents 89.53 percent of our non-performing loans. The allowance for non-performing assets was 74.56 percent at March 31, 2011, up from — slightly from 73.05 at March 31, 2010.

Non-performing assets ended the quarter at $54.7 million, or 2.65 percent of assets, down from 2.78 percent total assets on a linked-quarter basis and up slightly from $53.4 million, or 2.59 percent of total assets at March 31, 2010.

Total non-performing loans decreased to $45.6 million from $47 million on a linked-quarter basis and were up from $40.6 million in the first quarter of 2010. Restructured loans decreased $1.4 million from last quarter. Restructured loans are considered non-performing because of the changes in original terms granted to borrowers. It is important to note that these loans are still accruing.

Total classified loans increased $5.2 million to $131.9 million at March 31, 2011, from $126.7 million at March 31, 2010, and decreased $1.2 million from $133.1 million at December 31, 2010. We are encouraged with the near-term trend and continue to expect improvements in our overall risk profile throughout 2011.

Total delinquency rate was 3.2 percent at March 31, 2011, down from 3.36 percent on March 31, 2010, and down from 3.4 percent on a linked-quarter basis. The delinquency rate for loans 90 days past due or on non-accrual increased to 2.76 percent this quarter up from 2.68 percent in the fourth quarter of 2010 and up from 2.1 percent at March 31, 2010. We are not satisfied with the overall levels of 90-day delinquencies; however, of the total non-accrual loans of $41million, $12.4 million, or 30 percent, are under 90 days past due. We are very pleased with the improvement in the 30-to-89-day level of delinquencies. The 30-to-89 days past due decreased 67 percent from $20 million a year ago to $6.6 million in the first quarter of 2011 and decreased on a linked-quarter basis from $11.1 million in the fourth quarter of 2010. This improvement helps to signal improved credit quality trends as we work through the current problem credits.

Mortgage banking was down in the first quarter, impacted by rising rates and seasonal patterns. We have seen a tapering off of applications over the last several months. Overall, mortgage banking income in the quarter was $1.3 million compared to $1.8 million in the first quarter of 2010 and $2.7 million on a linked-quarter basis.

We had a gain on sale income of $726,000 in the first quarter of 2011 compared with $1.2 million in the first quarter of 2010 and $1.8 million in the fourth quarter of 2010. We also reported a positive valuation adjustment to mortgage servicing rights of $171,000 in the first quarter of 2011 compared with positive valuation adjustments of $321,000 in the first quarter of 2010 and positive valuation adjustments of $1.1 million on a linked-quarter basis. The positive valuation adjustment in the first quarter reflects the steady change in the level of market interest rates over the last several quarters that affect the assumed prepayment speed of the underlying collateral.

At March 31, 2011, First Defiance had $1.3 billion of loans serviced for others. The mortgage servicing rights associated with those loans had a fair value of $9.6 million, or 76 basis points of the outstanding loan balance serviced. Total impaired reserves, which are available for recapture in future periods totaled $953,000 at quarter end. In the first quarter, we reported charges of $2,000 for other temporary impairment compared with the first quarter of 2010 charge of $70,000. This fact reflects a more stable economic environment as it relates to our investments and trust-preferred collateralized debt obligations. Management believes the probability is low that we will have any significant OTTI charges in the future. The stability of the marketplace and the continuing analysis of the current portfolio assist us in making this conclusion.

Turning to the other operating results, our net interest income was $17.2 million for the quarter compared to $17.1 for the first quarter of 2010 and $17.8 million on a linked-quarter basis. For the quarter, our margin was 3.89 percent, which was a 4 basis point increase from the first quarter of 2010 and flat on a linked-quarter basis. We've been successful in lowering our cost of funds to offset the decline in asset yields. We have seen more aggressive competitive pricing pressure and the downward repricing of variable rate loans based on the current yield curve.

The continued high level of liquidity has also impacted the margin, as we have seen an increase in overnight deposits which were $207 million at the end of the quarter. This will likely increase the securities portfolio in order to deploy lower yielding overnight deposits into securities on a short to intermediate term and of the yield curve. We will continue to use this strategy over the next quarter until loan demand picks up. We have been staying in the four- to five-year weighted average life range. Even with the give-up in yield associated with the high liquidity level, we believe our liquidity position continues to be important and gives us added flexibility in the overall liability pricing. We're placing strong emphasis on non-interest-bearing deposit accounts as some of the balances grow this quarter. Non-interest-bearing deposits represent 14 percent of total deposits.

We are focusing on pricing opportunities to maintain and expand the margin. We are particularly focused on asset pricing discipline and the challenges of maintaining asset yields. Our cost of funds declined 10 basis points on a linked-quarter basis, with the yield on assets declining 10 basis points as well.

Non-interest income was $5.9 million for the first quarter down from $6.8 million in the first quarter of 2010. The income declined to $2.6 million in the first quarter of 2011 from $2.9 million on a linked-quarter basis and from $3.2 million in the first quarter of 2010. The decline in fee income is directly attributable to the downward trend in net NSF fee income as a result of new regulations. Net NSF fee income was $1.2 million for the first quarter of 2011 compared with $1.6 million for the fourth quarter of 2010 and $1.8 million in the first quarter of 2010.

Insurance revenue was $1.7 million in the first quarter of 2011, up from $1.3 million on a linked-quarter basis and up from $1.3 million in the first quarter of 2010. The year-over-year insurance revenue increase is driven by an increase in contingent income in 2011 to $329,000 from $91,000 in the first quarter of 2010 and the acquisition of a group benefits business line in the second quarter of 2010. This acquisition added approximately $207,000 in quarterly revenue.

Non-interest income also included loss on the sale of OREO of $311,000 in the first quarter of 2011. Overall, non-interest expense increased to $16.6 million this quarter compared to $14.4 million in the first quarter of 2010 and was basically flat on a linked-quarter basis.

The first quarter compensation and benefits expenses increased to $7.8 million from $7.2 million on a linked-quarter basis and from $6.5 million in the first quarter of 2010. The increases in compensation and benefit expense over the first quarter of 2011 — or over 2010 was due to the company freezing pay in 2010, coupled with no bonus accrual in the first quarter of 2010 based on the company not meeting certain performance targets. The company also had the additional compensation costs of about $100,000 in the first quarter of 2011 associated with the May 2010 acquisition of the group benefits business line.

Healthcare costs also increased $180,000 over the first quarter of 2010. Our total FTE level was consistently around 500 throughout the year. We believe we are close to the optimal staffing level necessary to maintain our quality customer service culture our customers desire and expect from First Defiance.

FDIC insurance expense decreased $132,000 in the first quarter of 2011 compared to the first quarter of 2010. Our non-interest expense increased to $4.1 million in the first quarter of — from $3.3 million in the first quarter of 2010 and declined from $4.4 million on a linked-quarter basis. Increases in expenses over the prior year were primarily due to secondary market buy-back losses of $228,000 and auditing examination services of $168,000.

On a linked quarter, other non-interest expense declined $308,000 primarily due to approximately $800,000 of core conversion [unintelligible] expenses in the fourth quarter of 2010 and a decrease in real estate-owned expenses of $54,000. These decreases were offset by the aforementioned secondary market buy-back losses and additional non-run rate charges of $248,000 in the first quarter of 2011.

The following is a three-quarter trend of certain significant expenses. Real estate owned expenses were $718,000 in the first quarter of 2011 compared to $772,000 in the first — in the fourth quarter of 2010 and $798,000 in the first quarter of 2010. Credit and collection expenses were $193,000 in the first quarter of 2011 compared to $162,000 in the fourth quarter of 2010 and $349,000 in the first quarter of 2010. Secondary market buy-back losses were $228,000 in the first quarter of 2011 compared to no losses in the fourth and first quarters of 2010.

We saw the balance sheet remain relatively flat from the first quarter of 2010 with total assets of $2.06 billion at March 31, 2011. On the asset side, cash and equivalents grew $81 million over the year to $235 million at March 31, 2011. Securities grew $32 million over the year to $180 million. Gross loan balances declined $105 million year over year and declined $48 million on a linked-quarter basis.

Loan activity in general continues to be weak, but we are seeing some signs of an increasing commercial loan pipeline. We continue to be prudent on our new loan activities. We have been very disciplined in our underwriting and have not focused on growth at the expense of taking on greater credit risk or lower rates to increase loan volume. We've been intent on making sure our service levels have not suffered as a result of increased loan — increased levels of loan workouts. We have been able to develop strong new relationships with good commercial clients.

Total deposits declined $8 million from March of 2010 but increased $17 million on a linked-quarter basis. We are pleased with the mix of deposits as we have seen a growth in non-interest bearing accounts. Non-interest-bearing deposits increased $219 million at March 31 up from $187 million at March 31, 2010. We continue to focus on growth in non-interest-bearing balances in correlation with our overall strategy and efforts to reduce our costs of funds in this interest rate environment.

As mentioned previously, we completed a common stock offering in March of this year and increased shareholders' equity by $20 million. Total shareholders' equity at March 31, 2011 was $263 million up from $236 million at March 31, 2010. Our capital position remains strong with shareholders' equity to assets improving to 12.76 percent at March 31, 2011 from 11.45 percent at March 31, 2010. The bank's risk-based capital ratio is strong at approximately 14.8 percent. We believe we are on target to repay our CPP investment in the latter part of 2013 without additional equity offering. The board continually assesses our involvement in this program. We recently applied to the Small Business Lending Fund in order to give us a possible alternative of refinancing our CPP investment. At the present time, we have not made a final determination as to our course of action.

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

WILLIAM SMALL: Thank you, Don. As we progress through 2011, we are aware that there are still challenges to a sustained economic recovery. Our three primary focuses remain asset quality, expense control, and core deposit growth. We have made significant strides is all three of these areas in recent quarters, and we must continue with this effort to meet the challenges and return to higher levels of profitability. We are hoping that recent indications of stronger loan demand continue to build and reverse the recent trend of declining balances.

The overall economic climate throughout our market area shows indications of strengthening. Commercial clients were showing improving cash flows and stronger balance sheets as 2010 wound down, and we are seeing these validated in year-end audited statements. Many are also reporting significant pickup in work orders and in some cases, new hiring. Most of our commercial clients are keeping a cautious eye on oil prices and the impact this is having on fuel, fertilizer, and other petroleum-based products.

We look for overall loan demand to slowly pick up as the economy improves. As stated previously, we already saw indications of this uptick late in the first quarter, and we anticipate this will continue. Pricing on both loans and deposits will be critical in maintaining our margin, especially as the Fed continues to work at keeping interest rates down.

Unemployment continues to run slightly above the national rate throughout our market area, and this may continue to stress some of our customers; however, we are pleased to see some improvement in the employment data and the additional consumer confidence that this seems to bring with it.

Don mentioned our common stock offering completed at the end of the first quarter with gross proceeds of slightly over $21 million. This additional capital creates liquidity at the holding company and an independent source of capital that will give us more future flexibility without needing to upstream capital from the bank.

We are keeping a cautious eye on the regulatory and legislative scene as regulators are now working on developing the regulations that will implement the Dodd-Frank Act. There are still many unanswered questions regarding this legislation, and our industry is working hard to help shape the final regulations to have the least damaging effects to banks and their customers.

Our mission is to be a community bank that provides a complete line of financial services with a relationship-oriented approach on a profitable basis. The staff we have throughout this organization understands the importance of relationship banking and the importance of delivering on that mission. I thank them for their diligence and loyalty, and I thank you for joining us this morning on the call. And now we would be happy to take your questions.

OPERATOR: Thank you. 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. If at any time your question has been answered and you would like to withdraw your question, please press star, then 2. At this time, we will pause momentarily to assemble our roster.

Our first question comes from John Barber of KBW.

JOHN BARBER: Hi, good morning, everyone.

MALE SPEAKER: Hi, John.

MALE SPEAKER: Good morning, John.

JOHN BARBER: Good morning. I think you said classified loans were down $1.2 million linked quarter. I was just hoping you could talk about any trends you're seeing and your expectations going forward for classified loans. Thanks.

MALE SPEAKER: I'll let Jim Rohrs, our President of the bank, answer on that, John.

JIM ROHRS: Well, we project the three quarters out through the end of the year, what credits we think will come off of our classified list, and we've got about $20 million that we think could come off by the end of the current quarter. Now, that's going to be offset somewhat by the potential for other credits to potentially be downgraded back into the classified, but we're hopeful to have probably somewhere around a $12 [million] to $15 million reduction in classifieds in the next quarter and then that trend hopefully continuing for the balance of the year, maybe not in such great numbers. We have a fairly large number coming off in the second quarter because of companies with calendar fiscal year ends where we get their CPA-prepared financial statements in the second quarter, and based on interim financials and preliminary year-end statements we already have, we have strong reason to believe that they'll be upgraded because of improving cash flow.

JOHN BARBER: Okay, that's good to hear. Thanks. My next question was related to the $228,000 rep and warranty charge you took this quarter. I was just wondering what triggered the repurchase.

DON HILEMAN: Agency requests. You know, they've been more aggressive in looking at issues and forcing buy-backs, and we had it in previous quarters, just not on a comparative, but there was a little bit more demand from them to repay.

JOHN BARBER: Okay. And —

MALE SPEAKER: I don't think there's any particular pattern in the issues, but that was the total, John.

MALE SPEAKER: That's something, I think, John, that you'll see that many in the industry are facing as particularly Fannie Mae and Freddie Mac are reviewing these loans very, very closely, and many of — many banks have faced this issue, and as Don said, we've had it in some of our other quarters, just not in the linked quarter or the first quarter of 2010.

JOHN BARBER: Okay, thanks. And can you talk about the upcoming change in regulators, if you expect there will be any changes to how you guys run your business on a day-to-day level and then on any actions you've taken to kind of help with that transition? Thanks.

MALE SPEAKER: Yeah, we've been in contact. The OCC will become our primary regulator at the bank, and the Federal Reserve will be our primary regulator at the holding company as the OTS is phased out as of July 21. We have been in contact with both those agencies. In fact, OCC, the deputy comptroller out of the Chicago region who heads up the Chicago region and his assistant deputy comptroller that works out of the Cleveland office, which will be the office that will primarily be responsible for our examination, both of those are coming for an onsite visit at our invitation. They're going to be here next Monday so that they get a chance to meet our management team. Don and I both have been to OCC outreach meetings that the Fed has also attended. I don't see any significant change in our approach to our business plan as a result of that. You know, we're feeling that, you know, our business plan, the way it's structured right now at the bank has been very much a commercial bank strategy for a number of years and a strategy that obviously the OCC is very familiar with. And at the holding company level, obviously, you know, we'll be entering a new era there with the Fed regulation, but I think in part the liquidity and the independent capital at the parent that was created through the recent stock offering I think puts us in good shape there, and so there's — you know, obviously you're always a little bit anxious when there's a change, but I think we're properly prepared for it.

JOHN BARBER: That's all I had. Thank you very much.

MALE SPEAKER: Thank you.

OPERATOR: As a reminder, if you'd like to ask a question, please press star, then 1 on your touchtone telephone.

As a final reminder, if you would like to ask a question, please press star, then 1.

Our next question comes from — and I apologize for the pronunciation — Don Burgess from Burgess Capital. Please go ahead.

DON BURGESS: Yes, could you comment on dividend policy going forward and how you're thinking about that?

MALE SPEAKER: As I'm sure most of our listeners are aware, we have — we had suspended our dividend in the fourth quarter of 2009. We continue to assess it on a quarter-by-quarter basis. As we've, you know, gone through the economic cycle that we've been in, we've just felt that it was prudent to preserve as much capital, especially at the bank, as possible. We do continue to assess it. We certainly are encouraged by the improvement in the — that we're starting to see in the economy, and our board will continue to evaluate, you know, bases on current economic conditions and economic forecasts and regulatory environment and make decisions based on that. Obviously, we're hoping to get back to paying a dividend sometime in the not-too-distant future.

DON BURGESS: Thank you.

MALE SPEAKER: You're welcome. Thank you.

OPERATOR: As a final reminder, if you'd like to ask a question, please press star, then 1.

I'm showing no further questions at this time, so we're going to conclude our question-and-answer session. I would like to turn the conference back over to Mary Beth Weisenburger for any closing remarks.

MARY BETH WEISENBURGER: We'd just like to thank everyone for their participation today, and this concludes our call. Thank you.

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