FIRST DEFIANCE
"Second Quarter 2014 Earnings Conference Call"

July 22, 2014 at 11:00 a.m. Eastern
Tera Murphy
Don Hileman
Kevin Thompson
Jim Rohrs

OPERATOR: Good morning and welcome to the First Defiance Second Quarter Earnings Conference Call. All participants will be in listen-only mode. After today's presentation there will be an opportunity to ask questions. To ask a question, you may press star then one on your telephone keypad. To withdraw your question you may press star then two. If at any time you need operator assistance, please press star then zero. Please note this event is being recorded.

I would now like to turn the conference over to 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 2014 Second 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 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 and forward-looking statements are included in the news release and in the company's reports on file with the Securities and Exchange Commission.

Now I'll turn the call over to Mr. Hileman for his comments.

DON HILEMAN: Good morning and welcome to the First Defiance Financial Corp Second Quarter 2014 Conference Call. Last night, we issued our 2014 second quarter earnings release and would now like to discuss that release and give you our outlook for the remainder of 2014. At the conclusion of our remarks we will answer any questions you may have.

Joining me on the call this morning to discuss the details of the financial performance for the second quarter is Kevin Thompson, CFO. Also joining us to answer questions is Jim Rohrs, President and CEO of First Federal Bank.

In our second quarter earnings release we announced net income on a GAAP basis was $5.7 million, or $0.57 per diluted common share, compared to 6.1 million, or $0.60 per diluted common share in the second quarter of 2013. We are pleased with our overall solid results in the second quarter. We see signs of increased economic activity within our footprint and in some local communities, very strong economic growth. This has contributed to average earning assets growing 6.9% over the second quarter of ’13.

While lower mortgage banking revenues from a year ago continue to have impact, both our net interest income and non-interest income revenues are reflecting progress in our core business strategies over the last quarter. We are encouraged by the loan growth this quarter and look for added contribution from our Columbus, Ohio, loan production office in the second half of the year. We expect the interest rate environment to be relatively stable at current levels in the near term as more viable growth is built into the overall economy.

We are pleased with our strong net interest income growth this quarter over the second quarter of last year. Driving factors were primarily growth in loans and the overall balance sheet.

The competitive loan rate environment continues to be very challenging as the industry focuses on growth. The credit quality metrics of our existing loan portfolio steadily improved as the year progressed.

Non-performing assets declined approximately $5 million, or 14% year-over-year. Non-performing loans decreased approximately $4 million, or 13% year-over-year to $24.9 million at quarter end.

Approximately 62% of the non-performing loans continue to make payments. Classified loans and non-accrual loans also showed progress in the second quarter of 2014, staying on a downward trend. Even with continuous declines in non-performing and classified asset levels, we still see potential for improvement as we work with our customers.

In addition, the deposit side of the balance sheet continued to show strong growth over last year. Non-interest bearing and interest bearing demand accounts have been the primary growth areas, with more movement in the interest bearing accounts this quarter. This is due in part to a lower interest rate environment leaving many people in businesses to park funds in non-term accounts rather than tying up funds for an extended period of time.

On a linked quarter basis we were able to increase our margin to 3.62%.

Non-interest income, excluding securities gains in the second quarter of 2014, was up over the linked quarter adjusting for contingency income – contingent insurance income received in the first quarter of 2014. We believe that several of the strategic initiatives we put into place in the first half of the year are starting to show results.

Nevertheless, the decline in mortgage banking income continued to be the most significant driver of the prior year comparison. Mortgage loan production in the second quarter of 2014 declined 55% from the second quarter of ’13, while increased income from our insurance and wealth management areas helped to mitigate this negative impact for the second quarter.

Total non-interest expense increased $633,000 for the second quarter of ’13, a decrease on a linked quarter basis due to the impact of the merger termination agreement in the first quarter.

In general, our expense trend is consistent with our long-term goals.

Regarding our capital management plans, we continue our stock buyback in the second quarter, repurchasing 168,000 shares and through June repurchasing a total of 318,000 of the 489,000 shares authorized.

We are also pleased to announce a second quarter dividend of $0.15 per share, representing an annual dividend yield of approximately 2.2%. Our continued strong performance in capital will support this utilization of capital.

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

KEVIN THOMPSON: Thank you, Don, and good morning, everyone. As Don indicated, all-in earnings for the second quarter were $5.7 million, or $0.57 per diluted share, which included securities gains of $306,000 after tax, or $0.03 per diluted share. This compares to record results of $6.1 million, or $0.60, in the second quarter of 2013, which included securities gains of only $28,000 after tax.

We were quite pleased with most aspects of our total performance in the second quarter and despite the lower level of mortgage banking revenues this year versus last, we had another solid quarter. Other than in mortgage banking, we generated year-over-year expansion and net interest income and overall non-interest income. Operating expenses are in line, supporting our growth strategies and credit quality continues to improve.

Turning to the details and starting with the income statement, our net interest income was $17.1 million for the second quarter of 2014, up slightly from $16.8 million in the linked quarter, which had one less accrual day and up $211,000 from the $16.9 million in the second quarter last year.

For the second quarter of 2014, our margin was 3.62%, up one basis point from last quarter but down from 3.82% in the second quarter last year. A majority of the decrease versus the prior year was a result of the strong deposit growth that exceeded loan growth in the second half of last year. This led to increased liquidity and overall lower yield on earning assets and a lower margin.

After a slow start to the year our earning asset mix showed signs of improvement as we moved through the second quarter. Our yield on earning assets still down 26 basis points from the second quarter last year, but was flat on a linked quarter basis.

Our cost of interest-bearing liabilities was down seven basis points from a year ago and was down two basis points on a linked quarter basis.

Our total new loans originated in the second quarter were put on at a weighted average of 4.51% compared to 4.57% in the first quarter of 2014, and enabled our loan portfolio yield in the second quarter of 2014 to remain at 4.37%, level on a linked quarter basis.

As our earning asset mix continues to improve through additional growth in loans and investments going forward, we expect our margin to improve accordingly. Total non-interest income was $7.6 million in the second quarter of 2014, up from $7.3 million on a linked quarter basis and down from $7.9 million in the second quarter of 2013. The decline from the second quarter last year was primarily due to lower mortgage banking revenues.

The second quarter last year was still quite favorable for mortgage volumes, with strong refinance activity. Higher rates in 2014 versus the prior year led to significantly lower volumes, primarily in refinance activity. Mortgage banking originations were $51.6 million in the second quarter of 2014, up from $28.6 million on a linked quarter basis, but down from $113.6 million in the second quarter of 2013, which included nearly $72 million in refinances.

Overall, mortgage banking income for the second quarter of 2014 was $1.5 million compared to $1.2 million on a linked quarter basis and $2.4 million in the second quarter of 2013.

Gain on sale income grew to $986,000 in the second quarter of 2014 compared to $641,000 on a linked quarter basis, but down from $1.9 million in the second quarter last year.

In addition, the second quarter included only a small positive adjustment to the valuation of mortgage servicing rights, up $44,000. This was up from the linked quarter, which included a negative valuation adjustment of $7,000, while the second quarter of 2013 adjustment was a positive $312,000.

At June 30, 2014, First Defiance had $1.4 billion in loans serviced for others. The mortgage servicing rights associated with those loans had a fair value of $9 million, or 71 basis points of the outstanding loan balances serviced.

Total impairment reserves, which are available for recapture in future periods, totaled $1 million at quarter end.

Partially offsetting the mortgage banking decline were the securities gains of $471,000 during the quarter. The second quarter of 2013 included only $43,000 of securities gains.

Service fee income was $2.5 million in the second quarter of 2014, an increase from $2.3 million in the linked quarter and nearly even with the $2.5 million in the second quarter of 2013.

Insurance revenue was over $2.2 million in the second quarter of 2014, down from $3 million in the linked first quarter, which included nearly $900,000 of contingent insurance commissions received on an annual basis, and was down only $33,000 from the second quarter of 2013.

Also, our trust income, while a smaller revenue component, continues to show significant growth from a year ago, totaling $302,000 in the second quarter, up 27% from $238,000 in the second quarter last year.

As for non-interest expense, second quarter expenses totaled $16.4 million, down from $16.7 million in the linked quarter, which included a $786,000 one-time merger termination charge, but up when compared to $15.7 million for the second quarter of 2013.

Compensation and benefits expense in the second quarter was up $234,000 from last year, primarily due to merit increases and higher health plan costs which were partially offset by lower incentives.

Regarding provision expense, the second quarter of 2014 totaled $446,000, up from $103,000 last quarter and basically even with the $448,000 in the second quarter last year.

Net charge-offs were 16 basis points of average loans for the second quarter of 2014, compared with seven basis points last quarter and 17 basis points in the second quarter a year ago.

Our allowance for loan loss at June 30, 2014, was $24.6 million, or 1.56% of total loans versus $26.3 million, or 1.68% at June 30, 2013. The change reflects the credit quality improvements achieved during the past year such that the allowance coverage of non-performing loans has increased to 99.1% at June 30, 2014, up from 91.7% at June 30, 2013. We expect the reserve, the loans percentage, to continue tracking toward 1.5% as asset quality continues to improve.

As for the asset quality numbers, we did see a decrease in the non-performing loans in the second quarter of 2014 to $24.9 million, down from $26.8 million on a linked quarter basis and down from $28.7 million at June 30, 2013. Our OREO balance also decreased on a linked quarter basis to $5.6 million from $6 million and was down from $6.5 million a year ago. Overall, non-performing assets ended the quarter at $30.4 million, or 1.41% of total assets, down from 1.70% of total assets at June 30, 2013.

Total classified loans also declined to $47.6 million at June 30, 2014, compared with $51.3 million on a linked quarter basis and well below the $58.4 million at June 30, 2013.

Moving to the balance sheet, total assets were $2.15 billion at June 30, 2014, down $12.2 million from last quarter and up $85.3 million from last year.

Cash and equivalents, including the higher liquidity mentioned earlier, increased to $156.2 million from $127.7 million at June 30, 2013.

Securities increased $44.1 million from a year ago to $232.6 million.

Gross loan balances increased $19.3 million, or 1.2%, year-over-year. This past quarter, however, loans increased $18 million, or about 4.6% annualized, following a similar but lesser seasonal pattern as last year's second quarter. We continue to be positive regarding our growth outlook ahead.

Total deposits increased $106.1 million from a year ago, but down $18.8 million on a linked quarter basis. Non-interest bearing deposits have increased to $355.3 million at June 30, 2014, from $301.7 million at June 30, 2013. We continue to be pleased with our ability to generate and maintain a strong low-cost core deposit base and we keep our loan growth as our top priority.

Looking at our capital position, total period end stockholder's equity finished June 30, 2014, at $276.4 million, up from $264.5 million at June 30, 2013. Our capital position remains strong with average period end shareholder's equity to assets up 12.77% at June 30, 2014, compared to 13.01% at June 30, 2013. The bank's total risk-based capital ratio is strong at approximately 14.9%.

Regarding our stock repurchase program, we repurchased about 168,000 shares during the quarter, and through June 30th a total of 318,000 has been repurchased of the 489,000 shares authorized last September.

Finally, I'd like to conclude with some comments on our year-to-date results. For the first six months of 2014, net income was $10.9 million or $1.08 per diluted share versus $11.7 million, or $1.15 per diluted share for the same period in 2013. Looking at the $0.07 year-to-date decline for a moment, clearly there have been two key items impacting our results this year. Most significantly has been the decline in mortgage banking income, about $2.5 million pretax, or $1.6 million after tax, or about $0.15 per share year-to-date. The other item was the one-time merger charge in the first quarter which cost $0.05 per share. That's a total of $0.20 per share negative impacts, yet earnings per share are down only $0.07 per share.

We've been able to offset $0.13 per share so far this year, about $0.02 from net securities transactions and a penny from reduction in shares. The other $0.10 is from core earnings improvement. We believe those are indicators of strong underlying performance that we believe will become more evident as we go forward.

That completes my financial review, and now I'll turn the call back over to Don.

DON HILEMAN: Thank you, Kevin. I'm very pleased about the position of First Defiance and look for continued strong performance over the remainder of 2014. We are starting to see the results of our initiatives in non-interest income and expect that to continue in the second half of the year. Going forward, the combination of loan growth, improved asset quality, and expense control will play a role in improved financial performance.

As previously communicated, our three areas of internal focus at First Defiance are core balance sheet growth, revenue growth, and expense control. We do believe loan demand will continue improving in 2014 and should provide an opportunity to grow our portfolio. The size of our current pipeline is heartening and our lenders tell us activities and inquiries are strong.

The market remains very competitive, but we believe we can grow our business without making significant concessions in rate and other terms. As learned from the past several years, we know it is important to maintain our disciplined underwriting during this period and continue our unwillingness to compromise our standards to achieve this loan portfolio growth. While we are encouraged by the loan portfolio growth this quarter, we are focused on increasing our growth rate over the remainder of the year.

Our business banking initiative has kicked off and we did see marginal growth in this area for the second quarter. Our business bankers in each of our markets are focused entirely on this new opportunity and we expect continued growth in this portfolio throughout the remainder of the year.

Positive loan activity from our Columbus, Ohio, loan production office in the second quarter is expected to transition into closed loans in the third and fourth quarter, further contributing to our loan portfolio outlook.

Regarding our non-interest revenue initiatives, we have recently completed a thorough analysis of our retail and commercial products and fee schedules. This was last done several years ago. The analysis resulted in a new fee schedule and product designs based on relationships and fees for services used, which also includes enhancements to our alternative delivery channels, providing our customers with the convenient services they want and need, and at a lower cost.

I'm also pleased to announce our second Fort Wayne, Indiana; location will open on or about August 11th. Fort Wayne has been a very good market for us, so we look forward to expanding our presence and continued growth in the Fort Wayne market area.

Growth in our insurance and wealth management revenues is also an important component of non-interest income and results in new business sales this year have been very encouraging. We look to grow our insurance revenues primarily organically, but are also continuously looking for strategic acquisition opportunities.

We are very heartened by our recent performance and look to continue to drive initiatives we believe will help us to maintain our goal of being the consistently high performing community bank we strive to be every day. Our business plans have served us well over the years and we need to continually adapt to the changing operating environment. This is both from the regulatory and customer viewpoints. We remain confident in our strategy and the people we have working hard to execute our plans and looking at our new initiatives as enhancements to our overall strategy. We feel good about our performance for the first half of 2014 and look forward to the rest of the year.

Finally, I'm pleased to announce the appointment of Charles Niehaus to our board of directors. Chuck hails from the Toledo market and brings to the board significant experience in the legal and financial services areas. We look forward to his contributions.

We are committed to all of our customers and shareholders and appreciate the trust being placed in us as we work to make First Defiance a high performing community banking organization.

Thank you for your interest in First Defiance Financial Corp and thank you for joining us this morning. We will now be happy to take your questions.

OPERATOR: We will now begin the question and answer session. To ask a question, you may press star then one on your telephone keypad. If you're using a speakerphone, please pick up your handset before pressing the keys. To withdraw your question, please press star then two. Once again, pressing star then one will allow you to ask a question.

At this time, we will pause momentarily to assemble our roster.

Our first question comes today from Christopher Marniac of FIG Partners. Please go ahead.

CHRISTOPHER MARNIAC: Thanks. Good morning. Don, you mentioned a little bit of this at your closing remarks, just about the growth rate and I just want to make sure I was clear that you are seeking to grow that in the second half of this year. Also, I just want a little bit of color on terms of the mix of the loan portfolio as you grow. Will the mix be similar to what we saw this quarter or do you think you'll get it from different sources?

DON HILEMAN: Hello. Good morning, Chris. Yes, we are looking to increase the growth rate in the second half of the year. A lot of the initiatives that we put in place we think will actually relate to more closed loans, which will allow for a higher growth rate than we saw in the first half of the year. That's our goal. That's our expectation.

The mix I think will be, pretty consistent. We're not changing strategies dramatically from where we are. I think the one factor we probably won't be at the same pace is construction. We had a pretty good pickup on that. That'll probably—that growth rate will level out a little bit and we'll see more of CRE growth offsetting that to get that higher growth rate.

CHRISTOPHER MARNIAC: Okay, great. Then my follow-up just has to do with the agriculture business and sort of what you're seeing from your ag clients and just sort of, I guess, the outlook on that part of the business.

DON HILEMAN: I'll let Jim Rohrs answer that question.

JIM ROHRS: That's still a very attractive area for us for lending. I think the consensus is that the ag economy is going to probably soften from what it's been the last couple of years. We've been fairly cautious in terms of what we're loaning against farm real estate, so we've financed some of the expensive real estate but we've not loaned 80% of some of the prices that are being paid out there. So in that regard we've been cautious, but we think that's an area that we can continue to grow and grow profitably.

It's like any other business. If you pick the right customers, you're doing business with the winners, and so we have experienced ag lenders who know customers and know how to calculate cash flows for farmers. So we're—that's a part of our business I'd like to see us grow over the next couple of years, but I think it will be softening.

CHRISTOPHER MARNIAC: Great, Jim. Thanks very much for your color, guys.

DON HILEMAN: Thanks, Chris.

OPERATOR: Once again, if you have a question, please press star then one.

Our next question comes from Damen DelMonte of KBW.

DAMEN DELMONTE: Hello. Good morning, guys. How are you?

DON HILEMAN: Hello. Good morning, Damen.

DAMEN DELMONTE: My question, first question has to do with the outlook for the margin, and obviously a strong quarter this quarter with the reported number of $362 million. Can you talk a little bit about the dynamics behind the margin as you kind of look into the back half of the year? Do you think you're able to keep it steady? Do you think you might see a little additional pressure? What are some of the dynamics behind that?

KEVIN THOMPSON: Sure. This is Kevin, Damen. We're expecting to see the margin continue to move in a positive direction. We're not anticipating a lot of near-term changes to the interest rate environment. We think the continued expansion, as Don talked about, in our loan portfolio and we're also increasing our investment securities portfolio moderately as well, so as we move out of the fed funds overnight liquid assets into, higher yielding earning assets we're going to see, I think, a natural pickup in the margin the next couple of quarters.

DAMEN DELMONTE: Okay. How about on the funding side? Are there any more levers you could pull on the funding side to lower your cost of funds?

KEVIN THOMPSON: I don't think so. We continue, I think, to do pretty well from a cost standpoint there. Even though we did pick up a couple basis points this quarter, it's hard for me to imagine that that's going to be significant in terms of an opportunity going forward. If anything, we'll be looking probably to introduce some better structure given the outlook for rates in the future.

DAMEN DELMONTE: Okay. Then I guess a follow-up question on the loan growth. Has anything changed in your appetite for size of loans that you're adding to the portfolio?

DON HILEMAN: No. I think, we have an internal lending limit that's lower than our regulatory lending limit and we have not looked to grow. If anything, I think from our business banking initiative we think there's more opportunity for smaller loan growth through that channel.

DAMEN DELMONTE: Okay. So could you give us some idea as to what the sweet spot is, like say in the construction lending that we saw this quarter or in commercial real estate?

DON HILEMAN: I'd say our sweet spot's probably between $1.5 million and $5 million on the credit side. That seems to be a little bit more activity there. From the construction side, some of that was a larger credit that were building out projects, apartment projects and things like that, that'll go to perm financing.

DAMEN DELMONTE: Okay. Okay, that's all that I had for now. Thank you very much.

DON HILEMAN: All right. Thanks a lot.

OPERATOR: Again, our final reminder. If you would like to ask a question, please press star then one.

We do have a follow-up from Damen DelMonte of KBW.

DAMEN DELMONTE: Hello. Thanks. Yes, just a quick follow-up question here. Could you guys just give us a quick update on your outlook for M&A? I know it's something that you've talked about in the past. We know you had a transaction that was kind of on deck for a short period of time, and it ended up being terminated. Could you just give us a little idea what the landscape looks like in Ohio these days?

DON HILEMAN: Yes. I think the landscape is still picking up. We saw some new activity recently with a couple announcements, and we're seeing and expect that activity to be at a little bit more robust pace for the rest of the year into next year.

DAMEN

DELMONTE: Okay, and M&A is still something that you guys are actively pursuing, is that correct?

DON HILEMAN: Yes.

DAMEN DELMONTE: Could you just remind us again of the size and characteristics of what you'd be looking for?

DON HILEMAN: Well, I think, as we talked about, we're looking for something that's significant, but we were looking for the right opportunity, and I think as we look to where we want to round out our footprint and we look to the economics and how any particular transaction would add value to the organization. I think size may be becoming a little less as a driver, but clearly something in the half a million, half a billion ranges, would fit well with us. It's more about certain opportunities and characteristics for market and value than it is necessarily size for us now. That's a little of a shift for us.

DAMEN DELMONTE: Okay. All right. That's helpful. Thank you very much.

MALE SPEAKER: All right. Thanks a lot.

OPERATOR: There are no further questions at this time, so I'd like to turn the conference back over to Mr. Hileman for any closing remarks.

DON HILEMAN: With that, we'd like to thank you for your participation and have a great day.

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