First Defiance

Fourth Quarter Earnings

January 20, 2015 at 11:00 a.m. Eastern

CORPORATE PARTICIPANTS

Tera Murphy – *Marketing Specialist*

Don Hileman – *President and Chief Executive Officer*

Kevin Thompson – *Executive Vice President and Chief Financial Officer*

Operator
Good morning, and welcome to the First Defiance Fourth Quarter Earnings and Year-End 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 one on your telephone keypad. To withdraw your question, please press star then two. 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 Fourth Quarter Earnings and Year-End 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 forecast 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
Good morning, and welcome to the First Defiance Financial Corporation Fourth Quarter and Full Year 2014 conference call. Last night, we issued our 2014 earnings release, and now we would like to discuss that release and give you a look into 2015.

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 fourth quarter and full year is our CFO, Kevin Thompson.

We are very pleased with our fourth quarter and the full year performance, both overall and on a core basis. 2014 was the third consecutive year of record earnings, reflecting a 9% improvement over 2013.

Fourth quarter 2014 net income on a GAAP basis was $5.8 million, or $0.59 per diluted common share compared to $5.1 million and $0.50 per diluted common share in the fourth quarter of '13. For the year ended December 31, 2014, First Defiance earned $23.7 million, or $2.38 per common share compared to $22.2 million or $2.19 per diluted common share for '13.

Our overall performance this quarter was very solid with continued improvement in core operating results. We are fortified by the year-over-year and the linked quarter loan growth. Our ability to growth our loan portfolio was a very important piece of our strategic plan. We expect a more consistent contribution from our Columbus, Ohio loan production office and the Fort Wayne, Indiana market as we increased the number of lenders in those markets to expand our growth opportunities.

The continued loan portfolio growth contributed to the improving earning asset mix, increasing our net margin and net interest income. The growth in both our net interest income and non-interest income revenues on a quarterly basis reflects the contributions from our core business strategies over the third quarter of 2014 and over 2013.

We're also pleased with our strong net interest income growth this quarter of 6% over the fourth quarter of 2013. Competitive loan rate environment remains very challenging as the industry focuses on growth. We expect the interest rate environment to be relatively stable at the current levels in the short-term, but we do see momentum building for market increases as the Federal Reserve settles into their position.

In addition, the deposit side of the balance sheet continues to show strong growth driven by non-interest bearing and interest bearing demand accounts over the last year. On a linked quarter basis, we were able to increase our margin to 3.76% from 3.73%, and an increase, over 3.61%, in the fourth quarter of 2013. We are very pleased with this quarterly improvement.

Non-interest income showed growth both on a GAAP and core operating basis over the fourth quarter of 2013. We're seeing the results of the strategic initiatives put into place in the first half of the year. We experienced an increase in insurance revenues on both a full year-over-year and a linked quarter basis, and trust income was also up on both a full year and a linked quarter basis. Service fees and other charges also displayed a positive growth pattern.

We were pleased to see the reversal of a trend in mortgage loan production on a comparative basis with the fourth quarter of 2014 showing a 12% increase over the fourth quarter of 2013. Total non-interest expense increased $981,000 from the fourth quarter of 2013, and increased on a linked quarter basis.

The credit quality metrics showed continued overall improvement this quarter from a year ago. Non-performing assets declined approximately $3.4 million, or 10% year-over-year. Non-performing loans decreased approximately $3.8 million, or 13% year-over-year to $24 million.

Approximately 67% of the non-performing loans continued to make payments. While the non-accrual ticked up slightly this quarter, we expect the trend over the next year to show improvement and be reflected by improving non-performing asset ratios.

We are pleased with the decline from a year ago in the level of 30 day/90 day delinquencies to 0.18% of loans for the fourth quarter 2014 compared to 0.20% of loans in the fourth quarter of 2013. Non-performing and classified asset levels will remain areas of focus to ensure additional new clients in the future.

Regarding our capital management plans, our stock buyback program continued in the fourth quarter with the repurchasing of 135,000 shares. We're also pleased to announce a first quarter of 2015 dividend of $0.175 per share, representing an annual dividend yield of approximately 2.1%. Our ongoing strong performance in capital let us support this utilization of capital.

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

Kevin Thompson
Thank you, Don and good morning, everyone. As Don stated, net income for the fourth quarter was $5.8 million, or $0.59 per diluted share. This compares to prior year results of $5.1 million, or $0.50 in the fourth quarter of 2013.

The fourth quarter this year did not include any significant non-recurring type items while last year's fourth quarter was lowered by realized losses on collateralized debt obligations that totaled $219,000 after tax, or $0.02 per share. Those obligations were sold in January of 2014.

Even adjusting for last year's losses, it's clear to see substantial improvement in fourth quarter earnings versus last year with EPS up $0.09, or 18% overall and $0.07, or 14% adjusting for those losses.

We are very pleased with the continued momentum of our overall performance results for the fourth quarter, and particularly as we look ahead to 2015.

Loan and deposit growth were both positive. We maintained our improved earning asset mix, and increased both our net interest margin and net interest income.

Non-interest revenues reflect solid growth on a core basis from a year ago, and credit quality remains much improved from a year ago.

While operating expenses have increased to support our growth strategies, our results reflect positive operating leverage as part of our earnings improvement.

Looking at the details of the income statement, our net interest income was $18.1 million for the fourth quarter of 2014, up from $17.7 million in the linked quarter and up over a million dollars from the $17 million in the fourth quarter last year.

For the fourth quarter of 2014, our margin was 3.76%, up three basis points from last quarter, and up 15 basis points from 3.61% in the fourth quarter of last year. Our earning asset mix and margin have shown considerable improvement over the course of the year. Growth in loans and securities has reduced our excess liquidity position, benefiting both the margin and earnings. Our yield on earning assets was up 12 basis points from the fourth quarter last year, and up 3 basis points on a linked quarter basis. Our cost of interest-bearing liabilities was down four basis points from a year ago, and only one basis point on a linked quarter basis.

Total new loans originated in the fourth quarter were put on at weighted average of 4.34%. That's an increase from the 4.12% in the third quarter of 2014. Our loan portfolio yield in the fourth quarter of 2014 of 4.38% increased by two basis points on a linked quarter basis.

We still look to improve our earning asset mix through additional loan and investment growth going forward, and anticipate our margin to respond accordingly.

Total non-interest income was $7.3 million in the fourth quarter of 2014, down from $9.4 million in the linked quarter, which was positively impacted by several significant gains, which totaled about $1.9 million, but up from $6.5 million in the fourth quarter of 2013, which, again, was negatively impacted by realized losses on some collateralized debt obligations, which totaled about $337,000 pretax.

On a core basis, all major categories of non-interest income except mortgage banking increased over the fourth quarter last year. Overall, mortgage banking income for the fourth quarter of 2014 was $1.3 million, which was down $275,000 from the linked quarter, but down only $54,000 from the fourth quarter of 2013. The fourth quarter mortgage banking originations were $43.8 million compared to $52.2 million last quarter and $43 million in the fourth quarter of 2013.

Gain on sale income was $734,000 in the fourth quarter of 2014 compared to $973,000 on a linked quarter basis and $756,000 in the fourth quarter last year.

At December 31, 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 70 basis points of the outstanding balances serviced. Total impairment reserves, which are available for recapture for future periods totaled $911,000 at quarter-end.

Service fee income reflecting some fee and product design changes initiated last quarter was $2.8 million in the fourth quarter of 2014, an increase from $2.7 million in the linked quarter and from $2.5 million in the fourth quarter of 2013.

Insurance revenue was nearly $2.2 million in the fourth quarter of 2014, up from $2.1 million in the fourth quarter of 2013. Also, our trust income, while a smaller component of revenue, continues to show significant growth from a year ago, totaling $345,000 in the fourth quarter, up 26% from $274,000 in the fourth quarter last year.

As for non-interest expense, fourth quarter expenses totaled $17 million, up from $16.8 million in the linked quarter and $16 million in the fourth quarter of 2014. The increase was primarily in compensation and benefits expense, which in the fourth quarter was up $765,000 from last year mainly due to merit increases, higher health and life insurance costs, as well as some staffing additions for our Columbus, Ohio loan production office and the new Fort Wayne, Indiana branch opened in August.

Regarding provision expense, the fourth quarter of 2014 totaled $162,000 compared to $406,000 last quarter and $475,000 in the fourth quarter last year. The fourth quarter of 2014 included net recoveries of one basis point compared with net charge-offs of 12 basis points last quarter and net charge-offs of 39 basis points in the fourth quarter a year ago.

Our allowance for loan loss at December 31, 2014 was $24.8 million, or 1.50% of total loans versus $25 million, or 1.58% at December 31st last year. The change reflects the credit quality improvements achieved during the past year such as the allowance coverage of non-performance loans has increased to 103% at year-end, up from 90% at December 31, 2013.

We expect the reserve-to-loans percentage to continue to track favorably with ongoing asset quality improvements. As for the asset quality numbers, non-performing loans increased slightly this quarter to $24.1 million from $22.5 million on a linked quarter basis, but was down 13.3% from $27.8 million at December 31, 2013.

Our OREO balance increased to $6.2 million from $5.9 million in the fourth quarter last year. Overall, non-performing assets ended the year at $30.3 million, or 1.39% of total assets, down from $1.58% of total assets at December 31, 2013.

Total classified loans of $47.3 million at December 31, 2014 have declined considerably from the $55.6 million at December 31, 2013.

Moving to the balance sheet, total assets were $2.18 billion at December 31, 2014, up $27.9 million from last quarter-end and up $41.8 million from last year-end. Gross loan balances increased $10.5

million during the quarter and are now up $66.3 million, or 4.2% year-over-year. Securities increased $41.1 million from a year ago while cash and equivalents declined $66.4 million.

The continued loan growth this past quarter added to our improved earning asset mix, and our loan growth outlook remains very positive. Total deposits of $1.76 billion at year-end reflect an increase of $25 million from a year ago and were up $30.2 million on a linked quarter basis. Non-interest bearing deposits have increased to $379.6 million at December 31, 2014 from $348.9 million at December 31, 2013. We are still very pleased with our ability to generate and maintain a solid low-cost core deposit base.

Looking at our capital position, total period end stockholders' equity finished December 31, 2014 at $279 million, up from $272.1 million at December 31, 2013. Our capital position remains strong with period end shareholders' equity at 12.8% this year compared to 12.73% last year and with the bank's total risk-based capital at approximately 14.5%.

Our healthy capital position continues to provide us the opportunities to pursue our growth strategies, as well as enhance shareholder value through dividends and share repurchases as Don mentioned.

Finally, regarding our record full year results for 2014; net income was $23.7 million or $2.38 per diluted share versus $22.2 million, or $2.19 per diluted share for the year 2013. That's an increase of $0.19 per share.

This year's results have benefited from non-recurring stock items of about $0.12 per share year-to-date. That's about $0.14 per share from last quarter from mostly tax free gains, about $0.03 per share in the second quarter from some security gains while the first quarter included a one-time merger termination charge, which cost us $0.05 per share. Last year's results were negatively impacted by the net securities losses I discussed earlier of about $0.02 per share.

Then in addition, when you consider our 2014 also include overcoming a significant decline in mortgage banking income of about $1.8 million, or about $0.18 per share. So, with the exclusion of mortgage banking, the decline there and the non-recurring items, earnings grew about $0.23 per share. So, we're very pleased with our core earnings growth and the momentum we're bringing into the New Year.

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

Don Hileman
Thank you, Kevin. I'm very delighted with the progress we have made over the course of the year and the position of First Defiance at the end of 2014 with sights on 2015. Benefits of our non-interest income initiatives and pricing and account bundling changes are being realized with each statement. We expect that to build throughout 2015.

As stated previously, the company is focused on several areas believed to improve financial performance and help drive greater shareholder value. These include core balance sheet growth with a focus on loan growth, revenue growth, expense control and improved asset quality. We believe we are making progress in these areas.

The fourth quarter expense level was higher than we expect going forward and we look to leverage the quarter spend for infrastructure and compliance costs that occurred in 2014. We do believe loan demand will continue improving in 2015 aided by further improvement in the economic environment and our addition of commercial lenders in 2015.

The size of our current pipeline reflects increasing confidence of our ability to grow our outstandings. The lending environment remains very competitive, but we feel we can grow our business without making significant concessions in rate and other terms.

Our average loan yield increased three basis points on a linked quarter basis, reflecting a change in that overall trend. 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. In addition, our business banking initiative is now in full stride and we expect more activity in 2015 from this segment. Our business bankers in each of our markets are 100% dedicated to this new opportunity and production volumes are expected to build each quarter.

We also saw additional balances booked as result of the activity from our Columbus, Ohio loan production office, and we anticipate their further contribution to loan growth in 2015 as additional lenders join this office to capitalize on that strong market and opportunities.

Regarding our non-interest revenue initiatives, the third quarter changes in our fee schedule and product designs based on relationships and fees for services used are starting to help offset changes in customer use patterns that reduced NSF fee income and contribute to the overall growth and service fee income.

We are continuously looking to enhance our electronic and mobile banking capabilities to give our customers more choices on how they access our products and services.

We introduced Mobile Deposit early in 2014, and are launching online account opening to the public in the very near future. The digital delivery environment is changing at a very rapid pace and we need to keep pace.

Growth in our insurance and wealth management revenues was also reflected in our quarterly results and will remain in our plan for revenue growth. While organic growth is our primary focus, we are continuously looking for strategic acquisition opportunities.

We are very inspired by our recent performance and look to continuously driving the initiatives we believe will equate to results that will help us obtain our goal of being a consistently high-performing community bank we work hard to be every day.

We remain confident in our strategy and in the people working hard to execute our plans and evaluating new initiatives to enhance our overall strategy. We feel good about our performance in 2014 and look forward to 2015.

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

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

QUESTIONS AND ANSWERS

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 are using a speakerphone, please pick up your handset before pressing the keys. To withdraw your question, please press star then two. At this time, we will pause momentarily to assemble our roster.

And our first question comes from Damon Delmonte with KBW.

Damon Delmonte
Hi. Good morning guys. How are ya?

Don Hileman
Hey, good morning, Damon.

Damon Delmonte
My first question, just wanted to touch on the margin and any outlook going forward. Obviously, a nice quarter with the three-basis point increase over last quarter. How are you viewing the margin kind of as we to go into 2015, with the ten year staying below that 2% threshold?

Don Hileman
Certainly the persistence of the curve staying low and the flatness of it are a bit of a challenge. As you heard our result here for the fourth quarter though, we remain pretty disciplined in our pricing, although it gets pretty competitive, certainly with some of those pressures. We think we can continue to maintain a pretty strong pricing in our loan book and continue to move our mix favorably.

We think we still have a fair amount of liquidity on the asset side of our balance sheet. That should support our ability to maintain and possibly improve our margin as we go through 2015. I mean that's our outlook at this time.

Damon Delmonte
Okay, and are you—within your outlook or in your internal forecasting models, are you factoring in Fed rate hikes as the year progresses?

Don Hileman
We, at this time, are thinking that is going to move the Fed are going to move the Fed funds rate sometime probably in the third quarter and we still have an interest rate risk position that is asset sensitive. And so, we don't see any looming near-term issues from that kind of timing that we anticipate from the Fed.

Damon Delmonte
Okay. Great. And then with regards to the operations in the Columbus, Ohio market and Fort Wayne, Indiana, can you just talk a bit about some of the market opportunities that you think you guys have going forward, and are those areas where you'd look to build a bigger physical presence, or do you think what you have now is adequate?

Don Hileman
The opportunities, those are both markets, and particularly the Columbus market that the economic environment and the growth opportunities are a lot stronger than a lot of our other areas where we have offices.

I think we're pretty well satisfied with initially here our loan production office strategy. We are hiring new lenders in both of those markets to take advantage of, as I said, the opportunities. We're seeing more development. We're not shying away from commercial real estate, and we think that's a good opportunity there, but we are very disciplined in our underwriting on those kinds of deals.

But, we think we expect to see some growth in commercial real estate lending in both those areas as we go forward and more than likely we will keep loan production office strategy. We think that's we're focused right now and feel that the other offices and branches that we have can be the deposit generating facility for the corporation.

Damon Delmonte
Okay. Are you gathering deposits in those markets as well as, or is this more of a pure loan production?

Don Hileman
It is pure loan production.

Damon Delmonte
Pure loan production, okay. Okay, and then could you just give us an update on your thoughts on M&A? Would you say that you have seen increased dialogue in the last quarter? Are you optimistic that you could potentially find the right transaction in 2015?

Don Hileman
Yeah, we've seen a lot of dialogue. We expect that to continue. I think we are going to be very patient and very direct in looking for the right type of transaction, and we're going to be more opportunistic than we are anything else, I think, on the M&A front. So, we don't have any specific timeline or expectation relative to time. We just wanna to make sure it's the right fit.

We place a lot of importance on the culture and making sure there's the right culture versus just doing a transaction. So, we're going to spend a lot of time, and make sure we get the right fit.

Damon Delmonte
And as far as the size of a bank that you would go after, $500 million or so kind of the sweet spot, and on the high end of the range something upwards to a billion in assets?

Don Hileman
I think that's still consistent with our thinking.

Damon Delmonte
Okay. And then just my final question and you may have said this, but I missed it; what was the origination volume for mortgage banking this quarter?

Kevin Thompson
Business banking?

Don Hileman
Mortgage banking.

Damon Delmonte
Mortgage banking, yeah.

Kevin Thompson
$43.8 million.

Damon Delmonte
$43.8 million, okay. That's all I had for now. Thank you very much.

Kevin Thompson
Great.

Don Hileman
Thanks, Damon.

Operator
Again, if you would like to ask a question, please press star then one. And our next question will come from Daniel Cardenas of Raymond James.

Daniel Cardenas
Good morning guys.

Don Hileman
Good morning, Dan.

Daniel Cardenas
Could you give me the footings for the Columbus, the loan footings for the Columbus and the Fort Wayne market? What were your balances at year-end?

Kevin Thompson
Columbus, I know was about $20 million. Fort Wayne, I'm not sure I have that number at hand.

Don Hileman
It's a lot higher than that, but it's—we think—when we talk about the opportunities, we're looking at—a lot of it has to do with the economic environment, and we're seeing a lot more lending opportunities in those areas. That is why I think it's, for us, the greatest growth opportunity.

Daniel Cardenas
And then in terms of, just jumping over to capital real quickly, in terms of your buyback, what's in your program, and would you guys be willing re-up once that program is completed?

Kevin Thompson
There are about 300,000 shares left in the current authorization. And every time we complete the authorization, we'll reexamine that, but we certainly are interested in maintaining a strong capital management program going forward.

Daniel Cardenas
What do you kind of see—if you look at the TCU ratio, I mean where do you kind of see the point that you won't cross, the line that you won't cross on your tangible common equity ratio?

Kevin Thompson
Well, it's pretty distant from where we are right now.

Daniel Cardenas
Right.

Kevin Thompson
But, probably 8%, and but I don't think that's an imminent issue based on existing strategies.

Daniel Cardenas
Okay, and then just last question here. Looking at your NPAs, the sequential quarter increase, was that just one credit that drove that number up?

Don Hileman
It's primarily one credit. I think it was about $2.2 million, one credit that was a late fourth quarter add.

Daniel Cardenas
Is that a commercial credit?

Kevin Thompson
Yeah. Yeah. We still feel pretty comfortable with that level that it will be trending downward as I said in my comments. We wish everything was linear, but it's kind of a little bit up and down.

Daniel Cardenas
Great. Great. Just some turbulence. Okay.

Don Hileman
Yep.

Daniel Cardenas
Great. Thanks guys.

Don Hileman
Thank you.

Operator
This concludes our question and answer session. I would like to turn the conference back over to Tera Murphy for any closing remarks.

CONCLUSION

Tera Murphy
I'd just like to thank everyone for joining us on our earnings call today. And thank you for your interest in First Defiance Financial Corp. Have a great day.

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