First Defiance Financial Corp.

First Defiance Financial Corp. Second Quarter 2015 Earnings Conference Call

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CORPORATE PARTICIPANTS

Don Hileman - *President and CEO*
Kevin Thompson – *Executive Vice President and CFO*
Tera Murphy – *Vice President*

PRESENTATION

Operator
Good day and welcome to the First Defiance Financial Corporation's Second Quarter 2015 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 (0). After today's presentation, there will be an opportunity to ask questions. To ask a question, you may press star (*) then one (1) on a touchtone phone; to withdraw your question, please pres star (*) then two (2). Please note this event is being recorded. I would now like to turn the conference over to Ms. Tera Murphy, Vice President. Please go ahead.

Tera Murphy
Thank you. Good morning, everyone, and thank you for joining us for today's 2015 second quarter earnings conference call. This call is also being webcast and the audio replay will be available at the First Defiance's 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 at First Defiance Financial Corp. Actual results may differ materially from current management forecasts and projections as a result of factors over which the Company has no control. Information on these risk factors and additional information on forward-looking statements are included in the news release and in the Company's reports on file with the Securities and Exchange Commission. And now I'll turn the call over to Mr. Hileman for his comments.

Don Hileman
Good morning and welcome to the First Defiance Financial Corporation's second quarter conference call. Last night, we issued our 2015 second quarter earnings release and now we would like to discuss that release and give you a look into the remainder of 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 quarter is our CFO, Kevin Thompson. The second quarter results reflect a continued improvement in several strategic performance areas. Second quarter 2015 net income on a GAAP basis was $6.6 million or $0.70 per diluted common share, compared to $5.7 million or $0.57 per diluted common share in the second quarter of 2014. The overall momentum gained during previous several quarters continued in the second quarter of '15 with both solid loan growth and net interest income growth. We experienced solid year-over-year and linked quarter loan growth, with total loans at June 30th up 7.8% over a year ago. This follows a strong first quarter growth. Our continued ability to grow our loan portfolio has been a key focus of our strategic plan. We continue to see contributions from all areas of our footprint. The competitive market continues to be very aggressive as all institutions are looking for loan growth. The effective new loan rate for the second quarter was 4.2%, compared to 4.4% in the first quarter of 2015. The overall yield on loans for the second quarter of 2015 was 4.36%, down only 1 basis point from the second quarter of 2014.

We are very pleased with our margin this quarter, which reflects our disciplined pricing. Loan portfolio growth contributed to the improving earning asset mix, increasing our net interest income. Growth in both our net interest income and our non-interest income revenues on a quarterly basis reflects contribution from our core business strategies. This is reflected in our strong net interest income growth this quarter of 7% over the second quarter of '14, and 8% year-to-date growth over 2014. We expect the net-interest rate environment to be reflective of the anticipated likelihood of a fed rate increase in the fourth quarter of 2015. We continue to measure our interest rate risk position and are managing toward a neutral position. Our net interest margin increased to 3.81% over the second quarter of '14 margin of 3.62%. We are very satisfied with our margin trend.

Non-interest income generally saw improvements across the board over the second quarter of 2014. Mortgage banking saw a 16% improvement from the second quarter of '14 and we also had a 7% year-over-year increase in service fees and other charges. We experienced an increase in insurance revenues, as well as an increase in trust income, on a year-over-year basis. We were pleased to see the reversal of a trend in mortgage loan production on a competitive basis with the second quarter of '15, which showed a 49% increase over the second quarter of '14 in loans originated. The credit quality metrics showed continued overall improvement this quarter from a year ago. Non-performing assets declined $2.9 million, or 12%, and non-performing loans decreased approximately $2 million, or 11%, on a linked-quarter basis. We continue to see approximately 56% of our non-performing loans continue to make payments. We are very pleased with the reduction in non-accrual loans and will focus on further reductions that will be reflected by an improving non-performing asset ratio. Despite seeing a slight increase in the 30 day to [unintelligible] past due, as we believe the overall trend will remain positive and we're seeing overall improvement in asset quality trends across the board. We will continue to focus on reducing non-performing and classified assets in the future. We did not buy back any of our stock in the second quarter. Our buyback activity was impacted by our higher stock valuation in the second quarter. We are also delighted to announce a 2015 third quarter dividend at $0.20 per share, representing an annual dividend yield of approximately 2.18%. Our ongoing strong performance in capital levels continue to allow for this utilization of capital. I will now ask Kevin Thompson to provide additional details for the quarter before I conclude with an overview. Kevin?

Kevin Thompson

Thanks, Don. Good morning, everyone. As Don stated, earnings for the second quarter were $6.6 million, or $0.70 per diluted share. This compares quite favorably to the $5.7 million, or $0.57 per diluted share, in second quarter of 2014. This is a 23% increase in EPS, driven by contributions from virtually every aspect of our performance. Compared to the second quarter last year, our current results reflect the benefits of balance sheet growth with margin expansion, higher revenues in our fee income businesses, ongoing credit quality improvement and continued control of core operating expenses. For some of the details, let's start with the income statement.

Our net interest income was $18.4 million for the second quarter of 2015, up from $18.2 million in the linked quarter, which had one less accrual day and up $1.2 million from the $17.1 million in the second quarter last year. For the second quarter of 2015, our margin was 3.81%, down seven basis points from 3.88% last quarter and up 19 basis points from 3.62% in the second quarter last year. Net interest recoveries on non-performing loans were less significant this quarter, adding only about 2 basis points to our margin, while last quarter's margin benefited by 6 extra basis points. Versus the prior year's second quarter, a majority of the increase was the result of strong loan growth, reducing excess liquidity and improving the earning asset mix and yield.

In the second quarter 2015, our yield on earning assets increased 19 basis points from the second quarter last year, while declining 5 basis points on a linked-quarter basis due to the lower interest recoveries. Our cost of interest bearing liabilities has remained relatively flat over the last year, up 1 basis point from a year ago and up 2 basis points on a linked quarter basis. Total new loans originated in the second quarter were put on at a weighted average rate of 4.20%, a decrease from new loan yields of 4.40% in the first quarter of 2015. Our loan portfolio yield in the second quarter of 2015 decreased by 6 basis points to 4.36% on a linked quarter basis, again, primarily due to the lesser impact of the recovered interest, but also influenced by slightly tighter yields this quarter. We are pleased that our current strong earning asset mix much improved from a year ago and we expect to maintain a strong mix as we grow, going forward.

Total non-interest income was $7.8 million in the second quarter of 2015. This is down $472,000.00 from the first quarter, mainly because the first quarter included annual contingent insurance commissions totaling $967,000.00. Otherwise we would be up $495,000.00. Compared to the second quarter last year, total net interest income was up a $192,000.00 overall. However, prior year included $471,000.00 in gains on the sale of securities. Excluding last year's gains, total non-interest income was up $663,000.00, or 9.3%, with the improvement spread through all of our fee income businesses.

Service fee income was $2.7 million in the second quarter of 2015, up from $2.5 million in both the linked quarter and the second quarter of 2014. Insurance revenue was $2.3 million in the second quarter of 2015, down from $3.1 million in the linked quarter due to the contingent commission income last quarter, but up from $2.2 million in the second quarter of 2014.

Also our trust income continues to build, totaling $367,000.00 in the second quarter, up 22% from $302,000.00 in the second quarter last year.

Regarding the improvement in mortgage banking revenues, rates remained favorable during the quarter and seasonal activity was strong, leading to higher volumes in both purchase and refinance activity. Mortgage banking originations were $76.9 million in the second quarter of 2015, up from $52.7 million on a linked quarter basis and up from $51.6 million in the second quarter of 2014. Overall mortgage banking income for the second quarter of 2015 was $1.8 million, about even with the linked quarter and up $1.5 million in the second quarter of 2014. Gain on sale income was $1.2 million in the second quarter of 2015, down slightly from $1.3 million on a linked quarter basis and up from $1 million in the second quarter last year. In addition, the second quarter included a positive valuation adjustment to the mortgage servicing rights of $141,000.00, compared to a positive adjustment of $26,000.00 last quarter and $44,000.00 in the second quarter of 2014. At June 30, 2015, First Defiance had $1.3 billion in loan serviced for others. The mortgage servicing rights associated with those loans had a fair value of $9.6 million or 71 basis points of the outstanding loan balance in service.

Total impairment reserves, which are available for recapture in future periods, totaled $743,000.00 at quarter end. As for non-interest expense, second quarter expenses totaled $16.8 million, down slightly from $16.9 million in the linked quarter and up when compared with $16.4 million for the second quarter of 2014. Compensation and benefits expense in the second quarter of 2015 was up $473,000.00 from last year, primarily due to higher incentives and merit increases and partially offset by lower medical insurance costs. Other non-interest expense was $3.3 million in the second quarter of 2015, about even with the same quarter last year, but this included $182,000.00 of OREO write-downs in 2015 compared to only $73,000.00 in the last year.

Regarding provision expense, the second quarter of 2015 did not require any provision expense. This was down from a $120,000.00 last quarter and $446,000.00 in the second quarter last year. The second quarter of 2015 included net recoveries of 2 basis points of average loans, which compares with 10 basis points of recoveries last quarter and 16 basis points of net charge-offs in the second quarter last year. Our allowance for loan loss closed at $25.4 million at June 30, 2015, up from $24.8 million at year end and $24.6 million at June 30, 2014. Credit quality improvements achieved during the past year led to an allowance percentage at the second quarter end of 1.49%, which was down from 1.50% at the prior quarter end and down from 1.56% a year ago. While the allowance ratio has decreased, the allowance coverage of non-performing loans has increased. The allowance now represents 152% of our non-performing loans, up from 99% at June 30, 2014. We expect continued improvement in our credit quality, which should benefit our performance, going forward.

As for the levels of non-performing assets overall, we saw a decrease in non-performing loans in the second quarter of 2015 to $16.7 million, down from $18.7 million on a linked quarter basis and down from $24.9 million at June 30, 2014, and our OREO balance decreased on a linked quarter basis to $5.4 million from $6.4 million last quarter and $5.6 million a year ago. Overall non-performing assets ended the quarter at $22.1 million, or 1.01% of total assets, down from 1.41% of total assets at June 30, 2014. Total classified loans also declined to $30.3 million at June 30, 2015, compared to $34.3 million on a linked quarter basis and significantly below the $47.6 million at June 30, 2014.
Moving to the balance sheet, total assets remained fairly steady at $2.2 billion at June 30, 2015, down only $4.8 million from last quarter end, but up $45 million from last year. Our improved earning asset mix, cash, I'm sorry, with our improved asset mix, cash and equivalents decreased to $65.6 million from $156.2 million at June 30, 2014. Securities increased $4.7 million from a year ago to $237.3 million and gross loan balances increased $123.7 million, or 7.8%, year-over-year. In this past quarter, loans increased $21.2 million. We continue to see steady strong loan demand as we start the third quarter.

Total deposits increased about $21.6 million from a year ago, although down $9.3 million on a linked quarter basis. Non-interest bearing deposits increased to $379 million at June 30, 2015 from $355.3 million a year ago. We remain pleased with our low cost deposit funding mix but recognize that deposit growth could be more of a challenge in the forecasted economic and interest rate environment.

Looking at our capital position, total period end stockholders' equity finished June 30, 2015 at $276 million, down just slightly from $276.4 million at June 30, 2014. While we had no share repurchases this past quarter, over the past year we have repurchased 337,000 shares for about $10 million, and last quarter we repurchased the warrant issued to the U.S. treasury under the TARP Capital Purchase Program for just under $12 million. Our capital position remains strong with period end shareholders equity to assets of 12.39% at June 30, 2015, compared to 12.77% at June 30, 2014. The Bank's total risk based capital ratio is strong at approximately 13.5%.

Also, in our release last night we announced the declaration of our quarterly dividend of $0.20 per share and are very pleased to provide additional value to our shareholders. Finally, regarding our year-to-date results, for the first six months of 2015 net income was $13.2 million, or $1.39 per diluted share, versus $10.9 million, or $1.08 per diluted share, for the same period in 2014. That's a 29% increase in diluted earnings per share, driven by a 21% improvement in earnings and the remaining increase due to the reduction in shares from our capital management efforts. That completes my financial review and I will turn the call back over to Don.

Don Hileman
Thank you, Kevin. I'm thrilled with the start to 2015 and the progress we've made to position First Defiance for the rest of the year. As mentioned, we continue to focus on several key areas we believe important to improve financial performance and drive greater shareholder value.

These areas remain core balance sheet growth with a focus on loan growth, overall revenue growth, expense control and improved asset quality. As noted, steady progress is being made in all of these areas. We do believe improvements in loan demand, aided by further improvements in the economic environment, will continue in 2015. We also expect more activity from our Columbus, Ohio, loan production office with the addition of lenders, allowing us to capitalize on strong opportunities. The size of our current portfolio reflects increasing confidence in our ability to continue to grow our loans outstanding. The lending environment remains very competitive but we feel we can grow our business without making significant concessions in rate and another terms. Our average loan yield declined 1 basis point from the second quarter of '14 and 6 basis points on a linked quarter basis. It will be challenging to uphold growth in the loan yield until market rates move higher. We will stay focused on disciplined pricing and building strong relationships with our clients. We are continuing to progress in our business banking initiative and more activity is expected from this segment throughout the course of this year and into next year.

We continue to look to enhance our electronic and mobile capabilities, giving our customers more choices in how they bank with us. Online account opening, which launched last quarter, has had an encouraging start with month-over-month increases in new accounts opened. While we are pleased with the start to this initiative, balance growth in these accounts has been somewhat slower to develop. Digital delivery environment is changing at an accelerated space and we are committed to providing our clients a quality choice of products and services. Growth in our insurance and wealth management revenues was also reflected in our quarter results and will remain in our plan for revenue growth.

We are very inspired by our recent performance and look to constantly drive our performance through initiatives that will help us obtain our goal of being a consistent high performing community bank. We look to achieve this goal through a balanced and long term focus. We remained confident in our strategy and in the people working hard to execute our strategy. We feel that the performance of the organization reflects our focus on shareholder values, at the same time our commitment to being a strong community partner in the areas we serve. Our commitment remains steadfast to all our customers and shareholders and we appreciate the trust you have placed in us as we work to make First Defiance a consistently high performing community banking organization. Thank you for your interest in First Defiance Financial Corp., and we thank you for joining us this morning. We will now be glad 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 (1) on your touchtone phone. If you are using a speakerphone, please pick up you handset before pressing the keys. If, at any time, your question has been addressed and you would like to withdraw your question, please press star (*) then two (2). At this time, we will pause momentarily to assemble our roster. The first question comes from Damon DelMonte of KBW. Please go ahead.

Damon DelMonte
Hey, good morning guys. How you are doing?

Don Hileman
Good morning, Damon.

Kevin Thompson
Good morning.

Damon DelMonte
My first question, just kind of starting up with the margin and kind of taking a look at your outlook, I guess if rates do not move at all, and if there’s no action by the Fed, you made a comment about loan yields being tough to sustain at current levels, should we factor in some measure of compression, going forward?

Kevin Thompson
Damon, I don't think so to any if any rates don't change, I mean it is competitive. I think the decline we experienced this quarter from say, prior quarters, is maybe just due, more due to the mix than anything else. But I think if the rate environment is stable, I think, as we performed over the last year, when you look at our loan yields, only a basis points different year-over-year, I think we would expect it to

continue to be maintained.

Damon DelMonte
Okay, and then if the Fed does raise rates, either in September or later this fall, then, would there be a benefit immediately to your margin or do you need to see it go up a certain amount in order to maybe eclipse some floors that you have on some of the loans?

Kevin Thompson
Yeah. We would probably not have much of immediate benefit and it we would build as time passed.

Damon DelMonte
Okay, that's helpful. Thank you.

Kevin Thompson
Sure.

Damon DelMonte
And then, I guess, this is more a technical question, on the mortgage banking, could you repeat what the origination volume was for this quarter?

Kevin Thompson
$72.6 million, I believe.

Damon DelMonte
Okay. And what, do you have a rough breakdown between purchased mortgages and refinances?

Kevin Thompson
I do and let me put my hands on it here. It was about 50/50, maybe a little bit heavier on purchase versus refinance, maybe 55/45, something like that.

Damon DelMonte
Okay, all right, that's helpful, thank you. And then, I guess, Don, maybe more a bigger picture for you, could you just kind of update us on your thoughts for M&A? I mean, obviously, you guys have ample capital to do a transaction, your share prices have been performing quite strong versus the rest of the market, and it gives you a little greater currency to maybe try to put something together. What are your thoughts on likelihood of a transaction for you guys?

Don Hileman
I think there's the opportunity, but I think, as we said, we're trying to continue to focus on driving some of the results in our core strategic areas to even improve our performance a little better, as we look to navigate through what's going on with the regulatory environment and also our market share. So I think the opportunity will keep presenting itself and our focus will continue to be on how do we drive better financial results.

Damon DelMonte
Thank you, okay. That's all that I had for now. Thanks a lot.

Operator
Once again, if you have a question, please press star (*) then one (1). The next question comes from

Christopher Marinac of FIG Partners. Please go ahead.

Christopher Marinac
Thanks, good morning Don; good morning Kevin.

Don Hileman
Good morning.

Kevin Thompson
Good morning.

Christopher Marinac
Just want to dig further into the margin question from before and, I guess, can you give us a little bit of more color on some of the difference between your current loan yield and the low 430, or mid 430's compared to what new loans are going on the books and just to kind of support your background on margin being somewhat stable?

Kevin Thompson
Well again, if you just kind of track our numbers over the last quarters, again I don't think there has been a lot of variation in some of the loan yields this quarter. I think we were a little bit lower than we'd been. Our focus right now, you heard Don talk about managing our interest rate risk position, basically to neutrality and that's where we're at. And so our discipline, right now, is really to maintain a match funded balance sheet. So depending upon the types of loans that we make, whether it's a fixed rate loan or a variable rate loan, I mean, we're going to ensure that our balance sheet and our margin maintains that interest rate neutrality. And so this quarter we had a little bit more variable rate lending and it kind of lowered our yield for the quarter but, on a going forward basis, I think where we'd expect that the margin overall, or the yield overall in the portfolio would be pretty constant. And certainly the impact on the margin would be neutral, so to speak. Does that help?

Christopher Marinac
No, it does, it does, that's great, thanks for that. And I guess the follow-up question just has to deal in the mortgage business. Is there any, I guess, sort of regulatory noise that would change the production levels in general? I'm just thinking of TRID regulations coming in later this year, does that at all impact just overall volumes the second half of the year?

Kevin Thompson
It could. We're obviously spending a lot of time in preparing for that. We're not really sure is the best way I can answer that. I think from the customer standpoint, it might be a little bit more complex and harder to navigate that process than it is today. But from our perspective, we're hoping and not really expecting a great decline in that. I think if there would be a natural decline, it would be offset by stronger economic activities that would encourage people to make that next step into home ownership.

Christopher Marinac
Got you okay, great, and last question, Don, just has to do, I guess, with overall expenses, going forward. Are there any opportunities for you to either re-examine the branch footprint or anything more substantive on expenses? Just curious if there are other initiatives out there that could influence earnings in the future.

Don Hileman
You know, good question. That's an area I think we have some flexibility. We don't have any initiatives

in place, but I think as we start to, and we talked about it before, try to be more efficient and use technology to a greater extent, that would have some impact on our branch transformation strategies. The actual footprint of a branch and things like that, we're looking at, but I think to answer your question, there's potential there but we don't have any direct initiatives in place right now.

Christopher Marinac
Okay, great.

Kevin Thompson
We are always looking at cost, Chris, and whether it's the branch structure or other elements of the operation, that we've got ongoing initiatives to examine our costs and to find savings and we see some of those opportunities and we're working hard on them all the time.

Christopher Marinac
Great, guys, thanks for the color here, much appreciated.

Don Hileman
Thanks a lot.

Operator
The next question comes from Eric Grubelich, a bank investor. Please go ahead.

Eric Grubelich
Hi, good morning. Can you hear me okay?

Don Hileman
Yeah, we can.

Kevin Thompson
Good morning, Eric.

Eric Grubelich
Just wanted to follow up with something about your comment about no buyback this quarter, is that more of a function of you just don't like the tangible book dilution you'd take by buying it back at a premium or is it that you think you may have some M&A activity to put that to work and you want to keep the powder dry?

Don Hileman
It's more of the prior. I think when we look at where we are trading and we want to get, we still think we're a good value at 150% tangible book, that's not the issue. I think it's just kind of where the Board gets comfortable setting some parameters around our buyback range for the valuation. And I think as we continue to get more confident of our ability to perform at these levels, we'll maybe think to up that level. But it's more for the relative level discussion than it is that we're keeping our powder dry.

Eric Grubelich
Okay, so we shouldn't assume, then, that at 150%, that that's just sort of the red line, you won't cross it that could change?

Don Hileman
It could.

Kevin Thompson
I don't know if it's red line, but it's

Don Hileman
It's a dotted line, maybe. Yeah, it is an influence. Clearly it's an influence. We finally build ourselves up to that and we're very pleased with getting at that level and then, like I said, we still think we're a good value and that's one of the things we have a lot of discussion with the Board about, is what those levels and that dilution factor and all the things that precipitated your question.

Eric Grubelich
Okay, and just any kind of comment on the other sort of what I alluded to on the M&A side, discussions increasing, decreasing, you're getting more looks, less looks, how does that look?

Don Hileman
I think we are about the same. I think from our perspective, we're looking to do with the best we can to get us to consistently be a high performing bank and I think we made progress. So that's more of where our internal focus has been and will remain for a while.

Eric Grubelich
Okay, thanks very much.

Don Hileman
Thanks, Eric.

Operator
The next question comes from Daniel Cardenas of Raymond James. Please go ahead.

Daniel Cardenas
Good morning, everybody.

Don Hileman
Good morning, Dan.

Kevin Thompson
Good morning.

Daniel Cardenas
Just couple of quick questions here. On your loan to deposit ratio, that kind of keeps inching up every quarter and you're, I think, just a hair under 97%. How comfortable are you guys going too much higher than that rate right now?

Kevin Thompson
It could edge up a little bit. I think there's still some room and, certainly, we see loan demand greater than our deposit growth potential, at least in the near term here. We have a significant unutilized borrowing capacity from FHLB, so we certainly got access to funding and so if that was to edge up a little bit over the next quarter or so, I think that could be very manageable for us.

Daniel Cardenas
Okay and then it looks like there was a little bit of an increase in your FHLB advances this quarter, was

that for growth purposes?

Kevin Thompson
Little bit and some of the interest rate risk position. As I said before, we are trying to make sure that, as we grow, going forward, that we're very disciplined in terms of matching our interest rate risk and keeping it neutral. So you'll see elements of that, probably, as we go forward.

Daniel Cardenas
Perfect and then should we expect to see any substantial technology investments as you guys look at your platform in the second half of this year?

Don Hileman
No, I think we've had some of that spend already. We're still trying to get the best benefit out of that and the efficiencies out of some of that spend. So a lot of that is already in our run rate and we have no real plans for any kind of major technology spend that would affect our non-interest expense numbers in the second half of this year, Dan.

Daniel Cardenas
Good. All right, that's all I have. Good quarter. Thanks guys.

Don Hileman
Thank you, appreciate it.

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
Thank you for joining us today as we discussed our quarterly results. We appreciate your time and interest in First Defiance Financial Corp. Have a great day.

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