First Defiance Financial Corp.

Second Quarter 2016 Earnings Conference Call

July 19, 2016 at 11:00 a.m. Eastern

CORPORATE PARTICIPANTS

Don Hileman - *President and CEO*

Kevin Thompson - *Executive Vice President and CFO*

Tera Murphy - *Assistant Vice President, Investor Relations*

PRESENTATION

Operator
Good morning and welcome to the First Defiance Second Quarter Earnings 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.

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 2016 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 at 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
Thank you. Good morning and welcome to First Defiance Financial Corporation's second quarter conference call. Last night we issued our 2016 second quarter earnings release and now I would like to discuss that release and provide insight into the remainder of 2016. 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.

A very strong second quarter financial performance results reflects our continued success in growing profitability. Second quarter diluted earnings per share grew to $0.80, a 14.3% increase over the second quarter of last year. Second quarter 2016 net income on a GAAP basis was $7.3 million compared to $6.6 million and $0.70 per diluted common share in the second quarter of 2015. At quarter end, our total assets exceeded $2.4 billion, up 9.7% from a year ago.

The overall momentum gained during the previous quarters continued in the second quarter with solid loan growth, deposit growth and net interest income growth. Total loans at June 30th were up 9% over a year ago and up 8% on a linked quarter annualized basis. Total deposits were up 11% on a linked quarter basis and up 9% year-over-year. We are pleased with the balance in the loan and deposit growth.

Our ongoing ability to grow our loan portfolio supported by contributions from all areas of our footprint has been a key focus of our strategy moving forward and will continue to be extremely important. The competitive markets continue to be very aggressive as all institutions are looking for loan growth and the lower rate environment looks to be extended. I would consider our commercial loan demand to be good to very good; the majority of our clients are doing well, and have improved confidence in their company's outlook.

Our overall pipeline remains solid relative to the same level as the first quarter and we continue to see strong performance in our Columbus market, growing $12 million this quarter. The effective new loan rate in the second quarter was 3.97% compared to 4.16% in the first quarter of '16. The overall yield on loans for the second quarter of '16 was 4.34%, down 2 basis points from the second quarter of '15.

Our net interest margin decreased to 3.71% from 3.81% in the second quarter of '15. Our ability to grow loans helped to offset some of the margin compression. This is reflected in our net interest income growth this quarter of 6% over the second quarter of '15, as well as a 6% increase year-to-date over '15. The growth in both our net interest income and our non-interest income revenues on a quarterly basis reflects contributions from our core business strategies.

We expect the interest rate environment to be reflective of the anticipated likelihood of a Fed increase possibly in the fourth quarter of 2016 or the early part of '17. We continue to measure our interest rate risk position and are managing toward a neutral to slightly asset sensitive position. The credit quality metrics showed continued overall improvement this quarter from a year ago with a reduction in the year-over-year in a linked quarter non-performing loan to asset ratio. We also had a significant reduction in restructured loans this quarter of 15% on a linked quarter basis and 57% year-over-year.

We did not buyback any stock in the second quarter. Our buyback activity is impacted by our higher stock valuation in the second quarter. We are also delighted to announce a 2016 third quarter dividend of $0.22 per share, representing an annual dividend yield of approximately 2.23% and an increase of 10% over the second quarter of '15. Our ongoing strong performance in capital levels allowed for this continued 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. Good morning, everyone. As Don stated, net income for the second quarter was $7.3 million or $0.80 per diluted share. This compares to prior year results of $6.6 million or $0.70 per share in the second quarter of 2015. Our second quarter financial performance results reflect our continued positive momentum and are clearly encouraging as we consider our outlook for the remainder of 2016.

Starting with growth, our loan and deposit balances both had solid increases in the second quarter, which was a continuation of our strong growth performance for the past several quarters. Total loans finished the quarter up $36.4 million from last quarter and up $155.7 million or 9.1% from a year ago, keeping our earning asset mix strong and profitable.

On the deposit side, we saw balances increase $49.1 million in the quarter and $156.9 million or 8.9% from a year ago. Over the past two quarters, we've seen our deposit growth outpace our loan growth creating slightly more liquidity on the asset side of our balance sheet. Importantly overall though our steadily growing balance sheet has continued to generate strong earnings growth.

Turning to the income statement, our net interest income was $19.4 million for the second quarter of

2016, up from $19.2 million in the linked quarter and up just over $1 million from the $18.4 million in the second quarter last year. Our margin this quarter was 3.71%, down 10 basis points from 3.81% in the second quarter of last year and down 9 basis points from the last quarter.

On a linked quarter basis, our yield on earning assets declined 8 basis points as our loan portfolio yield held steady at 4.34%, while our asset mix shifted to more short-term investments. Our cost of interest bearing liabilities rose just 2 basis points on a linked quarter basis. Even though our margin and growth remain strong, we see opportunities to further optimize our earning asset mix going forward. Our interest rate risk position, while essentially neutral and balanced, has moved slightly more asset sensitive with our shift in short-term assets. This supports our pursuit of opportunities to improve our earning asset mix.

Total non-interest income was $8.6 million in the second quarter of 2016, even with the linked quarter, which included contingent insurance commissions and up from $7.8 million in the second quarter of 2015. The second quarter of 2016 does includes $227,000 of securities gains while the second quarter last year had no securities gains. So excluding the securities gains second quarter non-interest income was up year-over-year about $539,000 or 6.9%.

Every category of fee income increased over the same quarter last year, excluding mortgage banking, which was basically flat, but even there excluding the MSR valuation adjustments, mortgage revenues were up 13% year-over-year. Within non-interest income notably, service fees rose $109,000 or 4.1%, insurance commissions were up $160,000 or 6.8% and trust income grew $42,000 or 11.4%. Regarding mortgage banking revenues for the second quarter of 2016, they totaled $1.8 million, up $225,000 from the linked quarter, but down just slightly overall, $29,000 from the second quarter of 2015.

The second quarter mortgage banking originations were $76 million compared to $51.1 million last quarter and $76.9 million in the second quarter of 2015. Gain on sale income was $1.4 million in the second quarter of 2016 compared to $1 million on a linked quarter basis and $1.2 million in the second quarter of last year. In addition, the second quarter included negative valuation adjustment to mortgage servicing rights of $104,000 compared to a negative adjustment of $21,000 last quarter, but a positive adjustment of $141,000 in the second quarter of 2015.

At June 30, 2016, First Defiance had $1.3 billion in loan service for others. The mortgage servicing rights associated with those loans had a fair value of $9.1 million or 72 basis points of the outstanding loan balances serviced, and total impairment reserves, which are available for recapture in future periods, totaled $770,000 at quarter end.

As for non-interest expense, second quarter expenses totaled $17.4 million, up slightly from $17.3 million in the linked quarter and up from $16.8 million for the second quarter of 2015. The increase was primarily in compensation and benefits expense, which in the second quarter 2016 was up $588,000 from last year, primarily due to higher costs for health benefit plans, merit increases and new staff to support our growth strategies.

Other non-interest expense was $3.2 million in the second quarter of 2016, down from $3.3 million in the same quarter last year, mainly due to reductions in OREO write-downs, which totaled $182,000 in the second quarter of last year compared to no write-downs in the second quarter of 2016.

Regarding provision expense, the second quarter of 2016 totaled $53,000 compared to $364,000 last quarter and no provision in the second quarter of last year. The second quarter of 2016 included net recoveries of 5 basis points compared to net charge-offs of 2 basis points last quarter and net recoveries of 2 basis points in the second quarter a year ago.

Our allowance for loan loss at June 30, 2016 was $25.9 million or 1.39% of total loans versus $25.4 million or 1.49% at June 30 last year. The change in the allowance ratio reflects the credit quality improvements achieved during the past year such that the allowance coverage of nonperforming loans has increased to 158% at quarter end, up from 152% at June 30, 2015. And going forward we continue to expect the allowance to loans percentage to reflect our strengthening asset quality.

As for the asset quality numbers, nonperforming loans decreased this quarter to $16.4 million from $17.7 million on a linked quarter basis and from $16.7 million at June 30, 2015. Our OREO balance this quarter was $1.1 million, down just slightly from last quarter, but down significantly from $5.4 million in the second quarter last year.

Overall nonperforming assets ended the quarter at $17.5 million or 0.73% of total assets, down from $22.1 million or 1.01% of total assets at June 30, 2015. Our troubled debt restructured loans this quarter were $9.6 million, down from $11.3 million last quarter and down considerably from $22.2 million a year ago.

Looking at our capital position, total period end stockholders' equity finished the quarter at $286.6 million, up from $276 million at June 30, 2015. During the quarter, we did not repurchase any shares and still have approximately 377,500 shares remaining under our current repurchase authorization.

Our capital position remains healthy and consistent with our growth strategies, as well as supportive of considerations to enhance shareholder value through additional share repurchases and dividends. At quarter end shareholders equity to assets was solid at 11.82%, although down from 12.39% last year. And the bank's total risk-based capital ratio is approximately 12.9% at quarter end June 30, 2016.

Regarding our year-to-date results, for the first six months of 2016 net income was $14.4 million or $1.59 per diluted share, which includes a penny per share increase to our first quarter for the adoption of ASU 2016-09 improvements to share-based payment accounting.

The current year result compares quite favorably versus net income of $13.2 million or a $1.39 per diluted share for the same period 2015. That's a 14% increase in diluted earnings per share driven by a 10% improvement in earnings and the remaining increase due to the reduction in shares as a result of our capital management efforts.

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

Don Hileman
Thank you, Kevin. We're pleased with both our performance and the momentum we have generated during the first half of this year. As noted previously, we continue to focus on several key areas we believe are important to improve financial performance and drive greater shareholder value. These include core balance sheet growth with the focus on loan growth, overall revenue growth, expense control and improved asset quality. We have seen improvement or stabilization in these areas this quarter.

We are pleased with our second quarter asset growth of 8.6% on a linked quarter basis and 9.7% year-over-year. We do believe loan demand will remain steady aided by some improvements in the economic environment in '16. As we have discussed we have looked to strategically grow our overall position in metro markets of Fort Wayne, Indiana, Toledo, Ohio and increase loan production in Columbus, Ohio. We continue to see solid activity in these areas.

We still believe a growth rate in the high single-digits is appropriate for the remainder of the year. We are very focused on relationship management pricing and believe our delivery and service model is effective in this interest rate environment and helping to achieve our loan growth. We understand the headwinds and challenges ahead, including the economic, regulatory and operational factors. We believe we can accomplish our goals through a balanced approach and long-term focus on shareholder value. We feel the performance of the organization reflects our focus on shareholder value, and at the same time, our commitment to being a strong community partner in the areas we serve. Our business banking initiative is progressing and more activity is expected from this segment throughout the course of the year and in the next year.

The digital delivery environment is changing at an accelerated pace and we are continuously evaluating opportunities to provide our clients a quality choice of products and services.

Growth in our insurance and wealth management revenues are also a component in our plan for revenue growth. We are very encouraged by our recent performance and look to constantly drive our performance through these initiatives and others that will help us obtain our goal of being a consistently high performing community bank. We look to achieve this goal through a balanced and long-term focus, remain confident in our strategy, our ability to adapt to overcoming obstacles and the people working hard to execute our plans.

Our commitment, we remain steadfast to all of our customers and shareholders. And we appreciate the trust you have placed on us as we work to make First Defiance a high performing community banking organization. Thank you for your interest in First Defiance and we thank you for joining us this morning.

We will now 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 you question, please press star then two. At this time, we will pause for a moment to assemble our roster.

And our first question will come from Damon DelMonte of KBW. Please go ahead.

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

Don Hileman
Good morning, Damon.

Damon DelMonte
Nice quarter by the way.

Don Hileman
Thank you.

Damon DelMonte
My first question just regarding the deposit growth, I mean it was very strong this quarter. Could you

talk a little bit about what's driving that? Is it a function of winning over new customers just purely on a deposit side and getting those deposit relationships, bringing in some larger accounts? Or, is it maybe more of a function of the lending side of the equation where you're getting, you're making loans to new customers and you're getting the depository business as well or maybe a combination of both?

Don Hileman
I think it's the latter, I think it's a combination of both. We're focused on the commercial relationship and the deposits. As we talk about, we are a relationship lender. One of the other things we've done this year is add deposit growth as a key component to commercial lender incentives. So there's some line of sight that benefit for that added relationship there, and we are seeing some pretty good deposit growth in some of the retail side, too. So I think it's a combination of both those aspects.

Kevin Thompson
Just to add on to Don's comments, last year we saw loan growth outpace our deposit growth and so as we came in to this year we really put an additional emphasis in terms of our plans and goals and incentives on deposit growth. And we've had a lot of success and a lot of it is mining the relationships we have as well as selling in to new business as well.

Damon DelMonte
Okay that's helpful, thank you. And then as it kind of relates to the margin so obviously your deposit growth outpaced the loan growth, so I am assuming that's what kind of lead to the shorter term positioning in the securities portfolio.

Kevin Thompson
That's right. We're very pleased obviously with the deposit growth that we've had as well as the loan growth, but as we've experienced over the course of time, sometimes those flow a little bit unevenly and back and forth from quarter-to-quarter. So we're fully expecting that we'll be able to more effectively deploy some of those funds as we go forward and bring some of those basis points back in to the margin for dollars and net interest income, too.

Damon DelMonte
Right, so kind of along those lines and so it sounds like your margin is positioned to at least hold steady if not maybe see a bit of an uptick regardless of what happens with rates. Right? Because you're moving the shorter term liquidity into—

Kevin Thompson
That's what we would expect. That would be an opportunity that we see to pursue here in the quarter.

Don Hileman
And I think we're a little bit comfortable with that plot because our loan pipeline is still pretty strong. We've had growth, but we maintained about the same level of our pipeline as we did in the first quarter. So that gives us a little confidence that there's activity out there that we could end up being book balances.

Damon DelMonte
Got you, okay. And then I guess just lastly on the provision, I think the net recovery has kind of helped you this quarter and we were kind of looking for something similar to the previous quarter from a provisional level perspective, but you had the net recovery. So absent any more outsized net recoveries, should we expect something in the maybe $500,000 to $600,000 range for a quarterly provision?

Kevin Thompson
That might be—that would be the upper end of my expectation. We still think we've got room to move some of our asset quality in a more favorable position if you will, which benefits the allowance. And so we would expect maybe a provision somewhere between what you described and maybe what we had in the first quarter.

Damon DelMonte
Got you, okay, sounds good, thanks. That's all I had for now.

Don Hileman
Thanks, Damon.

Operator
Again, to ask a question, please press star then one. Our next question will come from Christopher Marinac of FIG Partners. Please go ahead.

Christopher Marinac
Thanks, good morning. Kevin and Don, I was wondering if you could give us some color on how Michigan is performing and just kind of compare and contrast with your other markets in both eastern Indiana as well as the rest of Ohio.

Don Hileman
Sure, I think it's solid. It's a better deposit-performing piece of our franchise than others, has been for a quite while after that acquisition out there. I think we're finding loan growth a little bit slower in that market than we are in others. But we're still satisfied with where we are out there.

Christopher Marinac
Okay. And then is the pace of what you're seeing in Indiana and your Ohio footprint, should that remain the same or do you think the economic activity could change as the next few quarters unfold?

Don Hileman
I think there's an opportunity for it to change, but I think we're pretty comfortable we're going to continue with the decent pace of loan growth here. And a lot of it is, as I said, a good piece of that was in Ohio and Columbus and we expect that to continue to perform well. Fort Wayne, our market was a little lighter this quarter than it had been, but we expect that to bounce back. And that's primarily in the Indiana footprint there. And Ohio should be pretty solid and stable. So I think we expect contributions from all of those areas going forward.

Christopher Marinac
Great and my follow-up just had to do with just sort of M&A in general. I mean are you seeing a fair amount of activity that you could do and I guess from also, and maybe a common sense sort of what price expectations and if those are higher or lower than the past?

Don Hileman
I think the activity is starting to pick up a little bit especially as some institutions try to figure out how long this interest rate flatness will continue and how long there'll be a lot of these headwinds and challenges. It's hard to make money in this environment and we'll continue to do that. So I think there's going to be some more opportunities of that because of the economic conditions that we've seen. So and we'll be looking out for the right opportunity on that.

As far as pricing expectations, yeah, I think I could say that I've seen some creep in what that expectation is over the course as there maybe gets to be a little bit more activity and maybe more buyers that are interested as things have stabled out here. So I think that is an observation I would make that the pricing does seem to be a little stronger here and our expectations of pricing has been a little bit stronger.

Kevin Thompson
But our current cycle has improved as well.

Don Hileman
Yeah.

Christopher Marinac
Great, and just one more follow-up just had to do with the mortgage business. Is your pipeline still as strong as it was in the second quarter and then given how interest rates closed in the quarter, does that give you flexibility in terms of how the amortization numbers shape up for Q3?

Kevin Thompson
I don't know that I see any significant change, Chris, from at the end of the quarter through sort of the trend we've been on through the second quarter. Amortization isn't going to be a significant impact within our mortgage banking revenue. So we still have a very strong pipeline, and I feel like we're going to have a very good third quarter very similar to the second; that's how it's starting out anyway.

Christopher Marinac
Okay, yeah, great, Kevin.

Don Hileman
Yeah. One of the things, Chris, mortgage banking, too, is we're hoping—part of our issue in some of the muting of it was inventory of new purchases. We're still doing a decent percentage of re-fi's right now. So if some of that new inventory comes online and that opportunity for some of those new purchases happens, we think that will help us well stabilize our mortgage banking operators.

Christopher Marinac
Great, Don. Thank you both you and Kevin for the color here.

Don Hileman
All right, thanks.

Operator
Our next question will come from Daniel Cardenas of Raymond James. Please go ahead.

Daniel Cardenas
Good morning, guys.

Don Hileman
Good morning, Dan.

Kevin Thompson
Good morning, Dan.

Daniel Cardenas
Congrats on a good quarter, just a couple of questions. Kevin, I'm not sure if I understood you correctly,

but are you guys projecting in your models maybe a modest rate increase, end of this year or early next year?

Kevin Thompson
Our expectation the way we're doing our models is for—if there is an increase it's very late in the year, so really not any significant impact on 2016.

Daniel Cardenas
Okay, perfect. All right, that's what I thought I just wanted to make sure. And then I mean you continue to do a good job of controlling cost and your efficiency ratio is in that low 60% range. I mean what are your thoughts on your ability to get at or below 60% within the next year and a half or so?

Don Hileman
I think there's an opportunity. I think when we look at where we are, I don't know if that's necessarily a target. We look at things in a bigger picture and don't focus on one versus another. But I think we're aware that we need to manage expenses as we look at some of the other areas that might have more risk margin, etc. So we've got to stay on top of that.

I can tell you, I don't know if we have a target number, Dan, that we want to get to, but that'll remain a focus, the expense part of the efficiency ratio, yeah.

Kevin Thompson
Right, I agree with that, Don. I mean I think as we continue to grow, we've had very good growth as you see in the last couple of quarters that as our size becomes more significant that we would expect that we should be able to leverage that more efficiently in terms of our profitability profile and whatnot. So we're directionally moving toward that 60% number. We like that direction and I think that's something that at some point, Dan, that we would expect to occur, but it's going to be more of a paced function of how we grow and continue to execute on our business model. And it will come more naturally than we're going to make it happen next quarter.

Daniel Cardenas
All right, got you. Okay, perfect. And then just one last question, a follow up on the M&A side, really more on the non-bank type of deals. I mean what's your appetite there and what does that pipeline look like?

Don Hileman
We have an appetite for insurance agency acquisitions and the pipelines are not as strong as we'd like to see it. There is a couple of things we're potentially working on, but I'd like to see a little bit more activity in there. I like the insurance agency business; I like that contribution to our non-interest income numbers. And that's still a focus and we're pushing to try to see if we can do something in that area.

Daniel Cardenas
Okay, great. All right, thanks, guys.

Don Hileman
Thank you.

CONCLUSION

Operator
Ladies and gentlemen, this will conclude our question-and-answer session. I would like to turn the conference back over to Tera Murphy for any closing remarks.

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