First Defiance Financial Corp.

3rd Quarter 2016 Earnings Call

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CORPORATE PARTICIPANTS

Tera Murphy - *Assistant Vice President, Investor Relations*

Don Hileman - *President and Chief Executive Officer*

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

PRESENTATION

Operator
Good morning, everyone, and welcome to the First Defiance Third 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 (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 your telephone keypad. To withdraw your question, please press star (*) then two (2). Please note that this event is being recorded today. I would now like to turn the conference over to Tera Murphy, Vice President of First Defiance Financial Corporation. Please go ahead.

Tera Murphy
Thank you. Good morning, everyone, and thank you for joining us for today's 2016 third quarter earnings conference call. This call is 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 would 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 third quarter conference call. Last night, we issued our 2016 third quarter earnings release, and now we would like to discuss that release and provide insight into the remainder of 2016. We also announced in this quarter a definitive merger agreement between First Defiance and Commercial Bancshares Incorporated, which I will discuss later in my comments. Joining me on the call this morning to give more detail on the financial performance for the quarter is our CFO, Kevin Thompson. At the conclusion of our remarks, we will answer any questions you might have.

Our solid third quarter financial performance results reflect our continued success in growing profitably, driven in part by continued loan growth momentum. Third quarter diluted earnings per share grew to $0.78, an 8.3% increase over the third quarter of last year. Third quarter of 2016 net income on a GAAP basis was $7 million, compared to $6.7 million and $0.72 per diluted common share in the third quarter of '15. At quarter end, our total assets exceeded $2.4 billion, up 10% from a year ago. The overall momentum gained during the previous quarters continued in the third quarter with both solid loan growth, deposit growth, and net interest income growth. Total loans at September 30th were up 11% over a year ago and up 14% on a linked quarter annualized basis. Total deposits were up 8%, year-over-year, and 2% on a linked quarter basis.

We are pleased with the strong loan growth this quarter, but are looking for a better balance between loan and deposit growth going forward. Our overall pattern of loan growth in our footprint this quarter is consistent with that of the first two quarters in 2016. We saw double-digit annualized growth in three out of our five market areas. We are very pleased with our ongoing ability to grow our loan portfolio in this very competitive marketplace. I would consider our commercial loan demand a bit softer than last quarter, but still at a good to very good level. Our overall pipeline remains firm but down from the previous quarterly levels. The majority of our clients continue to perform very well and have improving confidence in their futures. We continue to see strong performance in our Columbus market, with loan growth of $7 million this quarter. The effective new loan rate in the third quarter was 4.03 compared to 3.97 in the second quarter of 2016. The overall yield on loans for the third quarter of '16 was 4.3%, down 2 basis points from the third quarter of '15. Our net interest margin decreased, excuse me, to 3.69% from 3.78% in the third quarter of '15. Our ability to grow loans helped to offset a portion of the margin compression. This is reflected in our net interest income growth this quarter of 7% over the third quarter of '15, as well as the 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 possible Fed rate increase during the fourth quarter of '16 or early part of '17, but do not believe multiple short-term interest increases will occur. We actively 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 and linked quarter non-performing loan-to-asset ratio. We also had a significant reduction in restructured loans this quarter, up 48%, year-over-year, and a slight decrease on a linked-quarter basis. Overall, non-performing loans elevated slightly this quarter, but we expect to see a decline in the fourth quarter reflecting an anticipated pay off.

We did not buy back any of our stock in the third quarter as buyback activity was impacted by our higher stock valuation in the third quarter. We are also delighted to announce a 2016 fourth quarter dividend of $0.22 per share, representing an annual dividend yield of approximately 2% and an increase of 10% over the fourth quarter of 2015. Our overall capital planning is supported by our ongoing solid performance in capital levels. This allows us to consider multiple uses of capital.

In August, we announced the signing of a definitive agreement to acquire Commercial Bancshares, Incorporated, and its wholly-owned subsidiary, Commercial Savings Bank, a $342 million commercial bank that operates seven full-service branches in Wyandot, Marion, and Hancock Counties in Ohio. The merger is expected to close in the first quarter of 2017 and is subject to Commercial Bancshares' shareholder approval, regulatory approval, and other conditions set forth in the merger agreement. Commercial Savings Bank is a high-quality bank, and will be an excellent fit, culturally, with our franchise. 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 third quarter was $7 million, or $0.78 per diluted share. This compares to prior-year results of $6.7 million, or $0.72, in the third quarter of 2015. In the third quarter, it did include some expenses related to our pending merger of Commercial Bancshares, Inc., which reduced EPS by about $0.02. Our third quarter financial performance results show the benefits of our steady revenue growth and credit quality improvement from the prior year, which also supports our positive outlook for the fourth quarter and the year ahead.

Starting with the balance sheet, our loan growth was particularly strong in the third quarter, while deposits grew more modestly. Total loans finished the quarter up $64.3 million from last quarter and up $92.2 million, or 11.1%, from a year ago, continuing to give us a strong and profitable earning asset mix. On the deposit side, we saw balances increase only $7.4 million in the quarter, or up $134.6 million, or 7.5% from a year ago. While our deposit growth outpaced our loan growth in the previous two quarters, we saw this reverse in the third quarter. We expect more balanced growth going forward and our steadily growing balance sheet to continue generating strong growth in earnings.

Turning to the income statement, our net interest income was $19.8 million for the third quarter of 2016, up from $19.4 million in the linked quarter and up $1.3 million from $18.5 million in third quarter last year. Our margin this quarter was 3.69%, down just 2 basis points from 3.71% in the second quarter, and down 9 basis points from 3.78% in the third quarter last year. On a linked-quarter basis, our yield on earning assets declined 2 basis points. Our loan portfolio yield, at 4.30%, was down 4 basis points while our asset mix shifted slightly more toward loans in the third quarter. Our cost of interest bearing liabilities raised just 1 basis point on a linked-quarter basis. With the strength of our margin and growth momentum, we see additional opportunities for further expansion of net interest income as we move forward.

Our interest rate risk position, while essentially neutral and balanced, remains slightly asset sensitive and we believe this best supports our revenue growth objectives given the current risks and the interest rate outlook. Total non-interest income was $8.5 million in the third quarter 2016, down just $49,000.00 from the linked quarter, but up from $8 million in the third quarter of 2015. The third quarter 2016 does include $151,000.00 of security gains, while the linked quarter had $227,000.00 in security gains and the third quarter last year had no security gains. So excluding the securities gains, third quarter non-interest income was up year-over-year about $393,000.00, or 4.9%. We had particularly nice revenue increases in our key business lines, with mortgage up $359,000.00 or 21.4%; insurance up $163,000.00 or 7.1%; and wealth management, which grew $50,000.00 or 13.5%.

Regarding mortgage banking revenues for the third quarter of 2016, they were $2 million, up $275,000.00 from the linked quarter and up $359,000.00 from the third quarter 2015. The third quarter mortgage banking originations were $101.7 million, compared to $76 million last quarter and $68.2 million in the third quarter 2015. Gain on sale income was $1.7 million in the third quarter of 2016, compared to $1.4 million on a linked quarter basis and $1.2 million in the third quarter last year. In addition, the third quarter included a positive valuation adjustment to mortgage servicing rights of just $7,000.00, compared to a negative adjustment of $104,000.00 last quarter and a positive adjustment of $24,000.00 in the third quarter 2015.

As of September 30, 2016, First Defiance had $1.37 billion in loans serviced for others. The mortgage servicing rights associated with those loans had a fair value of $9.3 million, or 72 basis points of the outstanding loan balances serviced. Total impairment reserves, which were available for recapture in future periods, totaled $763,000.00 at quarter end. Also, within non-interest income, we had a decline in gains on the sales of non-mortgages of $395,000.00, comparing the third quarter of this year to the same quarter last year. This revenue from sales of SBA, FSA, and USDA loans flows from the volumes generated and tends to be a bit volatile on a quarter-to-quarter basis. Somewhat offsetting that was the increase in other income, up $263,000.00 in the third quarter versus last year's third quarter. This increase was largely due to changes in the value of assets associated with the deferred compensation plan. This, too, can be volatile on occasion and the third quarter of this year included $62,000.00 positive change in value, while the third quarter last year was a $166,000.00 loss in value, for a difference of $228,000.00. There was also expenses related to this plan, which I will cover in a moment.

As for non-interest expense, third quarter expenses totaled $18.3 million, up from $17.4 million in the linked quarter and up from $16.8 million for the third quarter of 2015. The increases were primarily in compensation and benefits expense and other expenses. Compensation and benefits expense in the third quarter 2016 was up $504,000.00 from last year, primarily due to merit increases, higher incentive compensation costs, and new staff to support our growth strategies. Other non-interest expense was $3.6 million in the third quarter 2016, up from $2.8 million in the same quarter last year, mainly due to the inclusion of $252,000.00 in merger-related expenses for our pending merger with Commercial Bancshares, Inc., and an increase in our deferred compensation planned expense, up $478,000.00. For the deferred compensation plan, the third quarter this year included expenses of $296,000.00, while the third quarter last year reflected a credit of $182,000.00. This fluctuation was similar to what we saw on the revenue side, but a bit heavier on the expense side in the third quarter 2016.

Regarding provision expense, the third quarter of 2016 totaled $15,000.00, compared to $53,000.00 last quarter and a credit provision of $27,000.00 in the third quarter last year. The third quarter 2016 included net loan charge-offs of just 1 basis point, compared with net recoveries of 5 basis points last quarter and net charge-offs of 3 basis points in the third quarter a year ago.

Our allowance for loan loss at September 30, 2016, was $25.9 million or 1.35% of total loans, versus $25.2 million or 1.45% at September 30th last year. The change in allowance-to-loan ratio reflects the maintenance of strong credit quality and low loan loss experience achieved over the last year. The allowance coverage of non-performing loans at third quarter end was 142% versus 152% at September 30, 2015. Going forward, we anticipate the allowance to loans percentage to reflect our strengthened asset quality. As for the non-performing asset numbers, non-performing loans increased this quarter to $18.2 million from $16.4 million on a linked-quarter basis and from $16.6 million at September 30, 2015. This is primarily due to one credit, which is expected to be resolved by the end of the year.

Our OREO balance this quarter was just at $704,000.00, down from $1.1 million last quarter and down significantly from $4.9 million in the third quarter last year. Overall, non-performing assets ended the quarter at $18.9 million, or 0.77% of total assets, down from $21.5 million, or 0.97%, of total assets at September 30, 2015. Our troubled debt restructured loans this quarter were just $9.1 million, down from $9.6 million last quarter and down significantly from $13.8 million a year ago.

Looking at our capital position, total period end stockholders equity finished the quarter at $292.1 million, up from $280.2 million at September 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, but also supportive of considerations to enhance shareholder value through share repurchases and dividends.

At quarter end, shareholders equity-to-assets was solid at 11.92%, although down from 12.5% last year. The Bank's total risk-based capital ratio is approximately 12.3% at quarter end, September 30, 2016.

So to recap the results, diluted earnings per share for the quarter was $0.78 per share. Security gains after tax helped earnings about $0.01 per share, but the merger expenses after tax reduced earnings about $0.02 a share and the usually high deferred compensation cost, which we do not expect to repeat going forward, further reduced earnings after tax by another penny and a half. So we're very pleased with our results for the quarter and even more so when we peel back the unusual items. As we look ahead to the fourth quarter, we see our earnings momentum continuing. We expect our balance sheet growth to continue expanding our revenue, although we do anticipate some seasonal slowing in mortgage banking. We see our strength in credit quality holding steady and expenses normalizing, except for some additional expenses as we ready for our first quarter merger with Commercial Bancshares, Inc. That completes my financial review and I'll turn the call back over to Don.

Don Hileman
Thank you, Kevin. Our strong performance in the third quarter helps position us for the economic challenges we could face in the coming quarters. Uncertainty remains as to the direction of interest rates and, more impactfully, the level and volatility of the potential changes. We continue to focus on several key areas believed to be very important to improving financial performance and driving greater shareholder value. These include core balance sheet growth with a focus on loan growth, overall revenue growth, expense control, and improved asset quality. We have seen improvement in or stabilization in these areas, year-to-date.

We are very pleased with the third quarter asset growth of 7% on a linked-quarter basis and 10% year-over-year, driven by a loan growth of 14% on a linked-quarter basis. We anticipate loan demand will remain steady, either by some improvement in the economic environment in '16, but not at the third quarter pace. We still believe a growth rate in the high single digits is appropriate for the remainder of this year and into 2017. Our ongoing plan is to strategically grow our overall position in the metro markets of Fort Wayne, Indiana; Toledo, Ohio; and increase loan production in Columbus, Ohio; and continue to assess more ways to service our current and potential clients in these markets. Continue to focus on relationship management pricing in our delivery and service model is effective in helping achieve loan growth. We are very focused on deposit growth initiatives to overcome challenges in attracting core deposit relationships at a correlated pace with loan growth.

We are aware of and prepared to address the headwinds and challenges ahead, including economic, regulatory, and operational factors, including the integration of Commercial Bancshares. Through a balanced approach and a long-term focus on shareholder value, we believe we can accomplish our goals. As I have noted in the past, 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. These opportunities include mobile, as well as more user-friendly of products to create a better customer experience. We've expanded our mobile wallet offering beyond Apple Pay to include Samsung Pay and Android Pay. We believe we are a leader amongst community banks in offering all three mobile options to our customers.

We are encouraged by the overall growth in revenues, driven by net interest income and look to continue to focus on opportunities to grow our insurance and wealth management revenues as components in our overall plan for revenue growth. Our recent performance and our drive to complete initiatives that deliver strong results leave us encouraged that we will be a consistently high-performing community bank. We have set several key strategic objectives to help us achieve our long-term goals. The first is to continue to refine our metro market growth plan and expectations. The second is to continue the development of our human capital. The third is to use technology to become more efficient and utilize data to better serve our clients and assist in making customer-focused decisions. And lastly, the fourth is to gain a deeper understanding of changing customer expectations for products and services and be prepared to meet those expectations in a way that matches our overall risk profile. We remain confident in our strategy and our ability to adapt to overcome obstacles and on our people working hard to execute our plans. Our commitment remains steadfast to our customers and our shareholders and we appreciate the trust that you have placed in us as we work to make First Defiance a consistently high performing community bank. Thank you for your interest in First Defiance Financial Corporation and we thank you for joining us this morning. We will now be glad to take any of your questions

QUESTIONS AND ANSWERS

Operator
We will now begin the question-and-answer session. To ask a question, you may press star (*) and then one (1) 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 (2). At this time, we will pause for a moment to assemble our roster.

And our first questioner today is Damon DelMonte from KBW. Please go ahead.

Damon DelMonte
Hi, good morning, guys. How's it going today?

Don Hileman
Good morning, Dan.

Kevin Thompson
Very good. Good morning.

Damon DelMonte
Good. So my first question just kind of relates to the margin outlook. I mean, obviously, there's going to be some impact once the deal is closed in the beginning part of 2017, but what's the underlying trend can we expect for the core margin from this point forward, absent any rate movement?

Kevin Thompson
Yes, Damon, I think it's, we had a modest decline on a linked-quarter basis. I think we expect it to remain pretty stable as we go forward. We don't see a lot of change. Again, as we look at our interest rate risk position, it's very balanced and neutral. When you look at our earning asset mix, it's been pretty strong and consistent. Our yield on our loan portfolio has been pretty steady. We're at 4.30% this quarter. We're down 4 basis points on a linked-quarter basis, but if you kind of look back over the last 2.5, 3 years, we're probably no more than 5 basis points different than where we were 2.5 years ago.

So we feel pretty good about maintaining our pricing disciplines, and maintaining the strength of our earning asset mix and maintaining our overall yields. And on the funding side, our deposit costs have come up a basis point or so now and then this quarter. Our deposit growth was a little bit modest, didn't really get the lift that we've seen in prior quarters from strong non-interest bearing deposit growth. We think that's just sort of a quarter issue and that we'll see that pick back up as we go into the fourth quarter. So, we're expecting more balanced balance sheet growth between loans and deposits and pretty much stability in our balance sheet and maintaining pricing. So we think the margin stays more consistent than not.

Damon DelMonte
Okay, that's helpful, thanks. And then, the loan growth this quarter, as you commented, was very strong. Commercial real estate was a significant driver of that. Could you talk a little bit about some of the credits that were coming on the books this quarter, maybe kind of in what industries or the types of loans and the sizes?

Don Hileman
Yes, I think it's pretty consistent. I'm trying to recall if we thought there was anything out of character for us and I think it was pretty more of the same. We're continuing to get some good looks. We're still adding some balances to some of our current client relationships in segments. I think we feel we have a pretty good pipeline of diversity in loan types between industries. I think we did have one large apartment complex that added to their new outstandings, but I think it's pretty diversified and not any specific one area of concentration that I can recall this quarter.

Kevin Thompson
Nothing is jumping out, Damon, from anything out of the ordinary in terms of any major changes in the shift of our portfolio.

Don Hileman
Right.

Damon DelMonte
Okay, good, and then just lastly, the increase in NPLs, you had mentioned that there's one credit that you expect to pay off or be resolved by the end of the year. Could you just give a little color on the size of that loan and the nature of why you feel confident that it will be resolved? Is it something that's a timing issue? Is it in the process of being moved off the books? What can we learn about that?

Don Hileman
Yes, it's about $2.5 million. We think it is a timing issue. We've been, have some guarantees on that, it was the timing between how those all play out, and we think that it will either be paid off or significantly paid down here in the fourth quarter. I mean, that's our expectation in talking to the client. This is not something that will have to go through any kind of foreclosure process or any of that thing to get resolved. We think that it will be handled with communication and working with the client.

Damon DelMonte
Okay, great, that's all that I had for now. Thank you.

Don Hileman
All right, thanks sir.

Operator
Again, if you would like to ask a question, that is star (*) then one (1) on your touchtone phone. Our next questioner is Daniel Cardenas from Raymond James. Please go ahead.

Daniel Cardenas
Hi, good morning, guys.

Don Hileman
Morning, Dan.

Kevin Thompson
Good morning.

Daniel Cardenas
Just related to that follow-up on Damon's question, do you guys expect to take any charges related to this credit, or is it just going to work its way through the system with minimal impact?

Don Hileman
We think it will work through the system with minimal impact, Dan.

Daniel Cardenas
Okay.

Don Hileman
We're not expecting to take any additional charges on that. It had been classified and our focus just moved up to a different level here this quarter and needs to get resolved.

Daniel Cardenas
Okay, perfect, all right. And then following up on your comments of you guys getting more looks in your marketplace. Do you attribute that to the bigger banks pulling out of your lending area or just stronger calling efforts? What do you attribute the fact that you are getting more looks than you have been historically to?

Don Hileman
I think it's a continuation of our efforts to call. I don't think this quarter, in particular, maybe even year-to-date, that we've seen as much contraction in, out of the markets or certain product lines from the larger banks as we've seen in the past. I think it's more of an effort that we continue to focus on client relationships. We really strive to look at the full package of relationships, that's the lending side, the deposit/treasury management side of things, as well as the insurance/wealth management side. We think we have a good community bank approach to all of that for clients that we believe are interested those kind of services and we've focused a lot on our sales calling efforts. We've been fairly consistent in that over the long-term and we think that's helping. I can't tell you that's the only reason, but I think that's helping.

Daniel Cardenas
Okay, all right, and then as you look at your pipelines, say, versus a quarter ago, how are those looking?

Don Hileman
It's down probably about 10% from where it might have been on a previous quarterly average. It was pretty stable the last three or four quarters. What we believe is that it dropped because of the higher loan growth this quarter and it might take a little bit to build back up. But we're expecting to have still a pretty stable pipeline. But it's down about 10% or so, maybe a little higher from the previous couple quarter averages, Dan.

Daniel Cardenas
Is that kind of typical for fourth quarter, coming into the fourth quarter for you guys?

Don Hileman
I don't know if it's typical. We would probably say we were a little flatter, historically, than this, so but I think we're attributing a little bit to the higher level of actually growth we saw.

Kevin Thompson
We pulled it through.

Don Hileman
Yeah, there you go. We pulled it through a little bit faster than maybe we had in the past.

Daniel Cardenas
Okay, all right, and then as you guys look at your initiatives or your focus going forward about your growing into the metro markets, your investment in human capital, technology, et cetera. Do you have a significant, or is your infrastructure capable of supporting that or do we need, or can we expect to see additional investments, or I guess higher operating expenses going forward to support what you're talking about?

Kevin Thompson
Technology is an ongoing investment in the world today, and so we're continuing. We're investing on a continuous basis, Dan, and that will continue as we go forward. As we think about our expenses ahead, we will expect some expense growth to support all those areas in 2017, but we expect the revenue growth, obviously, to outpace that and continue to help us grow our bottom line.

Daniel Cardenas
Okay, perfect, and then tax rate, should we kind of assume that you're going to be around this 33% rate, going forward, or is it going to pop up a little bit as we model forward?

Kevin Thompson
33%, is that on a TE basis or something?

Daniel Cardenas
Correct, correct, that's on a TE basis.

Kevin Thompson
All right, pop up. I would think on the margin, that is one thing we're seeing, is that on the margin we'll probably see that edge up a basis point or so over time, just due to the mix of taxable versus non-taxable income, if you know what I'm saying.

Daniel Cardenas
Right. Okay, great. All right, thank you, guys.

Kevin Thompson
But I don't think it will jump next quarter or anything.

Daniel Thompson
Okay, got it.

Kevin Thompson
All right?

Daniel Cardenas
Thank you, Kevin.

Don Hileman
Thanks, Dan.

Operator
Once again, if you would like to ask a question, that is star (*) then one (1) on your touchtone phone. We have no further questions, so this will conclude our question-and-answer session. I would now 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 all for attending today's presentation. You may now disconnect your lines.