First Defiance Corp.

Q4 and Yearend 2016 Earnings call

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CORPORATE PARTICIPANTS

Tera Murphy - *VP, Marketing Director*

Don Hileman - *President and CEO*

Kevin Thompson - *Executive Vice President and CFO*

PRESENTATION

Operator
Good day, everyone, and welcome to the First Defiance Fourth Quarter and Yearend 2016 Earnings Conference Call. All participants will be in listen only mode. After today's presentation, there will be an opportunity to ask questions. To ask a question, you may press star (*) then one (1) on your touchtone phone. Please note that 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 2016 fourth quarter and yearend earnings conference call. This call is also being webcast and the audio replay will be available at the First Defiance website at fdef.com.

Providing commentary this morning will be Don Hileman, President and CEO of First Defiance; and Kevin Thompson, Executive Vice President and Chief Financial Officer. Following their prepared comments on the Company's strategy and performance, they will be available to take your questions. Before we begin, I'd like to remind you that during the conference call today, including during the question and answer period, you may hear forward-looking statements related to future financial results and business operations for First Defiance Financial Corp. Actual results may differ materially from current management forecasts and projections as a result of factors over which the Company has no control. Information on these risk factors and additional information 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 the First Defiance Financial Corp fourth quarter conference call. Joining me on the call this morning to give more detail on the financial performance for the quarter and the full year is our CFO, Kevin Thompson.

Last night, we issued our 2016 fourth quarter and full year earnings release and now we'd like to discuss that release and give you some insight into 2017 and our progress on our merger between First Defiance and Commercial Bancshares Incorporated that's expected to close this quarter. At the conclusion of our remarks, we will answer any questions you might have.

I am pleased with the overall momentum we are carrying into 2017 relating to both our financial and strategic performance. Fourth quarter 2016 net income on a GAAP basis was $7.4 million or $0.81 per diluted common share, compared to $6.6 million and $0.71 per diluted common share in the fourth quarter of 2015. For the year ended December 31, 2016, First Defiance earned $28.8 million or $3.19 per diluted common share, compared to $26.4 million or $2.82 per diluted common share for 2015. At quarter end, our total assets were $2.5 billion, up 8% from a year ago. The healthy growth trends on both loans and net interest income continued in the fourth quarter. Gross loans at December 31 were up about 8% over a year ago. Loan growth was lighter in the fourth quarter at 3%, but we are still expecting to see full year growth in 2017 in the upper single digits, inclusive of the impact from the Commercial Savings Bank merger.

As we look into 2017, our continued ability to grow our loan portfolio will be a key focus of our strategic plan. We are very satisfied to see loan growth across our footprint in the face of strong competitive market pressures, particularly in pricing, as all institutions are more aggressively seeking loan growth. Total new loans originated in the fourth quarter were put on at a weighted average rate of 4.15%, compared to 4.04% in the third quarter of 2016. The overall yield on loans for the fourth quarter of '16 was 4.38%, up 4 basis points from the fourth quarter of 2015.

Our core business strategies contributed to both growth in our net interest income and the solid performance of our noninterest income revenues on a quarterly basis. This is reflected in our solid net interest income growth this quarter of 8.3% over the fourth quarter of 2015. Year-over-year net interest income increased 6.6%. We expect the interest rate environment to be reflective of continued anticipation of multiple Federal rate increases over the course of 2017. We continue to measure our interest rate risk position and we are managing toward a neutral to slightly asset-sensitive position. Kevin will provide additional commentary on this in a few minutes.

We are very satisfied with our margin, considering the very competitive operating and rate environments. Our net interest margin increased to 3.76% over the third quarter of 2016 margin of 3.69%. We did see a slight compression of the margin from the fourth quarter of '15 of 1 basis point, but we are content with our margin trend and will continue to balance pricing discipline with growth. The credit quality metric showed continued overall improvement this quarter from a year ago with a reduction in year-over-year and linked quarter nonperforming assets of 15.8% and 22%, respectively. We also had a reduction in restructured loans this quarter of 15.7%, year over year, despite a slight increase on a linked quarter basis. Our nonperforming assets to total assets declined to 0.6% this quarter, down from 0.77% in the fourth quarter of 2015. Our allowance coverage of nonperforming loans increased to 180% this quarter. Our overall capital planning is supported by our ongoing solid performance in capital levels. We are very pleased to announce a 2017 first quarter dividend of $0.25 per common share, representing a 13.6% increase and an annual dividend yield of approximately 2.1%. We did not buyback any stock in the fourth quarter as our buyback activity was impacted by our higher stock valuation.

As for our pending merger, we are on track to close the Commercial Savings Bank transaction on February 24. We have received all regulatory approvals and await the Commercial Bancshares' shareholder meeting scheduled for January 26. Our joint teams have been working diligently on planning and preparing for the integration of Commercial Savings Bank's customers from the their branches located in Wyandot, Marion, and Hancock counties in Ohio. We are excited to add Commercial Savings Bank to our franchise as part of our southern market area.

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

Kevin Thompson
Thank you, Don. Good morning to everyone. Don indicated our net income for the fourth quarter was $7.4 million or $0.81 per diluted share. This compares to prior year results of $6.6 million or $0.71 in the fourth quarter of 2015. Fourth quarter 2016 did include some expenses related to our pending merger of Commercial Bancshares Inc., which reduced EPS by about $0.02. It also included a onetime expense for a lease termination that reduced EPS by about $0.02 and a favorable adjustment to our MSR valuation that increased earnings per share by about $0.02. Last year's fourth quarter included some OREO gains and a favorable MSR adjustment that, together, benefited earnings per share by about $0.015. So clearly our fourth quarter was pretty strong versus a year ago.

Our fourth quarter financial performance results show the benefits of our steady revenue growth, positive operating leverage, and continued credit quality improvement from the prior year and evidences the strong momentum we are bringing into the new year. Starting with the balance sheet, after an exceptionally strong third quarter, our loan growth slowed some in the fourth quarter, while deposit growth slower in the third quarter, picked up nicely in the fourth quarter. Total loans finished the quarter up $14.8 million from last quarter and up $138.3 million or 7.7% from a year ago, maintaining our strong and profitable earning asset mix. On the deposit side, we saw a solid increase of $53.9 million this quarter and we're up $145.3 million or 7.9% from a year ago. While our loan and deposit growth has been a bit unbalanced the past two quarters, we are very pleased with the overall balanced results for the year. Looking forward into 2017, we expect our steadily growing balance sheet to continue generating strong earnings growth.

Turning to the income statement, our net interest income was $20.5 million for the fourth quarter of 2016, up from $19.8 million in the linked quarter and up about $1.5 million from the $19 million in the fourth quarter last year. Our margin this quarter was 3.76%, up 7 basis points from 3.69% in the third quarter and down just one basis point from the fourth quarter last year. These results do include and effect from recovered interest, which was very strong in the fourth quarter. Recovered interest totaled $500,000.00 in the fourth quarter 2016 compared to about $50,000.00 in the third quarter 2016 and $227,000.00 in the fourth quarter 2015. The recovered interest benefited earning asset yields and net interest margin by about 9 basis points this quarter, 1 basis point last quarter versus about 4.5 basis points in the fourth quarter last year.

Our loan portfolio yield at 4.38% was up 8 basis points from the linked quarter and 4 basis points from the prior year, remaining strong but, again, impacted by the recovered interest. Our cost of interest bearing liabilities raised just one basis point on a linked quarter basis, mainly due to balances within our interest bearing deposits beginning to slightly shift for higher yields. Looking forward, our interest rate risk position remains basically neutral with a slight asset-sensitive bias and we see the steepened yield curve as a favorable environment for us. These elements, coupled with our growth momentum, leave us optimistic about continued expansion of net interest income in 2017.

Our total noninterest income was $8.3 million in the fourth quarter of 2016, down $233,000.00 from the linked quarter and up from $7.7 million in the fourth quarter of 2015. The third quarter 2016, the fourth quarter 2016, I'm sorry, the third quarter 2016 did include $151,000.00 of securities gains and seasonally stronger mortgage banking revenues. Compared to the fourth quarter last year, noninterest income was up about $563,000.00 or 7.3%. We had particularly strong revenue increases in our key businesses of mortgage banking, up $463,000.00 or 31.6%, and wealth management, which grew $78,000.00 or 21.3%. Insurance commissions were $2.3 million in the fourth quarter, up $45,000.00 or 2% from the prior year.

Regarding mortgage banking revenues for the fourth quarter of 2016, they were $1.9 million, down $111,000.00 from the linked quarter but up $463,000.00 from the fourth quarter of 2015. The fourth quarter mortgage banking originations were $77.6 million, down from $101.7 million last quarter, but up nicely from $56.3 million in the fourth quarter in 2015. Gain on sale income was $1.2 million in the fourth quarter 2016, compared to $1.7 million on the linked quarter basis and $836,000.00 in the fourth quarter last year. In addition, the fourth quarter included a positive valuation adjustment to mortgage servicing rights of $241,000.00, compared to positive adjustments of $7,000.00 last quarter and $75,000.00 in the fourth quarter 2015. At December 31, 2016, First Defiance had $1.37 billion in loans serviced for others. The mortgage servicing rights associated with these loans had a fair value of $9.6 million or 70 basis points of the outstanding loan balances serviced. Total impairment reserves, which are available for recapture in future periods, totaled $522,000.00 at quarter end.

Also within noninterest income, our gains on the sale of non-mortgages were $149,000.00 in the fourth quarter, 2016, up from only $48,000.00 in the fourth quarter last year. As for noninterest expense, fourth quarter expenses totaled $18.2 million, down from $18.3 million in the linked quarter and up from $17.3 million in the fourth quarter of 2015. The fourth quarter included $292,000.00 of onetime expenses for our pending merger with Commercial Bancshares Inc. Last quarter included $252,000.00 of merger related expenses. The fourth quarter 2016 also included a onetime charge of $300,000.00 for the termination of a lease. As for the rest of the detail in expenses, compensation and benefits expense in the fourth quarter of 2016 was up only $64,000.00 from last year as increases from new staff additions for our growth strategies and merit increases were mostly offset by lower benefits expenses. Our other noninterest expense was $3.9 million in the fourth quarter 2016, up from $3.3 million in the same quarter last year, mainly due to the inclusion of merger related expenses for our pending merger and the onetime cost for the lease termination mentioned earlier.

Regarding provision expense, our strong credit quality continues to contain our provision expense. The fourth quarter of 2016 included a credit provision of $149,000.00 compared to a $15,000.00 expense last quarter and an expense of $43,000.00 in the fourth quarter last year. The fourth quarter of 2016 included net loan recoveries of 2 basis points compared with charge-offs of 1 basis point last quarter and net recoveries of 3 basis points in the fourth quarter a year ago. Our allowance for loan loss at December 31, 2016, was $25.9 million or 1.33% of total loans, versus $25.4 million or 1.41% at December 31 last year. The change in allowance ratio reflects the maintenance of strong credit quality and low loss experience achieved over the past year. The allowance coverage and nonperforming loans at fourth quarter end was increased to 180%, versus 156% at December 31, 2015. We continue to anticipate the allowance to loans percentage to reflect our strengthened asset quality and favorable loss experience.

As for nonperforming asset numbers, nonperforming loans decreased this quarter to $14.3 million from $18.2 million on a linked quarter basis and from $16.3 million at December 31, 2015. As expected, the onetime credit causing the uptick last quarter was resolved by the end of the year. Our OREO balance this quarter was just $455,000.00, down from $704,000.00 last quarter and down from $1.3 million in the fourth quarter last year. Overall, nonperforming assets ended the quarter at $14.8 million or 0.60% of total assets, down from $17.6 million or 0.77% of total assets at December 31, 2015. Our troubled debt restructured loans this quarter were up a bit from last quarter to $10.5 million from $9.1 million but still down from $11.2 million a year ago.

Looking at our capital position, total period-end stockholders equity finished the quarter at $293 million, up from $280.2 million at December 31, 2015. During the quarter, we did not repurchase any shares, leaving approximately 377,500 shares remaining under our current repurchase authorization. Our capital position remains healthy and consistent with our growth and capital management strategies. At quarter end, shareholders equity to assets was a solid 11.84%, although down from 12.20% last year. The Bank’s total risk-based ratio was approximately 12.1% at yearend December 31, 2016.

At this point, I’d just like to take a moment to recap the fourth quarter diluted EPS and how we look at it. As stated, for the quarter we reported $0.81 per share. Adjusting for significant non-operating items included the merger expenses $0.02 a share and the lease termination $0.02 per share offset partially by the MSR valuation benefit of $0.02 per share. That would get us to about $0.83 a share. Further adjustments for the high level of recovered interest, $0.03 to $0.04 a share, and the negative provision expense of about $0.01 per share, would lead to a firmer core number in the $0.78 to $0.79 range.

Regarding our year-to-date results, for the year 2016 net income was a record $28.8 million or $3.19 per diluted share, which compares quite favorably versus net income of $26.4 million or $2.82 per diluted share for the year 2015. That's an overall 13% increase and diluted EPS driven by a 9.2% improvement in earnings and the remaining increase due to the reduction in shares through our capital management efforts. Overall, we were pleased with the results and, as Don indicated, the Board approved the dividend increase to $0.25 per share this quarter for an increase of 13.6% over the previous rate. Finally, we are excited about our outlook for 2017 and especially the closing of our merger with Commercial Bancshares in the first quarter. When the Commercial merger closes, we expect we'll add approximately $355 million in assets with about $310 million in both loans and deposits. We plan to issue approximately 1,139,000 shares and pay $13 million in cash to complete the transaction. Since the merger will be closing on February 24, the operating results and average shares will only have a partial quarter effect, which we do not expect to be significant in the quarter. However, closing the deal will involve some additional onetime expenses in the first quarter. Currently, we are expecting a net after tax charge between $2.4 million or $2.6 million or between $0.24 and $0.26 per diluted share.

Also in the first quarter, we expect to complete some BOLI transactions to address an underperforming BOLI policy. This should have a onetime negative impact of about $0.02 in the quarter. Overall, we are still comfortable with the current market expectations for our 2017 core operating results; however they should be lowered by the expected onetime cost. That completes my financial review.

I'll turn the call back over to Don.

Don Hileman
Thank you, Kevin. I am pleased with 2016 results and the continued progress we have made to position First Defiance for future success. The national election results and the impacts on the financial sector have the potential for a positive impact but we remain cautious as to the economic environment and more directly, the level and volatility of the potential changes. We continue to focus on several key areas we believe are very important, including core balance sheet growth with the focus on loan and deposit growth, overall revenue growth, expense control, and improved asset quality.

We made solid progress in all of these areas in 2016. We do believe a rise in loan demand aided by further improvement in the economic environment will carry through to 2017. We look to grow our position in the metro markets of Fort Wayne, Indiana, Toledo and Columbus, Ohio. While lending environment remains very competitive, we feel we can accomplish loan growth without making significant concessions in rate and other terms through a strong process of relationship building and quality client focused service. We understand it will be challenging to drive growth in loans and maintain yield management until market rates move a little higher. We are heavily focused on relationship management pricing. Our delivery and service model is effective in helping to achieve this balance. We are very focused on deposit growth initiatives to overcome challenges and attracting core deposit relationships at a correlated pace with the loan growth.

We are aware that customer expectations, especially pertaining to digital delivery methods, are changing at an accelerated pace and we are committed to providing our clients quality products and services within the environment they prefer. While we look to technology for continuous enhancements of our digital delivery capabilities that are growing in popularity with our client base, we have launched a branch transformation initiative to introduce more technology into our customer service model. The deployment of inline teller units increases efficiency in certain locations and offers customers additional choices within a traditional branch environment.

In addition, we have expanded our physical branch presence by opening an in-store branch in Downtown Toledo and expanded to a full service branch from a loan production office in Columbus. Through 2017, we will be continually looking to enhance the customer experience, both in person and through our digital channels. We will also continue to focus on growth of our insurance and wealth management revenues as part of our strategic plan. It's important to reflect on 2016 as an excellent year for our Company with notable progress made towards achieving our long-term strategic goals. We were particularly pleased by the significant improvement in credit quality, reflected by lower charge-offs in the overall lower nonperforming assets.

We are very encouraged by the recent performance and look to constantly drive our performance through initiatives that will help us obtain our goal of being a consistently high performing community bank. As we look to carry this success forward, we have 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. 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 our 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, our ability to adapt to overcome obstacles, and in our people working hard to execute our plans. We feel that 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. We remain dedicated to all of our customers and shareholders and we appreciate the trust you have placed in us as we work to build pride in First Defiance.

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 your 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 for a moment to assemble our roster and the first question today comes from Damon DelMonte with KBW. Please go ahead.

Damon Delmonte
Hey, good morning, guys, how's it going today?

Don Hileman
Good morning, Damon.

Kevin Thompson
Good morning.

Damon DelMonte
Good morning. So my first question just deals with loan growth. Don, I think you had mentioned that you're comfortable with upper single digit growth for 2017. Did you say that that includes the impact from the Commercial Savings Bank acquisition?

Don Hileman
No, that would exclude that. We think that an organic exclusive of what they bring over that will have that upper single digit growth.

Damon DelMonte
Okay, so that's on an organic basis. Okay, great and then what areas of the portfolio do you think will be driving that growth?

Don Hileman
I think it will be a similar mix to what we've seen in the past. I don't think we have any expectations that will drive different patterns as a percentage as, clearly, we expect some commercial real estate to pick up as we go forward [technical difficulty] year and that will be, as we've talked about in the past, that's a driver of where we position ourselves.

Damon DelMonte
Do you have any concerns as far as concentration risk goes, as far as being percentage of regulatory capital?

Don Hileman
Not in the near term, Damon. We look at that, we think we're well positioned for that. Actually, with the acquisition, it kind of blends a little bit better for us. So as we look forward, at least for 2017, we've got that capacity and the other thing we believe is we've got the systems and monitoring in place to handle that kind of a concentration.

Damon DelMonte
Okay and then with regard to the provision expense, you know in the last couple years it's been pretty low, obviously not at a normalized level. As we look into 2017, can we expect it to begin to go back to a normalized level and if so, what's the general parameter we should consider when looking for that level?

Kevin Thompson
Yeah, good question and we certainly expect it to increase in 2017. Normalized level, we think our credit quality, still, is going to enable us to contain provision expense to some degree but probably not on the order it has in the last couple years. We expect charge-offs in the 5 basis point range up to that next year. So we would expect some impact from that plus, obviously, the growth that Don has talked about in the upper single digits. So those will be two things that will kind of push the provision up. That said, some continuing reduction in nonperformers would tend to reduce the allowance on a going forward basis. So if I was to, we're always very cautious on provision. Again, we've had great experience the last couple of years, but I would think it would be more normalized based upon the factors that I've outlined there.

Damon DelMonte
Okay.

Kevin Thompson
That help?

Damon DelMonte
That's good, yup, that's helpful, thanks. Yes, obviously, not an easy question to give a pinpoint answer to, I can appreciate that.

Kevin Thompson
All right.

Damon DelMonte
I guess this is my last question. Could you just give an update on the LPO in Columbus, maybe the amount of outstanding that you have coming out of that portfolio?

Don Hileman
Yes, that's grown. We grew about another $3.5 million in the fourth quarter, so we're expecting that to continue. It's up over $100 million and continue to grow at a little faster pace, actually, for '17 than it did in the latter part of '16.

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

Don Hileman
Thank you very much.

Operator
Again, if you would like to ask a question, please press star (*) then one (1). Our next question for today is Emily Chambers with FIG Partners. Please go ahead.

Emily Chambers
Good morning.

Kevin Thompson
Good morning.

Don Hileman
Good morning, Emily.

Emily Chambers
I just wanted to ask you, do you think mortgage banking can grow this year, given your pending acquisition as well as your focus on purchase business and is there more than just a seasonal decline expected in the first quarter?

Don Hileman
I didn't catch the last part of the question, Emily.

Emily Chambers
Is there, do you think there's more than just a seasonal decline expected in the first quarter?

Don Hileman
I think there's some headwinds there as we look to where rates will be and that might have a little bit more of an impact than just a seasonal impact on the first quarter. So we're anticipating some declines in our run rate to our mortgage banking, somewhat based to the rates and somewhat based to the seasonal aspects of the first quarter.

Kevin Thompson
We had particularly strong fourth quarter, I think, for us, much higher than we would have seasonally expected. As we've come into 2017, we still feel we've got a pretty good momentum in mortgage but probably expect to experience a little more of the seasonal effect, if you would. For all of 2017, again, we think rates are probably more apt to move up and that probably would tend to contain any kind of growth. The merger itself, we think is an opportunity for us to actually do better. They, their mortgage originations, they've done it a little differently than us, we think we can perhaps grow that business a little bit, maybe not immediately, but over time from the merger. So going forward, that should be a plus. But the general basic, I think, rate expectations, economic trends, probably would be looking for more of a slight decline in 2017, overall.

Emily Chambers
Great and I just had another quick question. Is there a minimum level of loan reserve that you envision or do you need a minimum provision for new loans this year?

Kevin Thompson
I don't know, I mean that's a determination that's made on a quarterly basis. I don't know that there's a minimum that we expect. We do, as I said, expect that it will probably decline as our asset quality continues to be improving and our low loss experience will also continue to drive that down, going forward. I don't have a floor that I could give you. Obviously, we'll have some purchase accounting effect when we do close the transaction with Commercial in the first quarter, as all those loans will come on at a market discounted value, as well.

Emily Chambers
Right, right, that makes sense. All right, thanks, guys, that's all I have for now.

Kevin Thompson
All right.

Don Hileman
All right, thank you very much, Emily.

Operator
Again, if you would like to ask a question, please press star (*) then one (1). Just once again, if anyone would like to ask a question, please press star (*) then one (1). It looks like we have no further questioners, so this will conclude the 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 and yearend 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.