First Defiance Financial Corp.

Third Quarter 2017 Earnings Call

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CORPORATE PARTICIPANTS

Tera Murphy - *Assistant Vice President, Investor Relations*

Don Hileman - *President, Chief Executive Officer*

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

PRESENTATION

Operator
Good morning and welcome to the First Defiance Third Quarter 2017 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 touchtone phone. To withdraw that question, please press star then two. Please note this event is being recorded.

I would now like to turn the conference over to Tera Murphy with First Defiance Financial Corporation. Please go ahead.

Tera Murphy
Thank you. Good morning everyone, and thank you for joining us for today’s 2017 third 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 the 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 Corporation third quarter conference call. Last night we issued our 2017 third quarter earnings release, and now we would like to discuss the third quarter results and provide some insight into the remainder of 2017.

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 be glad to answer any questions you might have.

Our solid third quarter financial performance results reflect our continued success and profitable growth in the execution of the first and second quarter acquisitions. Third quarter diluted earnings per share grew to $0.92, an 18% increase over the third quarter of last year. Third quarter 2017 net income on a GAAP basis was $9.4 million compared to $7 million, or $0.78 per diluted common share, in the third quarter of 2016. At quarter-end, our total assets exceeded $2.9 billion, up 20% from a year ago.

The overall momentum gained during the previous quarters continued in the third quarter, with solid loan and deposit growth as well as net interest income growth. Total loans at September 30th were up 18% over a year ago and up 4% on a quarter annualized basis. Total deposits were 22% year-over-year and 6% on a linked quarter basis.

The efficiency ratio improved to 58.7% from 58.96% on a linked quarter basis, and from 63.87% at the end of the third quarter of '16. Our third quarter '17 results reflect strong profitability, with an ROA of 1.28 compared to 1.16 in the third quarter of 2016. Net charge-offs moderated lower in the third quarter to $36,000 compared to $1.9 million last quarter, and were basically flat with the third quarter of '16.

We are satisfied with our gross loan production this quarter, but the impact of several large payoffs to net growth was disappointing. Our overall pattern of loan growth in our footprint this quarter is consistent with that of the first two quarters. We are focused on our ongoing ability to grow our loan portfolio in this very competitive marketplace. While down from levels of previous quarters, our overall pipeline remains very active. The majority of our clients continue to perform very well and have improved confidence in their companies' outlook.

The effective new loan rate for the quarter was 4.67% compared to 4.52% in the second quarter of 2017. Our overall loan yield for the third quarter of '17 was 4.59%, up 29 basis points from the third quarter of 2016. Our net interest margin increased to 3.91% from 3.69% in the third quarter of 2016. We expect the interest rate environment to be reflective of a possible Fed rate increase in December. We actively measure our interest rate risk position and are managing toward a neutral to slightly asset position.

The credit quality metrics showed slight overall improvement this quarter compared to the second quarter of '17, which saw an increase discussed last quarter. Overall, non-performing loans declined this quarter, and we are working toward additional improvements, as we are still not satisfied with the current levels.

We are also delighted to announce the 2017 fourth quarter dividend of $0.25 per share, representing an annual dividend yield of approximately 1.86%. Our overall capital planning is supported by our ongoing solid performance and capital levels. This allows us to consider multiple uses of capital.

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

Kevin Thompson
Thank you, Don, and good morning to everyone. As Don stated, net income for the third quarter was $9.4 million, or $0.92 per diluted share. These results favorably compare to prior year third quarter results of $7 million, or $0.78 per diluted share. That's an increase of 17.9%. Our third quarter 2017 results reflect strong profitability, with an ROA of 1.28% and a net interest margin of 3.91%, solid expense control with an efficiency ratio of 58.70%, and stable asset quality with net loan charge-offs below 0.01% and an improving growth momentum for both loans and deposits.

Now to the details behind these highlights, we'll turn to the balance sheet with third quarter total loan growth at $21.6 million, just under 4% annualized and up from $16.4 million last quarter and $12.8 million organically in the first quarter. We expect our loan growth profile to continue elevating toward an upper single digit growth rate in the fourth quarter.

On the other side of the ledger, total deposits reflected an increase of $34 million. Last quarter we had a decline of $47 million in deposits due to a large deposit at the end of the first quarter which ended up exiting the bank over the course of the second quarter as planned. So, we were pleased to see our deposit growth of 5.8% annualized back on a solid track. The combined growth impact maintained our strong earning asset mix, low cost deposit funding, and profitable margin, all of which are expected to continue.

Following those areas, we'll move to the income statement and our net interest income. For the third quarter 2017, net interest income was $25 million, up from $24.6 million in the linked quarter, and up $5.2 million or 26.2% from the $19.8 million in the third quarter last year. The increase over the prior year was primarily driven by growth, which includes the addition of the CSB acquired balances in the first quarter of 2017, but also reflects margin expansion, as the loan portfolio yield has increased with the rate hikes over the past year while deposit funding costs have been less impacted.

As a result, our margin this quarter at 3.91% was up two basis points from last quarter and up 22 basis points from 3.69% in the third quarter last year. On a linked quarter basis, our yield on earning assets was up five basis points, as our loan portfolio yield rose to 4.59% for the third quarter of 2017.

Our cost of interest bearing liabilities was up three basis points on a linked quarter basis, mostly due to marginal rate impacts. With the expected balance sheet growth, we are confident in the continued strength and stability of our margin and that we are well balanced in exposure to interest rate changes and anticipated Fed actions.

Total non-interest income was $9.5 million in the third quarter of 2017, down from $10.1 million in the linked quarter but up from $8.5 million in the third quarter of 2016. The third quarter 2017 did include $158,000 of securities gains versus $267,000 in gains last quarter and $151,000 of gains in the third quarter last year. Excluding the securities gains, quarterly non-interest income was up year-over-year about $962,000 or 11.5%.

Other than mortgage banking income and gains on the sale of non-mortgage loans, we had increases in all categories of fee income primarily from the growth of our company, which includes contributions from the CSB and Corporate One mergers.

Regarding mortgage banking revenues, for the third quarter of 2017 they were $1.7 million, down just $132,000 from the linked quarter and down $341,000 from the third quarter 2016. The third quarter mortgage banking originations were $71.8 million compared to $64.2 million last quarter and $101.7 million in the third quarter 2016. Gain on sale income was $1.2 million in the third quarter of 2017 compared to $1.3 million on a linked quarter basis and $1.7 million in the third quarter last year.

Changes to mortgage servicing rights valuation were not significant in the third quarter or in the respective comparative periods. At September 30th, 2017, First Defiance had $1.3 billion in loans serviced for others. And the mortgage servicing rights associated with those loans had a fair value of $9.7 million, or 71 basis points, of the outstanding loan balances serviced. Total impairment reserves, which are available for recapture in future periods, totaled $501,000 at quarter-end.

As for non-interest expense, third quarter expenses totaled $20.4 million, down from $20.6 million in the linked quarter which included about $310,000 of merger related expenses, but up from $18.3 million for the third quarter of 2016. Comparing to the same quarter last year, the increase was primarily attributable to the additional operating costs from the commercial savings bank and corporate loan benefits mergers, which were respectively completed in the first and second quarters this year.

We continue to be very pleased with our efficiency ratio, improved by realizing the cost synergies from the CSB merger. Our efficiency ratio of 58.70% in the third quarter of 2017 versus 63.87% in the third quarter last year clearly reflects this benefit.

Regarding asset quality, provision expense in the third quarter of 2017 totaled $462,000, compared to a provision of $2.1 million last quarter and $15,000 in the third quarter last year. The provision decrease from last quarter was due to the charge-offs recorded last quarter after the downgrade of two larger credits. Provision in the third quarter of 2017 was mainly driven by growth in the loan portfolio.

Net loan charge-offs in the third quarter 2017 were only $36,000, or 0.01% annualized, down from just under $2 million, or 35 basis points, annualized in the linked quarter and basically even with the level of the third quarter last year at $40,000, or 0.01% annualized.

Our allowance for loan loss at September 30th, 2017 was $26.3 million, or up by $426,000 versus June 30th and up $418,000 from a year ago. The allowance to total loans ratio at September 30, 2017 was 1.16%, up a basis point from last quarter but down from 1.35% last year. The decline in the ratio from last year was primarily due to the addition of the acquired CSB loans, which were discounted and recorded to fair value with no allowance. The remaining CSB acquired loans are currently carried at a discount of $4.2 million, or 1.9% of balances.

As for the non-performing balances, non-performing loans decreased this quarter to $29.2 million from $30.4 million at last quarter-end, which included the two large downgrades totaling $13.6 million, but were up from $18.2 million at September 30th, 2016.

Our OREO balance remains low and declined this quarter to $532,000, compared to $672,000 last quarter and $704,000 in the third quarter last year. Overall non-performing assets ended the quarter at $29.7 million or 1.01% of total assets, still up from $18.9 million or 0.77% of total assets at September 30th, 2016.

Our accruing troubled debt restructured loans this quarter were $13 million, up from $10.5 million last quarter and $9.1 million a year ago. As a result of the change in NPAs, at quarter-end the total allowance coverage of non-performing assets was 89%, compared to 137% at September 30, 2016. While last quarter's two downgrades are still impacting the numbers, we are confident in our overall portfolio strength and look to see additional improvement in asset quality in the quarters ahead.

Looking at our capital position, total period-end stockholders' equity finished the quarter at $367.9 million, up from $293 million at September 30th, 2016. The increase includes the acquisition of Commercial Bancshares. Our capital position remained strong, with quarter-end shareholders' equity to assets up 12.54%, up from 11.92% last year. The bank's total risk-based capital ratio is approximately 12.4% at quarter-end, September 30th, 2017. Our capital position remained solid in support of our ongoing growth and shareholder value enhancement objectives.

So again, in summary, our balance sheet and profitability are strong, enhanced by the full integrations of the CSB and Corporate One mergers into our operations. Our asset quality is solid and stable, and our outlook is positive for our continued growth.

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

Don Hileman
Thank you, Kevin. Our steady performance, client-focused values, and engaged employees merge together to deliver exceptional results to our shareholders. Our strategy keeps us moving forward, as we look to expand our branch and agency networks through mergers and acquisitions and to deepen relationships within our footprints, especially in our metro markets.

We continue to focus on and redefine several key strategies to help us achieve our long term goals. The first is our metro market growth plan and expectations. We are excited by the appointment of two senior executives to lead our strategic metro market strategy in Toledo and Fort Wayne to supplement our strong leadership in the Columbus, Ohio market

In addition, our strong performance in the third quarter helps us position for opportunities to move forward and address potential economic challenges in the coming quarters. Uncertainty remains in the direction of interest rates, and the more impactful are the level and volatility of those potential changes. With continued focus on core balance sheet growth, particularly loan growth, overall revenue growth, expense control, and improved asset quality, we believe these key factors will further improve financial performance and drive greater shareholder value.

We believe a growth rate in the high single digits is appropriate going forward, despite not yet achieving that rate on a net basis in recent quarters. Our ongoing plan is to strategically grow our overall position in the metro markets of Fort Wayne and Toledo, Ohio, and increase loan production in the Columbus, Ohio markets.

In addition, we continue to assess better ways to more conveniently serve our current and potential clients in these markets. Our loan growth is being achieved with continued focus on relationship management pricing and our delivery and service model.

We are also continually evaluating and implementing deposit growth initiatives to overcome challenges in attracting core deposit relationships at a correlated pace with loan growth. With our balanced approach and our 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 continually evaluating opportunities to provide our clients a quality choice of products and services. We have seen steady improvement in the adoption and use of electronic delivery channels. We believe we are a leader amongst community banks in offering customers the variety of digital solutions ranging from mobile wallet options to People Pay, and the additional enhancements and offerings are in various stages of planning and development.

We are encouraged by the overall growth in revenues driven by net interest income, and our plans for additional revenue growth include capitalizing on opportunities for our insurance and wealth management divisions.

Our recent performance and our drive to complete initiatives that deliver strong results leaves us encouraged that we'll be a consistently high performing community bank. We remain confident in our strategy and our ability to adapt to overcome obstacles, and our people are working hard to execute our plans. Our commitment remains steadfast to all the customers and shareholders, and we appreciate the trust you have placed in us as we work to make First Defiance a consistently high performing financial institution.

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

QUESTION AND ANSWER

Operator
We will now begin the question and answer session. To ask a question, you may press star then one on your touchtone phone. If you're using a speakerphone, please pick up your handset before pressing the keys. To withdraw that question, press star then two.

Our first question comes from Matthew Forgotson with Sandler O'Neil and Partners. Please go ahead.

Matthew Forgotson
Hi. Good morning, gentlemen.

Don Hileman
Good morning, Matt.

Kevin Thompson
Good morning, Matt.

Matthew Forgotson
I was just looking for a little bit of detail around net interest margin, just trying to get a feel for the trajectory going forward. So, I might ask how much loan discount accretion did you record this quarter? It was $76,000 or so in the linked quarter.

Kevin Thompson
I don't recall the $76,000 number exactly, but I'll believe you if you took it out of your notes. This quarter was about $400,000, Matt.

Matthew Forgotson
Okay. And do you think that that's a reasonable expectation going forward, or is that a bit elevated?

Kevin Thompson
I would say that's elevated, and probably be down. I would estimate that more in the $300,000 range, at least for the near term quarter.

Matthew Forgotson
Perfect. Thank you. And then how about prepayment penalties or interest recoveries?

Don Hileman
Nothing significant.

Kevin Thompson
Yes, this quarter did not have anything significant.

Matthew Forgotson
Okay, excellent. Okay. So, what's your sense here off of this 3.91%? Do you think you're going to come in a little bit as the loan discount accretion normalizes, or do you think you can overpower that with mix shift?

Kevin Thompson
I think we'll probably come in a little bit. That would be my expectation, maybe back to where we were last quarter.

Matthew Forgotson
Okay, perfect. Thank you. And on organic loan growth, just want to make sure I heard you correctly. Did you say that we should expect a build towards upper single digit annualized growth in the fourth quarter of the year?

Kevin Thompson
That's what we're anticipating at this time, Matt.

Matthew Forgotson
Okay, perfect. And then you mentioned some elevated pay-downs in the quarter. Could you just bracket that out for us, provide a little bit more granularity?

Kevin Thompson
Well, it was larger loans, one a construction loan that, upon the completion of the construction, we lost out on the permanent loan. That was about $12 million. That's an example of what we've seen, a couple of instances like that.

Matthew Forgotson
And how would you describe the pipeline today relative to where it was at June 30?

Don Hileman
It's down a little bit, but not anything that I would say is material. It's still a pretty strong pipeline. And if we have a solid close rate on the pipeline, we'll be around our target.

Matthew Forgotson
Okay, perfect. And then certainly the credit commentary in the release and then on the call was encouraging, expect an improvement in the NPA ratio going forward. Are you signaling that we might see, well, one of the two problem credits that went sour last quarter maybe two are going ahead, or were you making a bit more of a broader statement?

Don Hileman
I think that our expectation is that one of those credits is moving positively as we analyze it here at the end of this quarter, and that if it keeps on its current trend that would be a significant improvement in our credit quality with that credit. So, it's trending in the right direction. Timing is the question.

Kevin Thompson

Yes, I would say they're both trending in the right direction. One's maybe just a little slower. But we're very encouraged by the operating results of those borrowers and where they're going. And as Don said, one of them may be on a more accelerated pace, and that would be obviously significant.

Matthew Forgotson
Okay. And the one that might be on the more accelerated pace is roughly how large? Can you remind us?

Kevin Thompson
About seven.

Matthew Forgotson
Okay, perfect. And then last question and then I'll step out. Just on M&A, Don, would you describe kind of activity across the footprint, what you're seeing, what you're hearing, and your level of enthusiasm for maybe get something else done?

Don Hileman
I think there's a lot of activity and a lot of interest. I'd say there is elevated conversations and discussions, Matt. I think there's still a robust environment for us and the opportunities are still there for us.

Matthew Forgotson
Okay. Well, thanks for taking my questions.

Kevin Thompson
Sure.

Don Hileman
Thank you.

Operator
The next question comes from Damon DelMonte with KBW. Please go ahead.

Damon DelMonte
Hey, good morning, guys. Just wondering if you could just give us an update on the integration of the CSB deal. And have you extracted all of the expected cost savings from that transaction?

Kevin Thompson
They are wrung out.

Damon DelMonte
They're wrung out. Okay, that's good. So, there's nothing in the way of ongoing lingering integration that would preclude you from partaking in an opportunity should one arise.

Don Hileman
That's correct. That would be our assumption. We had a very successful system and technology integration with CSB. And like Kevin said, we've realized the cost saves we anticipated there and don't see any more in the future.

Damon DelMonte

Okay. And then with regards to I think you had mentioned growth in fee income initiatives to try to build out insurance and wealth management, could you just talk a little bit about some of the opportunities you may have to grow those two lines of business?

Don Hileman
Sure. Both of those are very customer focused in relationship, which we think we do well as a company. And we have outstanding opportunity with the acquisition we did last quarter on the insurance side to reach different clients than we would've had before. So, a cross ability for us to reach out to more clients and to sell additional products and services that we offer to those clients gives us additional revenue opportunity there. We're constantly looking for additional bolt-ons in our footprint for acquisitions as well.

The wealth management's a little bit more challenging, but we continue to see some opportunity there to grow that business. And this is primarily through our footprint. As we start to integrate more conversations between bankers and in our markets and the wealth management people, we're seeing a little bit more activity on joint calls and things like that that are going to generate a little bit more revenue for us.

Damon DelMonte
Okay, that's helpful. Thanks. And then just my last question sort of as it relates to deposit pricing. Are there any particular areas of your footprint where you're maybe seeing more pricing pressure or sensitivity? And then within overall deposits, any particular categories of deposits where you're seeing the most pressure?

Kevin Thompson
Yes. I don't know that we've felt an abundance of pressure anywhere, Damon, at this point. But there's some targeted offers that our customers see that we compete with, some of the money market products for some of the larger depositors, that type of thing. But it's really been more of an invitation-only type competition more than any kind of real product pricing that we've seen.

I think in general we've seen prices edge up on the CD side a little bit with, again, maybe some selected offerings here and there, but nothing that is too far out of line or that we think presents a real competitive challenge for us at this point.

Damon DelMonte
Okay, that's all that I had. Thank you very much, guys.

Kevin Thompson
Sure.

Don Hileman
Thank you.

Operator
Again, if you have a question, please press star then one.

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

Daniel Cardenas
Hey, good morning, guys.

Don Hileman
Morning, Dan.

Kevin Thompson
Morning, Dan.

Daniel Cardenas
Just a quick question on your loan to deposit ratio. You're still right around north of 100%, right around 101%. What are some of the near term initiatives you guys have in place to maybe bring that ratio down a little bit?

Kevin Thompson
I'm not sure I agree with your number.

Don Hileman
Yes. Well, we're not totally uncomfortable with the around the 100% level. Some of the other initiatives that we've got, I still think we do believe we have a good opportunity. And we did see some of that little bit of imbalance in the deposit growth being a little stronger in the last quarter. Before we do take any actions, we want to let that play out. So, we think we have an opportunity to grow deposits to keep that ratio in line.

Kevin Thompson
Yes. Dan, I calculate more like 97.8%.

Daniel Cardenas
Right. I'll double check my math on that.

Kevin Thompson
Okay. And we keep an eye on that 100%. I wouldn't be uncomfortable going over that either. If I start to hit 105%, I might reexamine my balance sheet a little bit. But we think we've got room for further expansion on the loan side regardless of our deposit growth.

Daniel Cardenas
Okay. All right. And then just revisiting your M&A strategy here, is the thought to continue to find metro markets to expand into, or is it going to be more focusing on institutions that perhaps are a little bit more deposit rich and could help you out on the funding side?

Don Hileman
I don't exclude one for the other. Right now we're trying to be as opportunistic as we can in what comes across my desk to look at. Both of those would be attractive to us. Obviously, something on deposit side would be very beneficial to us with just the previous conversation about our loan to deposit ratio being…to size it up. So, if we could get something that would help with that, that would be very attractive to us as well.

Kevin Thompson
Most people would like a deposit rich acquisition. We definitely are in that camp as well.

Don Hileman
Yes, we're not going to be different there.

Daniel Cardenas

Good to hear. Good to hear. And then last question I have just in terms of the pay-downs and pay-off that we saw this quarter. Did that have any impact on your deposit side? Did you see any exiting of deposits due to these relationships coming off your books?

Don Hileman
Nothing material because these were more, like Kevin said, the one was a construction project.

Kevin Thompson
Right.

Don Hileman
So, we would've had the operating account, which would have carried a little lower balances when it was moving around there. So, nothing significant because of these relationships on the deposit side, Dan.

Daniel Cardenas
Okay, good. Good. All right. Well, good quarter. Thanks for taking my question, guys.

Kevin Thompson
We thought so.

Don Hileman
Yes.

Kevin Thompson
Thanks.

Don Hileman
We agree. Thank you very much, 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.