First Defiance

First Quarter 2019 Earnings Conference Call

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CORPORATE PARTICIPANTS

Tera Murphy - *Vice President of Marketing*

Donald Hileman - *President and Chief Executive Officer*

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

Paul Nungester - *Executive Vice President and Director of Finance & Accounting*

Brent Beard - *Senior Vice President and Controller*

PRESENTATION

Operator
Good morning, and welcome to the First Defiance First Quarter 2019 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. Please note, 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 2019 First 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; Kevin Thompson, Executive Vice President and Chief Financial Officer; and Paul Nungester, Director of Finance and Accounting.

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.

Donald Hileman
Thank you. Good morning, and welcome to the First Defiance Financial Corporation's first quarter conference call. Joining me on the call this morning is our CFO, Kevin Thompson; Paul Nungester, Director of Finance and Accounting; and Brent Beard, our Controller as we discuss our 2019 first quarter earnings release issued last night and give more detail on our financial performance and provide our outlook for the remainder of 2019. At the conclusion of our remarks, we will answer any questions that you might have.

Net income for the first quarter of 2019 on a GAAP basis was $11.5 million or $0.57 per diluted common share compared to $11.7 million or $0.57 per diluted common share in first quarter of 2018, which was driven by a $2 million recovery. Our first quarter 2019 results reflect strong profitability with an ROA of 1.46 and return on tangible equity of 15.93.

We continue to see improvement in asset quality with year-over-year reductions in non-performing loans in OREO and net charge-offs at 0.06% remain at historically low levels. We also saw a reduction in the 30-day to 90-day past due loans this quarter compared with year-end. We will also continue to focus on asset quality by reducing the non-performing and classified asset levels in the future, leading to improvements in our opinion on the non-performing asset ratios.

Our overall core performance this quarter remains solid and provides a foundation for the rest of the year. While we were slower in loan growth during the quarter than we would like, year-over-year loan growth was 8.1% and linked quarter loan growth was 1.4% annualized. However, we expect the growth rate to increase in the future, as the first quarter growth trends seem to be seasonally weaker. Our ability to grow our loan portfolio remains a key piece of our strategic plan and we have continued to allocate resources and improve processes to efficiently originating close loans.

The lending environment is very competitive with rate and structure pressures relating to terms and conditions and the uncertain economic environment. Despite this environment, it is encouraging for us to see contributions from our entire footprint and to end the first quarter with the pipeline up from year-end. We believe that we can still achieve our annual growth goal in loans of upper single-digits.

We did see an increase in loan yields of 5 basis points on a linked quarter basis and 38 basis points compared with the first quarter of 2018. Total deposits were up 8% year-over-year and 10% on a linked quarter annualized basis. We were also very pleased with our margin of this quarter growing slightly to 4.03%, an increase in 8 basis points over the first quarter of 2018 and 1 basis point on a linked quarter basis.

In regards to our capital management plans, we're also pleased to announce a 2019 second quarter dividend of $0.19 per share, representing a 26% increase in annual dividend yield of 2.69%.

I'll now ask Kevin Thompson and Paul Nungester to provide additional financial detail 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 first quarter was $11.5 million or $0.57 per diluted share versus prior year results of $11.7 million or $0.57 in the first quarter of 2018. While our earnings per share was level with the prior year for the first quarter, the year-over-year comparison was affected by the large $2 million recovery recorded in the first quarter last year, which resulted in a credit provision of $1.1 million in last year's results.

The pretax pre-provision earnings for the first quarter of 2019 were up 8.2% over the first quarter of 2018, reflecting our high profitability with a ROA of 1.46%, return on tangible equity of 15.93%, net interest margin of 4.03%, improved efficiency and credit quality from a year-ago and continued growth of our balance sheet.

Turning to the details and starting with the balance sheet, after very strong growth in the second half of 2018 and particularly in the fourth quarter last year, first quarter 2019 growth was a bit slower reflecting a reduced level of loan originations, mostly from expected seasonality, which constrained net growth on the loan side. In total, loans had net growth of about $9 million in the first quarter after growing $84 million last quarter. You may recall that our loans grew only $10 million in the first quarter last year, but ended the full-year 2018 up $191 million, or 8.1%.

Here at the start of the second quarter, we are seeing signs of improving growth over the remainder of 2019 and our outlook continues to be for upper single-digit growth for the year. As for deposits, we had an increase of about $65 million this past quarter, after an increase of $96 million last quarter.

Our momentum remains strong on the deposit side, which drove the overall growth in our balance sheet.

All things considered, we remain very pleased with our balance sheet, our solid low cost deposit growth and strong earning asset mix, both supporting our profitable margin, and our full-year growth outlook for loans and deposits remaining in the upper single-digit range.

Which leads me to the income statement; our net interest income was $28.3 million for the first quarter of 2019, down slightly from $28.5 million in the linked quarter, but up $2.6 million or 10% from the $25.7 million in the first quarter last year. The increase over the prior year first quarter is primarily driven by growth in average balances, but also reflects margin expansion from a year-ago as the loan portfolio yield has increased nicely with the rate hikes over the past year, while overall funding costs have been less impacted, which includes the benefit of our strong component of non-interest bearing deposits.

Our margin this quarter was 4.03%, up 1 basis point from last quarter and up 8 basis points from 3.95% in the first quarter last year. On a linked quarter basis, our yield on earning assets was up 9 basis points as our loan portfolio yield rose to 5.03%.

Our cost of interest bearing liabilities was up 11 basis points on a linked quarter basis. However, despite the narrower spread, our non-interest deposit mix lowering overall funding costs led to margin expansion again this quarter.

Our earning asset mix and funding mix, both remained strong and by maintaining our balanced exposure to interest rate changes, we believe that our margin will continue to perform well considering our growth expectations and outlook for no additional Fed rate increases this year.

Now before moving to non-interest components of earnings, you may recall last quarter, we made a change in our accounting for deferred compensation. The change, which involved a one-time adjustment last quarter was made expecting to reduce the volatility of any bottom line impacts from the plan and market fluctuations.

While I'm glad to say that for the first quarter, the net bottom line impact was basically neutral. The swing in the market from year-end still had an impact on both the assets and liabilities of the plan, which inflated both non-interest income and non-interest expense by about $560,000 in the first quarter.

Total non-interest income was $10.8 million in the first quarter of 2019, up from $8.4 million in the linked quarter and up from $10.7 million in the first quarter of 2018. Recall that the fourth quarter 2018 included a negative impact of $690,000, due to the market value reduction in the deferred compensation plan assets, while the first quarter 2019 had a $559,000 positive pickup in deferred compensation plan assets from the improvement in the market. The deferred compensation plan impact in the first quarter of 2018 was a negative $37,000.

In addition, the first quarter is generally when we receive our contingent insurance commissions, which were good this year totaling $920,000; however, down from a strong $1 million a year ago. Excluding the deferred comp and the contingent income from each year, non-interest income was down year-over-year about $406,000, as our uptick in mortgage banking was more than offset by decreases in our other businesses.

Regarding mortgage banking, revenues for the first quarter of 2019 were $1.8 million, up $396,000 from both the linked quarter and up $99,000 from the first quarter of 2018, while the first quarter mortgage banking originations were $45.9 million, seasonally down compared to $60.9 million last quarter and down from $50.7 million in the first quarter 2018, with the favorable movement in rates during the quarter.

The pipeline at quarter end was $23.1 million, the highest it's been in 21 months, and gain on sale income was strong at $1.3 million in the first quarter of 2019, well up from $758,000 in the linked quarter and up from $1.1 million in the first quarter last year.

In addition, somewhat trimming the mortgage banking improvement, the downward movement in rates at quarter end reduced the valuation of mortgage servicing rights in the first quarter, causing a negative adjustment of $113,000 compared to positive adjustments of $41,000 last quarter and $37,000 in the first quarter 2018.

Other non-interest income sources tended to be a bit down this quarter with service charges, insurance commissions and trust, all slightly down compared to a year ago. The increase in other income was again related to deferred compensation plan.

Looking ahead, overall, we expect seasonal pickup in non-interest income to keep our revenue in the next two quarters in the $10.5 million to $10.7 million range, before seasonally tapering in the fourth quarter.

As for non-interest expense, first quarter expenses totaled $24.9 million, up from $21.2 million in the linked quarter and $23.3 million for the first quarter of 2018. This comparison is, again, affected by the deferred compensation plan fluctuations, specifically related to the deferred compensation plan. The first quarter 2019 included about $559,000 of other expense due to the market movement in the quarter, basically offsetting the other income amount.

However, last quarter's expenses included both a credit expense of $1.1 million and a one-time credit adjustment of $806,000 and the first quarter 2018 included an expense of $130,000 related to the deferred compensation plan. Also in the first quarter of 2019, other expenses included $264,000 of OREO write-downs, while the first quarter 2018 included $544,000 of OREO write-downs.

Excluding these unusual items, non-interest expenses would be about $24 million for the first quarter 2019, compared to $22.6 million a year ago, up about $1.4 million or 6.5%. This still included some seasonal costs and items that tended to raise expenses this quarter. Looking ahead, we expect total non-interest expenses in the $23.5 million to $24 million level per quarter.

Now, I'll turn it over to Paul for the rest of the details.

Paul Nungester
Thank you, Kevin, and good morning, everybody. Regarding asset quality, provision expense for the quarter was $212,000 compared to last quarter's expense of $472,000, and the first quarter 2018's credit provision of $1.1 million. Provision this quarter was lower than anticipated primarily due to the lower loan growth as noted earlier, while the credit provision last year reflected a large loan recovery in that quarter.

Our allowance for loan loss at March 31, 2019 was $28.2 million, down slightly from $28.3 million at year-end 2018, but up versus $27.3 million on March 31 of last year with the year-over-year change primarily driven by the growth in loans.

Our allowance to total loans ratio at March 31, 2019 was 1.10% compared to 1.12% last quarter and 1.16% a year-ago, which reflects reduced levels of non-performing loans and improving asset quality metrics. As for the non-performing balances, our non-performing loans declined this quarter to $17.6 million from $19 million at last quarter end and were down 37% from $27.9 million at March 31, 2018.

Our OREO balance also decreased this quarter to $941,000 from $1.2 million last quarter and $1.4 million in the first quarter last year. As noted earlier, we did take an OREO write-down of $264,000 in the first quarter. Our accruing troubled debt restructured loans this quarter edged up slightly to $11.9 million from $11.6 million last quarter, but we're still down about 13% from $13.7 million a year-ago.

With a change in NPA, the allowance coverage of non-performing assets at quarter end improved to 152% compared to 140% at December 31, 2018, and 93% a year-ago. Needless to say, we are very pleased with our recent trends and improvement from a year-ago and we remain confident in our overall portfolio strength and asset quality, as we continue to pursue our growth strategies.

Looking at our capital position, total period end stockholders equity was $395.8 million, up from $379.2 million at March 31, 2018. During the quarter, we did repurchase approximately 515,000 shares for $15.1 million, yet our capital position remains strong with quarter end equity to assets of 12.41%, down only slightly from 12.56% last year.

The bank's total risk-based capital ratio is approximately 12.6% at quarter end March 31, 2019. Our healthy capital position continues to support our strategies for growth and shareholder value enhancement.

So in summary, we're off to a very good start to 2019. Our balance sheet is solid, our margin is performing well, our operating profitability is strong, asset quality continues to improve and our outlook for the year remains very positive.

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

Donald Hileman
Thank you, Paul. I'm very pleased with the core results this quarter. Our overall strategic goals remain focused on several key areas. We are concentrated on core balance sheet growth with a focus on loan growth and deposit growth, overall revenue growth, expense control measured by efficiency ratio and improved asset quality. As I mentioned, we have started the year slower than we would like in loan growth, we feel confident that we will hit our annual target of upper single-digits.

We are pleased that we maintained a positive trend in the margin, as well as the gross loan yield. We understand it will be challenging to drive growth in loans and maintain yield management and know that some trade-offs might be necessary as we are heavily focused on relationship management pricing.

We are very pleased with the deposit growth this quarter; we are concentrated on deposit growth initiative to overcome the challenges in attracting core deposit relationships. Expenses were challenging this quarter and reflected higher levels than we expect going forward. This negatively affected the efficiency ratio, while asset quality did improve in the quarter.

Throughout 2019, we'll place emphasis on technology and our digital strategy to differentiate our organization. By increasing our ability to innovate and use data to better serve our customers, we will be able to exceed our customers' rapidly changing expectations.

We believe the first step is to gain a deeper understanding of where we are as a company through a comprehensive assessment of our current digital capabilities. This will allow us to define short and long-term vision and strategies for digital banking. Through our teams of talented employees working toward the same goals, we are confident that together, we can make a positive impact and grow as a consistently high performing, community focused financial institution. We feel that our performance reflects our focus on shareholder value and at the same time our commitment to serve our customers and the communities we serve.

As announced in our press release, Kevin will be retiring at the end of the month. I would like to personally thank Kevin for his dedication and service to me as the CEO and First Defiance and wish him well in the next chapter of his life. We remain dedicated to all of our customers and shareholders and we appreciate the trust you have placed in us as we build pride in First Defiance.

Thank you for your interest in First Defiance Financial Corporation, and we thank you for joining us this morning. And now we'll be happy 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 then one on your telephone keypad. If you are using a speakerphone, please pick up your handset before pressing the keys. To withdraw from the question queue, please press star then two. At this time, we will pause momentarily to assemble our roster. The first question is from Nick Cucharale of Sandler O'Neill & Partners. Please go ahead.

Nicholas Cucharale
Good morning.

Donald Hileman
Good morning, Nick.

Nicholas Cucharale
First off, best wishes to Kevin in your well-deserved retirement and congratulations to Paul.

Kevin Thompson
Thank you.

Paul Nungester
Thank you, Nick.

Nicholas Cucharale
I heard your commentary that you expect the NIM to continue to perform well. After three consecutive quarters of expansion, can you help us think about the trajectory and the magnitude in coming quarters?

Donald Hileman
Paul?

Paul Nungester
Sure. Yes, happy to take that. Our NIM has performed very well, continues to exceed even our expectations here and we do continue to expect it to maintain similar levels. But pressures are increasing on the downside, specifically, deposit costs have been climbing, the beta has been increasing quarter-to-quarter and you saw in our results here the spread did compress. We see that in our outlook that, that could continue. Now we're optimistic about our chances there.

We have very good growth opportunities that will help lift that and to the extent that we can continue to do well on our non-interest bearing component deposits just like this quarter that will help maintain that margin level. While we do, at least for outlook purposes, see it potentially coming down a bit into the high 3.90s there, it's still going to perform strong.

Nicholas Cucharale
Okay, great. And then secondly, you stepped up the share repurchases this quarter. Can you give us some color on your priorities for capital and if we should be expecting a re-upping of the authorization if and when the 9,000 shares remaining is exhausted?

Paul Nungester
Yes, Nick. I think we're still—we're focused on dividends. We included our $0.19 a share dividend which is up from a year ago and the second quarter in a row. We'll be focusing on that, but share repurchases are part of our longer term capital strategic plan and we would expect to have that tool going forward.

Nicholas Cucharale
Okay. And then lastly, the allowance bled down a little bit in the quarter. Do you expect that trend to continue or stay relatively consistent in future periods with where you are?

Paul Nungester
Yes. In terms of the allowance, at least as a percentage of loans, given the trends that we've been seeing on the asset quality front, we would expect it to be comparable to that. It could improve if we continue to see additional credit quality improvements on that front. But we did have some charge-offs this quarter verses recoveries in the last quarter or so and just have to see where that lands at the end of the day.

It was a little low provision-wise this quarter, as we said earlier, in part because of the low loan volume, the low growth there, but while we had charge-offs, they weren't that high either. If the trends continue on the economic front and on the internal credit quality front, we should be able to certainly maintain those levels.

Donald Hileman
I would say, Nick, just to further on to what Paul said that with the trend in our asset quality, which has been improving, it's more likely to go down a basis point or so than up, okay? That would be more in line with our expectations. But we don't see any significant change really.

Nicholas Cucharale
No. Great. Thanks for taking my questions.

Donald Hileman
Thank you.

Kevin Thompson
Thank you.

Operator
Again, if you have a question, please press star then one. The next question is from Damon DelMonte of KBW. Please go ahead.

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

Donald Hileman
Good Damon.

Kevin Thompson

Good Damon

Damon DelMonte
Good. Kevin, congratulations and best of luck on the next chapter, and Paul, congrats on the promotion and look forward to working with you.

Paul Nungester
Thank you, Damon.

Damon DelMonte
First question, just wanted to touch a little bit on the outlook for mortgage banking. Pretty strong quarter and we usually see some positive seasonality in the second and third quarter. How are you thinking about the state of your pipelines today going into the second quarter? And what your outlook is for that?

Kevin Thompson
Like I said, the pipeline hasn't been this high in 21 months. I mean it's very strong coming into the quarter. And given where rates are, I mean we think it's about as favorable an environment probably as we've had in a while, we are looking for that seasonal pickup in terms of mortgage banking. We did have a strong quarter, but we would still be looking for 20%, 25% increase over the first quarter into the second quarter or something like that.

Paul Nungester
Similar trends as—

Kevin Thompson
As we've seen at last year.

Paul Nungester
Exactly.

Damon DelMonte
Okay. Got it. All right, great. And then, obviously the credit is very strong here, but could you put a little perspective on the expectation for the provision going forward?

Paul Nungester
Yes. We were saying earlier on the allowance front, we expect it to maintain around the same level, maybe tick down a little bit, but on the provision side, that will be tied to loan growth, obviously. As our loan growth starts to accelerate here in the coming quarters that will get back up to normal levels around $1 million plus/minus depending on actual volumes in the quarter.

Donald Hileman
Yes. The other thing, we don't see rise in any significant recoveries. I think we've kind of run that benefit out. It will be basically, like Paul said, driven in our loan growth and the overall quality of the portfolio.

Damon DelMonte
Got it, okay. Great, and then lastly, the average loan balances during the quarter were pretty strong quarter-over-quarter compared to the end of the period. Did you experience some like late in the quarter payoffs or something like that?

Kevin Thompson
Not really, Damon. It was more of just a slower origination quarter, again, but the pipelines all indicate

we're expecting that to increase here in the second quarter. But the lift in average balances was certainly more connected to the big growth in the fourth quarter and the growth in the first quarter.

Paul Nungester
And a lot of that happened late in the year.

Kevin Thompson
Correct.

Damon DelMonte
Got it, okay. That makes sense. Okay. That's all that I had. Thanks a lot for taking my questions.

Kevin Thompson
Yes, all right.

Donald Hileman
Thanks, Damon.

CONCLUSION

Operator
That concludes our question-and-answer session. I would like to turn the conference back over to Tera Murphy for 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 has now concluded. Thank you for attending today's presentation. You may now disconnect.