First Defiance Financial Corporation

Fourth Quarter and Year-End 2019 Earnings Conference Call

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CORPORATE PARTICIPANTS

Tera Murphy - *Investor Relations*

Don Hileman - *President and Chief Executive Officer*

Paul Nungester - *Executive Vice President and Chief Financial Officer*

Vince Liuzzi – *President*

PRESENTATION

Operator
Good morning, and welcome to the First Defiance Fourth Quarter and Year-End 2019 Earnings Conference Call. All participants will be in listen-only mode. Should you need assistance, please signal a conference specialist by pressing star then zero on your telephone keypad. 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 fourth quarter and year-end 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 Paul Nungester, 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
Good morning, and welcome to the First Defiance Financial Corporation 2019 fourth quarter and full year conference call. Joining me on the call this morning to give more detail on our financial performance is our CFO, Paul Nungester, and at the conclusion of our remarks, Paul, Vince Liuzzi, our Bank President, and I will answer any questions you might have.

Last night we issued our 2019 fourth quarter and full year earnings release, and now we would like to discuss that release and give you some insight onto an exciting 2020. At the conclusion of our remarks, we will answer any questions you might have.

I am pleased with the great momentum that the fourth quarter provided in growth, financial and strategic performance going into 2020 in our merger with the United Community Financial Corp, or UCFC. Fourth quarter 2019 net income on a GAAP basis was $12.5 million, or $0.63 per diluted common share, compared to $12.1 million and $0.59 per diluted common share in the fourth quarter of 2018.

For the year ended December 31, 2019, First Defiance earned $49.4 million, or $2.26 per diluted common share, compared to $46.3 million or $2.26 per diluted common share for 2018, an increase of 9.7%. At quarter end, our total assets were $3.5 billion, up 9.4% from the year ended 2018.

We had healthy growth trends for both loans and deposits in the fourth quarter. Total loans at December 31 were up 9.4% over a year ago and up 15.5% on a linked-quarter annualized basis. Total deposits were up 9.5% year-over-year and 15.9% on a linked-quarter annualized basis. The efficiency ratio decreased to 60.08% from 60.29% at the end of the fourth quarter of 2018, including merger-related costs.

Our ROA for the full year of 2019 was 1.5%, compared to 1.52% for 2018. Our fourth quarter results reflect strong profitability, with an ROA of 1.45%, compared to 1.53% for the fourth quarter of 2018, with both quarter and full year reflecting merger-related costs.

Net charge-offs for the quarter were 0.01% or $91,000 compared to net recoveries of $220,000 for the fourth quarter of 2018. In 2019, we had $7,000 of net recoveries compared to 472 [ph] in 2018.

Our allowance for loan losses ended the year at a strong 1.12%, and we are also well prepared for the adoption of CECL in 2020. We are pleased with the continued positive momentum and lower non-performing loans-to-assets at 0.39% at year-end—down compared with both a linked-quarter and year-end 2018. As we look into this year and the merger with UCFC, our continued ability to grow our loan portfolio will be a key focus of our strategic plan. We are very satisfied to see an increase from loans across our footprint in the fourth quarter, driven by our metro markets, even in the face of strong competitive market pressures relating to lower rates and somewhat uncertain economic conditions.

While we look to our legacy markets for consistent growth, our metro markets contributed to growth at an accelerated pace. The total new loans originated in the fourth quarter were put on at a weighted average rate of 4.55%, compared to 5.28% in the fourth quarter of 2018 and 4.82% in the third quarter of 2019. The overall yield on loans in the fourth quarter of 2019 was 4.7%, compared to 4.83% at the end of 2018.

Our core business strategies contributed to both growth in our net interest income and solid performance of our non-interest income revenues on a quarterly basis. This is reflected in our solid increase in our net interest income this year of 13.1% over last year. Net interest income increased 1.56% on a linked-quarter basis. We're particularly satisfied with the consistency of our margin, considering the very competitive operating and rate environments.

Our net interest margin for the full year was 3.93%, compared with 3.98% for 2018. We did experience a decline of 8 basis points in the fourth quarter for a quarterly margin of 3.80%. We are especially pleased with the resiliency of our margin and expect our margin trend will moderate, reflecting a balance in pricing discipline with growth.

The credit quality metrics show continued improvement this quarter from last quarter and were an improvement over year-end 2018. Our non-performing loans-to-total assets were 0.39% this quarter, compared with 0.64% in the fourth quarter of 2018 and 0.44% last quarter.

Our overall capital planning is supported by our ongoing solid performance and capital levels. We are very pleased to announce an increase in our 2020 first quarter dividend to $0.22 a share, representing a 16% increase from a year ago and an annual dividend yield of approximately 2.82%. At year-end, we had 500,000 shares of common stock remaining under our authorization for repurchase.

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

Paul Nungester

Thank you, Don. Good morning everyone. I'm pleased to report our fourth quarter and full year 2019 financial results.

Net income for the quarter was $12.5 million, up 3.5% from $12.1 million last year, and earnings per share was $0.63, up 7% from $0.59 last year. However, there are a couple items impacting those comparisons. First, the current quarter's results include merger-related costs, which reduced earnings by $697,000 or $0.03 per share.

In fact, the fourth quarter of 2018 included a positive after-tax adjustment of $636,000 or $0.03 per share for an accounting correction to our deferred compensation plan. Excluding those items, EPS would have increased 18% to $0.66 in 4Q 2019 from $0.56 in 4Q 2018. But with or without those adjustments, the year-over-year comparison reflects our normal strong core profitability growth.

Looking at the balance sheet, loan growth for fourth quarter 2019 was a robust $112 million, which represented approximately 17% annualized growth. Full year loan growth was $237.5 million or 9.35% growth. This did come predominantly from our commercial portfolio, and we are pleased to get growth in all of our markets.

Turning to deposits, $110 million of growth or an annualized rate of 16%, represented another area of strong performance in the fourth quarter. For the full year, deposits were up $249 million or 9.5% growth. Overall, we are very pleased with these results and we remain comfortable with the strength of our balance sheet as we move forward into 2020.

Transitioning to the income statement, our net interest income was $29.5 million for the fourth quarter of 2019, up $607,000 from the prior quarter and up $1 million or 3.5% from the $28.5 million in the fourth quarter last year. The increase over the prior year was primarily driven by growth in earning assets. Our margin this quarter was 3.80, down 8 basis points from the third quarter.

As noted on our October earnings call, we did expect additional contraction this quarter. First, our yield on interest earning assets declined 12 basis points on a linked-quarter basis, and it's primarily attributable to our loan portfolio, where we continue to experience some compression from the down rate environment. However, our cost of interest-bearing liabilities was down 4 basis points after a 5 basis point increase last quarter, mainly due to a decrease in our cost of interest-bearing deposits. This is a reflection of our successful efforts to reduce deposit costs in concert with Fed Fund rate cuts.

However, improvements here are slower to realize as we turn over the CD portfolio compared to our loan yields. This pattern should further improve as we continue to work through our CD portfolio and loan yield compression settles down. So we do expect further contraction in the first quarter, but less than we saw this quarter.

Separately, we continued to deliver again on cost containment and revenue enhancements, as evidenced by this quarter's results. Total non-interest income was $11.8 million in the fourth quarter of 2019, consistent with the linked-quarter and up from $8.4 million in the fourth quarter of 2018. Approximately $1 million of that increase is due to the deferred compensation plan, which experienced a negative $690,000 in 4Q 2018 due to stock market performance, compared to a positive $324,000 in 4Q 2019.

An additional $1.2 million increase derived from mortgage banking, which was volume-driven from originations of $106.5 million in 4Q 2019, compared to $61 million in 4Q 2018. Aside from mortgage banking, we generated service charges of $3.7 million, up $355,000 or 11% from last year, and insurance commissions of $3.1 million, essentially flat from a year ago.

Trust income increased $235,000 from the linked-quarter and $243,000 from the fourth quarter of 2018, primarily due to the acquisition we completed on September 30, 2019 and stock market performance. Overall, we are pleased with the performance of our core fee businesses in the fourth quarter.
Regarding non-interest expenses, fourth quarter 2019 totaled $24.8 million, up from $23.2 million in the

linked-quarter and up from $21.2 million from the fourth quarter of 2018. The expense fluctuations for both are generally attributable to compensation, FDIC premiums and merger-related costs, with other expenses also impacting the year-over-year comparison.

Compensation and benefits rose $1.1 million from last year and $571,000 from last quarter, generally reflecting our continued metro market expansion efforts, incentives and medical benefits. The FDIC premiums were a credit of $255,000 in the third quarter of 2019, compared to a $208,000 expense this quarter. This is due to the small bank assessment credit being applied in September from the deposit insurance fund reserve ratio we discussed last quarter.

Lastly, we did recognize $882,000 in merger-related costs in the fourth quarter of 2019, compared to $539,000 last quarter and none in the prior year. Other non-interest expense was $4.2 million in the fourth quarter of 2019, compared to $2 million in the fourth quarter of 2018. This comparison includes a one-time $806,000 reduction in expenses from the accounting correction to the company's deferred compensation plan in the fourth quarter of 2018.

Additionally, results for the fourth quarter of 2018 included a $1.1 million benefit from a decrease in deferred compensation plan liabilities, compared to a $321,000 increase for the same period in 2019 due to the relative stock market performance. Excluding the impact of these items, other non-interest expense for fourth quarter 2019 would be $3.9 million, compared to $3.9 million in the fourth quarter of 2018.

The net impact of all the above drove strong and improved operating profitability. Pre-tax, pre-provision income was $16.5 million for fourth quarter 2019, an increase of 6% from $15.7 million in the fourth quarter of 2018.

Regarding asset quality, provision expense for the quarter was $1.1 million, compared to last quarter's expense of $1.3 million and the fourth quarter 2018's expense of $0.5 million. The provision this quarter was as expected, primarily due to loan growth, offset partly by some improved qualitative factors.

Our allowance for loan loss at December 31, 2019 was $31.2 million, up from $30.3 million at September 30 and up from $28.3 million on December 31 last year, with the year-over-year change mostly driven by loan growth. The allowance to total loans ratio at December 31, 2019 was 1.12%, consistent with last year and down from 1.13% last quarter.

The linked-quarter decrease reflects lower qualitative factors due to a meaningful decrease in delinquencies and improved non-performing asset levels. Non-performing loans declined again this quarter to $13.5 million from $14.7 million last quarter and were down 29% from $19 million at December 31, 2018.

Our OREO balance increased slightly to $100,000 this quarter from zero last quarter, but was down $1.1 million from fourth quarter 2018. Our accruing troubled debt restructured loans this quarter decreased to $8.4 million from $10.3 million last quarter and were down 27% from $11.6 million a year ago. The allowance coverage of non-performing assets at quarter-end increased to 230%, compared to 206% at September 30 and 140% a year ago. We remain pleased with our overall recent trends and improvements from last year, and are still confident in our asset quality as we continue to pursue our growth strategies.

Looking at our capital position, total quarter-end stockholders' equity was $426 million, up from $400 million at December 31, 2018. As a reminder, during the first quarter of 2019, we repurchased approximately 515,000 shares for $15.1 million.
Our capital position remains strong, with quarter-end tangible equity-to-assets ratio of 9.58%, down very

minimally from 9.63% last year and a consolidated total risk-based capital ratio of approximately 12.7%. Our solid capital position continues to support our ongoing growth and shareholder value enhancement strategies.

Regarding full year results, net income was a record $49.4 million or $2.48 per diluted share for 2019, up from net income of $46.2 million or $2.26 per diluted share for the year 2018. That's a 7% increase overall. However, 2019 was impacted by $1.1 million or $0.05 per share after-tax acquisition costs for our pending merger, while 2018 had the deferred compensation one-time accounting adjustment, which increased earnings $636,000 or $0.03 per share. So, our core earnings per share would be calculated as up 13.5% in 2019 over 2018, excluding those items.

In conclusion, our positive momentum continued yet again in the fourth quarter, with strong earnings and operating profitability, while our capital position remains solid. We believe we are well positioned as we begin 2020 and look to complete our merger at the end of the month.

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

Don Hileman
Thank you, Paul. I can easily say that I'm very pleased that 2019 marks our seventh consecutive year of record earnings for First Defiance. As a community bank, our definition of success goes well beyond the numbers of our financial statements. Our employees have consistently risen to the challenge of finding smart solutions for our clients, communities and shareholders. The synergies between our employees, both internally and within the communities we serve, have taken us to higher levels of performance and elevated our customer experience.

Two thousand and nineteen marks successful execution of our metro market strategies. Significantly greater contributions from our Columbus Ohio market were evident. The addition of lenders and treasury management sales staff in this market will support future growth objectives, including our expansion plans in the Dublin's Bridge Park area early in 2020. This will be our first office that's designed with our branch-of-the-future models developed in 2018. Our rapidly increasing commercial and personal client base have been very encouraging, and we look forward to continued success to match Columbus—Columbus' overall economic growth.

Strong collaboration between leadership and sales teams in the Fort Wayne, Indiana market resulted in a record level of deposits and a record level of commercial loans outstanding during this year, several back-to-back record months for total dollar amount and retail loans also marked the notable achievements for the Fort Wayne market in 2019. When you pair these accomplishments with our community engagement, our momentum provides a positive outlook for 2020.

Our support for our communities remain essential to living out our Better Together philosophy throughout the year. We were able to successfully exceed our goal of contributing 500 hours of home-related community service during our second annual Building Better Communities initiatives in the celebration of National Homeownership Month.

In addition, we achieved record-breaking engagement with our annual Pay It Forward campaign in November. We invested $10,000 into non-profit organizations that our employees are most passionate about as part of the celebration, and surpassed 3,500 random acts of kindness performed since the campaign was established in 2014. These types of initiatives keep us focused on the communities we serve and are the foundation of a community bank.

I am very pleased with the progress to-date of our strategic merger with UCFC. Integration teams composed of experienced employees from both organizations have shown tremendous dedication and effort in identifying and addressing key issues concerning people, processes and technology. We are confident we will build upon our collective strengths and minimize employee and customer impact. I couldn't be happier with the progress as we work toward full system conversion early in the third quarter of 2020.

This momentum we have built in the past 12 months will carry us into 2020 strongly. In addition to core system conversions related to the merger, we will also continue to focus on several key areas we believe were very important, including core balance sheet growth with a focus on loan growth and deposit growth, overall revenue growth, expense control and improved asset quality that will improve our non-performing loans-to-total assets beyond what we experienced in 2019.

While the lending environment remains very competitive, we feel we can utilize on a combined basis with the UCFC both our metro and legacy markets to achieve high-single-digit loan growth without making significant concessions on rate and other terms through a strong process of relationship building and quality client-focused service. We are very concentrated on deposit growth initiatives to develop a sustainable growth engine that will provide long-term organic deposit growth at a correlated pace with our loan growth. We will also continue to focus on growth in our insurance and wealth management revenue areas as part of our strategic plan.

Building off an extensive internal education campaign for wealth management, we are in an excellent position to share our wealth management solutions with our customers across the expanded footprint. Heightened focus on our digital strategy will help us further enhance the customer experience in person through digital channels and within our internal operations.

Our customers' expectations, especially pertaining to digital delivery methods, are changing at an accelerated pace and we are committed to providing our client quality products and services within an environment they prefer. We will align our employees to help us identify ways to improve our customer experience and be part of implementing innovative solutions to reduce friction.

As announced last night, we are pleased to have received all necessary shareholder approvals in December and now have received all required approvals from the regulatory authorities. We are progressing as planned, and we anticipate to close the transaction at the end of January.

We are excited to bring together two organizations as a premier community bank with enhanced products, services and technology, while honoring our commitment to superior customer service, personalized financial solutions and unwavering community support. We appreciate the trust you have placed in us, and want to thank you for joining us today and your interest in First Defiance Financial Corporation.

We will now be glad to answer any of your questions.

QUESTIONS AND ANSWERS

Operator
We will now begin the question and answer session. To ask a question, you can press star then one on your telephone keypad. If you're 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.

Our first question will come from Damon DelMonte with KBW.
Damon DelMonte

Hey, good morning guys. How's it going today?

Don Hileman
Good morning, Damon. Good.

Paul Nungester
Good.

Damon DelMonte
Good. Good to hear. All right. So, first question, just regarding loan growth and kind of the outlook as you go into 2020, a pretty strong year, this year I think you are at 9% for the full year. Based on what you're seeing in your pipelines and the traction you're gaining in the Columbus market and Fort Wayne, what do you project for full year growth in 2020?

Don Hileman
Yes, we're still looking at something in the mid to upper-single-digits there, probably not as strong as obviously where we ended the quarter with that strong double-digit growth. But I think we're still projecting to have mid-single-digits to upper-single-digits loan growth, with a consistent strategy of the metro and legacy markets.

And Vince, any other comments on that?

Vince Liuzzi
Sure. I would just add that, while our metro markets kind of led the way from a loan growth standpoint, we also had some pretty respectable growth and healthy growth in our core community markets, greater Defiance [ph] and southern Michigan as well. So it was across the board. The story for 2019 was across the board loan growth, with certainly big production out of Columbus, but all of the markets contributing in the core community markets as well. So, the outlook is pretty good for next year, feeling good about a repeat performance.

Damon DelMonte
Great. And with respect to Columbus, how big is that right now as far as loan outstandings are concerned?

Vince Liuzzi
$385 million right now, up over $120 million for the year.

Damon DelMonte
Okay, great. Then with respect to the margin, Paul, can you give a little perspective on what the combined company margin would look like? I know you said for the core margin you're probably going to see a little bit more compression in 1Q and things will hopefully settle out after that. But UCFC currently has a lower margin than you guys, so how do we look at the combined company margin?

Paul Nungester
Yes, sure. So, obviously, excluding the impact of whatever the final purchase accounting might do to those numbers on a core basis combined, we're still looking in the 3.5 to 3.6 blended range for that that we had originally projected.

Damon DelMonte
Okay. All right, great. And then one more here on CECL. Can you just give a little updated expectation on the impacts from CECL when you adopt that?

Paul Nungester
Sure. Yes, with 2019 total GAAP now in the books, we're turning our attention to that. We've run some preliminary estimates, and we think it's going to come out in the $2.5 million to $4.5 million range. We will be finalizing that over the next month or so to get auditors through it and everything, so there will be the disclosure in the 10-K eventually. But that's our current estimate.

Damon DelMonte
You mean, $2.5 [million] to $4.5 million of an increase in your loan loss reserve?

Paul Nungester
Correct, correct. Yes.

Damon DelMonte
Okay.

Paul Nungester
Yes.

Damon DelMonte
Got it, okay.

Paul Nungester
And that's just for, obviously, that's standalone the impact for the 1/1 adoption. We'll have to account for the acquisition under CECL, which we talked about that before as well.

Damon DelMonte
Got it, okay. And then, just lastly, I think at the time of the merger, you guys had indicated that you'd probably have a new name for the combined company. Have you guys settled on that yet?

Don Hileman
We have not. We are working diligently on trying to come up with that. So we're looking a couple of months out before we get that all finalized, Damon.

Damon DelMonte
Got it, okay. That's all that I have for now. Thank you very much.

Paul Nungester
Thank you.

Don Hileman
Thanks, Damon.

Operator
The next question comes from Christopher Marinac with Janney Montgomery Scott.

Christopher Marinac
Yes, hey. Thanks. Good morning. Just want to continue on the CECL topic real quick. So, how does Day 2 work for you? Is it any different than what you originally outlined in September pro forma with the merger?
Paul Nungester

No, no, it's still consistent with that. So, if you're talking about the acquisition there, Chris, same thing, we will have what they're calling the double dip here, where first we have to mark the loans being acquired to the transaction for fair value both on rates and credits. So we'll take a credit mark on that portfolio and then we will have to take a provision charge through the income statement to put up an allowance against the performing portfolio there.

So, still consistent with those original estimates. Obviously, it will depend on final balances at closing and then going through that analysis in terms of the credit marks and qualitative factors, things like that, but still consistent with what we had originally thought.

Christopher Marinac
Okay. And then if we took the $2.5 [million] to $4.5 million range you just mentioned here, just as a percentage increase, could we apply that to your ongoing provision for just normal new loans that come in, or is that not a proper way to interpret that?

Paul Nungester
Not entirely. I mean, it will be different under CECL because it's more of a – it is a forward-looking forecast model versus an in the rearview kind of model. Generally, that's not a bad way to think of it, but it won't be perfectly correlated quite like that. So, really it's bumping it up the one time, and then going forward, assuming you don't have significant changes in external factors, like if unemployment took a major turn in a short timeframe, things like that, it shouldn't move too much. But that's where some volatility will come into play. As we now have to look forward versus backwards we'll see some of that, but it's somewhat consistent but for those factors.

Christopher Marinac
Got it. Okay, that's helpful. Thanks for the background. I appreciate that. And then, just moving on, when you look at the mortgage business and the big success you had in 2019, how does that build this next year, or could this year be more of a flat year? What would be your outlook at this juncture?

Don Hileman
We've posted a pretty terrific performance in Q3, but it was matched in Q4 and so we've seen a pretty significant pipeline that we've been working through in mortgage. We have our pipeline set for Q1 which is pretty solid right now. But we're leading into the year with the wind at our back, so to speak, from a productivity standpoint. We expect a pretty similar performance through the year, and I would look forward to a good year with mortgage.

Paul Nungester
And maybe I'd add to that that one of the benefits of this transaction that we had pointed out was on the loan side, they bring more to the table on the residential mortgage perspective. So, as we bring those teams and processes and systems together, we are expecting some enhancements. It will take some time to kind of get that going and build, but that would be the long-term perspective there.

Christopher Marinac
Okay, great. Thanks for that. And just a final question on deposits. What's your thought about deposits in 2020? Is there still core growth in your footprint in which – particularly as you combine the two companies together, would there be a different deposit opportunity in the Eastern Ohio versus your legacy First Defiance markets?

Don Hileman
Well, I would start with the answer that we do expect some deposit growth. That's one of the focus areas, as we start to look at enhanced products and services, maybe through treasury management, some of

the expanded wealth that would help drive some deposit growth as well. And then expanded that commercial opportunity on the loan side, we expect to generate some deposits from that as well. So, I think from an overall standpoint we're expecting to be in a position, like I said, to try to match the loan growth and the deposit growth more neutrally as we go forward here, from a percentage standpoint anyway, Chris.

Christopher Marinac
Got it. Sounds good, Don. Thanks very much for all the feedback this morning.

Paul Nungester
Thank you.

Don Hileman
Appreciate it.

CONCLUSION

Operator
Again, if you'd like to ask a question, you can press star then one. As I'm showing no further questions, this will conclude our question-and-answer session.

I would like to turn the conference back over to Tera Murphy for any closing remarks.

Tera Murphy
Thank you for joining us today as we discussed our quarterly and year-end 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.