First Defiance Financial Corporation

Q1 2020 Earnings Conference Call

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CORPORATE PARTICIPANTS

Tera Murphy - *Vice President, Corporate Communications Manager*

Don Hileman - *Chief Executive Officer, First Defiance Financial Corp. and First Federal Bank*

Paul Nungester - *Chief Financial Officer*

Gary Small – *President, First Defiance Financial Corp. and First Federal Bank*

Matt Garrity - *Chief Lending Officer*

Vince Liuzzi – *Chief Banking Officer, Head of Community Banking*

PRESENTATION

Operator
Good morning, and welcome to the First Defiance First Quarter 2020 Earnings Conference Call. All participants will be in a 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 and 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 2020 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. Following leadership's 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, Tera. Good morning, and welcome to the First Defiance Financial Corporation 2020 first quarter conference call. Joining me on the call this morning to give more detail on our financial performance for the quarter is our CFO, Paul Nungester; as well as Gary Small, our Bank President; Matt Garrity, Chief Lending Officer; and Vince Liuzzi, our Chief Banking Officer.

Last night, we issued our 2020 first quarter earnings release as well as provided a slide deck with further data in our 8-K filing. And now, I would like to discuss that release and give some insight into the remainder of 2020. At the conclusion of our remarks, we will answer any questions you might have.

These are truly challenging times as we try to navigate through the health and economic ramifications we are all facing related to COVID-19. The pandemic has caused severe interruptions in the global and regional economies, and the markets in which we operate. Our primary concerns have shifted to servicing the immediate liquidity needs of our clients, ensuring the health and well-being of our employees and supporting the communities in which we live and serve. Our teams have been working diligently to assist clients in executing the SBA Paycheck Protection Program, or PPP, enacted as part of the CARES Act stimulus legislation, assisting with payment forbearance as appropriate and other relief programs. We are pleased to participate in the JobsOhio program designed for our current small business clients to provide loan funds to those not participating in the PPP program. These and other initiatives have been the main focus of our management team and the staff as we look to the coming weeks and months ahead.

We have executed our strategic pandemic plan, which included implementing remote work arrangements to the fullest extent possible, separating individual departments, operating a majority of our branch lobbies by appointment only, fully staffing all branch drive-through lanes and communicating with them and encouraging our customers to use our free self-service tools such as interactive teller machines and automated teller machines, mobile services, and online technology to actively promote physical distancing in all aspects of our everyday business. It is also impossible for us to anticipate our future financial performance based on the uncertainty of the economic environment related to COVID-19 and the variables outside of our control.

As noted, we had an active first quarter with the completion of our merger with United Community Financial Corporation or UCFC and the adoption of CECL, both impacting our performance. I am pleased with the strong core performance we had in the first quarter and our position going into the rest of the year.

First quarter 2020 net income on a GAAP basis was a loss of $22.5 million or $0.71 per diluted common share, compared to $11.5 million or $0.57 per diluted common share in the first quarter of 2019. On a core basis, net income for the first quarter was $7.5 million or $0.24 per diluted share.

Our overall capital planning is supported by our ongoing solid performance and capital levels at the end of March, and we have looked at the potential future impacts on capital levels of the environment we are in. We are also very pleased to announce our 2020 second quarter dividend of $0.22 per share, representing a 16% increase from a year ago and an annual annualized dividend of approximately 6%. At quarter-end, we had 570,000 shares of common stock remaining for purchase under our share repurchase plan authorization. During these uncertain times, we have suspended any buyback activity.

I will now ask Paul to provide more in-depth financial details for the quarter. Paul…

Paul Nungester
Thank you, Don. And good morning, everyone. As Don mentioned, this was an adventurous quarter for us, with the pandemic starting to impact the economy, rates dropping precipitously late in the quarter, the adoption of CECL and closing on a merger of equals. I will summarize our first quarter results and hopefully, shed some light on these impact areas.

First, let's start with the balance sheet. Obviously, the most impactful item here is the merger that closed on January 31. Our closing price that day was $29.39, and we issued a little over 17.9 million shares for a total purchase price of approximately $527 million. Net loans acquired were $2.34 billion, including an $8.8 million positive rate mark and $34.9 million of credit marks, of which $7.7 million was for PCD loans recorded as allowance. Intangible assets created were $33 million, including a $29.3 million core deposit intangible and $3.7 million for the insurance agency and trust wealth management divisions acquired.

On the liability side, deposits were $2.08 billion, including a $7.1 million time-based deposit rate mark. More details are provided in our press release, but the net of everything resulted in $217.5 million of goodwill.

Separate from the merger, we are pleased to have generated good organic growth in the quarter despite the economic downturn that commenced. For loans, we added $36.6 million or a 5.3% annualized growth rate, with the growth primarily coming from commercial, while residential was down due to pay-offs and refinancing in the low rate environment. For deposits, we added $41.2 million for a 5.7% annualized growth rate. Non-interest deposits represent about 21% of total deposits, and we do not have any brokered deposits.

Next, I'll explain the allowance. We did adopt CECL effective January 1 rather than delay and need to restate financials, including the merger later in the year. In connection with adoption, we recorded a $2.4 million increase to the allowance on 1/1 with an offset to retained earnings of $1.9 million and the remainder to deferred taxes. In connection with the merger, we then added $33.6 million to the allowance. Of this, $7.7 million was for PCD loans recorded in purchase accounting. The other $25.9 million is for the acquired non-PCD loans, and under CECL, that is required to be recorded as a day one provision charge popularly known as the double dip since these loans also have a credit mark.

The last components to the allowance are net recoveries of $0.8 million and a core provision expense of $17.8 million. It's obviously a big number, and it's directly attributable to the fact that we have adopted CECL, which is a life of loan forward-looking estimate model, and this happened at the same time that the economy turned south fast indeed. A key driver for our model is national unemployment, and that forecast is for 12.5% in 2Q versus the mid-3% we had been experiencing pre-pandemic.

At 3/31, our allowance coverage to loans was 1.68%, but for non-PCD loans, it was 1.55%. Prior to the economic downturn, we had estimated our allowance coverage under CECL could be 1.25%, so one can say that the pandemic added 30 basis points to our allowance, which translates to about $15.1 million of our provision charge. More details can be found in our slide presentation posted to the First Defiance website this morning.

To finish the balance sheet, I'll discuss capital, where we ended with $916 million of equity at March 31. The increase from year-end is primarily due to the $527 million added in connection with the merger. Separately, we did recommence stock buybacks after the merger closed. We completed 430,000 shares for $10 million before suspending buyback activity in mid-March. At March 31, our tangible equity ratio was 9.1%,l and our total risk-based capital is estimated to be about 13.7%.

Next, I'll turn to the income statement. I would like to preface this with noting that year-over-year comparisons are obviously skewed by the fact that we have two months of operations, including UCFC in first quarter 2020, compared to none in first quarter 2019.

Let's start with net interest income, which was $45.5 million for the first quarter of 2020. This resulted in a net interest margin of 3.78%, which is down 2 basis points on a linked quarter basis. This does include the benefit of accretion from purchase accounting marks, with $312,000 coming through interest income and $1 million coming through interest expense. Excluding the impact of those items, our net interest margin would be 3.68%. This contraction was not unexpected given the precipitous drop in the external rate and yield environment that occurred during the quarter. Further, we do expect further contraction in 2Q since the rate drops happen in the back half of the first quarter. Non-interest income was $14 million for 1Q and represented approximately 23.5% of total revenues.

I will focus my comments on a few key items impacting these results. First, regarding insurance commissions, the first quarter is a period each year when we generate contingent commission. This year, we earned $1.3 million compared to $0.9 million in the first quarter of 2019.

Second, other non-interest income was $960,000, but it included a $1.1 million gain related to an earn-out that was not achieved for a prior acquisition. Excluding that, other income would be a negative $137,000, and that is attributable to a $0.7 million decrease in deferred compensation plan assets, due to the stock market performance in the first quarter of 2020.

Lastly for revenues, I'll discuss mortgage banking income, which was $848,000 for first quarter 2020 and down from $1.8 million for first quarter 2019.

First, gains on sale of mortgage loans was $4.9 million, up from $1.3 million last year due to volumes. In the first quarter of 2019, we sold about $38 million in mortgage loans, where this year we sold over $120 million. This is partly due to having two months of activity from UCFC this year, but it's also attributable for the down rate environment that made mortgage activity very attractive during the quarter.

On the flip side, this down rate environment led to a large increase in our valuation allowance to the tune of $4.5 million. To provide some color on that, the 10-year treasury declined from 1.92% at 12/31/19 to 1.51% at 1/31/20 when we acquired UCFC and all the way down to 0.7% at 3/31/20. Last year only saw a 28 basis point decline in the first quarter. As rates improve in the future, we will be able to recover against that valuation allowance.

Next, I'll discuss expenses. First, we incurred $11.5 million in merger-related costs in the first quarter of 2020. Prior to closing, UCFC incurred $13.9 million in January. And on a combined basis, we had both incurred $2.8 million in 2019. So cumulatively, we have incurred $28.2 million against the original estimate of $30 million. We do expect to exceed that original estimate. However, most of that excess will involve enhanced synergies. And as a reminder, we expect the bulk of our synergies to begin materializing in the second half of the year after our core conversion is completed in mid-July.

Excluding merger costs, total expenses were $32.3 million compared to $24.9 million in the first quarter of 2019, with the increase generally due to two months of operating costs from UCFC in the current year. I'll note just a few items here. Compensation represents the biggest component of $17.6 million of expenses, which is up $3.6 million from the prior year first quarter, but was less than expected due to deferred costs on the strong mortgage volume activity. Amortization of intangibles is up almost $1 million, due to the core deposit and other intangibles recorded in connection with the UCFC merger.

Other expenses had a $0.7 million benefit due to a decrease in deferred compensation plan liabilities, similar to the income item I noted earlier. And last, we estimate that we incurred approximately $210,000 of costs in the first quarter related to the COVID-19 outbreak. So excluding the merger costs, we generated a core efficiency ratio of 54.06%, which compares favorably to 57.49% last quarter and 63.22% in the 2019 first quarter.

Additionally, our core pre-tax pre-provision income was $27.2 million, which generated a strong 2.04% return on average assets. Needless to say, we are very pleased with our first quarter operating profitability as we start 2020 as a combined organization with UCFC.

I already covered provision expense in my earlier discussion of CECL, so I will wrap up with a summary of net earnings. On a GAAP basis, we reported a net loss of $22.5 million or $0.71 per share. However, this was most significantly impacted by one-time merger specific items. Merger costs represented $9.5 million on an after-tax basis or $0.30 per share, and the one-time provision expense required under CECL for non-PCD acquired loans represented $20.5 million on an after-tax basis or $0.65 per share. Excluding the impact of these items, core earnings were $7.5 million or $0.24 per share. Further, with the adoption of CECL, we estimate that approximately $15 million to $16 million of expense could be attributable to the impact of deteriorated economic forecast. However, we have not excluded that for core earnings purposes.

In summary, we are off to a solid start to 2020 despite the economic headwinds we face. Our strong capital levels and operating profitability provide a good foundation in the current uncertain environment and allow us to support our customers, while we work together during this challenging time.

That completes my financial review. And I'll now turn the call over to Gary for highlights on our community banking initiatives, including updates on the merger integration progress and our COVID-19 response. Gary…

Gary Small
Thank you, Paul, and good morning to all. As Paul mentioned, I'm going to give you a few comments on our merger integration process and the actions and activities around the organization in response to COVID-19. We'll take that first. First Federal's reactions to the COVID-19 challenge have been swift and effective. We had 650 non-branch associates made remote capable within the first two weeks of the incident, and that's resulted in us having about 500 associates working from home on any one given day over that period.

Our branch lobbies remained open with appointment-only traffic, as folks are directed to mobile and online and to our drive-thrus. It's been very effective, and we continue to see new business booked through the period. We did institute what we call Appreciation Pay to assist our branch and operations and support teams who are continuing to head into the office, while navigating the challenges of home and the challenges that were presented by this unique environment. We've made adjustments to our PTO practices and generally have taken steps to support the team at every turn.

For our clients, in early March we executed a substantial outreach program to our business client base. We listened, provided counsel and made some appropriate recommendations. We are also very responsive to the needs of our consumer clients, and our team in the field is absolutely empowered to do what makes sense for those clients given their situation. In keeping with our community approach to doing business, we've contributed over $100,000 across the communities we serve to assist elders in need during this uncertain time and have contributed in-house stock of PPE gear to our local medical response organizations. We are all in this together.

Here in Ohio, we do expect to begin to return to work in a phased-in approach over the next few weeks. Our governor outlined the return-to-work approach earlier this week, and we will generally be adhering to the state recommendations. On to the integration, the process for First Federal and Home Savings continues on plan, and our targeted integration date remains set for early July. It's been an outstanding effort and outcome to date, especially considering the additional challenges we've all faced over the past couple of months.

Our annual cost saving expectations continue to be on track with the pro forma expectation of $17 million a year. The total one-time costs associated in the merger are also on track. We should land within 5% to 10% of our $30 million pro forma expectations, the increase coming to the benefit of improved run rate going forward.

Relative to our Q1 results, it's worth reiterating that our results exclude January core earnings of Home Savings and that the ongoing costs associated with sustaining two backrooms through the integration period are approximately a $1.5 million per quarter drag on our reported earnings. While March certainly saw a natural slowing down of business, we did have a good quarter of commercial and consumer activity. Obviously, residential mortgage business was strong in every market and continues to be, and we are very focused on the Payroll Protection Program and meeting the needs of our clients. The job done there we expect will pay dividends down the road and strengthen our relationships going forward. We, as an organization, are very focused and prepared to address the opportunities and challenges ahead facing our clients and for us as an organization.

With that, I'm going to turn it over to Matt Garrity, who heads up our lending and credit efforts.

Matt Garrity
Thanks, Gary. I'd like to provide an update on activities in our loan portfolio as we work with clients impacted by COVID-19. On the lending side, we've been very active in the Paycheck Protection Program with our clients and have received and gotten authorization for over 2,300 PPP loan requests, representing over $415 million in loan volume.

In addition to PPP, as Don noted, we are proud to be one of two banks selected to partner with the state agency JobsOhio to provide our small business customers with up to $200,000 in additional loans to support their capital needs during this time. These loans come with a 90% guarantee from JobsOhio with a total program commitment of $25 million. The program was just launched late last week, and we've received a lot of interest from our client base early on.

In addition to the significant amount of additional capital we are providing the clients, we have also been very proactive in working with our customers impacted by the pandemic to provide modification of payment terms, consistent with regulatory guidance. We currently have approved payment modifications for loans in our commercial portfolio totaling approximately $922 million. While in our residential mortgage portfolio, we have provided payment deferral for approximately $38 million of loans.

I'd now like to turn the call over to Don for closing comments. Don…

Don Hileman
Thank you, Matt. To wrap things up, we are pleased with our balance sheet and capital position as we move into the second quarter and a period of more challenges. Credit, as noted, will be a major focus as we look to future growth in loan balances and see what stress has developed for our different portfolios due to the COVID-19 environment.

In summary, I would like to express my sincere appreciation to each of our employees for their efforts and dedication to serve our customers during this pandemic crisis. I also want to recognize the team effort in handling the challenges of the PPP initiative. I also want to express my gratitude to all of those in the front lines of the pandemic, especially healthcare workers and first responders who are there to help us all. We will get through this difficult time together, and I believe that we as a company will emerge from the crisis stronger than ever. We appreciate the trust you have placed in us, and thank you for joining us and for your interest in First Defiance Financial Corp.

We will be now glad to accept your questions. Operator, we will accept questions at this time.

QUESTIONS AND ANSWERS

Operator
Sure. Thank you, sir. 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're using a speakerphone, please pick up your handset before pressing the keys. To withdraw your question, please press star then two. At this time, we'll pause momentarily to assemble our roster.

Our first question will come from Scott Siefers with Piper Sandler. Please go ahead.

Jamie Benjamin
Good morning. This is Jamie Benjamin on for Scott. Thanks for taking my questions.

Don Hileman
Good morning, Jamie.

Jamie Benjamin
First, can you guys run us through some of the macroeconomic assumptions you used to arrive at your reserve level?

Don Hileman
Paul, I'll let you handle that question.

Paul Nungester
Sure, no problem. First, just for reference, we do use the Moody's forecast, so we elected here at adoption to go ahead and acquire subscription there. So going forward, we will be relying on that. For 3/31, we are using the March baseline with our final March baseline, which at the end of the day incorporated their estimated impact of the COVID-19 outbreak as well as the CARES Act that came out right at the end of March. So that's the background that we'll be using here for the quarter and for go forward.

In terms of some of the economics that are in there, key ones I mentioned on the call, national unemployment is a specific driver within our model. And prior to the pandemic, when you go back to adoption, the 12/31 baseline forecast was calling for about 3.6% unemployment during 2020. With all the impact of the COVID outbreak and things like that, by the end of the day the estimated unemployment rate was projected to jump to 12.5%, a little over 12.5% for second quarter and then start to improve from there.

Similarly on the GDP front, originally, they were projecting positive GDP for all of 2020, almost 2% for the second quarter back at 12/31 estimates, and then by 3/31 that baseline was showing a significant recession, 18.3% recession or negative growth of GDP for the second quarter. And as I think a lot of us probably saw this morning, they've come out and announced the first quarter was in fact negative growth for real GDP. So those are some of the basics I'd say that are underlying that. Each quarter, we'll be updating in line with the new baseline forecasts and can provide some color on those as we progress.

Jamie Benjamin
Perfect. Thanks so much for the color. And then just want to follow up, given the way that the stock has behaved, I think there might be some confusion on what ongoing credit costs might look like. You guys are a little unique in that you were one of the few companies to have a merger close in the first quarter. You reported roughly $44 million provision with $26 million of that due to merger accounting. Then, we layer on the reserve build due to COVID. While there is so much uncertainty, what is the best way for us to think about ongoing provisioning?

Paul Nungester
That is a very good question. So obviously, this is the beginning of CECL, so we're all going to be learning as we go to some extent. However, conceptually CECL is a forecast model. It's a forward-looking model. So the intent there is to bring forward potential future reserve builds to the current end-of-period accounting date, such that, if things don't get worse or essentially if they, call it, stable from that point forward, then the reserve should move kind of like it used to, which is up for volume, maybe some adjustments for qualitative factors, things like that, where the volatility will come into play, obviously, as those forecasts change.

So while at 3/31 it had a forecast of X for unemployment, GDP, things like that, if that gets worse, the model will force additional reserves. If it gets better, we'll be able to take some of that back. But again, conceptually as long as things essentially stay stable, you take your lumps upfront and then you move on, and it's all about volume and things like that, just like the old days.

Jamie Benjamin
Great. Thank you. That's all from me.

Paul Nungester
Yes. Thanks, Jamie.

Operator
The next question is from Christopher Marinac with FIG Partners. Please go ahead.

Christopher Marinac
Good morning. Thanks for all the information last night and today. We appreciate it. What is your sense about the deferrals, and will those possibly get larger from what you've already reported? And then, do you think any of those would sort of be relatively quick to move off the books and then not threaten you to be a future classified or criticized asset?

Don Hileman
Yes, Chris. I'll start out and then turn it over to Matt. Right now, we're feeling we have the deferral. I think it could go up a little bit, that balance that Matt disclosed. And we're probably a little on the longer end. A lot of those are going to be six-month deferrals versus something shorter. So we're anticipating that you go through that six months process and coming out the end of that tunnel, those loans will be the same quality rating as long as some business activity that supports those loans come back. But right now our anticipation is that we'll be in a better position because of that deferral down the road.

Matt, do you want to give some more color on that one, if you would?

Matt Garrity
Sure, Don. I would agree with what you're saying there. I would expect as we look at credit risk rating and credit modifications going forward on those deferred loans, probably important to note that about 75% of the loans that we've identified is at risk in the investor deck have had some form of payment modification already approved to them. I think as we see the year go on, as the numbers, the financial statements start to come in for those borrowers, we'll start to see some deterioration in risk rating. But from a pure credit cost perspective, I don't see a lot of that activity dropping into the 2020 performance.

Christopher Marinac
Okay, so then basically the reserve you have now is properly geared toward what you know. And then, as you see things change, positively and negatively, then you would kind of reexamine the reserve every quarter, is that a correct way to think about it?

Paul Nungester
Yes, that's correct.

Don Hileman
Yes, that is, Chris. As we look at that, and like Paul said, a lot of that's going to be on the economic forecast, the unemployment rate and things like that. We have a baseline that we've talked about that moves around. So, how I look at it, I think we're probably—if everything stays stable, our provision will be well in line and lower than a lot of the expectations because we've already taken it in the first

quarter. But time will tell, and I don't have my crystal ball all ready. But it will be a modified, and we're going to try, like Paul said, to give a lot of clarity on the assumptions in that model on a quarterly basis to help you with your models and expectations.

Christopher Marinac
Okay, great. And then the $35 million or $36 million we see of the discounts that you footnoted, that includes the CECL double count that you had talked about way back when the merger was announced.

Paul Nungester
Yes. So in those, there is a credit mark, yes. So there's a credit mark on the entire loan book, out of that $27 million non-PCD and $7.7 million in PCD mark. Now, just to be clear, the mark in the PCD shows up in the allowance. So that was part of the allowance build there that didn't hit the P&L though. The $27 million of non-PCD credit marks are a reduction of the loan balance on the face of the balance sheet. That number did not go straight in the allowance. Instead, that's where the double-dip then comes in. On top of that, we then have to run balances through the model, and it kicked out a $26 million, roughly, provision charge at the date of acquisition to add to the allowance. So, there's your double-dip. You've got the credit market and then on top of that, we booked in allowance. And going forward, what we get to do is accrete in that credit mark then over the life of the loans.

Christopher Marinac
And the credit mark being the $27 million that is off, not part of that.

Paul Nungester
Correct.

Christopher Marinac
Got it. Perfect. Okay. So we can still think of the reserves being the $179 million and then add this credit mark on top of it, which I just want to make sure I got the math straight.

Paul Nungester
Yes. Exactly. It's not in the reserve. But you're right, there is an inherent reserve in the loan balances for that, yes.

Christopher Marinac
I just wanted to clarify it. Thanks for walking us through it.

Paul Nungester
Sure. No problem.

Don Hileman
Thanks, Chris.

Operator
The next question is from Michael Perito with KBW. Please go ahead.

Michael Perito
Good morning, guys. Glad to hear everyone is doing well. Thanks for taking my question.

Don Hileman
Sure, Mike. Good to see you, on the phone anyway.

Michael Perito
Yes, busy quarter for you guys, I guess, right? So a lot of my credit questions have been answered, so I want to ask a couple other ones. I wanted to start, and I apologize if I missed this. I got on the call a little late. But on the expense side, I realize there's still another month I believe of the UCFC expenses to come over, but it still seemed like it was maybe a little ahead, at least of what I was expecting. I was curious if you could maybe provide just like an updated near-term thought on kind of the expense run rate and remind us when you expect to realize most of those synergies, which I believe is after the conversion in July. But just to get an update there would be helpful.

Don Hileman
Paul, can you handle that, please?

Paul Nungester
Sure. Yes, I did touch on it just a little bit in the script part of the call there, Mike. And you're right, expenses are better than probably expected, even accounting for the fact that we only have two months versus three months of operating costs from UCFC. And the reason for that, for the most part, a key one is related to the mortgage activity that went on. And so, deferred costs that relate to that volume activity, and that ends up kicking out through gain on sale or amortizing over time, depending on whether they were sold or portfolio'd. So, roughly $1.5 million, $2 million maybe of costs related to that, that helped the quarter.

We did have one unusual item, not very big. Our deferred comp plan, which is effectively reliant on stock market activity, because it was down there by the end of the quarter and pretty significantly, we had a hit to the revenue line, which reduced that up in non-interest income. But we also got a benefit, and those essentially offset because they're matched. But it was $0.7 million through the other non-interest lines for both revenues and expenses.

Aside from that, it's really as you noted, starting next quarter we'll have a full run rate of costs from UCFC. And then in terms of timing of the synergies, yes, for the most part, the vast majority of those will start to hit in the second half of the year, once we get to conversion in mid-July. We have had some. Once we closed there at the end of January, we were able to execute on some of our synergies day one. So we've got a little bit of benefit starting out of the gate. But most of it will come later when we finish conversions and can eliminate a lot of duplicity, both in terms of data processing, personnel costs and such.

Michael Perito
Thanks, Paul. So a couple moving pieces there. I mean, are you guys willing to provide a ballpark of where you think the second quarter expense number might be within the range of? I know there's a lot of uncertainty out there, but it would seem like there is some controllable actions within the expense side. I mean, any thoughts?

Paul Nungester
Yes, I would say probably the best thing to do would be to add back, call it that $1.5 million to $2 million. It will depend on mortgage activity primarily here in the second quarter, which is starting to -- we got a lot of it in the first quarter based on what happened with the rate environment, and that has started to normalize here in the second quarter. So I wouldn't expect that necessarily to recur here in the second quarter.

Michael Perito
Okay. And can you remind us what would be—sorry, go ahead.

Gary Small
Mike, this is Gary. A couple other items that may help with the modeling. The residential mortgage book continues to run very well for the last month. The origination activity was three times its normal volume. And with the rate environment where it's at, we still see refinancings coming in, and we expect that to carry into the second quarter. So, some of the good that you see on the expense side relative to that will continue to be good, and the gain on sale income will be reflective of that.

What you won't see as much going forward is the kind of reduction you saw this last quarter on the MSR valuation. We're really at the floor on MSR. The rates can only move down so much more and effect that valuation. So we would expect net-net, a good second quarter of residential will give us great gain on sale, great cost deferral and less on MSR. And then on the point of my earlier comments, we still will have about $1.5 million in the second quarter of expenses that are relative to running both operations until we merge them in July. So on a go-forward run rate post integration, that's the number that you could add to the bottom line pre-tax pre-provision.

Michael Perito
Got it. Helpful. Thank you, guys. And in terms of the merger, more of a bigger picture question here, a broader question here. But obviously, I'm sure there were many plans alongside of revenue synergies and things of that nature. When you guys kind of put the deal together and obviously, the economic environments kind of threw a curve ball at all of us here. So I'm just curious if you provide us any broader update on how some of the initiatives that you guys maybe were looking to get going on right away, have the timelines around them changed or altered or anything of that nature, given everything going on?

Don Hileman
Great question, Mike. I think from the synergy side, a lot of that we didn't anticipate that to really happen until we had the core system converted. So in our thoughts and modeling, that would have been a probably a post third quarter kind of look at the world in more geared at '21 to get things all kind of cleaned up and in place. We still have this conversation, we've not taken a backseat in any of our thoughts on that. Clearly, like you said, it's a bit more challenging to try to think about how we get things done. But we're generally still on schedule for most of the things that we wanted to accomplish kind of bundled in with the core conversion.

Michael Perito
Okay, helpful. Thank you. And then lastly, I heard you guys on the residential side, and sorry if I missed it, but any thoughts, Matt, about the commercial pipeline and how closings there could trend given everything going on? I mean, is the second quarter likely to be pretty soft, but are the pipelines still fairly steady, or what are your updated thoughts there?

Matt Garrity
Sure, I'll give you a couple of thoughts there, Mike. As you mentioned, the first quarter was really solid. We really hit the ground running in commercial banking, really good organic growth, really for both sides of our businesses. Both our legacy First Federal side and legacy Home Savings side, both had a really good quarter. And probably a little understated from what's reported simply because there was one month of activity missing from the UCFC side. So, all-in-all, really good growth there.

Second quarter, we have enough good activity in the pipeline in the queue to close where we should see a good growth quarter on the commercial business. I think where our math gets a little fuzzier or where Don had mentioned the crystal ball comment, it gets a little tougher for us as we think Q3, Q4. Just not enough visibility to really give a whole lot of good guidance there yet.

Michael Perito
Okay. Really appreciate it, guys. Echo the comments. All the extra disclosures are helpful. So, thanks for including it. And stay well.

Don Hileman
Thanks, Mike. You too.

Paul Nungester
Thank you.

Operator
Once again, if you have a question, please press star then one. The next question is a follow-up from Scott Siefers with Piper Sandler. Please go ahead.

Jamie Benjamin
Hi guys, thanks for the follow-up. This is Jamie again. Just a couple of more questions here. Do you have a sense for how much purchase accounting adjustments we should expect for the rest of the year? And then relatedly, I know you mentioned there should be additional pressure on the margin, but any thoughts on the core margin further?

Don Hileman
I'll let you start, Paul, and I might give some color on the margin after you're done. So go ahead, Paul.

Paul Nungester
Sure, no problem. Yes, no problem. Jamie, can you clarify your question on the marks. So you're asking if things will change from here, or what's your question exactly on that?

Jamie Benjamin
Just the level of accretion running through the margin for the rest of the year in dollars or basis points, whatever.

Paul Nungester
Yes, yes, yes. So because they closed the end of January, we've only got two months of accretion here in the first quarter. So if we gross that up for a full quarter, that would be a better estimate. And then, part of that is some of them will burn down faster like the CD mark that's tied to maturity. That will be gone definitely within two years, if not sooner, as that book turns over. So we had, what did I say, $1.3 million for the quarter for two months' worth. Gross that up, that's a better estimate on a quarterly run rate.

So that did represent about 10 bps benefit for the margin. At the end of the day, that's about what we expected. We were projecting 9 bps to 10 bps, so that should come in maybe a little bit more with a full quarter's worth here starting in second quarter. But still somewhat pick up there on the reported NIM side.

And then on the core side, as we noted in the script part of the call, we do expect more contraction here in the second quarter. So that's a little hard to predict with exactly how PPP ends up in terms of the volumes and how that will start to flow into the second quarter. But prior to all this, we had been generally talking about a 3.5% to 3.6% core margin at the end of the day when rates started turning in that. So we're definitely in the low end of that, and so could it be 3.5%, a little under down to into this higher 3.4s. Yes, we can see that. But again, depending on how much we end up getting done with PPP and if that can help a little bit, plus, we are still seeing some activity, as Matt was saying, on the commercial side and whatnot that will help as well.

Don Hileman
Yes, I think a couple of things to think about that. Like Paul said, we get the PPP, that's a lower effective rate, but that'll help the provision because it's guaranteed. So you look at some of the trade-offs as we do in the margin versus the guarantee, which is worth quite a bit, and then the funding source of that will be lower on a net basis. A lot of the programs we're doing, JobsOhio, etc. is a prime-based product, so that will be a little lower rate than some of the commercial stuff. All that blended in, I think we're going to be fairly consistent.

It's going to be a challenge to work through that. But I think from the way we look at it, it's a benefit on the capital side and then some of that ties into the provision. Hopefully, expected in the lower provision because of the guarantees.

Jamie Benjamin
Great. Thank you so much. And just one more question. Do you guys have a sense for what stress losses through the cycle could look like for the combined company? And I'll preface that by saying, and I know you guys don't run through a DFAST model, but I was wondering if you have done any internal stress testing? And how does the combined company come through, if at all?

Don Hileman
Yes, we have. Nothing we're prepared to disclose. Our projections on a more moderate to severe stress test shows still well-capitalized levels.

Jamie Benjamin
Great. Thank you. That's all from me. Thanks, guys.

Don Hileman
All right. Thank you.

CONCLUSION

Operator
Ladies and gentlemen, this concludes 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 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.