

First Merchants
Q3 Earning Release Conference Call
Wednesday October 19, 2005

OPERATOR:

Greetings, ladies and gentlemen, and welcome to the First Merchants corporate third quarter earnings release conference call. At this time all participants are in a listen-only mode. A brief question-and-answer session will follow the formal presentation.

If anyone should require operator assistance during the conference, please press star-0 on your telephone keypad. As a reminder, this conference is being recorded.

During the call, we may make forward-looking statements about the relative business outlook. These forward-looking statements and all other statement made during the call that do not concern historical facts are subject to risks and uncertainties that may materially affect actual results. Specific forward-looking statement include but are not limited to any indications regarding the financial services industry, the economy and future growth of the balance sheet or income statement.

It is now my pleasure to introduce your host Mr. Michael Cox, Chief Executive Officer of First Merchants Corporation. Thank you. Mr. Cox, you may begin.

Michael Cox, CEO:

Thank you, Melissa. Good afternoon, everyone. We appreciate your dialing in to our third quarter release conference call.

As you know, we released our earnings on October the 17th. They were picked up by most of the financial press yesterday, on 18th, and with me today is Mark Hardwick, our Chief Financial Officer, and we want to elaborate a bit on those results as released, and answer any questions you may have.

As you know by now, our third quarter results were generally pretty positive across the board. Most of our key drivers improved quarter over quarter. And we're encouraged by that.

Diluted earnings per share came in at 44 cents versus 41 cents in the prior quarter, up 7.3%. Year to date net income was \$1.22 versus \$1.18, a more modest three and a half

percent increase year over year. However, we do want to continue to remind our investor and readers that the first quarter of this year did include a \$1.6 million charge for our pension curtailment expense. So we have overcome that through the first three quarters of the year, and anticipate the fourth quarter looking pretty good.

With regard to our balance sheet, total assets at quarter end were 3,238,000,000. An increase of about \$57 million over a year ago. You may have noticed, or perhaps some of the analyst noticed, that we added a new page to our financial breakdown release. Actually, it's the last page of the report. And it really is not new to us, but new to this release format. And it's consistent with our filing of call reports and our 10-Qs.

Essentially, this report gives you a five-quarter running breakdown of our loan and deposit categories, or by category. And I might just highlight a few of those for you. Our commercial and industrial loans were -- are up \$40 million over the prior period, or 9%. Construction loans are up 17 million, or 10%. And commercial loans, 127 million, 21% over the prior period. So some fairly robust loan growth in those categories.

However, those totals are mitigated by a continuing decline in residential mortgages. Down \$113 million, or 13%, from the prior year. Candidly, we expect -- this is according to plan, and we expect it to continue for a while, given prevailing yield curve condition and demand characteristics from our customer base.

As you know, and as we've reported numerous times, we are not booking long-term fixed-rate mortgages. If demand continues to prevail in that category, we're selling that volume into the secondary market. And therefore, our portfolio of residential mortgages is fairly static. And then as you apply the traditional amortization of that portfolio, it is -- it's likely to shrink over time, and it is.

That strategy, we think, is somewhat helping us maintain our net interest margin, and frankly, our net interest margin has improved a bit year over year. We came in at the quarter at slightly over 4% for the first time in about three years, I might add. And we're pleased by that. And we think, again, part of that is discipline on deposit pricing, and discipline in not booking long-term low-rate mortgages.

Our return on average assets is at 1.03%, which is up fairly steadily over the last five quarters, as you'll note from the report. Our allowance for loan losses remains consistent or steady at slightly above 1%, coming in at 1.03 for the quarter.

Return on tangible equity is probably not in that ratio of breakdown, but it should be. But our return on tangible equity for the quarter is 18.2%, a slight improvement over the last several quarters. And a number, frankly, that we're not disappointed with at all, at 18%.



I might say a word about our economy and our service areas, and I realize this is going to sound like a broken record from prior quarters. But I think we would characterize it as continuing to improve modestly. And use the term modestly in a guarded fashion, because there are pockets of weakness in the economy, but also some very strong segments as well.

The strong segment in the markets we serve are education, health care, service industries in federal, all being very solid. Many of us in this part of the country are watching closely the Delphi announcement. We don't feel we have any unusual concentrations or vulnerability to the Delphi developments, but we're watching them closely.

With that, I would turn it over to Mark Hardwick, our Chief Financial Officer, and Mark will expand on some of the details included in our report. Mark?

Mark Hardwick, CFO:

Thank you, Mike. Ladies and gentlemen, thank you for joining us again this afternoon. The press release, as Mike commented, was published Monday, the 17th, and I do hope you have all had an opportunity to dig into our release.

In the release, as Mike mentioned, we did add two additional tables with a significant amount of loan and deposit detail to help you understand the trends in our balance sheet.

I plan to primarily cover second quarter of 2005 to third quarter 2005 changes, but I will also discuss a few year over year trends, so listen closely as I go through the numbers.

Total increases in the loan portfolio quarter over quarter were \$3 million, and that increase again primarily came from C&I increases of 13 million, real estate construction increased by 5 million, and individual loans for household and personal expenditures were up 4 million. But as the trends continued this quarter that Mike discussed, we did see a continued decrease in the residential real estate portfolio of \$12 million.

Improvement in the C&I, and commercial real estate and commercial loans have been masked this year by paydowns of our residential real estate portfolio, and it has the position of this corporation to sell all fixed-rate mortgages into the secondary market.

In the short-term, this strategy has mitigated our loan growth. And absent the residential real estate portfolio, loans have increased by 10.5%. We are confident that our loan growth -- or that our growth strategies are on track and that our Alco (ph) position is the best long-term approach. I would also like to discuss our current residential real estate portfolio just

to shed some additional light on the type of loans that we are holding in the portfolio. And I think that will help you understand our position from an interest rate risk perspective.

As of September 30th, and you can see this detail on the last page of the release, we have \$747 million in loans that are classified as residential real estate. Of the 747 million, 115 million are home equity lines. Of the remaining 634, just a little over 125 million are single-family rental properties, structured much like a commercial loan or multifamily real estate loan would be. And that typically is a very short maturity.

So the remaining 500 million in owner-occupied residential real estate loans, we have just 27% that are fixed rate loans, and weighted average maturity of those loans totals about 174 months. And those are seasoned loans that we've had on the books for quite some time. The remaining 73% are adjustable rate loans. The average yield on the owner-occupied residential real estate portfolio remains over 6%, and 70% of our owner-occupied loans are investment grade, while 19% are private grade.

I believe that our mortgage portfolio structured more conservatively than other institutions and I'm confident that our diligence in this regard will help preserve our net interest margin for years to come.

Total investments increased by 16 million from last quarter, as federal agency asset-backed securities increased by 2 million, and tax-exempt securities increased by 14 million. The purchase of -- the purchases for the quarter had between a 4 and 5-year duration, and a tax effective yield of a little over 5%. Deposits increased by 61 million, resulting from a \$86 million increase in CDs over 100,000. And as I discussed last quarter, our public deposits do create some volatility in our deposit totals, and that's clearly demonstrated in the move -- in those balances from first to second quarter, and then from the second quarter to third quarter this year, in our trends.

As public deposit increase, our borrowing positions do decrease. A \$30 million reduction in borrowings did occur quarter over quarter with a \$19 million decrease in repurchase agreements, a \$9 million decrease in fed funds, and holding company also reduced its line of credit by 3 million.

During the quarter, total stockholders equity increased by \$5 million, as tangible capital improved to 577 for the quarter. Net interest margin on a fully taxable equivalent basis increased by 1 basis point to 4%. This is the first time, as Mike indicated, since the first quarter of 2003 that margins have topped 4%. Given the flattened and flattening yield curve this improvement demonstrates our commitment to protecting our balance sheet against rising rates. The corporation's yield earnings assets increased by 26 basis points

while the cost of supporting liabilities increased 25 basis points. As with many banks in the country, we're keeping a very close eye on deposit pricing and core deposit balances.

The increased earnings assets and improved net interest margin resulted in an increase in net interest income of 219,000 over the second quarter of 2005. The provision for loan losses during the quarter totalled 1,794,000, down slightly from the second quarter, adding 154,000 to pretax income. This quarter's provision is, however, 414,000 more than the same quarter one year ago, as we continue to be diligent about the level of our allowance for loan losses. The allowance for loan losses remained at 103 at the end of the quarter and nonperforming loans increased by 5 basis points to 18.3 million.

Of the increase in the nonperformers, they were primarily attributable to an increase in ORE, and 90 days past due, which is in the release as well. ORE increased by 1.2 million, and the analysis of our problem loan updates, which we prepare for all watch list credits, suggests that the loans that were added to ORE, after discounted collateral values, do exceed the book balance. So all ORE assets are in the process of liquidation and all nonperforming loans are in the process of collection.

Other noninterest income was basically flat from the second to third quarter, but did increase over the prior year by 369,000, and the fluctuations are small enough that I will not go into the details. And the same holds true on noninterest expense. Other expenses increased by just 102,000 over the second quarter, and 511,000 over the prior year, or just 2.2%.

Overall earnings per share improved from .43 in the second quarter of 2005 to .44 in the third quarter, and improved from 41 cents in the prior year to 44 cents this year, resulting in a 7.3% increase.

Year to date earnings per share absent the expenses related to the curtailment of the corporation's defined benefit pension plan, increased by 7.6%. As Mike indicated, the return on tangible was 18 -- 18.15%, and efficiency ratio totalled 59% for the quarter.

As Mike state in the release, CPS is consistent with manage management's expectations to high single digits to low double-digit earnings per share growth. And with that, I think it's time to open the call up for questions.

OPERATOR:

(operator instructions)

Our first question comes from the line of Steve Covington of Stieffel. Please state your question.

<Q>: Good afternoon, guys.

<A>: Good afternoon, Steve. How are you?

<Q>: Good, thank you. I appreciate all the detail you guys always do a nice job with adding color. I guess first question is more -- is general in nature, but we're hearing some of your peers comments on some irrational price competition in some of your markets. And I guess specifically I've heard that parts of Ohio maybe specifically in Columbus. Can you comment on some of the competition and what you see out there with some of your competitors?

<A>: Well, I hope they're not referring to us.

<Q>: I don't think so.

<A>: We're attempting to be as rational as we know how. We see a little bit of that, Steve, but it's primarily coming at least in our markets from our non-traditional competitors. Coming from insurance companies who seem to be willing to book long-term, fixed rate assets, and credit unions who are getting more involved in commercial financing. With a little different view of the Alco (ph) strategy that we employ, anyway. So yeah, short answer would be we are seeing some price competition on the commercial side, but it's nontraditional competitors and so far at least they're not cutting into our business base.

<Q>: Good. I guess secondly, and you commented a little bit on this, but it sounded like the way you sit today, that you would anticipate at least being able to maintain a margin right around here, is that a reasonable guesstimate for our model?

<A>: Guesstimate is probably the key word.

<Q>: Yeah.

<A>: But yeah, I think that's reasonable. It's going to depend a lot on future fed movements, but currently it looks like each quarter point movement upward we're able to maintain some positive part of that, anywhere from 5 to 8 basis points in our margin. So I think we can maintain. And if the fed keeps moving upward, we might see a little bit more expansion.

<Q>: Okay. And then lastly, it looked like the -- is the tax rate that you show for the quarter, Mark, is that a good number to use going forward? I think maybe it was a little less than last quarter, but year to date, I think they're pretty consistent.

<A>: Yeah, that's consistent.

<Q>: Okay, thanks a lot, guys.

<A>: Thank you, Steve. Appreciate it.

OPERATOR:

Our next question comes from the line of Evan of (indiscernible) Capital Advisors. Please state your question.

<Q>: Hi, guys, how is it going?

<A>: Hey, Evan, how are you?

<Q>: Pretty good. Thanks for taking my questions. I just had a couple. Your trust revenue seems to be weakening. What's your thoughts here and what do you see as a good run rate for this item?

<A>: With regard to run rate, Evan, I don't know, I hesitate to venture a number on that because we're not -- that would become a pretty significant component of earnings guidance, and we're not offering guidance at the moment. But I think our run rate actually is fairly steady over the last five quarters. So when you refer to some disappointment, I'm not sure what you mean by that.

<Q>: Well, it dropped, what, almost \$170 million this quarter. Over the prior quarter.

<A>: No. It dropped from a million-963 to a million-794.

<Q>: Right.

<A>: 170,000 -- I think the key to that is there hasn't been a significant decrease in the customer base in the trust department. I mean, there's been no extraordinary event.

<Q>: Okay.

<A>: I don't see, other than market trends, anything that would indicate a weakening of that number going forward.

<Q>: Okay. Great, thanks. And also, the cost savings from consolidating your offices, how much if any came through this quarter? And do you expect any going forward?

<A>: Are you referring to the operational consolidation?

<Q>: Yes, sir.

<A>: That is still in the buildout phase, so we have not transferred employees into that new location to date.

<Q>: Okay. When do you expect that to go through?

<A>: It's under way right now, Evan, we've sort of been moving people in stage. You are referring to our ops and tech center relocation, aren't you?

<Q>: Yes, I am.

<A>: Okay. Yeah, that is ongoing, but I don't anticipate significant cost savings in that process. As you recall, we're going to maintain our old data center as our disaster recovery backup site. It's on a different power grid and we already have it fully wired and equipped, and it's fully depreciated.

<Q>: Okay.

<A>: We're going to retain that one. So the cost justification, if you will, and it's not necessarily a big savings, but we will discontinue our long-term disaster recovery contract and essentially become our own provider, bring that back in-house.

<Q>: Gotcha.

<A>: But we're kind of moving people to that new center steadily, month by month, and should have it complete by end of November.

<Q>: Okay, great. And two more questions, if you will. The miscellaneous fee income item, was up \$300,000 quarter over quarter. Of the press release said it was due to customer fees. Could you provide any more color on that?

<A>: Mark, I can't. Can you?

<A>: Yeah, I really -- no, I really don't have any specific items. A number of customer -- other customer fees, ATM type fees, debit card transactions, those types of things that run through that account, but there wasn't one significant increase that I'm aware of.

<Q>: Okay. And final question. What's the status of the COO replacement? It seems to be taking a bit longer than expected.

<A>: Good question, Evan. As a matter of fact, we think that's coming near a conclusion. We have a series of interviews yet this week, as a matter of fact, and with directors participating in that process. So while it may have taken -- it has taken a good while, but it's been a deliberate process and we're pretty encouraged by the way it's run its course.

I would think we'll have an announcement forthcoming within 30 to 45 days.

<Q>: Okay. And the candidates that you're interviewing, are they external or internal?

<A>: I can't comment on that at present.

<Q>: Okay. Great, well, thanks a lot for answering all my questions.

<A>: Thank you, Evan, appreciate it.

OPERATOR:

Our next question comes from the line of Joe Stephens, of Stephens Capital. Please state your question.

<Q>: Good afternoon, guys.

<A>: Hi, Joe, how are you?

<Q>: Good, how about you?

<A>: Very good.

<Q>: I joined a little bit late so I hope I'm not covering something that you already answered, but when I look at your loan portfolio, in total you didn't show -- it wasn't a whole lot of growth. But in select sectors you showed pretty good growth, both on the construction and in some of the C&I lending. Could you give a little color on that, on those areas of growth? Thanks, Mike.

<A>: Yeah, Joe. I did comment on that earlier, and you may have joined us a little late. In terms of the dollar net change year over year, it has been strong in C&I, as you know, construction and commercial. Residential is down for the reasons Mark and I both commented on.

<Q>: Right.

<A>: In terms of color, I think we're getting -- first of all, loan growth -- or loan demand is starting to pick up a bit through our markets. But I think we're really seeing the benefit of some of our new market initiatives. Our expansion in the Indianapolis market, year over year we're up over \$20 million in that market. Columbus, our Columbus bank, Commercial National, has opened an office in Cincinnati. And last number I saw, they had picked up about \$12 million in growth out of that market.

And Lafayette Bank has opened an office in Laporte in northwest Louisiana, and that's showing very promising signs as well. So the commercial growth, commercial and real estate is obviously coming out of our more robust market. And Indianapolis, laugh yet, Columbus, Ohio, and Cincinnati.

OPERATOR:

Our next question comes from the line of Kenneth James of FTN Midwest. Please state your question.

<Q>: Good afternoon, gentlemen.

<A>: Good afternoon.

<Q>: I have a question about your expense levels and your cost control. Really kind of impressive, the expense level has been right around this 22 to 23 million run rate for about three years now. Is there anything that's going to get that moving upwards, any initiatives or expansions you guys have planned, or can we expect more of the same there?

<A>: Our run rate on expenses?

<Q>: Yeah.

<A>: I hope it's steady to down, frankly. That's our tactic. Trying overall to improve our efficiency ratio, Ken, and get more effective as we do that. Mark, I interrupted you, I think. You had a thought on that?

<A>: If you look back over the history of our company with the acquisitions that have occurred, we continue to streamline operations and look for ways to reallocate resources to our growth markets and still maintain relatively flat total expense line item.

<Q>: Okay, thank you.

OPERATOR:

Our next question comes from the line of Brian Martin of Hal Barnes (ph). Please state your question.

<Q>: Hi, guys.

<A>: Hi, Brian.

<Q>: A couple quick things here, and one being the capital level, I know you guys have talked a little about it in the past, but the tangible level, you know a little bit below 6%, is that any issue with the growth you're expecting? It doesn't sound like to but I want to get your thoughts on the capital, and a couple other things, if you want to go to that one first.

<A>: Yeah, go ahead, Mark.

<A>: No, Brian, I think if you look back at our history, we continue to allow -- or increase the capital level slightly. Obviously, we do have a high dividend payout ratio, and we are retaining a portion of our earnings to support the loan growth, and then do a few stock buybacks, depending on how strong the loan growth is. So I feel like we have the capital that does support the dividend payout. It does support the growth initiatives. And then depending on the amount that remains, we're deciding whether or not to engage in any buyback activity.

<Q>: Okay. And how about just briefly on credit quality. You guys -- do you feel pretty good about where things are at this point? I guess, do you see more likelihood that things deteriorate slightly or get a little better? Is it more steady, is this kind of on the nonperforming number and/or chargeoffs?

<A>: I think we caught most of that, Brian. Your phone is cutting in and out a little bit.

<Q>: Okay.

<A>: With regard to credit quality, yeah, we feel like it's steady to improving. As you know, we hit either a low water mark or a bad water period two years ago.

<Q>: Right.

<A>: And we've gotten that behind us, we hope. And nonperforming and chargeoff numbers have been relatively steady to down now, the last three quarter. And I look for that obviously it can't go down to zero, and never will. But I think we'll be able to maintain in this current level. Pretty well.

<Q>: Okay. And how about lastly, maybe -- some of these cost saving initiatives over the past year taken care of, what should we look for as far as any initiatives you guys have on the horizon for '06 at this point, whether it be I guess on the acquisition front, bank or insurance companies or if neither one of those, maybe talent additions, as far as some of the new market or more metropolitan markets, where the growth is coming from. Thanks.

<A>: Thank you. Good question, Brian. With regard to initiatives in new market, or acquisitions, we are -- we continue to have conversations ongoing with people who might want to join us at a future date. We also are talking to investment bankers who are presenting ideas. I think we now have sufficiently integrated our last two acquisitions that we would be open and receptive to an opportunity that made sense for us. So -- and that would be true both in the bank side and in the insurance side. And those insurance acquisitions, I think, will continue to happen fairly steadily. But they're small and generally done for cash or stock that is not material in the whole filing arena.

With regard to adding people, obviously we have a COO search under way, and we would again be very receptive top opportunities of adding good people in good market. And those conversations go on fairly regularly as we speak.

OPERATOR:

(Operator instructions)

Gentlemen, it appears that we have no further questions at this time.

>> Thank you, Melissa. Let me just close by saying we appreciate, again, the attendance of a number of callers. There appear to be about 20 today on our screen. Appreciate the questions and interest from our investment bankers, our market makers, et cetera. We need your support and we hope our results are proving rewarding to you and our shareholders. So we look forward to another positive call in 90 days. Thank you all very much.

OPERATOR:

Ladies and gentlemen, this concludes today's teleconference. We thank you for your participation and you may disconnect your lines at this time.

