

FIRST DEFIANCE FINANCIAL CORP

Form S-3

April 24, 2012

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As filed with the Securities and Exchange Commission on April 24, 2012

Registration No. 333-

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form S-3
REGISTRATION STATEMENT

UNDER

THE SECURITIES ACT OF 1933

FIRST DEFIANCE FINANCIAL CORP.

(Exact name of Registrant as specified in its charter)

Ohio
(State or other jurisdiction of

31-1803915
(I.R.S. Employer

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incorporation or organization)

Identification Number)

601 Clinton Street

Defiance, Ohio 43512

(419) 782-5015

(Address, including zip code, and telephone number, including area code, of Registrant's principal executive offices)

William J. Small

Chairman, President and Chief Executive Officer

First Defiance Financial Corp.

601 Clinton Street

Defiance, Ohio 43512

(419) 782-5015

(Name, address, including zip code, and telephone number, including area code, of agent for service)

With a Copy to:

Kimberly J. Schaefer, Esq.

Vorys, Sater, Seymour and Pease LLP

301 East Fourth Street

Suite 3500, Great American Tower

Cincinnati, Ohio 45202

(513) 723-4000

From time to time after the effective date of this Registration Statement

(Approximate date of commencement of proposed sale to the public)

If the only securities being registered on this Form are being offered pursuant to dividend or interest reinvestment plans, please check the following box: "

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If any of the securities being registered on this Form are to be offered on a delayed or continuous basis pursuant to Rule 415 under the Securities Act of 1933, other than securities offered only in connection with dividend or interest reinvestment plans, check the following box:

If this Form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act, please check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering:

If this Form is a post-effective amendment filed pursuant to Rule 462(c) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering:

If this Form is a registration statement pursuant to General Instruction I.D. or a post-effective amendment thereto that shall become effective upon filing with the Commission pursuant to Rule 462(e) under the Securities Act, check the following box:

If this Form is a post-effective amendment to a registration statement filed pursuant to General Instruction I.D. filed to register additional securities or additional classes of securities pursuant to Rule 413(b) under the Securities Act, check the following box:

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer
 Non-accelerated filer (Do not check if a smaller reporting company) Smaller reporting company

CALCULATION OF REGISTRATION FEE

| Title of each Class of Securities to be Registered | Amount to be Registered | Proposed Maximum Offering Price Per Unit | Proposed Maximum Aggregate Offering Price | Amount of Registration Fee |
|---|-------------------------------|---|--|-------------------------------|
| Fixed Rate Cumulative Perpetual Preferred Shares, Series A, par value \$.01 per share (2) | 37,000 | \$1,000 (1) | \$37,000,000 | \$4,241 |
| Depository Shares (2) | | | | |
| Common Shares, par value \$.01 per share (3) | 550,595 | \$10.08 (4) | \$5,549,998 | \$637 |
| Warrant to Purchase Common Shares, par value \$.01 per share (5) | | | | |
| Total | | | \$42,549,998 | \$4,878 |

- (1) Represents the liquidation preference amount for each Fixed Rate Cumulative Perpetual Preferred Share, Series A (the "Series A Preferred Shares"), which we sold in a non-public offering to the United States Department of the Treasury (the "U.S. Treasury") under its Troubled Asset Relief Program Capital Purchase Program. Calculated in accordance with Rule 457(a) under the Securities Act of 1933, as amended (the "Securities Act of 1933"), and includes such number of additional Series A Preferred Shares, of a currently indeterminable amount, as may from time to time become issuable by reason of share splits, share dividends or similar transactions, which Series A Preferred Shares are registered hereunder pursuant to Rule 416 under the Securities Act of 1933.
- (2) In the event the U.S. Treasury requests that we deposit the Series A Preferred Shares with a depository pursuant to a depository arrangement, depository shares evidencing fractional Series A Preferred Shares may be sold pursuant to this Registration Statement in lieu of whole Series A Preferred Shares.

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- (3) The Common Shares being registered are purchasable upon exercise of the Warrant to Purchase Common Shares being registered, which we issued to the U.S. Treasury in a non-public offering concurrent with the sale of the Series A Preferred Shares to the U.S. Treasury as described in footnote (1). In addition to the number of Common Shares stated in the table above, there is registered, pursuant to Rule 416 under the Securities Act of 1933, such number of additional Common Shares, of a currently indeterminable amount, as may from time to time become issuable by reason of share splits, share dividends or similar transactions and certain anti-dilution provisions set forth in the Warrant to Purchase Common Shares.
- (4) Estimated in accordance with Rule 457(i) under the Securities Act of 1933 and calculated on the basis of the \$10.08 per share exercise price of the Warrant to Purchase Common Shares.
- (5) Pursuant to Rule 457(i) under the Securities Act of 1933, no additional fee is payable for the Warrant to Purchase Common Shares.

The registrant hereby amends this registration statement on such date or dates as may be necessary to delay its effective date until the registrant shall file a further amendment which specifically states that this registration statement shall thereafter become effective in accordance with section 8(a) of the Securities Act of 1933 or until the registration statement shall become effective on such date as the Commission acting pursuant to said section 8(a), may determine.

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The information in this prospectus is not complete and may be changed. The selling securityholders may not sell these securities or accept an offer to buy these securities until the registration statement filed with the Securities and Exchange Commission is effective. This prospectus is not an offer to sell, nor is it a solicitation of an offer to buy, these securities in any jurisdiction where an offer or sale thereof is not permitted.

Subject to Completion, dated April 24, 2012

PROSPECTUS

First Defiance Financial Corp.

**37,000 Fixed Rate Cumulative Perpetual Preferred Shares, Series A, Par Value \$.01
Per Share**

(or Depositary Shares Evidencing Fractional Interests in Such Fixed

Rate Cumulative Perpetual Preferred Shares, Series A, Par Value \$.01 Per Share)

Warrant to Purchase 550,595 Common Shares, Par Value \$.01 Per Share

550,595 Common Shares, Par Value \$.01 Per Share

This prospectus relates to the potential resale from time to time by the selling securityholders of some or all of 37,000 of our Fixed Rate Cumulative Perpetual Preferred Shares, Series A, par value \$.01 per share, liquidation preference \$1,000 per share (the Series A Preferred Shares), or, in the event such Series A Preferred Shares are deposited with a depositary as described in this prospectus, depositary shares evidencing fractional interests in such Series A Preferred Shares; a warrant (the Warrant) to purchase 550,595 of our common shares, par value \$.01 per share (the Common Shares); and any Common Shares issuable from time to time upon exercise of the Warrant. The Series A Preferred Shares and the Warrant were originally issued by us pursuant to the Letter Agreement dated December 5, 2008, and the related Securities Purchase Agreement Standard Terms, between us and the United States Department of the Treasury (the U.S. Treasury), in a transaction exempt from the registration requirements of the Securities Act of 1933, as amended (the Securities Act).

The selling securityholders who may sell or otherwise dispose of the securities offered by this prospectus include the U.S. Treasury and any other holders of the securities covered by this prospectus to whom the U.S. Treasury has transferred its registration rights in accordance with the terms of the Letter Agreement between us and the U.S. Treasury. The selling securityholders may offer the securities from time to time directly or through underwriters, broker-dealers or agents and in one or more public or private transactions and at fixed prices, at prevailing market prices, at prices related to prevailing market prices or at negotiated prices. If these securities are sold through underwriters, broker-dealers or agents, the selling securityholders will be responsible for underwriting discounts or commissions or agents' commissions. We will not receive any proceeds from the sale of securities by the selling securityholders.

Neither the Series A Preferred Shares nor the Warrant is listed on any national securities exchange, and, unless requested by the U.S. Treasury, we do not intend to seek such a listing for the Series A Preferred Shares or the Warrant.

The Common Shares of First Defiance Financial Corp. (First Defiance) are listed on the NASDAQ Global Select Market under the symbol FDEF. On April 20, 2012, the closing price for the First Defiance Common Shares was \$16.59.

Investing in our securities involves risks. We urge you to carefully review the information contained in this prospectus under the caption **RISK FACTORS** beginning on page 3 and other information included or incorporated by reference in this prospectus and any prospectus supplement for a discussion of factors you should carefully consider before you make your investment decision.

NEITHER THE SECURITIES AND EXCHANGE COMMISSION, NOR ANY STATE SECURITIES COMMISSION NOR ANY BANK REGULATORY AGENCY HAS APPROVED OR DISAPPROVED OF THESE SECURITIES OR PASSED UPON THE ACCURACY OR ADEQUACY OF THIS PROSPECTUS. ANY REPRESENTATION TO THE CONTRARY IS A CRIMINAL OFFENSE.

THESE SECURITIES ARE NOT DEPOSITS OR ACCOUNTS OR OTHER OBLIGATIONS OF ANY BANK OR SAVINGS ASSOCIATION AND ARE NOT INSURED OR GUARANTEED BY THE FEDERAL DEPOSIT INSURANCE CORPORATION, THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM OR ANY OTHER GOVERNMENTAL OR REGULATORY AGENCY OR INSTRUMENTALITY.

Our principal executive offices are located at 601 Clinton Street, Defiance, Ohio 43512-3272, and our telephone number is (419) 782-5015.

The date of this prospectus is _____, 2012.

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WHERE YOU CAN FIND MORE INFORMATION

Available Information

We file annual, quarterly and current reports, proxy statements and other information with the SEC. The reports, proxy statements and other information that we file with the SEC are available to the public from the SEC's website at <http://www.sec.gov>. Copies of certain information filed by us with the SEC are also available through our Internet site at <http://www.fdef.com>. The information on the SEC website and on our website is not a part of this prospectus. You may also read and copy any document we file with the SEC by visiting the SEC's Public Reference Room in Washington, D.C. The SEC's address in Washington, D.C. is 100 F Street N.E., Washington, D.C. 20549. Please call the SEC at 1-800-SEC-0330 for information on the operation of the Public Reference Room.

We will provide without charge, upon written or oral request, a copy of any or all of the documents that are incorporated by reference into this prospectus (other than exhibits, unless they are specifically incorporated by reference in the documents). Requests should be directed to: First Defiance Financial Corp., 601 Clinton Street, Defiance, Ohio 43512-3272, Attention: Donald P. Hileman, telephone number (419) 782-5015.

Incorporation by Reference

The SEC allows us to incorporate by reference into this prospectus information that we file with the SEC. This means that we can disclose important information to you by referring you to those documents. Any information we incorporate in this manner is considered part of this prospectus, and information that we file later with the SEC will automatically update and supersede information included or previously incorporated by reference into this prospectus from the date we file the document containing such information.

Except as noted below, we incorporate by reference the following documents that we have filed with the SEC and any future filings we will make with the SEC under Sections 13(a), 13(c), 14 or 15(d) of the Exchange Act from the date of this prospectus until the completion of the offering in the relevant prospectus supplement to which this prospectus relates or this offering is terminated:

Annual Report on Form 10-K for the fiscal year ended December 31, 2011, filed on March 7, 2012, and Annual Report on Form 10-K/A (Amendment No. 1) for the fiscal year ended December 31, 2011, filed on April 3, 2012;

Current Report on Form 8-K filed on March 15, 2012; and

The description of our Common Shares set forth in the Registration Statement we filed with the SEC on Form 8-A on September 25, 1995, including any amendment or report filed with the SEC for the purpose of updating this description.

Pursuant to General Instruction B of Form 8-K, any information furnished pursuant to Item 2.02. Results of Operations and Financial Condition or Item 7.01. Regulation FD Disclosure of Form 8-K is not deemed to be filed for purposes of Section 18 of the Exchange Act, and we are not incorporating by reference any information furnished pursuant to Item 2.02 or Item 7.01 of Form 8-K into this prospectus.

ABOUT THIS PROSPECTUS

This prospectus is part of a registration statement that we filed with the SEC utilizing a shelf registration process for the delayed offering and sale of securities pursuant to Rule 415 under the Securities Act. Under this shelf registration process, the selling securityholders named in this prospectus may sell any of the securities described in this prospectus in one or more offerings from time to time. When we use the term securities in this prospectus, we mean any of the securities that the selling securityholders named in this prospectus may offer under this prospectus, unless we say otherwise. We may provide a prospectus supplement containing specific information about the terms of a particular offering by the selling securityholders. The prospectus supplement may also add, update or change information contained in this prospectus. If the information in this prospectus is inconsistent with a prospectus supplement, you should rely on the information in the prospectus supplement. You should carefully read both this prospectus and any prospectus supplement. You also should carefully read the documents incorporated by reference into this prospectus and the documents we have referred you to in **WHERE YOU CAN FIND MORE INFORMATION Available Information** for additional information about our Company, including our financial statements.

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Unless the context otherwise requires, references to First Defiance, the Company, we, our and us and similar terms mean First Defiance Financial Corp. and its subsidiaries.

The selling securityholders named in this prospectus may use this prospectus to offer any of the following of our securities from time to time:

Fixed Rate Cumulative Perpetual Preferred Shares, Series A, par value \$.01 per share, either directly or represented by depositary shares;

Warrant to purchase 550,595 of our Common Shares, par value \$.01 per share; or

Common Shares, par value \$.01 per share, issued upon exercise of the Warrant.

You should rely only on the information contained or incorporated by reference in this prospectus and any prospectus supplement. We have not, and the selling securityholders have not, authorized anyone to provide you with any other information. If you receive any other information, you should not rely on it. This prospectus does not constitute an offer to sell, or a solicitation of an offer to purchase, any of the securities to which this prospectus relates in any jurisdiction to or from any person to whom it is unlawful to make such an offer or solicitation in such jurisdiction. You should not assume that the information contained in this prospectus and, if applicable, any prospectus supplement or any document incorporated by reference in this prospectus or any prospectus supplement, is accurate as of any date other than the date on the front cover of this prospectus or on the front cover of the applicable prospectus supplement or document or as specifically indicated in the document. Our business, financial condition, results of operations and prospects may have changed since that date.

SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

This prospectus and the documents incorporated by reference herein may contain forward-looking statements within the meaning of Section 27A of the Securities Act, and Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act) with respect to our financial condition, results of operations, cash flows, plans, objectives, strategies, targets, prospects and business. Forward-looking statements reflect our expectations, estimates or projections concerning future results or events. These statements are generally identified by the use of forward-looking words or phrases such as believe, strategy, expect, anticipate, may, could, intend, intent, belief, estimate, will, should or other similar words or phrases. Forward-looking statements are not guarantees of performance and are inherently subject to known and unknown risks, uncertainties and assumptions that are difficult to predict and could cause our actual results, performance or achievements to differ materially from those expressed in or implied by the forward-looking statements. We cannot assure you that any of our expectations, estimates or projections will be achieved and you should not place undue reliance on forward-looking statements.

The risk factors set forth or incorporated by reference below under the section captioned **RISK FACTORS** could affect future results, causing our results to differ materially from those expressed in our forward-looking statements.

The forward-looking statements included or incorporated by reference in this prospectus are only made as of the date of this prospectus or the respective document incorporated by reference herein, as applicable, and we disclaim any obligation to publicly update any forward-looking statement to reflect subsequent events or circumstances. See the section captioned **WHERE YOU CAN FIND MORE INFORMATION**.

Numerous factors could cause our actual results and events to differ materially from those expressed or implied by forward-looking statements, including, without limitation:

Local, regional, national and international economic conditions and the impact they may have on us and our customers and our assessment of that impact.

Volatility and disruption in national and international financial markets.

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Government intervention in the U.S. financial system.

Changes in the level of non-performing assets and charge-offs.

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Changes in estimates of future reserve requirements based upon the periodic review thereof under relevant regulatory and accounting requirements.

Acquisitions and integration of acquired businesses.

Changes in consumer spending, borrowings and savings habits.

Changes in the financial performance of our borrowers.

The effects of and changes in trade and monetary and fiscal policies and laws, including the interest rate policies of the Federal Reserve Board of Governors.

Inflation, interest rate, securities market and monetary fluctuations.

The timely development and acceptance of new products and services and perceived overall value of these products and services by users.

Technological changes.

The ability to increase market share and control expenses.

Changes in the competitive environment among financial holding companies and other financial service providers.

The effect of changes in laws and regulations (including laws and regulations concerning taxes, banking, securities and insurance) with which we must comply.

The effect of changes in accounting policies and practices, as may be adopted by the regulatory agencies, as well as the Public Company Accounting Oversight Board, the Financial Accounting Standards Board and other accounting standard setters.

The costs and effects of legal and regulatory developments, including the resolution of legal proceedings or regulatory or other governmental inquiries and the results of regulatory examinations or reviews.

Greater than expected costs or difficulties related to the integration of new products and lines of business.

The list of factors above is illustrative but by no means exhaustive. All forward-looking statements should be evaluated with the understanding of their inherent uncertainty. All subsequent written and oral forward-looking statements concerning the matters addressed in this prospectus and attributable to us or any person acting on our behalf are qualified by these cautionary statements.

RISK FACTORS

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Before making an investment decision, you should carefully consider the risks described under the section captioned **RISK FACTORS** in the applicable prospectus supplement, under the heading **Item 1A. Risk Factors** in Part I of our most recent Annual Report on Form 10-K, and in our updates to those risk factors under the heading **Item 1A. Risk Factors** in Part II of our Quarterly Reports on Form 10-Q, together with all of the other information appearing in this prospectus or incorporated by reference into this prospectus and any applicable prospectus supplement, in light of your particular investment objectives and financial circumstances. In addition to those risk factors, there may be additional risks and uncertainties of which management is not aware or focused on or that management deems immaterial. Our business, financial condition or results of operations could be materially adversely affected by any of these risks. The trading price of our securities could decline due to any of these risks, and you may lose all or part of your investment.

OUR COMPANY

First Defiance is a unitary thrift holding company that conducts business through its two wholly owned subsidiaries, First Federal Bank of the Midwest (**First Federal**) and First Insurance Group of the Midwest, Inc. (**First Insurance**). First Federal's traditional banking activities include originating and servicing residential, commercial and consumer loans and providing a broad range of depository, trust and wealth management services. First Federal is primarily

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engaged in attracting deposits from the general public through its offices and using those and other available sources of funds to originate loans primarily in the counties in which its offices are located. First Insurance is an insurance agency that does business in the Defiance and Bowling Green, Ohio areas offering property, casualty, group health, and life insurance products.

First Defiance was incorporated under the laws of the State of Ohio in 1995. Our principal executive offices are located at 601 Clinton Street, Defiance, Ohio 43512, and our telephone number is (419) 782-5015. Our website can be accessed at <http://www.fdef.com>. Information contained in our website does not constitute part of, and is not incorporated into, this prospectus.

At December 31, 2011, we had consolidated assets of \$2.07 billion, consolidated deposits of \$1.6 billion, and consolidated shareholder's equity of \$278.1 million.

RATIOS OF EARNINGS TO FIXED CHARGES AND PREFERRED SHARE DIVIDENDS

The following table sets forth our consolidated ratios of earnings to fixed charges and preferred share dividends for the periods shown. For the purpose of computing the ratios, earnings represent the sum of income before income taxes plus fixed charges and preferred share dividend requirements. Fixed charges represent total interest expense, including and excluding interest on deposits, and one-third of rental expense (which First Defiance believes is representative of the interest factor). Preferred share dividend requirements represent the amount of pre-tax income required to pay the dividends on preferred shares. First Defiance had no preferred shares outstanding before the Series A Preferred Shares issued in December 2008.

| | For the Three Months Ended | | For the Year Ended December 31, | | | | |
|--|-------------------------------|-------|---------------------------------|-------|-------|-------|-------|
| | March 31, 2012 | 2011 | 2011 | 2010 | 2009 | 2008 | 2007 |
| Ratio of earnings to fixed charges and preferred dividends: | | | | | | | |
| Excluding Interest on Deposits | 2.37x | 1.65x | 2.11x | 1.39x | 1.27x | 1.26x | 1.41x |
| Including Interest on Deposits | 4.08x | 2.80x | 3.82x | 2.21x | 2.00x | 2.06x | 3.06x |

USE OF PROCEEDS

We will not receive any of the proceeds from the sale by the selling securityholders of the securities offered by this prospectus or any accompanying prospectus supplement. If the holder of the Warrant does not elect a cashless exercise, we may receive proceeds from the exercise of some or all of the Warrant, which we will use for general corporate purposes. See the discussion in the section captioned **DESCRIPTION OF WARRANT TO PURCHASE COMMON SHARES** **Exercise of the Warrant**.

CAPITAL STOCK OF FIRST DEFIANCE

The following summary describes the material features of our capital stock. This summary does not describe every aspect of our capital stock and is subject to, and qualified in its entirety by reference to, all the provisions of our Articles of Incorporation, as amended (the **Articles**), Code of Regulations and Bylaws, each of which is attached as an exhibit to the registration statement of which this prospectus is a part, and the applicable provisions of Ohio law.

We are authorized under the Articles to issue up to 25,000,000 Common Shares and up to 5,000,000 preferred shares, par value \$.01 per share. As of April 20, 2012, we had 9,728,491 Common Shares outstanding and 37,000 Series A Preferred Shares outstanding. See the description of the Common Shares in the section captioned **DESCRIPTION OF COMMON SHARES** and the description of the Series A Preferred Shares in the section captioned **DESCRIPTION OF SERIES A PREFERRED SHARES**.

Our authorized but unissued preferred shares are typically referred to as **blank check** preferred shares. This term refers to preferred shares for which the rights and restrictions are determined by the board of directors of a corporation at the time the preferred shares are issued. Under the Articles, our Board of Directors has the authority, without any further shareholder vote or action, to issue the remaining Preferred Shares in one or more series, from time to time, with such rights, preferences and relative, participating, optional or other special rights and privileges of, and qualifications, limitations or restrictions upon, the preferred shares, as may be provided in the amendment or amendments to the Articles adopted by our Board of Directors. Under Ohio law, absent a determination by our Board of Directors to establish different

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voting rights, holders of preferred shares would be entitled to one vote per share on matters to be voted upon by the holders of Common Shares and preferred shares voting together as a single class. Ohio law would also entitle the holders of preferred shares to exercise a class vote on certain matters.

The authority of our Board of Directors includes, but is not limited to, the determination or fixing of the following with respect to preferred shares of any series:

the division of the preferred shares into series and the designation and authorized number of preferred shares (up to the number of preferred shares authorized) in each series;

the voting rights (full, conditional or limited) of the preferred shares of each series;

the dividend rates or the amount of dividends to be paid on the preferred shares of each series and whether the dividends are to be cumulative;

whether preferred shares are to be redeemable, and, if so, the price or prices at which, and the terms and conditions upon which the preferred shares may be redeemed;

the liquidation rights to which the holders of preferred shares will be entitled;

whether the preferred shares will be subject to the operation of a sinking fund, and, if so, upon what conditions;

whether the preferred shares will be convertible into or exchangeable for shares of any other class or of any other series of any class of capital stock and the terms and conditions of the conversion or exchange;

the price or other consideration for which the preferred shares are to be issued;

whether the issuance of any additional shares, or of any shares of any other series, will be subject to restrictions; and

any other designations, preferences, limitations or rights permitted by the Articles and Ohio law.

DESCRIPTION OF SERIES A PREFERRED SHARES

The following is a brief description of the terms of the Series A Preferred Shares that may be resold by the selling securityholders. This summary does not purport to be complete in all respects. This description is subject to and qualified in its entirety by reference to our Articles, including the Certificate of Amendment by Directors to Articles with respect to the Series A Preferred Shares, copies of which have been filed with the SEC and are also available upon request from us.

General

Our Board of Directors has designated 37,000 of our preferred shares as Series A Preferred Shares, all of which were issued to the U.S. Treasury in a transaction exempt from the registration requirements of the Securities Act. The issued and outstanding Series A Preferred Shares are validly issued, fully paid and nonassessable.

Dividends Payable on Series A Preferred Shares

Holders of Series A Preferred Shares are entitled to receive if, as and when declared by our Board of Directors or a duly authorized committee of the Board of Directors, out of assets legally available for payment, cumulative cash dividends at a rate per annum of 5% per share on a liquidation preference of \$1,000 per Series A Preferred Share from December 5, 2008 to, but excluding, February 15, 2014. From and after February 15, 2014, holders of Series A Preferred Shares are entitled to receive cumulative cash dividends at a rate per annum of 9% per share on a liquidation preference of \$1,000 per Series A Preferred Shares with respect to each Dividend Period thereafter.

Dividends have been payable quarterly in arrears on each February 15, May 15, August 15 and November 15 (each, a Dividend Payment Date), since February 15, 2009. If any Dividend Payment Date is not a business day, then the next business day will be the applicable Dividend Payment Date, and no additional dividends will accrue as a result of the applicable postponement of the Dividend Payment Date. The period from and including any Dividend Payment Date to, but

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excluding, the next Dividend Payment Date is a Dividend Period, provided that the initial Dividend Period was the period from and including December 5, 2008 to, but excluding, February 15, 2009. Dividends payable during any Dividend Period are computed on the basis of a 360-day year consisting of twelve 30-day months. Dividends payable on any date prior to the end of a Dividend Period will be computed on the basis of a 360-day year consisting of twelve 30-day months, and actual days elapsed over a 30-day month.

Dividends payable with respect to the Series A Preferred Shares are payable to holders of record of Series A Preferred Shares on the date that is the 15th calendar day immediately preceding the applicable Dividend Payment Date or such other record date as our Board of Directors or any duly authorized committee of the Board of Directors determines, so long as such record date is not more than 60 nor less than 10 days prior to the applicable Dividend Payment Date.

If we determine not to pay any dividend or a full dividend with respect to the Series A Preferred Shares, we are required to provide written notice to the holders of Series A Preferred Shares prior to the applicable Dividend Payment Date.

We are subject to various regulatory policies and requirements relating to the payment of dividends, including requirements to maintain adequate capital above regulatory minimums. The Federal Reserve Board is authorized to determine, under certain circumstances relating to our financial condition, that the payment of dividends would be an unsafe or unsound practice and to prohibit the payment thereof. Currently, the Federal Reserve Board requires that we obtain its approval prior to paying dividends to our shareholders. In addition, we are subject to Ohio state laws relating to the payment of dividends.

Our ability to obtain funds for the payment of dividends and for other cash requirements largely depends on the amount of dividends that may be declared and paid by our subsidiaries. Thus, as a practical matter, any restrictions on the ability of our subsidiaries to pay dividends will act as restrictions on the amount of funds available for payment of dividends by First Defiance. Dividend payments from First Federal are subject to legal and regulatory limitations, generally based on net income and retained earnings. The ability of our subsidiaries to pay dividends to us is also subject to their profitability, financial condition, capital expenditures and other cash flow requirements and contractual obligations. Payments of dividends by First Federal may be restricted at any time at the discretion of the Office of the Comptroller of the Currency (OCC) if it deems such dividends to constitute an unsafe and/or an unsound banking practice.

Priority of Dividends and Payments on Liquidation

With respect to the payment of dividends and the amounts to be paid upon liquidation, the Series A Preferred Shares will rank:

senior to our Common Shares and any other class or series of stock the terms of which expressly provide that it ranks junior to the Series A Preferred Shares as to dividend rights and/or rights on liquidation, dissolution or winding up of First Defiance (Junior Stock); and

at least equally with any other class or series of stock the terms of which do not expressly provide that it ranks senior or junior to the Series A Preferred Shares as to dividend rights and/or rights on liquidation, dissolution or winding up of First Defiance (Parity Stock).

So long as any Series A Preferred Shares remain outstanding, unless all accrued and unpaid dividends on the Series A Preferred Shares for all prior Dividend Periods have been paid or are contemporaneously declared and paid in full, no dividend whatsoever will be paid or declared on our Common Shares, other Junior Stock or Parity Stock, other than a dividend payable solely in Common Shares. We and our subsidiaries also may not purchase, redeem or otherwise acquire for consideration any of our Common Shares, other Junior Stock or Parity Stock, unless we have declared and paid in full all accrued and unpaid dividends on the Series A Preferred Shares for all prior Dividend Periods, other than:

purchases, redemptions or other acquisitions of our Common Shares or other Junior Stock in connection with the administration of our employee benefit plans in the ordinary course of business (including purchases pursuant to a publicly announced repurchase plan up to the increase in diluted shares outstanding resulting from the grant, vesting or exercise of equity-based compensation) and consistent with past practice;

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purchases or other acquisitions by a broker-dealer subsidiary of First Defiance solely for the purpose of market-making, stabilization or customer facilitation transactions in Junior Stock or Parity Stock in the ordinary course of its business;

purchases by a broker-dealer subsidiary of First Defiance for resale pursuant to an offering by First Defiance of our capital stock that is underwritten by the related broker-dealer subsidiary;

any dividends or distributions of rights or Junior Stock in connection with a shareholders' rights plan or redemptions or repurchases of rights pursuant to any shareholders' rights plan;

acquisition of record ownership of Junior Stock or Parity Stock for the beneficial ownership of any other person who is not First Defiance or a subsidiary of First Defiance, including as trustee or custodian; and

the exchange or conversion of Junior Stock for or into other Junior Stock or of Parity Stock for or into other Parity Stock or Junior Stock but only to the extent that such acquisition is required pursuant to binding contractual agreements entered into before December 5, 2008 or any subsequent agreement for the accelerated exercise, settlement or exchange thereof for Common Shares.

If we repurchase Series A Preferred Shares from a holder other than the U.S. Treasury, we must offer to repurchase a ratable portion of the Series A Preferred Shares then held by the U.S. Treasury.

On any Dividend Payment Date for which full dividends are not paid, or declared and funds set aside therefor, on the Series A Preferred Shares and any other Parity Stock, all dividends paid or declared for payment on that Dividend Payment Date (or, with respect to Parity Stock with a different dividend payment date, on the applicable dividend date therefor falling within the Dividend Period and related to the Dividend Payment Date for the Series A Preferred Shares), with respect to the Series A Preferred Shares and any other Parity Stock, will be declared ratably among the holders of any such shares who have the right to receive dividends, in proportion to the respective amounts of the undeclared and unpaid dividends relating to the Dividend Period.

Subject to the foregoing, such dividends (payable in cash, securities or other property) as may be determined by our Board of Directors (or a duly authorized committee of the Board of Directors) may be declared and paid on our Common Shares and any other Junior Stock from time to time out of any funds legally available for such payment, and the holders of Series A Preferred Shares will not be entitled to participate in any such dividend.

Preemptive Rights

Our Articles provide that the holders of Series A Preferred Shares do not have preemptive rights.

Redemption

Under provisions introduced by the American Recovery and Reinvestment Act of 2009 (ARRA), First Defiance may provide notice to the Federal Reserve Board and the U.S. Treasury of First Defiance's desire to redeem all or part of the Series A Preferred Shares. The proposed redemption must cover a minimum of 25% of the Series A Preferred Shares originally issued.

After receiving the required notice, the U.S. Treasury and the Federal Reserve Board will consult about the request. First Defiance will be subject to the existing supervisory procedures for approving redemption requests for capital instruments, in which First Defiance's desire to redeem the Series A Preferred Shares will be weighed against the contribution of U.S. Treasury capital to First Defiance's overall soundness, capital adequacy and ability to lend, including confirmation that First Defiance and its banking subsidiary, First Federal, have a comprehensive internal capital assessment process.

When all consultations have been completed, the U.S. Treasury will contact First Defiance to discuss the redemption request, including the details of the redemption and the documentation to be completed.

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In any redemption, the redemption price is an amount equal to the per share liquidation amount plus accrued and unpaid dividends to but excluding the date of redemption.

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The Series A Preferred Shares are not subject to any mandatory redemption, sinking fund or similar provisions. Holders of Series A Preferred Shares have no right to require the redemption or repurchase of the Series A Preferred Shares.

If fewer than all of the outstanding Series A Preferred Shares are to be redeemed, the Series A Preferred Shares to be redeemed will be selected either *pro rata* from the holders of record of Series A Preferred Shares in proportion to the number of Series A Preferred Shares held by those holders or in such other manner as our Board of Directors or a duly authorized committee thereof may determine to be fair and equitable.

Series A Preferred Shares that are redeemed, repurchased or otherwise acquired by us will revert to authorized but unissued preferred shares.

Liquidation Rights

In the event that we voluntarily or involuntarily liquidate, dissolve or wind up our affairs, holders of Series A Preferred Shares will be entitled to receive an amount per share, referred to as the total liquidation amount, equal to the fixed liquidation preference of \$1,000 per share, plus any accrued and unpaid dividends, whether or not declared, to the date of payment. Holders of the Series A Preferred Shares will be entitled to receive the total liquidation amount out of our assets that are available for distribution to shareholders, after payment or provision for payment of our debts and other liabilities but before any distribution of assets is made to holders of our Common Shares or any other shares ranking, as to that distribution, junior to the Series A Preferred Shares.

If our assets are not sufficient to pay the total liquidation amount in full to all holders of Series A Preferred Shares and all holders of any shares of outstanding Parity Stock, the amounts paid to the holders of Series A Preferred Shares and other shares of Parity Stock will be paid *pro rata* in accordance with the respective total liquidation amount for those holders. If the total liquidation amount per share of Series A Preferred Shares has been paid in full to all holders of Series A Preferred Shares and the corresponding amounts payable with respect to other shares of Parity Stock have been paid in full, the holders of our Common Shares or any other shares ranking, as to such distribution, junior to the Series A Preferred Shares will be entitled to receive all of our remaining assets according to their respective rights and preferences.

For purposes of the liquidation rights, neither the sale, lease, conveyance, exchange or transfer of all or substantially all of our property and assets, nor the consolidation or merger by us with or into any other entity or by another entity with or into us, will constitute a liquidation, dissolution or winding-up of our affairs.

Voting Rights

Except as indicated below or otherwise required by law, the holders of Series A Preferred Shares will not have any voting rights.

Election of Two Directors upon Non-Payment of Dividends

If the dividends on the Series A Preferred Shares have not been paid for an aggregate of six quarterly Dividend Periods or more (whether or not consecutive), the authorized number of directors then constituting our Board of Directors will automatically be increased by two. Holders of Series A Preferred Shares, together with the holders of any outstanding Parity Stock with like voting rights (Voting Parity Stock), voting as a single class, will be entitled to elect the two additional members of our Board of Directors (Preferred Stock Directors) at the next annual meeting (or at a special meeting called for the purpose of electing the Preferred Stock Directors prior to the next annual meeting) and at each subsequent annual meeting until all accrued and unpaid dividends for all past Dividend Periods, including the last completed Dividend Period, have been paid in full, at which time such right will terminate with respect to the Series A Preferred Shares, subject to revesting in the event of each and every subsequent failure to pay dividends in the circumstances described above. The election of any Preferred Stock Director is subject to the qualification that the election would not cause us to violate the corporate governance requirements of the NASDAQ Global Select Market (or any other exchange on which our securities may be listed) that listed companies must have a majority of independent directors.

Upon the termination of the right of the holders of Series A Preferred Shares and Voting Parity Stock to vote for Preferred Stock Directors, as described above, the Preferred Stock Directors will immediately cease to be qualified as directors, their term of office will terminate immediately and the number of authorized directors of First Defiance will be reduced by the number of Preferred Stock Directors that the holders of Series A Preferred Shares and Voting Parity Stock had been entitled to elect. The holders of a majority of the Series A Preferred Shares and Voting Parity Stock, voting as a

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class, may remove any Preferred Stock Director, with or without cause, and the holders of a majority of the Series A Preferred Shares and Voting Parity Stock, voting as a class, may fill any vacancy created by the removal of a Preferred Stock Director. If the office of a Preferred Stock Director becomes vacant for any other reason, the remaining Preferred Stock Director may choose a successor to fill such vacancy for the remainder of the unexpired term.

Other Voting Rights

So long as any Series A Preferred Shares are outstanding, in addition to any other vote or consent of shareholders required by law or by our Articles, the vote or consent of the holders of at least 66²/₃% of the Series A Preferred Shares at the time outstanding, voting separately as a single class, given in person or by proxy, either in writing without a meeting or by vote at any meeting called for the purpose, will be necessary for effecting or validating:

any amendment or alteration of our Articles to authorize or create or increase the authorized amount of, or any issuance of, any shares of, or any securities convertible into or exchangeable or exercisable for shares of, any class or series of our capital stock ranking senior to the Series A Preferred Shares with respect to the payment of dividends and/or the distribution of assets on any liquidation, dissolution or winding up of First Defiance;

any amendment, alteration or repeal of any provision of our Articles (including any amendment, alteration or repeal by means of a merger, consolidation or otherwise, unless no vote on such merger or consolidation is required by the following paragraph) so as to adversely affect the rights, preferences, privileges or voting powers of the Series A Preferred Shares; or

any consummation of a binding share exchange or reclassification involving the Series A Preferred Shares or of a merger or consolidation of First Defiance with another entity, unless (1) the Series A Preferred Shares remain outstanding following any such transaction or, if First Defiance is not the surviving entity following such transaction, are converted into or exchanged for preference securities of the surviving entity or its ultimate parent and (2) such remaining outstanding Series A Preferred Shares or preference securities have rights, preferences, privileges and voting powers that are not materially less favorable than the rights, preferences, privileges or voting powers of the Series A Preferred Shares. Actual results could differ from those estimates.

Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted. The December 31, 2008 balance sheet data was derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States. It is suggested that these condensed statements be read in conjunction with the Company's most recent Annual Report on Form 10-K.

Reclassifications

In 2009, the Company's presentation of certain expenses within its consolidated statements of operations was changed. Depreciation and amortization expenses were previously recorded in the captions Cost of sales, Research, development and engineering and Selling, general and administrative. In the current year, depreciation and amortization expenses are now being presented separately under the caption Depreciation and amortization. The Company believes that this change in presentation provides a more meaningful measure of its cost of sales and other operating expenses. These reclassifications had no effect on reported consolidated income (loss) from operations, net income

(loss) or per share amounts. Amounts presented for the prior periods have been reclassified to conform to the current presentation. The following table provides the amounts reclassified for the three and nine months ended September 30, 2009 and September 30, 2008.

| Amounts reclassified: | For the Three Months | | For the Nine Months | |
|---------------------------------------|----------------------|-----------|---------------------|-----------|
| | Ended September 30, | | Ended September 30, | |
| | 2009 | 2008 | 2009 | 2008 |
| Cost of sales | \$ (255) | \$ (261) | \$ (763) | \$ (786) |
| Research, development and engineering | (10) | (12) | (32) | (35) |
| Selling, general and administrative | (98) | (106) | (309) | (321) |
| Depreciation and amortization | 363 | 379 | 1,104 | 1,142 |
| Total costs and expenses | \$ | \$ | \$ | \$ |

Financial Instruments

The Company's financial instruments consist primarily of cash and cash equivalents, receivables, payables and debt. Fair values of cash and cash equivalents, receivables and payables approximate carrying values due to their relatively short-term nature. The carrying amount of debt approximates fair value due to the length of maturity and the existence of interest rates that approximate prevailing market rates.

Subsequent Events

The Company has evaluated for disclosure all subsequent events occurring through November 13, 2009, the date the financial statements were issued and filed with the United States Securities and Exchange Commission.

PECO II, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited, in thousands except for share and per share data)

2. Recently Adopted and Recently Issued Accounting Pronouncements

Effective for the quarterly period ended September 30, 2009, the Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) became the single source of authoritative generally accepted accounting principles (GAAP) in the United States. The ASC does not change current GAAP, but introduces a new structure, organized by accounting topics, designed to simplify user access to all authoritative literature related to a particular accounting topic. All prior authoritative documents were superseded and all other accounting literature not included in the ASC is considered nonauthoritative. As a result, prior GAAP references are no longer applicable. In an effort to make the financial statements more useful, the Company has elected to omit specific GAAP references and to ensure accounting concepts and policies are clearly explained. Any new recently issued accounting pronouncements will be referenced to the FASB's Accounting Standards Update (ASU) referencing structure.

Fair value

As permitted, management elected to defer adoption of new fair value accounting standards until 2009 for nonfinancial assets and liabilities measured at fair value on a nonrecurring basis. Accordingly, beginning January 1, 2009, management began applying the new standards to nonfinancial assets and liabilities for any nonrecurring fair value measurements required. During 2009, there have been no fair value measurements on a nonrecurring basis of the Company's nonfinancial assets and liabilities that require further consideration or disclosure.

Effective for the quarterly period ended June 30, 2009, we also adopted new accounting standards that require disclosures about the fair value of financial instruments for interim reporting periods in addition to annual financial statements. The adoption of this standard does not have a material effect on our consolidated results of operations, financial position, or cash flows.

Business combinations and noncontrolling interests

Effective January 1, 2009, we adopted new accounting standards for accounting and reporting of business combinations and noncontrolling interests. We have not entered into any business combination transactions during 2009. Therefore, the effect of implementing these standards will be dependent upon the nature and extent of future business combination transactions.

Earnings per share

Effective January 1, 2009, we adopted a new accounting standard for determining whether instruments granted in share-based payment transactions are participating securities. Under the new standard, unvested share-based awards that contain non-forfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and are included in the computation of earnings per share pursuant to the two-class method. Before adoption, the Company already treated unvested share-based awards granted in share-based payment transactions as participating securities. As such,

the adoption of this new standard did not have any effect on the computation of earnings per share.

Subsequent events

Effective for the quarterly period ended June 30, 2009, we adopted a new accounting standard for subsequent events. The new standard provides guidance for the accounting and disclosure of events that occur after the balance sheet date but before financial statements are issued or available to be issued. It also requires us to disclose the date through which subsequent events were evaluated and whether that date represents the date the financial statements were issued or were available to be issued. The adoption of this standard did not have a material effect on our consolidated results of operations, financial position, or cash flows.

Revenue recognition

In October 2009, the FASB issued ASU 2009-13, *Revenue Recognition (Topic 605) Multiple-Deliverable Revenue Arrangements*. This ASU provides amendments to the criteria for separating deliverables and measuring and allocating arrangement consideration to one or more units of accounting. The amendments establish a selling price hierarchy for determining the selling price of a deliverable. The ASU permits the use of the best estimate of selling price in addition to vendor-specific objective evidence (VSOE) and third-party evidence (TPE) for determining the selling price of a deliverable. In cases in which VSOE or TPE cannot be determined, use of the best estimate of selling price is required. In addition, the residual method of allocating arrangement consideration is no longer permitted. This new update is effective for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. Early adoption is permitted. We are currently evaluating the impact that the adoption of this ASU will have on our consolidated financial statements.

From time to time, the Company has increased risk for obsolete and excess inventory depending on various unforeseen future events and circumstances, primarily related to the mix of future business and customer requirements for new technologies that could have a material impact on the Company's estimated allowance for obsolete and excess inventory in the near term. If these unforeseen events and circumstances do occur in the near term, the resulting changes in the estimate could be material to the Company's consolidated financial position and results of operation.

5. Uncompleted Contracts

Costs and estimated earnings on uncompleted contracts consist of the following:

| | September 30, | December 31, |
|---|----------------------|---------------------|
| | 2009 | 2008 |
| Costs incurred on uncompleted contracts | \$ 4,557 | \$ 2,500 |
| Estimated earnings | 1,572 | 500 |
| | 6,129 | 3,000 |
| Less: Billings to date | 2,616 | 2,613 |
| | \$ 3,513 | \$ 387 |

PECO II, INC.**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

(unaudited, in thousands except for share and per share data)

Included in the accompanying balance sheet under the following captions:

| | September 30, | December 31, |
|---|----------------------|---------------------|
| | 2009 | 2008 |
| Costs and estimated earnings in excess of billings on uncompleted contracts | \$ 3,795 | \$ 622 |
| Billings in excess of costs and estimated earnings on uncompleted contracts | (282) | (235) |
| | \$ 3,513 | \$ 387 |

6. Intangibles

Intangible assets are summarized as follows and relate to the product segment only:

| | September 30, | December 31, |
|--|----------------------|---------------------|
| | 2009 | 2008 |
| Intangible Assets with Determinable Lives | | |
| Customer relationships | \$ 2,000 | \$ 2,000 |
| Supply agreement | 3,700 | 3,700 |
| Total gross intangible assets | 5,700 | 5,700 |
| Less: Accumulated amortization | 3,756 | 2,952 |
| Intangibles, net | \$ 1,944 | \$ 2,748 |

Amortization expense for the nine months ending September 30, 2009 and 2008 was \$805 for both nine-month periods. Amortization is calculated using the straight-line method over the estimated useful lives of the assets. The estimated useful lives of the customer relationship and supply agreement intangibles are 6 years and 5 years, respectively.

7. Warranty

The Company's warranty activity for the nine months ended September 30, 2009 and 2008 are summarized below:

| | 2009 | 2008 |
|--|-------------|-------------|
| Accrued warranty cost, beginning of period | \$ 1,012 | \$ 908 |
| Warranty provision | 706 | 802 |

| | | | | |
|--------------------------------------|----|--------|----|--------|
| Warranty claims | | (521) | | (754) |
| Accrued warranty cost, end of period | \$ | 1,197 | \$ | 956 |

8. Contingencies

The Company is periodically a party, both as plaintiff and defendant, to lawsuits and claims arising out of the normal course of business. If necessary, the Company records reserves for losses that are deemed to be probable and that are subject to reasonable estimates. As of September 30, 2009, management does not believe that there are any matters that may have a material adverse effect on the financial condition or results of operations of the Company.

9. Earnings Per Share

The number of shares outstanding for calculation of earnings per share is as follows:

| (Shares in thousands) | For the Three Months Ended September 30, | | For the Nine Months Ended September 30, | |
|---|---|-------------|--|-------------|
| | 2009 | 2008 | 2009 | 2008 |
| Weighted-average shares outstanding - basic | 2,851 | 2,765 | 2,851 | 2,756 |
| Effect of potentially dilutive shares | | | | |
| Weighted average shares outstanding - dilutive | 2,851 | 2,765 | 2,851 | 2,756 |

Due to the Company's net loss for the nine months ended September 30, 2009 and the three and nine months ended September 30, 2008, no common equivalent shares were included in the calculation of diluted earnings per share for either period because their effect would have been anti-dilutive. For the three months ended September 30, 2009, all outstanding stock options were excluded from the calculation of diluted shares because the exercise price of the options was greater than the market price at the end of the period.

PECO II, INC.**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

(unaudited, in thousands except for share and per share data)

10. Stock-Based Compensation

Total stock-based compensation expense by type of award is as follows:

| | For the Three Months Ended September 30, | | For the Nine Months Ended September 30, | |
|--|---|-------------|--|-------------|
| | 2009 | 2008 | 2009 | 2008 |
| Stock options | \$ 26 | \$ 101 | \$ 48 | \$ 155 |
| Restricted stock awards | 59 | 46 | 147 | 171 |
| Employee stock purchase plan | | 1 | 1 | 3 |
| Total stock-based compensation expense | 85 | 148 | 196 | 329 |
| Tax effect on stock-based compensation expense | | | | |
| Net effect on income (loss) from operations | 85 | 148 | 196 | 329 |

There was no recorded tax effect on the recognition of stock-based compensation expense due to the Company's significant operating loss carry-forward and valuation reserve. In addition, there was no effect on the presentation of the statement of cash flows as excess tax benefits from the exercise of stock options have not been recorded as the Company does not expect to be able to realize current period deductions of taxable income.

Stock Options

The following table represents option activity for the nine months ended September 30, 2009:

| | Number of Shares | Weighted Average Exercise Price | Weighted Average Remaining Contract Life |
|-----------------------------------|-----------------------------|--|---|
| Outstanding at December 31, 2008 | 192,402 | \$ 9.98 | |
| Granted | | | |
| Exercised | | | |
| Forfeited/ Cancelled | (42,402) | 9.63 | |
| Outstanding at September 30, 2009 | 150,000 | 10.08 | 1.32 years |

PECO II, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited, in thousands except for share and per share data)

11. Related Party Transactions

The Company engages in certain related party transactions with the Company's largest shareholder, Delta Products Corporation. Delta is a significant supplier to the Company. The Company's related party transactions with Delta, for the nine months ended September 30, 2009 include \$62 in sales and \$4,749 in purchases (\$133 in sales and \$6,071 in purchases for the nine months ended September 30, 2008). At September 30, 2009, the Company had balances of \$20 and \$95 included in accounts receivable and accounts payable, respectively.

12. Major Customers

Because of the Company's concentration of sales to the Regional Bell Operating Companies (RBOCs) and wireless service providers, a small number of customers typically represent substantial portions of total sales. For the first nine months of 2009, sales to three companies comprised 74.4% of total sales. Sales to our top customer included \$10,289 in product and \$2,333 in services, our second highest customer included \$910 in product and \$7,861 in services, and our third highest customer included \$1,165 in product and \$16 in services.

For the first nine months of 2008, sales to three companies comprised 62.2% of total sales. Sales to our top customer included \$11,290 in product and \$2,150 in services, our second highest customer included \$3,252 in product and \$58 in services, and our third highest customer included \$606 in product and \$2,567 in services.

ITEM 2.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

References to we, us, our, the Company, or PECO II refer to PECO II, Inc. unless the context indicates otherwise.

Overview

PECO II, Inc. was organized in 1988 for the purpose of acquiring the assets of ITT's communications power product business. Today, we provide solutions to our telecommunications customers through a variety of products and services in order to meet their cost, quality, productivity and capacity challenges. As part of this process, we design and manufacture communications specific power products. We also provide on-site E&I, systems integration, installation, maintenance, and monitor service to our customers. Our power systems provide a primary supply of power to support the infrastructure of communications service providers, including local exchange carriers, long distance carriers, wireless service providers, internet service providers and broadband access providers. Our power distribution equipment directs this power to specific customer communications equipment. Our systems integration business provides complete built-to-order communications systems assembled and installed pursuant to customer specifications and incorporating other manufacturers' products.

Market conditions remain uncertain and difficult. In the recent past, several of our customers have engaged in mergers, acquisitions and divestitures, such as SBC acquiring AT&T, AT&T acquiring Bell South and Cingular, Alltel acquiring Western Wireless, and Sprint acquiring NEXTEL. Also, both Sprint Nextel and Alltel spun off their local wireline businesses to focus on their core wireless businesses. Recently Verizon has completed its purchase of Alltel and Embarq has merged with Century Telecom. Currently, major wireline companies are focusing their capital expenditure spending on FTTC (fiber to the curb) and FTTN (fiber to the node) for both broadband and video services distribution, while wireless companies are focusing their capital expenditure spending on migration of acquired systems to the standards of the acquiring carrier, integrating networks, improving area coverage, and deploying 3G data services and have begun to announce plans to deploy WIMAX and LTE networks.

While the telecommunications market is extremely volatile, capital expenditure spending expanded by the mid single digits in 2007 and 2008 and analysts have projected further growth in 2009. In the event that capital spending does not grow in 2009, we believe we are positioned to take market share based on our industry leading responsiveness capability.

In 2009, we believe the merger and acquisition activity noted above has resulted in a slowing of capital expenditure growth in segments of the wireless market. We have successfully ramped the mid-sized power products, which serve the wireless base station market, including both cabinet and hut applications. The mid-sized product platforms are standardized at 3 wireless operators.

Our R&D investment extends beyond traditional cell site applications. The Quantum[®] Power System, introduced to the market in 2008, positions us as a player in the shelf power market segment and the fast growing outside plant broadband market. According to industry analyst Skyline Marketing, the

size of this power market segment in the United States is estimated to be \$269 million in 2008, reaching \$450 million by 2011.

The Quantum platform is a 48-volt DC power system that combines high-density rectifiers, distribution and control in a sleek, low-profile shelf for optimized value to telecom carriers deploying fiber-to-the-node and traditional wireline architectures. Designed for the harsh outside plant environment, the Quantum system's small footprint makes it ideal for cabinets where rack space is at a premium.

The Quantum Power System has several distinctive features that optimize the user experience. Our innovative QuickLoad[®] feature enables the technician to rapidly configure the system. The system controller features a technician-friendly input control device and a display that can easily be read in difficult outdoor conditions. The rectifiers include our unique I-View[®] faceplate indicators that report rectifier current and load-sharing status.

PECO II, INC.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Cont.)

With the introduction of our small power products, we have an exciting opportunity to grow our business in a space in which we have not competed in to date. By leveraging our industry leading responsiveness capability with this new technology platform provides our customers with another reason to rely on PECO II for its power requirements.

Our services group focused on hardening our solution portfolio to meet the power needs of our Tier I customer base. The revenue growth in 2009 was primarily driven by a major customer contract that was awarded to us in late 2008.

Our services division continues to provide multi-vendor engineering and installation services for all major power product brands. This capability is both respected and valued in the marketplace. Our strong power E&I services reputation has provided many opportunities for introducing new power products as well as a real user feedback channel on deployed products. This feedback continues to aid us with designing and improving products to meet the industry evolving needs.

Looking forward, we will continue to focus our efforts on delivering the service solutions our customers have come to expect from working with PECO II. This dedication has enabled us to minimize customer turn-over. We will continue to expand our services footprint on those opportunities that make the best utilization of our current available resources, and/or those that position us for success as our industry matures to the next level.

Achieving net income in the third quarter of 2009 represents a major milestone in PECO II's journey to being a world-class industry vendor. Further, the third quarter is our second consecutive quarter of positive EBITDA performance. These financial results can be attributed to our efforts over the past few periods to focus on improving the processes that are key to delivering quality products and services to customers.

These results have been achieved in very challenging economic times. Dramatic growth in our services business, particularly engineering and installation activities, has offset a slowing in the product business, which we believe is the result of the various mergers and acquisitions that have occurred in 2009 among our customers, resulting in a delay in purchases. We do not believe PECO II has lost any market share through this period in our product business and that we have, in fact, dramatically taken market share from our competition in our services business.

The past two quarters' financial results reflect the start of PECO II accruing the financial benefit coming from our focus on world-class operational performance. Through these challenging times, we have maintained our focus on the customer, and all of our employees are constantly targeting serving the customer better than anyone else in the industry. Leveraging this employee focus with our industry-leading responsiveness capability and our new technology platforms provides our customers with another reason to rely on PECO II for their power requirements. This focus has led to dramatically improved operational performance and is the basis for the market share gains we continue to realize.

Other customer highlights include PECO II's first win with a new customer for battery backup cabinets, two major Tier II service providers placing their first orders for our small power product line, sixteen new account wins as a result of our growing focus on Tier III and independent service providers, a contract to provide network monitoring for a service provider's network and a major new win with the U.S. government for our small and mid-sized products.

Results of Operations

Our third quarter financial performance was primarily the result of our profitable growth in our services business from our engineering and installation capabilities offset by a continued slowing in product revenues. Our net sales increased to \$13.0 million for the three months ended September 30, 2009, an increase of \$1.0 million, or 8.2% over the three months ended September 30, 2008. For the nine months ended September 30, 2009 our net sales decreased to \$30.4 million, a decrease of 1.7 million, or 5.2% over the nine months ended September 30, 2008.

PECO II, INC.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Cont.)

Product net sales were \$6.3 million for the third quarter of 2009, a decrease of \$2.5 million, or 28.7%, compared to the third quarter of 2008. Product net sales were \$18.2 million for the nine months ending September 30, 2009, a decrease of \$6.5 million, or 26.3%, compared to the corresponding period in 2008. We believe that the reduction in product sales was primarily the result of the merger and acquisition activity occurring in the industry among our customers resulting in a slowing of spending as the customers integrate the acquired organizations.

Services net sales were \$6.7 million for the third quarter of 2009, an increase of \$3.5 million, or 112.5%, as compared to the third quarter of 2008. Services net sales were \$12.2 million for the nine months ending September 30, 2009, an increase of \$4.8 million, or 64.9%, compared to the corresponding period in 2008. The increase in sales year to date in the services segment was primarily driven by a major customer contract that was awarded to us in late 2008.

As of September 30, 2009, our sales backlog, which represents total dollar volume of firm sales orders not yet recognized as revenue, was \$9.3 million, a \$3.6 million, or 63.8%, increase from the comparable prior year period, and was a 264.9% increase of \$6.7 million from December 31, 2008, and a 28.9% increase of \$2.1 million from June 30, 2009. Product backlog of \$2.3 million was a \$0.4 million, or 20.5% increase from December 31, 2008, and was a \$1.1 million, or a 32.0% decrease from June 30, 2009, while services backlog was \$7.0 million, a \$6.4 million, or 998.7%, increase from December 31, 2008, and was a \$3.2 million, or an 82.9% increase from June 30, 2009. Dramatic growth in our services business, particularly engineering and installation activities, has offset a slowing in the product business, which we believe is the result of the various mergers and acquisitions that have occurred in 2009 among our customers, resulting in a delay in purchases. Third quarter 2009 bookings were 31.8% better than third quarter 2008.

Gross margin dollars were \$2.6 million and \$6.0 million, respectively, for the three and nine months ended September 30, 2009, as compared to \$1.8 million and \$5.1 million, respectively, for the three and nine months ended September 30, 2008. Gross margin as a percentage of net sales was 20.1% and 19.9% for the three and nine months ended September 30, 2009, compared to 14.9% and 15.8%, respectively, for the comparable prior year periods.

For the quarter ended September 30, 2009, product gross margin was \$0.8 million, or 12.4% of net product sales, as compared to \$1.2 million, or 13.7% of net product sales for the corresponding period in 2008. The quarter's product gross margin includes a \$0.6 million charge for stranded raw materials. This excess inventory was primarily the result of changes in buying patterns by customers as a result of the mergers that have occurred amongst our current customers in 2009 resulting in a shift in types of power systems being purchased as noted above. Adjusting for the excess inventory charge, operating gross margins would have been 21.9% for the quarter.

Services gross margin was \$1.8 million for the third quarter of 2009, or 27.4% of net services sales, as compared to \$0.6 million, or 18.3% of net services sales for the third quarter of 2008, or a services gross margin increase of 218.2%. The services gross margin increase was primarily driven by revenue

growth in the quarter which resulted in a high utilization of the workforce. Given the seasonality of the services business, this high utilization is not expected to occur in the fourth quarter of 2009 or first quarter of 2010.

Third quarter 2009 operating expenses of \$2.3 million are \$0.7 million less than third quarter of 2008 operating expenses. Year-over-year reductions were primarily attributed to cost-reduction actions discussed and taken in prior periods as the Company dealt with the macroeconomic environment. We expect our engineering expenses to grow in the fourth quarter as we complete external testing of our new products for certification for our customers' networks.

Research, development and engineering expense incurred was \$0.4 million and \$1.4 million respectively, for the three and nine months ended September 30, 2009, down from \$0.6 million and \$1.9 million, respectively for the three and nine months ended September 30, 2008. As a percentage of net product sales, research, development and engineering expense was 6.6% for the quarter ended September 30, 2009, which was a decrease of 31.8% from the third quarter of 2008. Our new product introduction cycles include, at times, significant out-of-pocket costs to bring

PECO II, INC.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Cont.)

new products to the market and as such, research, development and engineering expenses will likely continue to move up and down, period to period, as we introduce new products. As noted above, fourth quarter 2009 is expected to show an increase in engineering costs as we complete external testing of various products being evaluated by current customers.

Selling, general and administrative expense was \$1.5 million and \$5.2 million for the three and nine months ended September 30, 2009, as compared to \$2.0 million and \$6.0 million, respectively, for the comparable prior year period. As a percentages of net sales, selling, general and administrative decreased to 11.9% for the quarter ended September 30, 2009, as compared to 17.1% in the comparable prior year period. In the event that we have a profitable fourth quarter, selling general and administrative expenses may increase as a result of us incurring additional expense for 2009 management bonuses earned.

The third quarter 2009 net income of \$0.3 million was an increase over the second quarter of 2009 and was primarily attributed to the sequential revenue growth, offset by excess inventory charges of \$0.6 million. The net income improvement, when compared to the third quarter of 2008 net loss of \$1.2 million, was driven primarily by the improved services gross margin and reduced operating costs, offset by the excess product inventory charge.

Liquidity and Capital Resources

As of September 30, 2009, available cash and cash equivalents approximated \$4.2 million. We believe that cash and cash equivalents, anticipated cash flow from operations, and our credit facilities will be sufficient to fund our working capital and capital expenditure requirements for the next 12 months. Working capital at September 30, 2009 was \$11.9 million, which represented a working capital ratio of 2.5 to 1, compared to \$12.4 million at December 31, 2008, which represented a working capital ratio of 2.5 to 1. Capital expenditures for the nine months ended September 30, 2009, totaled \$185 thousand. We continue our efforts to conserve cash.

Cash flows used for operating activities for the nine months ended September 30, 2009, was \$0.5 million. This was primarily from the net loss and an increase in working capital from the additional E&I services business, offset by non-cash charges. There was \$945 thousand of cash used for investing activities, which was primarily from capital expenditures and transfers of available cash equivalents to restricted cash, offset by the sale of equipment sold as a result of outsourcing. Cash used for financing activities was \$207 thousand primarily from the net decrease in bank overdraft offset by increases in the line of credit.

Cash flows used for operating activities for the nine months ended September 30, 2008, was \$1.8 million. This was primarily from the net loss and an increase in working capital, offset by non-cash charges. There was \$779 thousand of cash used for investing activities, which was primarily from the issuance of a note and transfer of available cash equivalents to restricted cash, offset by the sale of equipment sold as a result of outsourcing. Cash provided by financing activities was \$649

thousand primarily from an increase in the line of credit.

Contractual Obligations

We have signed an agreement with National City Bank to provide all banking services and a \$3.5 million line of credit. As collateral for the line of credit, we established a \$3.5 million deposit account with the bank to cover any outstanding balance of the line of credit. As of September 30, 2009, the balance on the line of credit was \$1.6 million. As such, \$1.6 million of the deposit account is reflected as restricted cash.

Critical Accounting Policies and Estimates

In preparing the accompanying unaudited condensed consolidated financial statements and accounting for the underlying transactions and balances, we applied the accounting policies disclosed in the Notes to Consolidated Financial Statements contained in our Annual Report on Form 10-K for the year ended December 31, 2008. For a detailed discussion of the critical accounting policies and estimates, see the Management Discussion and Analysis included in our Annual Report. There were no significant changes in these critical accounting policies and estimates in the third quarter of 2009, except for the recently adopted accounting pronouncements as discussed below.

PECO II, INC.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Cont.)

Recently Adopted Accounting Pronouncements

Effective for the quarterly period ended September 30, 2009, the Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) became the single source of authoritative generally accepted accounting principles (GAAP) in the United States. The ASC does not change current GAAP, but introduces a new structure, organized by accounting topics, designed to simplify user access to all authoritative literature related to a particular accounting topic. All prior authoritative documents were superseded and all other accounting literature not included in the ASC is considered nonauthoritative. As a result, prior GAAP references are no longer applicable. In an effort to make the financial statements more useful, the Company has elected to omit specific GAAP references and to ensure accounting concepts and policies are clearly explained. Any new recently issued accounting pronouncements will be referenced to the FASB's Accounting Standards Update (ASU) referencing structure.

Fair value

As permitted, management elected to defer adoption of new fair value accounting standards until 2009 for nonfinancial assets and liabilities measured at fair value on a nonrecurring basis. Accordingly, beginning January 1, 2009, management began applying the new standards to nonfinancial assets and liabilities for any nonrecurring fair value measurements required. During 2009, there have been no fair value measurements on a nonrecurring basis of the Company's nonfinancial assets and liabilities that require further consideration or disclosure.

Effective for the quarterly period ended June 30, 2009, we also adopted new accounting standards that require disclosures about the fair value of financial instruments for interim reporting periods in addition to annual financial statements. The adoption of this standard does not have a material effect on our consolidated results of operations, financial position, or cash flows.

Business combinations and noncontrolling interests

Effective January 1, 2009, we adopted new accounting standards for accounting and reporting of business combinations and noncontrolling interests. We have not entered into any business combination transactions during 2009. Therefore, the effect of implementing these standards will be dependent upon the nature and extent of future business combination transactions.

Earnings per share

Effective January 1, 2009, we adopted a new accounting standard for determining whether instruments granted in share-based payment transactions are participating securities. Under the new standard, unvested share-based awards that contain non-forfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and are included in the computation of earnings

per share pursuant to the two-class method. Before adoption, the Company already treated unvested share-based awards granted in share-based payment transactions as participating securities. As such, the adoption of this new standard did not have any effect on the computation of earnings per share.

Subsequent events

Effective for the quarterly period ended June 30, 2009, we adopted a new accounting standard for subsequent events. The new standard provides guidance for the accounting and disclosure of events that occur after the balance sheet date but before financial statements are issued or available to be issued. It also requires us to disclose the date through which subsequent events were evaluated and whether that date represents the date the financial statements were issued or were available to be issued. The adoption of this standard did not have a material effect on our consolidated results of operations, financial position, or cash flows.

Revenue recognition

In October 2009, the FASB issued ASU 2009-13, *Revenue Recognition (Topic 605) Multiple-Deliverable Revenue Arrangements*. This ASU provides amendments to the criteria for separating deliverables and measuring and allocating arrangement consideration to one or more units of accounting. The amendments establish a selling price hierarchy for determining the selling price of a deliverable. The ASU permits the use of the best estimate of selling price in addition to vendor-specific objective evidence (VSOE) and third-party evidence (TPE) for determining the selling price of a deliverable. In cases in which VSOE or TPE cannot be determined, use of the best estimate of selling price is required. In addition, the residual method of allocating arrangement consideration is no longer permitted. This new update is effective for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. Early adoption is permitted. We are currently evaluating the impact that the adoption of this ASU will have on our consolidated financial statements.

PECO II, INC.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Cont.)

Forward-Looking Statements

Certain of the Company's statements in this Quarterly Report on Form 10-Q and the foregoing Management's Discussion and Analysis of Financial Condition and Results of Operation are not purely historical, and as such are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements include, but may not be limited to, all statements regarding the Company's and management's intent, beliefs, expectations, and plans, such as statements concerning the Company's future profitability, industry trends, operating results, and product development strategy. These forward-looking statements include numerous risks and uncertainties, including, without limitation: a general economic recession; a downturn in our principal customers' businesses; current and future mergers of key customers; the volatility in the communications industry; the demand for communications equipment generally and in particular for the products and services offered by the Company; the Company's ability to generate sales orders during fiscal 2009 and thereafter; the ability to develop and market new products and product enhancements; the potential environmental issues in regards to an aging manufacturing facility; the ability to attract and retain customers; competition and technological change; and successful implementation of the Company's business strategy. One or more of these factors have affected, and in the future could affect, the Company's business and financial results in future periods and could cause actual results to differ materially from plans and projections.

There can be no assurances that the forward-looking statements included herein will prove to be accurate, and issuance of such forward-looking statements should not be regarded as a representation of the Company, or any other person, that the objectives and plans of the Company will be achieved. In addition, this Quarterly Report on Form 10-Q contains time-sensitive information that reflects management's best analysis only as of the date of this report. PECO II does not undertake any obligation to publicly update or revise any forward-looking statements to reflect future events, information or circumstances that arise after the date of this release. Further information concerning issues that could materially affect financial performance related to forward-looking statements can be found in the Company's periodic filings with the Securities and Exchange Commission.

Results for the interim period are not necessarily indicative of the results that may be expected for the entire year.

ITEM 3.

QUALITATIVE AND QUANTITATIVE DISCLOSURE ABOUT MARKET RISK

Not applicable to smaller reporting companies.

ITEM 4T.

CONTROLS AND PROCEDURES

Disclosure Controls and Procedures

As of September 30, 2009, the end of the period covered by this report, an evaluation was carried out under the supervision and with the participation of our management, including our Chief Executive Officer/Chief Financial Officer, of our disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934). Based upon such evaluation, our Chief Executive Officer/Chief Financial Officer concluded that such disclosure controls and procedures were effective as of the end of the period covered by this report.

Changes in Internal Control Over Financial Reporting

There were no changes to our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934) that occurred during the period covered by this report that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 6.

Exhibits

31.1

Rule 13a-14(a) Certification of Chief Executive Officer and Chief Financial Officer

32.1

Section 1350 Certification of Chief Executive Officer and Chief Financial Officer

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Date: November 13, 2009

PECO II, Inc.

/s/ JOHN G. HEINDEL

John G. Heindel

Chairman, President, Chief Executive
Officer, Chief Financial Officer and
Treasurer

(Principal Executive Officer and Principal
Financial Officer)