Rockville Financial Incorporated
"Second Quarter 2012 Earnings Conference Call"

Thursday, July 26, 2012, 10:00 AM ET
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OPERATOR: Good day and welcome to the Rockville Financial Incorporated Second Quarter 2012 Earnings Conference Call. All participants will be in listen-only mode. Should you need assistance, please signal a conference specialist by pressing the "*" key followed by "0." After today's presentation, there will be an opportunity to ask questions. To ask a question, you may press "*" then "1" on your touchtone phone, to withdraw your question, please press "*" then "2." Please note this event is being recorded.

I would now like to turn the conference over to Ms. Marliese Shaw, Senior Vice President, Investor Relations. Ms. Shaw, the floor is yours, ma'am.

MARLIESE SHAW: Thank you, Mike. Good morning everyone. Welcome to our second quarter conference call. Before we begin, we would like to remind you to read our 'Safe Harbor' advisement on forward-looking statements on our earnings announcement. Forward-looking statements by their nature are subject to risks and uncertainties. Certain factors could cause actual results to differ materially from expected results. Our comments today are intended to qualify for the 'Safe Harbor' afforded by that advisement.

And now, I would like to introduce Bill Crawford, our Chief Executive Officer and President.

BILL CRAWFORD: Thanks, Marliese. Good morning and thank you for joining us on today's call and for your continued interest in our Company. Yesterday afternoon, we released second quarter earnings. This morning, I'll review some of the highlights of the second quarter and then my team will provide a more detailed overview of the quarter. With me this morning is John Lund, our Chief Financial Officer; Scott Bechtle, our Chief Risk Officer; and Eric Newell, our Director of Treasury; along with other members of the management team.

I am very pleased to announce that excluding our stock award grant expense, Rockville had record second quarter net earnings of \$3.8 million or \$0.14 per share, driven by our 24% core operating revenue growth. Significant to our quarterly earnings growth was the \$3.1 million or 23% increase in net interest income, which was primarily due to the \$2.4 million or 46% decrease in interest expense in the second quarter of 2012 when compared to the second quarter of 2011. The interest expense decline was largely from realizing the benefit of the second quarter 2011 balance sheet restructure and was also importantly from our continued focus on decreasing total funding costs and growing low-cost core deposits.

Our franchise cut funding cost by 45% or by 69 basis points to 0.85 for the second quarter of 2012 from 1.5% for the second quarter of 2011 and by 6 basis points from 0.91% in the first quarter of 2012. While decreasing the cost of funds will continue to be an important focus of the Company, Rockville is committed to organic growth of both loan and deposit portfolios and protecting asset quality.

Our commercial loans grew by 9% year-to-date and by 25% year-over-year. The compound annual growth rate of this portfolio over the last three years is 18%. We also produced 19% growth in our C&I portfolio during the year-to-date, which we feel is where we have the greatest market opportunity to bring a new commercial relationships with the use of deposit and cash management services. The lending team that we recruited has extensive experience in these markets and our growth in C&I lending also contributes to our portfolio diversification. Also contributing to the growth in loan portfolio is a significant increase in residential mortgage production.

Mortgage production increased to $80 million in the second quarter, a 264% increase in the volume from $22 million in the second quarter of 2011, and an 86% increase over the linked-quarter. The Company has invested in the infrastructure supporting this line of business in the past six months, both from a human capital and a technology perspective. Rockville grew demand deposits by $15 million or 3% for the year-to-date. Total low-cost core deposits grew by $57 million in the second quarter of 2012 and grew by $111 million or 14% year-over-year. At Rockville, we remain focused on driving organic growth by taking market share from the larger banks.

We also significantly invested in our company in the year ending June 30, 2012, as evidenced by an 18% increase in operating expense growth year-over-year, excluding quarterly events discussed in more detail in the earnings release.

Salaries and employee benefits increased $1.9 million or 28% during that time period related to the investment the company is making a human capital infrastructure to repair, to prudently leverage future growth. And other expense increased by $402,000 related also to the infrastructure investment as well as the increased cost being a fully public company.

Core operating profit increased by 46% year-over-year despite the aforementioned expense growth. The Company will continue to make investments in its infrastructure in order to manage long-term shareholder return and build franchise value. At Rockville, we remain committed to shareholder return and executing on sound, capital management principles. Capital management is the top priority for the Company, and we view efficiently returning capital to shareholders via increased dividends and our 10% stock buyback program as important tools in that regard. We are delighted to announce our 25th consecutive quarterly dividend, providing a 3.14% annualized dividend yield to our shareholders based on the average closing price in the second quarter. And we executed 45% of the stock buyback program as of June 30, 2012.

I would like to personally thank our investors for their confidence in the Company. At Rockville, we remain focused on creating prosperity for customers, communities and shareholders. Our total shareholder return year-over-year is 20.3% compared to the SNL thrift index of –2.2% during the same time period.

At this time, I am going to ask John Lund, our CFO to provide some further detail on the quarter's results. John.

JOHN LUND: Thank you Bill and good morning everyone. Thank you for joining us on our call today. I will review our second quarter operating results and financial position as described in our earnings release yesterday afternoon. As Bill indicated, the Company reported strong second quarter earnings. Net income for the quarter ended June 30, 2012, up $2.9 million or $0.11 per share is largely reflective of the Company's continued focus on decreasing the cost of funding across all sources as well as solid asset growth. Despite an $82 million increase in average interest bearing deposits, net interest expense was relatively flat on a linked-quarter basis, and decreased by $2.8 million or 45.6% year-over-year. The primary driver of the evenness in interest expense, while the company is experiencing growth is the 12 basis point decline in the cost of time deposits to 1.36%

from 1.48% coupled with the $71 million increase in average balance of low-cost core deposit accounts.

At Rockville, we thoughtfully price deposits in consideration of both the competitive and interest rate environment. On a year-over-year basis, interest expense continues to benefit from the Company's balance sheet restructure completed during the second quarter of 2011. This restructure provided Rockville with an interest expense savings of $5.1 million on an annualized basis.

The net interest margin was influenced by the decline in the cost of funds and improved 3.87% on a tax equivalent basis for the quarter from 3.08% during the same quarter in 2011 and improved from 3.83% in the prior quarter. The margin improvement on a linked-quarter basis reflects the tax benefit related to the Company's increased municipal bond portfolio. While we are certainly fully engaged and focused on the net interest margin going forward, we are cognizant that based on the near-term economic outlook and the FLMC's intention to maintain a low-rate environment for an extended period by growing or maintaining margins will be a 2012 challenge for many banks.

In order to meet this challenge, the Company will seek opportunities to mitigate interest rate risk through proactive asset liability management. Our goal is to not make interest rate bets, rather to maintain a neutral interest rate risk sensitivity position that is routinely monitored by a comprehensive asset liability management process.

Net interest income has benefited from continued organic growth in both loans and deposits, primarily attributable to the Company's commercial banking expansion and mortgage origination enhancement. Net loans have increased by $49 million or 3.3% during the second quarter to $1.55 billion, contributing to a 13.1% annualized growth rate and a 7.7% compound annual growth rate over the last five years.

Deposits have increased by $73.4 million or 5.3% during the second quarter to $1.46 billion, contributing to a 21.2% annualized growth rate and a 9% compound annual growth in that portfolio over the last five years.

Regarding non-interest expenses, excluding the effect of the stock award grant expense following shareholder approval of the Company's stock incentive plan in the second quarter of 2012, non-interest expense increased $305,000 or 2.5% on a linked-quarter basis. In comparison to the second quarter of 2011, when excluding the balance sheet restructure expense, the increase in non-interest expenses was primarily concentrated in salary and benefits expense. This increase is reflecting higher staffing levels related to investment the Company is making in its human capital infrastructure to prepare for future growth. Additionally, other expenses increased by $402,000 or 27% year-over-year related to additional expenses associated with being a fully public company, as well as the increase in other variable costs commensurate with the increase of 35 full-time equivalent employees hired throughout the 12-month period ending June 30, 2012. Partially offsetting these cost increases year-over-year, where the $338,000 or 76.6% decrease in marketing expense and a $305,000 or 60.3% decrease in FDIC expense.

The Company has paid dividends for 25 consecutive quarters. The dividend payout ratio for the quarter ended June 30, 2012 was 87%. Stock buy-backs became available as an option on March 3, 2012 and as such, the Company approved a 10% buy-back program at that time. As of June 30, 2012, the Company had purchased 1,328,379 shares or 45% of the approved plan.

To conclude, we are pleased with the strong operating results for the quarter and the resulting robust net interest margin. Going forward, we continue to focus on prudent growth, maintaining asset quality, and on seeking opportunities to decrease the cost of funds.

During the quarter, the Company embarked on a strategy to introduce interest rate hedging and also further expanded its municipal bond portfolio. We did so with the full confidence, given our in-house subject matter expertise of Eric Newell, our Senior Vice President and Director of Treasury. Eric holds the CFA designation and his experience includes his role as an FDIC examiner and as an analyst for both Fitch Rating Service and Alliance Bernstein.

ERIC NEWELL: Thank you John and good morning. During the second quarter, the Company entered into its first interest rate swap to hedge the variable cash flows associated with a forecasted adjustable rate wholesale funding. The Company's objectives in using interest rate risk derivatives are to manage its exposure to interest rate movements. To accomplish this objective, the Company intends to use interest rate swaps as part of its interest rate risk management strategy.

As of June 30, 2012, the Company had one outstanding interest rate derivative with a notional value of $50 million that was designated as a cash flow hedge of future variable rate funding whereby the Company will receive quarterly adjustable payments of three months LIBOR and will pay a quarterly fixed payment of 2.28%.

The Company also made additional purchases of approximately $29 million of Municipal bond securities and to the available for sale portfolio during the quarter, growing this sector of the portfolio to $68 million. At June 30, 2012 these investments represented 31% of total available for sale securities and 3.5% of total assets. The Company does not have plans to purchase additional municipal bonds at this time.

Individual investments in the municipal portfolio are limited to $2 million and will be largely rated AA or better. The Company does not rely on any other insurance or enhancement schemes, with the one exception being the Texas Permanent School Fund, which is rated AAA.

At quarter end, the portfolio ratings were comprised as follows: 13% is rated AAA, 20% is rated AA plus, 38% AA, 27% AA minus, and 2% A with a credit enhancement from the Texas Permanent School Fund. There are no special purpose bonds in the portfolio, such as stadiums, parking meters and other recreational projects. Approximately $23 million are general obligation bonds diversified geographically among 13 states, with the greatest concentration in California, which represents about $5 million. One important aspect of the general obligation portfolio is that only $8.3 million are direct obligations of a state, the remainder of the obligations are issued by political subdivisions.

The remaining $45 million are revenue bonds, diversified among 20 states, with the greatest concentration in New York representing about $5 million, followed by California representing about $4 million. These bonds are further diversified by several types of revenue representing, for example, waste water and water fees, college and university tuition, and real estate taxes in the support of school systems.

Our greatest concentration by revenue type of bond is waste water and water fees representing about $14 million, followed by college and university fees representing about $10 million. As we have stated in the past, education could be considered a concentration, however, university and college improvements are generally funded by student tuition and fees, whereas school improvements are paid by property taxes, which are often subject to constitutional mandates from minimum funding levels.

At this time, Scott will provide some further detail on the Company's asset quality.

SCOTT BECHTLE: Thank you Eric and good morning, everyone. Rockville's asset quality remains strong and it's top among its peer group by nearly every performance metric. Net-charge offs to average loans outstanding at June 30, 2012 was 0.03%. Total non-performing loans to total loans was 0.98%, and total non-performing assets to total assets was 0.90%. The allowance for loan losses was increased by $776,000 during the second quarter to $17.3 million. At June 30, 2012 the ratio of allowance for loan losses to non-performing loans was 113.47% and the allowance for loan losses to total loans was 1.11%.

Thank you for your time this morning and now Bill, John, Eric and I would be happy to answer any questions you may have today.

Q&A

OPERATOR: Thank you, sir. We'll now begin the question answer session. To ask a question you may press "*" then "1" on your touchtone phone. If you are using a speaker phone, please pick up your handset before pressing keys. If your question has been addressed and you'd like to withdraw your question, please "*" then "2.". Again, it is "*" then "1" to ask a question. At this time, we will pause momentarily to assemble our roster.

The first question we have comes from Timur Brazilier of KBW. Please go ahead.

TIMUR BRAZILIER: Hi, good morning, gentlemen.

BILL CRAWFORD: Hi, Timur.

TIMUR BRAZILIER: First question is on loan growth. Can you talk to me a little bit about the pipeline heading into the third quarter with expectations for growth in the third quarter?

JOHN LUND: Sure. We continue to have a strong commercial pipeline and we had very strong commercial production in the second quarter. We did have a big payoff in the second quarter in commercial that I think we had in the press release. Mortgage pipeline remains very strong at, you know, historic levels for us, so it's all steady as she goes. I will say the commercial lending environment is very competitive and so we are staying disciplined both with pricing and asset quality, but we think our, you know, we are very pleased with our pipelines right now.

TIMUR BRAZILER: Okay great. And you had mentioned the mortgage banking pipeline. The reduction in gains on sale of loans is that a result of lower level of originations or did you portfolio a larger portion of the originations?

BILL CRAWFORD: Yeah, we…it's more a timing difference. You know we've got more in portfolio, and so more about timing.

TIMUR BRAZILER: Should we expect to see that line item tick higher in the third quarter, the gain on sale of loans?

BILL CRAWFORD: You know all I'll say is we are originating much higher volumes right now, and we are always looking at the most opportunistic way to deal with that. And so, you know, we believe the numbers around loan sale gains is more about timing than anything else.

TIMUR BRAZILER: Okay great. Maybe switching over to the securities portfolio, I think in the release you had mentioned that in addition to purchasing the munis, you guys are starting to add a little bit of corporate debt onto the balance sheet as well. Can you maybe talk a little bit about that strategy, and what the overall appetite or size of appetite you would have for corporate debt?

BILL CRAWFORD: Sure, I'll turn that one to Eric Newell our Director of Treasury. Eric.

ERIC NEWELL: Yeah, we added some corporate debt earlier this year. It was more opportunistic given what we were seeing for the spreads on that type of instrument. I would say that, you know, we have a very conservative view in what we would introduce to the portfolio when it comes to ratings. You know, primarily ensuring that it's a single A or higher and we continue to meet that objective. I would say that, you know, going forward it's definitely making sure that if we were to evaluate new purchases in the corporate sector of the portfolio that would need to meet that requirement, and also ensure that, you know, we are kind of meeting some of the requirements for interest rate risk as well.

TIMUR BRAZILER: Okay and have you guys designated maybe a high water mark that you are willing to take on a corporate debt as a percent of the total securities portfolio?

ERIC NEWELL: I wouldn't say that we have a high mark but we definitely have, you know, within our policies limitations on, you know, as a percentage of the portfolio; also as a percentage of capital. And then we also have limits when it comes to, you know, exposure that will have per name and also per CUSIP.

TIMUR BRAZILER: Okay great, and then just a last question on the securities book. Are you still looking to grow it from the second quarter levels or is it going to pretty much flatten out at this point in time? And also how much liquidity is the portfolio spinning off every month?

ERIC NEWELL: In terms of the sizing of the portfolio to assets, that's definitely something that we consider when we, you know, strategically think ahead about where the balance sheet grows. Obviously, the investment portfolio serves as a liquidity purpose first. So, we want to make sure that the sizing of a portfolio and the yields that we are recognizing, you know, help us with the liquidity aspect. So you know, I would say that you know, probably the size of the portfolio that you are seeing is indicative of where, you know, we kind of feel that we are meeting the liquidity needs that we are seeing at this point. In terms of the amount of throw-off that occurs on the portfolio, we largely just make sure that, you know, one of the things that we are looking at there is that it's just steady; and we want to make sure that there is not a lot of variability in that type of cash that gets thrown off. And if there is, then we try to, you know, obviously look at some types of securities that could help you know steady that cash flow.

TIMUR BRAZILER: Okay great, thank you very much.

BILL CRAWFORD: Thanks, Timur.

OPERATOR: Again as a remainder, if you would like to participate in today's Q&A, please press "*" then "1" on your touchtone phone. The next question we have comes from Travis Lan of Stifel Nicolaus.

BILL CRAWFORD: Hey, Travis.

TRAVIS LAN: Hi, thanks good morning guys. Just circling back on the residential strategy. Is your portfolio more ready this quarter? There is a little bit of a departure from what we saw in the past few quarters. So can you just talk a little bit about you know, what went into that decision?

BILL CRAWFORD: Sure again it's a little more around timing. Obviously, we have significantly increased our run rate because we've hired a lot of new mortgage originators. And so, you know, with the way we originate currently on the secondary market, there is timing involved as to when we originate and when we sell. And so, I think that's what's going on there.

There is not a change a significant change in strategy to the portfolio or the mortgages. This is just more about timing of contracts.

TRAVIS LAN: Okay. So in the press release when it says year-to-date residential mortgages are up $27 or some million, we should expect that those will eventually be sold?

BILL CRAWFORD: You know, we continue to, you know, not want to pile on low rate, long duration mortgages on the balance sheet.

TRAVIS LAN: Okay. So, with common low rate, long duration I assume these are 30-year fixed.

BILL CRAWFORD: Yeah, it's a mix between thirty and fifteen.

TRAVIS LAN: Okay, all right. And then maybe, could you just help clarify the use of the interest rate swap that you mentioned? So it seems like it would imply that you are bringing on some adjustable rates borrowings in the future, but I just wonder why or maybe you could explain why you would go the adjustable route when, you know, kind of fixed borrowing costs are so low?

BILL CRAWFORD: Sure, I'll have Eric go into a little more detail on that strategy. Eric…

ERIC NEWELL: With the swap we decided to, you know, it's a forward starting swap. So we are variable now for the first three years and then once it becomes effective then it's fixed. That's when we would be paying that rate that was mentioned in the press release, or actually in my earlier comments. The reason that we chose that is because we feel that, you know, there is going to be continued variability. Our, you know, short term rates are going to be low for, you know, obviously what we think to be at least, you know, the next three years. But then, what we are trying to do is better position the balance sheet for rising rates and, you know, make sure that we, you know, manage the interest rate risk profile of the balance sheet to be as neutral as possible.

BILL CRAWFORD: You know, we saw this as a very opportunistic way to manage interest rate risk going forward and inside of three years, you know, we feel rates will be low.

TRAVIS LAN: That's right, that's helpful. And then just finally, I know you kind of gave some broad comments on it, John, but could you give just a little bit more color on the dynamics of the margin going forward and, you know, what kind of offsets you think you have to the, as you mentioned, the environmental pressure?

JOHN LUND: Yeah so…yeah I mean certainly we are pleased with the 3.7 tax equivalent margin. You know, we are obviously cognizant that there are a lot of headwinds with asset yields. So one, we want to continue with asset generation, which is going to result in continued revenue dollars. Also we are going to continue to look at our cost of funding structure. You know, there is probably some of a floor in some respects on that, but, you know, we are going to continue to revisit and look at where our funding source coupled with some of these interest rate risk strategies that we think will help propel us going forward. So certainly, there is pressure out there, but we are pleased with the steps we've made and in this interest rate environment, you know, certain that we are going to be mindful of where our cost of funds is and where we can continue to take it.

TRAVIS LAN: Okay and then just finally, do you guys have numbers for commercial loan originations in the quarter? Because I know obviously pay offs were kind of a big offset there. I don't know if you have numbers you could give us on what CRE….or CRE and C&I originations were?

BILL CRAWFORD: Yes. I think Scott Bechtle can give you that information. Scott.

SCOTT BECHTLE: You know, all in, Travis for the quarter when you are add in commercial and commercial real estate both, it was just shy of $36 million in June and $27 million in May and about $3 million in April.

TRAVIS LAN: Perfect. All right, thank you guys very much.

BILL CRAWFORD: All right, thanks.

OPERATOR: Again, if you'd like to participate in today's Q&A, please press "*" then "1" on your touchtone phone. Again that is "*" then "1." Ms. Shaw, gentlemen, it appears that we have no further questions at this time. Would you like to make any final comments?

BILL CRAWFORD: We would just like to thank everybody for dialing in and your continued interest in our Company and as always, if there are any questions or concerns, you know where to find us. Take care and have a great day.

OPERATOR: You also have a great day, sir. We thank you to the rest of management. The conference call has now concluded. At this time, you may disconnect your lines. Thank you again and have a good day.