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Rockville Financial, Inc. *(RCKB)*

Q1 2012 Earnings Call

CORPORATE PARTICIPANTS

Marliese L. Shaw
Vice President & Investor Relations Officer, Rockville Financial, Inc.

William H. W. Crawford, IV
President, CEO & Director, Rockville Financial, Inc.

John T. Lund
Chief Financial Officer, Treasurer & Executive VP, Rockville Financial, Inc.

Eric R. Newell
Vice President-Rockville Bank, Rockville Financial, Inc.

Mark A. Kucia
Head of Commercial Banking & Executive VP, Rockville Financial, Inc.

OTHER PARTICIPANTS

Damon P. DelMonte
Analyst, Keefe, Bruyette & Woods, Inc.

MANAGEMENT DISCUSSION SECTION

Operator: Good day, and welcome to the Rockville Financial Inc., First Quarter 2012 conference call. All participants will be in listen-only mode. [Operator Instructions] After today's presentation, there will be an opportunity to ask questions. [Operator Instructions] Please note this event is being recorded.

I would now like to turn the conference over to Ms. Marliese L. Shaw, Vice President, Investor Relations. Ms. Shaw, please go ahead.

Marliese L. Shaw
Vice President & Investor Relations Officer, Rockville Financial, Inc.

Thank you, Denise. Good morning, everyone. Welcome to our first 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.

William H. W. Crawford, IV
President, CEO & Director, Rockville Financial, Inc.

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 our first quarter earnings, this morning I'll review some of the highlights of the first 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; Mark Kucia, Head of Commercial Banking and Eric Newell, Director of Treasury, along with other members of our management team.

I am very pleased to announce that Rockville had record first quarter net earnings of $3.9 million, or $0.13 a share, driven by our 25% operating revenue growth. Significant to our quarterly earnings growth was the $2.7 million, or 20% increase in net interest income which is primarily due to the $2.5 million or 48% decrease in interest expense in the first quarter of 2012, when compared to the first 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 cost and growing low cost core deposits

Our franchise cut funding cost 44%, or by 71 basis points, to 0.91% for the first quarter of 2012 from 1.62% for the first quarter of 2011, and by 16 basis points from 1.07% in the fourth quarter of 2011. While decreasing the cost of fund 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 6% in the first quarter, and by 23% year-over-year. The compound annual growth rate of this portfolio over the last three years is 18%. Importantly we produced 19% growth in our C&I portfolio during the quarter which is where we feel we have the greatest market opportunities to bring in new commercial relationships which use deposit and cash management services. The lending team that we've recruited has extensive experience in these markets and our growth in C&I lending also contributes to our portfolio diversification.

Rockville grew demand deposits by $10 million or 5% in the first quarter and by $51 million year-over-year. Total low cost core deposits grew $53 million in the first quarter of 2012 and grew by $178 million or 26% year-over-year. At Rockville, we remain focused on driving organic growth by taking market share from the larger banks.

We also significantly invest in our company in the year ending March 31, 2012 as evidenced by 13% increase in operating expense growth year-over-year. Salaries and employee benefits expense increased $1.5 million or 26% during that time period, related to the investments the company is making in its human capital infrastructure to prepare prudently for future growth and other expense increased by $256,000 related also due to infrastructure investment as well as the cost of being a fully public company. Core operating profit increased by 77% 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 to executing on sound capital manager principles. Capital management is a top priority for the company, and we view efficiently returning capital to shareholders via increased dividends and our recently announced 10% stock buyback program as an important tools in that regard. We're delighted to announce our third consecutive quarterly dividend increase providing a 3.2% annualized dividend yield to our shareholders based on the average closing price in the first quarter, and we executed 22% of the stock buyback program as of March 31, 2012.

I'd like to personally thank our investors for their confidence in our company. At Rockville, we remain focused on creating prosperity for our customers, communities and shareholders. Our total shareholder return year-over-year is 14.9% compared to the SNL thrift index of negative 5.4% during the same time period. We mailed our proxy statement including the 2012 stock incentive plan to our shareholders earlier this month, and we'll be holding our annual meeting of shareholders on May 17. We appreciate your continued support and look forward to seeing those of you who are able to join us at the annual meeting, and we encourage shareholders to vote their proxy as this is an important part of our corporate governance.

At this time I am going to ask John Lund, our CFO, to provide some further details on the quarterly results.

John T. Lund

Chief Financial Officer, Treasurer & Executive VP, Rockville Financial, Inc.

Thank you, Bill, and good morning everyone. Thank you for joining us on our call today. I will review our first quarter operating results and financial position as described in our earnings release yesterday afternoon.

As Bill indicated, the company reported record first quarter earnings. Net income for the quarter ended March 31, 2012 of $3.9 million, or $0.13 per share, is largely reflective of the company's continued focus on decreasing the cost of funding across all sources.

Net interest expense decreased $415,000 or 12.9% on a linked quarter basis and by $2.5 million or 47.5% year-over-year. The primary driver of the linked quarter decrease is the 17 basis point decline in the cost of time deposits to 1.48% from 1.65% coupled with the $29 million decline in average balance of time deposits as the company continues to shift the deposit mix towards low cost core deposit accounts. At Rockville we thoughtfully priced 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 to 3.83% on a tax equivalent basis for the quarter from 3.1% during the same quarter in 2011 and improved from 3.77% in the prior quarter. While we are certainly fully engaged and focused on the net interest margin going forward, we are cognoscenti that based on the near term economic outlook and the FOMCs intention to maintain a low rate environment for an extended period that 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 to proactive asset liability management. Our goal is to not make interest bids rather to maintain a neutral interest rate risk sensitivity position. Net interest income has benefited from continued organic growth in both loans and deposits. Net loans have increased $38.9 million or 2.7% during the first quarter to $1.5 billion contributing to a 10.7% annualized growth rate and a 7.4% compound annual growth rate over the last five years.

During the quarter, the company sold $17.5 million of fixed rate residential mortgage loans to the secondary market. Deposits have increased by $55.5 million or 4.2% during the first quarter to $1.38 billion contributing to a 16.7% annualized growth rate and an 8.5% compound annual growth rate in that portfolio for the last five years. Both the loan and deposit portfolios are benefiting from the company's commercial banking expansion.

Commercial loans including commercial real estate and C&I loans grew by $43.8 million or 5.9% to $781.1 million at March 31, 2012 from $737.3 million at December 31, 2012. Reflective of the expansion of this team throughout the third quarter of 2011 commercial loans have increased by $87 million or 12.5% since September 30, 2011 or a 25% on an annualized basis. Non-interest bearing deposits grew by $10.2 million or 4.9%. Since year end and have grown by $34.9 million or 19.2% since September 30, 2011 primarily reflective of the investments the company made in the commercial lending and cash management teams in the third quarter of 2011.

Regarding non-interest expenses excluding the effect of the Charitable Foundation contribution in the first quarter of 2011, the increase in non-interest expense on a linked quarter basis and in comparison to the first quarter of 2011 was primary concentrated in salary and benefits expense. This increase is reflecting higher staffing levels related to the investment the company is making in its human capital and infrastructure to prepare for future growth.

Additionally, other expense increased by $256,000 or 18% year-over-year related to additional expenses associated with being a fully public company as well as the increase in other various variable cost commensurate with the increase of 61 full time equivalent employees, hired throughout the 12-month period ending March 31, 2012. Partially offsetting this cost increases year-over-year were the $210,000 or 64.8% decrease in marketing expense and the $209,000 or 40.6% decrease in FDIC expense.

The company has paid dividends for 24 consecutive quarters. The dividend pay-out ratio for the quarter ended March 31, 2012 was 61%. Stock buybacks became available as an option on March 3, 2012 and as such the company approved a 10% buyback program at that time. As of March 31, 2012, the company had purchased 647,900 shares or 22% of the approved plan.

To conclude, we're 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 expand its investment portfolio, specifically municipal bonds. We did so with the full confidence given our in-house subject matter expertise of Eric Newell, our Senior Vice President, Director of Treasury. Eric holds a CFA designation and his experience includes his roles as an FDIC examiner and as an analyst for both Fitch Ratings and AllianceBernstein.

Eric R. Newell

Vice President-Rockville Bank, Rockville Financial, Inc.

Thank you, John, and good morning. During the first quarter the company embarked on an initiative to purchase approximately $40 million of municipal bond securities into the available for sale portfolio. We continually annualize top performers in the industry and notice the pattern within the investment portfolios of those in the top quartile. Each had municipal exposures in their portfolios. With that in mind as well as a deepening bench of talent throughout our organization to handle this type of risk, management made a strategic decision to conservatively add this type of exposure to our investment portfolio. At March 31, 2012, these investments represent a 20% of total available for sale securities and 2% of total assets.

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 the follows: 18% is rated AAA, 28% is Aa1, 25% is Aa2, 27% Aa3 and 2% is A2, rated 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 $16 million are general obligation bonds diversified geographically among 10 states with a greatest concentration in California which represents about $4 million. One important aspect of the general obligation portfolio is that only $5.4 million are direct obligations of the state. The remainder of the obligations are issued by political subdivisions. The remaining $24 million are revenue bonds diversified among 13 states where the greatest concentration in California representing about $4 million followed by New York and Washington, representing about $3 million each. 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. The greatest concentration of revenue type of bond is waste water and water fees representing about $8 million, followed by college and university fees representing about $7 million.

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 for minimum funding levels.

Credit analysis will be paramount to managing risks in this portfolio. While we utilize reports from Moody's, S&P and Fitch, management will review continued disclosures from issuers and understand developing trends and proactively act when appropriate. We will not simply act in response to rating agency actions. We also leverage broker relationships in order to gain access to market information helping us understand developing topics such as pension obligations and how they relate to credits on our portfolio. You may expect to see expanded disclosures in our future quarterly financial reports surrounding this strategy.

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

Mark A. Kucia
Head of Commercial Banking & Executive VP, Rockville Financial, Inc.

Thank you, Eric, and good morning everybody. Rockville's asset quality remains strong and is top among its peer group by nearly every performance metric. Net charge-offs to average loans outstanding at March 31, 2012 was 0.01%. Total non-performing loans to total loans was 0.9% and total non-performing assets to total assets was 0.88%. The allowance for the loan losses was increased by $502,000 during the first quarter to $16.5 million. At March 31, 2012 the ratio of allowance for loan losses to non-performing loans was 121.03% and the allowance for loan losses to total loans was 1.09%. Thank you.

And now Bill, John, Eric and I would be happy to answer any questions you may have.

QUESTION AND ANSWER SECTION

Operator: Thank you. We will now begin the question and answer session. [Operator Instructions]

Marliese L. Shaw
Vice President & Investor Relations Officer, Rockville Financial, Inc.

A

Denise?

Operator: Yes ma'am?

Marliese L. Shaw
Vice President & Investor Relations Officer, Rockville Financial, Inc.

A

I would just first like to clarify that with regard to staffing increases year-over-year it's 38 FTE rather than 61 FTE, I just wanted to make that correction. And now we're ready for questions.

Operator: Thank you.

Marliese L. Shaw
Vice President & Investor Relations Officer, Rockville Financial, Inc.

A

You're welcome.

Operator: Our first question will come from Damon DelMonte of KBW. Please go ahead sir.

Damon P. DelMonte
Analyst, Keefe, Bruyette & Woods, Inc.

Q

Hi good morning, everyone, how are you?

William H. W. Crawford, IV
President, CEO & Director, Rockville Financial, Inc.

A

Hey, Damon, thanks for joining us.

Marliese L. Shaw
Vice President & Investor Relations Officer, Rockville Financial, Inc.

A

Hi, Damon.

Damon P. DelMonte
Analyst, Keefe, Bruyette & Woods, Inc.

Q

Sure, thanks. I guess my first question has to do with the – a little bit of the investment portfolio strategy and specifically the municipal portfolio, what is the average yield that you're seeing on that portfolio?

William H. W. Crawford, IV
President, CEO & Director, Rockville Financial, Inc.

A

Sure, Eric, I'd let you take that one.

Eric R. Newell
Vice President-Rockville Bank, Rockville Financial, Inc.

A

Hi, Damon, this is Eric.

Damon P. DelMonte
Analyst, Keefe, Bruyette & Woods, Inc.

Q

Eric, how are you?

Eric R. Newell
Vice President-Rockville Bank, Rockville Financial, Inc.

A

Good, how are you?

Damon P. DelMonte
Analyst, Keefe, Bruyette & Woods, Inc.

Q

Good, thanks.

Eric R. Newell
Vice President-Rockville Bank, Rockville Financial, Inc.

A

On a notional before tax effecting it, you're probably seeing something around 2.5% to 3%, but obviously since the municipals get a favorable tax calculations you're starting to see yields around 5% to 6%.

Damon P. DelMonte
Analyst, Keefe, Bruyette & Woods, Inc.

Q

Okay. And now, I think you said that currently it's about 20% of the available for sale portfolio what is the targeted allocation over time?

Eric R. Newell
Vice President-Rockville Bank, Rockville Financial, Inc.

A

I think that, you probably could see that the portfolio will grow modestly, because we're not fully deployed on the strategy but we have talked with the investment committee and ALCO and we have a basically a limit that we're not going to grow that portfolio to be an outsized portion of the investment portfolio.

Damon P. DelMonte
Analyst, Keefe, Bruyette & Woods, Inc.

Q

Okay, but it is at 20% number now, is that correct?

Eric R. Newell
Vice President-Rockville Bank, Rockville Financial, Inc.

A

Yes.

Damon P. DelMonte
Analyst, Keefe, Bruyette & Woods, Inc.

Q

Okay, and then I guess it looks like you guys didn't provide an average balance sheet in the release, so I am kind of guessing that I think your average securities for the quarter were $176 million, but your period end securities were $204 million. So maybe this is more of a question for John. Are we going to see some benefit to the margin then in the second quarter as kind of catch up happens from the period end to the average?

John T. Lund
Chief Financial Officer, Treasurer & Executive VP, Rockville Financial, Inc.

A

Yeah, I would say incrementally, yes, you will see that certainly the municipal portfolio is an important driver for that.

Damon P. DelMonte
Analyst, Keefe, Bruyette & Woods, Inc.

Q

Right.

John T. Lund
Chief Financial Officer, Treasurer & Executive VP, Rockville Financial, Inc.

A

We embarked on this diversification in the portfolio in the first quarter, so, certainly, there will be some lift there. And I just would follow-up to a comment Eric had made certainly, we're very mindful of diversification and credit quality with these types of security so.

Damon P. DelMonte
Analyst, Keefe, Bruyette & Woods, Inc.

Q

Okay. And then, what was the average loans outstanding for the quarter? And I guess what were total average earning assets?

John T. Lund
Chief Financial Officer, Treasurer & Executive VP, Rockville Financial, Inc.

A

Total average loans outstanding were $1.475 billion.

Damon P. DelMonte
Analyst, Keefe, Bruyette & Woods, Inc.

Q

Okay. And how about total average earning assets?

John T. Lund
Chief Financial Officer, Treasurer & Executive VP, Rockville Financial, Inc.

A

Total average earning assets were approximately $1.7 billion.

Damon P. DelMonte
Analyst, Keefe, Bruyette & Woods, Inc.

Q

Okay, great. And then, I guess, probably a question for Mark, can you just give us an update on the regional commercial real estate portfolio that you guys have and kind of what you're seeing I guess in the way of credit trends as well as continuing lending opportunities?

Mark A. Kucia
Head of Commercial Banking & Executive VP, Rockville Financial, Inc.

A

We still – Damon, we still see good opportunity there. The portfolio at 3/31 was about $253 million, 37 loans – average loans size just less than $7 million. We've got a weighted average LTV of about 63%, debt service risk coverage of [ph] $168 million. (21:08) All loans are performing as agreed and of course as we expand commercial that the production from the regional will represent on a relative basis as smaller percentage overall.

Eric R. Newell
Vice President-Rockville Bank, Rockville Financial, Inc.

A

Yeah Damon, we brought in another banker that Mark worked with in the past who has a lot of experience in that space and so we think that will be helpful.

Damon P. DelMonte
Analyst, Keefe, Bruyette & Woods, Inc.

Q

Okay. Great, that's all that I have for now. Thank you very much.

William H. W. Crawford, IV
President, CEO & Director, Rockville Financial, Inc.

A

Thanks, Damon.

Operator: [Operator Instructions] And this will conclude our question-and-answer session. I would like to turn the conference back over to management for any closing remarks.

William H. W. Crawford, IV
President, CEO & Director, Rockville Financial, Inc.

Okay, this is Bill Crawford. I want to thank everybody for joining us. One correction we wanted to make is in the number of hires we've had year-over-year, I think on the call I had said, 61 that's not correct, the right number is

38 of that new employees year-over-year. But we thank you for your interest and anytime we can handle any questions or concerns please contact us directly. And I hope everyone has a great day.

Operator: Thank you. The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.