ROCKVILLE FINANCIAL
"Rockville Financial Third Quarter 2012 Earnings Conference Call"

Friday, October 26, 2012, 10:00 AM Eastern
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OPERATOR: Hello and welcome to the Rockville Financial third quarter, 2012 earnings call. All participants will be in listen-only mode. Should you need assistance please signal a conference specialist by pressing the star key followed by zero. After today's presentation there will be an opportunity to ask questions. To ask a question you may press star then one on your touchtone phone. To withdraw you question please press start then two. Please note that this event is being recorded. I would now like to turn the conference over to Marliese Shaw. Please go ahead.

MARLIESE SHAW: Thank you, Amy. Good morning everyone. Welcome to our third 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 third quarter earnings as well as announced earlier this week that the company will be hard freezing its pension plan. This morning I will review some of the highlights of the third quarter and will discuss the actions related to the pension plan. 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; Mark Kucia, our head of Commercial Banking; and Eric Newell, our Director of Treasury; and Marino Santarelli, our Chief Operating Officer who was instrumental in our development of the mortgage banking business.

I'm very pleased to announce that Rockville reported its highest quarterly earnings in the company's 154-year history, $4.7 million or $0.17 per share. Return on average assets for the quarter was 97 basis points. The big story this quarter is mortgage banking. We are transitioning from a traditional model to a hybrid that incorporates advantages of dynamic secondary market capabilities. The company's been working hard to transform this business line and it continues to develop and achieve process improvements.

Rockville hired twelve mortgage loan officers and sixteen mortgage underwriters and processors this year, which contributed to both the significant increase in production and the mix of that production. Mortgage production increased 241 percent in the last year resulting in production volumes over $80 million in each of the last two quarters compared to $24 million in production in the third quarter of 2011. Furthermore, the addition of mortgage loan officers into the business model introduces the opportunity to develop relationships with local realtors in order to grow purchase mortgage production. This quarter's mortgage production included $32 million of purchased mortgages as compared to $9 million in the prior period, a 272 percent increase in this important source of application volume.

The quarter's results not only reflect this changing business model, which enhances production but also reflects especially wide margins on sales of loans in the secondary market over the last quarter. The company was in a position to take advantage of favorable market opportunity because of the infrastructure it had put in place during the year. Gains from sales on loans total $2.5 million in the third quarter, 101 percent higher the company's next highest quarterly gains.

While the company's pleased that mortgage banking is now a core line of business and the financial results reflect this strategy, it's important to remember that mortgage banking income is volatile and gains on loan sales will not only vary depending on application volume but also on market spreads. In addition to the organic growth in residential mortgages I'm also pleased to share with you, this morning, the positive results of the recently released FDIC summary of deposits. Rockville increased its deposit market share in the state of Connecticut during the twelve months ending June 30, 2012, and moved up in rank in the state to twelfth position from fourteenth position. The company increased market share in each of the counties it operates in, and the results reflect an increase in market share in all but one of the company's branch locations. The company continues to hold the number one or two position in each of its seasoned markets.

While organic growth is an important focus of Rockville so too is profitability. The company achieved record quarterly earnings despite a 37 percent increase in year-over-year operating expenses. Of note, the third quarter of 2012 included some expenses that are not anticipated to continue at the same run rate in the future. The pension plan is a good example of this. The company announced earlier this week that it will be hard freezing its defined pension plan as of December 31, 2012. Interest rates at historic lows have led to significant increases in the expense and widening of the pension liability. This action will limit future growth in the pension liability and the uncertain financial impact the plan includes. Hard freezing the plan this year is expected to decrease pension expansion by approximately 1.1 million dollars on an annual basis.

At Rockville we remain being committed to shareholder return and to executing on sound capital management principles. We're delighted to announce that our 26th consecutive quarterly dividend provides an 11 percent increase to $0.10 per share. That is a 3.37 percent annualized dividend yield to our shareholders based on the average closing price in the third quarter. We also executed 46 percent of our stock buyback program as of September 30, 2012. We recognize that we're operating in a difficult environment for banks with asset yields continuing to decline and pressuring margins. At Rockville we will always work thoughtfully and in the best interest of shareholders to carefully navigate through these challenges without compromising our core values.

I'd like to personally thank our investors for their confidence in our company. The company will continue to make investments in its infrastructure in order to manage long-term shareholder return and build franchise value. At the end of last week our total shareholder return year-over-year was 41 percent compared to the SNL thrift index of 25 percent during the same time period.

At Rockville we remain focused on creating prosperity for our customers and communities and wealth for our shareholders. At this time I'm going to ask John Lund, our CFO to provide some further detail on the quarter's results.

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

As Bill indicated the company reported record quarterly earnings. Net income for the quarter ended September 30, 2012 of $4.7 million or $0.17 per share is largely reflective of the company's expansion of the mortgage banking business. Net gains from sales of loans were $2.5 million in the third quarter of 2012, an increase from $44 thousand in the prior quarter and $405 thousand in the prior year period. This is a 101 percent increase over our next highest quarter when the company reported $1.3 million of net gains on loan sales in the fourth quarter 2011.

Timing of the application process was such that $63.6 million of residential mortgage loans were sold into the secondary market in the third quarter and $1 million were sold in the second quarter. The bulk of the loans sold in the third quarter were from third quarter production while most of the remaining loans sold were from first and second quarter production. While production increased significantly, 241 percent, the company also benefited from market spreads, which were incredibly wide during the quarter. The loans sold during the third quarter in 2012 realized net gains of about double those sold during the third quarter 2011.

We are pleased with the progress Rockville has made in this business line and look forward to incorporating continued process improvements to drive production and product delivery. We are cognizant however that the market spreads realized in the third quarter were exceptional and we recognize the potential for spreads to narrow over time.

The financial results also reflect the company's continued focus on decreasing the cost of funding across all sources. Despite a $34 million increase in average interest-bearing deposits net income expense declined $102 thousand on a linked quarter basis and decreased by $1.1 million or 28 percent year-over-year. The primary driver of the decrease in interest expense is the five basis point decline in the cost of interest-bearing deposits during the quarter to 0.69 percent from 0.74 percent coupled with the $41 million increase in the average balance of low-cost core deposit accounts.

At Rockville we thoughtfully price deposits in consideration of both the competitive and interest rate environment while continuing to foster deposit relationships that are not necessarily price driven.

The net interest margin was influence by the decline in the cost of funds but also by the decline in loan yields and decreased to 3.8 percent on a tax equivalent basis for the quarter from 3.87 percent in the prior quarter. However, the margin improved from 3.7 percent during the same quarter in 2011. On a linked quarter basis the average loan yield declined 15 basis points to 4.64 percent from 4.79 percent in the second quarter. Also the average yield of available for sale securities declined 13 basis points to 3.42 percent in the third quarter from 3.55 percent in the second quarter. Net interest income has benefited from the continued organic growth in both loans and deposits primarily attributable to the company's commercial banking expansion and mortgage banking business development.

Despite selling $82 million of residential mortgages into the secondary market year to date, net loans have increased by $73.2 million or 5.0 percent during 2012 to $1.53 billion, contributing to a 7.9 percent annualized growth rate and a 6.5 percent compound annual growth rate over the last five years.

Deposits have increased by $150.4 million or 11.3 percent during the year to $1.48

billion contributing to a 15.1 percent annualized growth rate and a 9.2 percent compound annual growth rate in that portfolio over the last five years.

Based on the near term economic outlook and the FOMC's intention to maintain a low rate environment for an extended period we acknowledge that growing or maintaining margins will be a 2012 and 2013 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. While we certainly cannot predict future interest rates we constantly strive to maintain relative neutrality in our interest rate risk sensitivity position.

Regarding non-interest expenses on a year-over-year basis the $3.9 million or 36.9 percent increase was primarily concentrated in salaries and benefits expense. This $2.3 million or 38 percent increase is reflecting higher staff levels related to the investment the company's making in its human capital and infrastructure to prepare for future growth. Forty-five fulltime equivalent employees were hired throughout the 12-month period ending September 30, 2012; 28 of which were in the mortgage banking business line. Additionally included is the impact of the June 2012 stock awards to officers, which reflects a $455 thousand increase in benefits expense. Also, as Bill indicated earlier, the increased cost of funding the company's pension plan has been a contributing factor to the increased benefits expense year-over-year. The pension expense in the third quarter 2012 of $430 thousand was a $236 thousand or 121.1 percent increase over the third quarter 2011.

For 2013, it is expected that the incremental decrease in pension expense net of the cost of additional 401k plan expenses will approximate $1.1 million and continue to diminish over time based on current modeling. Further, it is expected that accumulated other comprehensive income will see a slight improvement of approximately $1.5 million at year end 2012, and is projected to continue to improve as the future pension liability is now capped.

To conclude, we are pleased with the strong operating results for the quarter and the continued organic growth the company is experiencing. 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 added to its interest rate hedging portfolio. Eric Newell, our Director of Treasury will now provide further detail on that strategy.

ERIC NEWELL: Thank you, John, and good morning. During the third quarter the company entered into its second 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 derivatives are to manage its exposure to interest rate movement. To accomplish this objective the company intends to use interest rate swaps as part its interest rate risk management strategy. As of September 30, 2012, the company had two outstanding interest rate derivatives with notional values totaling $75 million. Both were designated as cash flow hedges of future variable rate funding whereby the company will receive quarterly adjustable payments of three month LIBOR and will pay a quarterly fixed payment.

At this time Mark will provide some further detail on the company's commercial banking business.

MARK KUCIA: Thank you, Eric, and good morning everyone. During the first nine months of 2012, commercial real estate loans grew by $47 million or 8.0 percent, and C&I loans grew by $27 million or 19 percent. Total year-to-date commercial loan growth was $74 million or 10 percent. The pipeline is robust and we expect the historical trend of strong commercial loan growth to continue. I would note, however, that currently the commercial loan environment is extremely competitive, which will impact production opportunities as we go forward. Typically in an extremely competitive environment pricing is compromised first and then loan structure or credit quality. Rockville will continue to maintain the credit disciplines and principles, which have provided strong loan growth and excellent asset quality over the years.

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

SCOTT BECHTLE: Thank you, Mark, and good morning everyone. Rockville's asset quality remains strong and is top amongst its peer group by nearly every performance metric. Net charge-offs to average loans outstanding at September 30, 2012 was effectively zero percent and is nominal at 0.04 percent for the year-to-date. Total nonperforming loans to total loans was 0.91 percent and total nonperforming assets to total assets was 0.85 percent.

The allowance for loan losses was increased by $776,000 during the third quarter to $18.1 million. At September 30, 2012 the ratio of allowance for loan losses to nonperforming loans was a very comfortable 128.93 percent and the allowance for loan losses to total loans was 1.17 percent.

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

OPERATOR: To ask a question you may press star then one on your touchtone phones. If you're using a speakerphone please pick up your handset before pressing the keys. To withdraw your question please press start then two. Again, that's star then one if you would like to ask a question. And our first question comes from Mark Fitzgibbon at Sander O'Neill.

MARK FITZGIBBON: Good morning and thank you for taking my question.

BILL CRAWFORD: Hey Mark, good morning. This is Bill Crawford.

MARK FITZGIBBON: Hi, Bill. The first question I had was on the tax rate. It looked like it was a little lower than what we've seen in past quarters. I know you've added to the muni book. Is 26 percent you think sort of the new run rate for the effective tax rate?

BILL CRAWFORD: Let me have John Lund give you some detail on that, Mark.

JOHN LUND: Good morning, Mark, and thank you for your question. Yeah. We had a slight adjustment to the tax accrual in the quarter. I think a more normalized effective tax rate for the company is probably around 30 percent. So …

MARK FITZGIBBON: Okay. And then, secondly, I wondered if you could maybe give us your thoughts on the margin as we look ahead into the fourth quarter. Do you think that given the remixing you're doing and the dynamics you're seeing with deposit re-pricing do you think you can hold the margin relatively stable?

JOHN LUND: Generally speaking, yes. I mean, we have said before that we did expect it to drift a little lower. It did on a linked quarter basis. I think our continued efforts to grow our organic growth in deposits coupled with continuing to build the revenue side will benefit the margin. But could it drift a little lower? Possibly, and from a tax equivalency basis I think we've really taken that on the portfolio side as far as we can.

MARK FITZGIBBON: Okay. And I think that you had said that the loan pipeline was robust. Could you give us a sense for how big that was and what the mix of it looked like?

BILL CRAWFORD: Yeah. Mark, you want to comment a little bit on the commercial pipeline?

MARK KUCIA: Yeah. In terms of the pipeline right now is very strong, the commercial pipeline. We have historically grown commercial double digit while maintaining excellent asset quality. And based upon the pipeline levels that we're seeing we expect that to continue.

MARK FITZGIBBON: And then lastly, based on what you said about the … capping the pension expense there, maybe flattening of the hiring, do you think non-interest expenses are relatively stable or are we going to still see some growth here in the near term on that line item?

BILL CRAWFORD: Mark, let's see. I think we gave some pretty specific information on the pension and how that'll impact 2013. In this quarter Q3 we did have about a million dollars of expenses that were around pension expense, consulting, recruiting. So we had about a million dollars of softer expenses in there as we build out mortgage and build out some other areas in the company. We also had debit card losses up in the $200,000 range for the quarter, which we would hope that would be an aberration. So we expect to continue to hire in commercial banking, in mortgage banking. But you can see we've got some softer expenses that we believe have the opportunity to go away in future quarters.

MARK FITZGIBBON: Okay, great. Then lastly on acquisitions I wondered, Bill, if you could maybe share with us what you're seeing out there in the M&A market? Are there opportunities? Is that a sort of priority for you right now?

BILL CRAWFORD: We're cautious with that, Mark. Like we sort of talked about before the challenge is sellers' expectations on price, where we trade, trying to get something done with a reasonable tangible book value payback period is difficult right now. So we're principally focused on growing organically and then we want to be thoughtful about capital management.

MARK FITZGIBBON: Thank you.

BILL CRAWFORD: Thanks, Mark.

OPERATOR: Our next question comes from Travis Lan at Stifel Nicolaus.

TRAVIS LAN: Thanks. Good morning, guys.

BILL CRAWFORD: Hey, Travis.

TRAVIS LAN: Couple questions on mortgage banking. Can you just give us …. do you have what the gain on sale margins were during the quarter?

JOHN LUND: Yes. Roughly in the quarter they were north of 300 basis points. As we said, they were exceptional. Certainly timing played a part of that. But I would say north of three is a reasonable range.

TRAVIS LAN: And can you talk a little about how your mortgage employees are compensated? In other words, is it commission salary? Or is it fixed expense? Just a little more detail on that.

BILL CRAWFORD: Sales people are basically commission and very small on the salary. And then, obviously, processors and underwriters would be salary.

TRAVIS LAN: And then how are these mortgages being sourced? Are these all coming out of the branch? Or is there some other additional marketing effort or …

BILL CRAWFORD: We used to originate mortgages out of the branch. Now what we do is we've hired twelve mortgage loan officers. Typically they have very strong relationships with realtors in the community and they get work referrals from our branches. So we're really changing how we source this business. And it'll become a new client acquisition tool for us. But we're really pleased with the talent of the mortgage lenders that we've recruited and our processing underwriting staff.

TRAVIS LAN: Yeah. So that was kind of the next question, is it you can use this as a tool going forward to kind of bring new customers into the bank in an attempt to cross-sell them on additional products? Is that kind of the way that you think about it a little bit?

BILL CRAWFORD: Absolutely, absolutely. Some of us come from Wells Fargo. And Marino Santarelli, our Chief Operating Officer, who is instrumental in driving this, And if you study Wells Fargo that's one thing they do very, very well is they use mortgage for new customer acquisition. And that's what we want to do. And we're very pleased that our purchase business was so much stronger than it's historically been. Because, obviously, the refinance business is great while you have it but ultimately if you really want to be good at mortgage you got to be really good at the purchase business. And that's where our focus is.

TRAVIS LAN: Just a couple more. Do you have a sense for what you think the capacity is for mortgage banking in terms of either quarterly loan production or even revenue, if you just have some idea?

BILL CRAWFORD: We are so early stage in really building that business that I would really hate to throw numbers out there. The other thing about it is the gain on sale is so high right now …

TRAVIS LAN: Right.

BILL CRAWFORD: Refinance activity is so high. Clearly it's a volatile business. The way we think about this it's sort of what ranges might we operate in, in terms of revenue. Because, obviously, refinance activity and spreads are going to really dictate what that ultimate revenue line looks like. And we would look to significantly grow our share. If you looked at us in 2011 we had $146 million, I think is the number that SNL has us down for. Obviously we're on a run rate to substantially improve upon that number.

TRAVIS LAN: Maybe a question for you, Mark. Do you think that the market offers enough potential growth for you guys to offset the lower yields and kind of stabilize net interest income dollars? Is that a goal? Or do you think …

MARK KUCIA: Yeah. Well, right now, in terms of bringing on new customers, et cetera, there is no economic growth to finance. Companies are building inventories, et cetera. So it's a game of market share. So we have brought on a team, as you know, down in New Haven. That will continue to be our strategy is to recruit top bankers, most likely from larger institutions that can bring over their book and increase market share. So we expect to continue to have success with that going forward. There is a lot of pressure on yields though. I mean, that is clear. It's a hyper-competitive environment out there.

TRAVIS LAN: All right. And then, just finally, obviously, buyback activity was lower in the quarter with, I assume, the run in the stocks. Could you just a sense for what your appetite is to buy back the stock at a premium to tangible book as something you want to avoid entirely? Just kind of any additional color on the buyback would be helpful.

BILL CRAWFORD: Sure. I think the good news is we're 46 percent through our 10 percent authorization. And we want to be patient and thoughtful with that. But we certainly expect to complete that 10 percent buyback authorization within a reasonable time period.

TRAVIS LAN: Okay. Thank you very much.

OPERATOR: Again, if you'd like to ask a question, you may press star then one on your touchtone phone. Our next question comes from Damon Delmonte, at KBW.

DAMON DELMONTE: Hey, good morning guys. How are you?

BILL CRAWFORD: Hey, Damon. Good, good.

DAMON DELMONTE: Just one more follow-up question on the mortgage banking. I know there's been a lot discussion on that so far this morning. How do rate your pipeline this far through the fourth quarter versus where it was in the third quarter? Like are you seeing a comparable level of that activity?

BILL CRAWFORD: It's consistent. And we continue to have strong pipeline and strong application volume.

DAMON DELMONTE: Okay. So I guess the success in the fourth quarter can, in part, be dictated by the gain that you're able to get on the sale of those loans.

BILL CRAWFORD: Yeah. Remember about the third quarter though, Damon, we had some timing differences there. And, you know, I think Q3 was a very exceptional quarter for us.

DAMON DELMONTE: Okay, great. My other question is, I mean, you guys have made a lot of commercial banking hires throughout the state, particularly down in the New Haven area. What's the thought process around putting up some physical locations in the New Haven area? Do you think you need to have a handful of branches down there? Or do you think you could essentially locate the bankers and they can work from there?

BILL CRAWFORD: We are absolutely looking at sites in New Haven County. We're very excited about the progress our commercial team is making down there, our mortgage bankers are making in that area. So we're in the process of evaluating that currently.

DAMON DELMONTE: Okay. And then, my last question, obviously you're managing capital, you just raised the dividend and you're buying back shares, but have you given any thought to a special dividend by year-end, especially with the potential change of tax rates in 2013?

BILL CRAWFORD: Damon, we're always vetting ideas around how we can be effective in capital management. And we've certainly batted that around too. But no decisions made yet.

DAMON DELMONTE: Okay. That's what I had. Thank you very much.

BILL CRAWFORD: Thanks, Damon. Appreciate it.

OPERATOR: Once more, if you'd like to ask a question you may press star then one. This concludes our question and answer session. I would like to turn the conference back over to management for closing remarks.

BILL CRAWFORD: Okay. Well, thank you everybody for joining us on the call. Obviously, we were very pleased with the quarter. We're very excited about our company's prospects. Any time you have any questions or anything feel free to give us a call directly here at Rockville. Hope everybody has a great weekend. Thanks.

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