BRANCHING MANIA

by Steve Brown

As of the end of June 2006, the FDIC reported there were 80,495 branches across the nation. Branch growth shows little sign of letting up, as the need to bring in cheaper deposits is now more critical than ever. In fact, almost every bank more than 3Ys old that we have visited recently, said they have plans to open at least one branch this year and one next year. Given that most branches need to attract at least $12mm of new deposits (at or below their current cost of funds), over a 3Y period of time to be profitable, many banks will struggle with branch profitability. By looking at data of branches that opened fairly recently, less than 20% of these could be considered clearly successful. A full 50% of these new branches fell into a middle category that it is difficult to tell and 30% are draining profitability, as they have less than $8mm of deposits. In attempting to discern what demographic factors lead to a successful branch, we found it interesting that none stood out, despite reviewing more than 20 different variables - such as regional disposable income, branches per household, population growth, etc. While high growth and favorable demographics surely help, the strategy has two things working against it. The first is competition. Since most banks analyze the same demographic data when deciding on location, most branch models reach the same conclusion. Those areas that are deemed "under-banked," usually end up being "over-banked" within a 4Y period of time, hurting everyone's path to profitability. Las Vegas, Phoenix, Chicago and Atlanta are all prime examples where most banks looked at static models, not factoring in increasing future branch competition. The second factor explaining new store success is the fact that branching alone does not generate greater net interest income. In our opinion, even more important to branch location is a bank's "value proposition." If a bank does not have, and articulate, a reason to share a customer's wallet, then branching will only serve to add overhead cost. Independent banks that have consistently produced successful branches all have a "message" that they deliver. These range from superior customer service, a specialty such as wealth management, to knowledge of a particular industry such as unions, physicians or technology. The best location in the world won't help a branch strategy, as the area will soon be over-banked and the branching bank will once again have to compete on its value proposition. A poor location and a great value proposition are always better than a great location and a poor value proposition. Before investing in more infrastructure, top performing banks would do well to examine how their value proposition stacks up against current and potential future bank competition in a given area. Doing so not only helps protect the branch investment, but also helps define the probability of success. After looking at all the demographic data, the best predictor of future branch success, is past branch openings. Management that has a string of successful de novo branches is 70% more likely to repeat that success in the future - no matter what the location.

BANK NEWS

Rating Help

The Credit Rating Agencies Reform Bill of 2006 was passed unanimously by the Senate and now gets reconciled to the passed House bill. Should it become law, which it is expected to do by early next year, would all for more "nationally recognized rating agencies" and help break the duopoly that both Moody's and S&P enjoy. This is expected to be positive for banks, as the cost of ratings should be reduced with better feedback for those that are applying for ratings. By our estimation 10% more banks will be able to garner an investment grade rating to help with their funding strategy.

Home Equity

According to the Fed, Americans pulled out a mere $497mm in home equity during 2Q of 2006, the lowest amount in the last several years. In addition, homes that had home equity take cash outs, appreciated at the slowest percentage at 4.4% since 2002. On the good news front, owners retain 54.1% equity in their existing homes, a percentage that has largely been constant.

Bankruptcy Lending

Interstate Bakeries, the home of the Hostess Twinkie and Cup Cake, is suing 110 lenders for the $250mm of interest that it paid during the preference period before filing bankruptcy. The company claims it was insolvent and the payment should be part of the bankruptcy.

Less Charging

The FRB said consumer credit increased by a smaller-than-expected $5.5B in July, as consumers borrowed less. Revolving credit (credit cards) climbed at a 3.4% annual rate in July, following a 13.2% jump in June. Meanwhile, the non-revolving side of the ledger (loans for cars, boats and education) rose at a 2.50% annual rate.