SWINGING FOR A NEW BRANCH

by Steve Brown

In a recent golf magazine, we came across an ad for a "Ballistic Driver." You place this swing-less club next to the golf ball, pull the trigger and a spring loaded metal plate contacts the ball. Upon impact, the ball is propelled "250 yards, every time, down the middle exactly where you aimed it." This is a major breakthrough in the world of athletics, as having to actually hit a golf ball is a distraction. We love driving the cart; we love the shoes; and we love saying "Fore" - but we always felt hitting the ball created more frustration than need be. The ease of the Ballistic Driver got us thinking about the ease of which some banks make the decision to open up new branches. In the last 2Ys, the economics for branch opening have changed, so banks might want to rethink their expansion decisions. While branching is still important, in our opinion, it has been dramatically reduced by the advent of imaging, remote capture, advanced ATMs, profitability systems, more sophisticated marketing, optimizing sweeps and online banking. At present, the national average is 3.2 branches for every 10k persons and by our estimates, that number should be closer to 2.0. In a review of several de novo banks that adopted current bank technology from the start, branch traffic is approximately 60% less than that of legacy banks. This is not to say branching is dead, just that it will become more efficient. To thrive in the current environment, banks must reduce branch efficiency ratios below 35%. This can be done in two ways. 1) Having regional banking hubs, spoked by multiple LPO offices and augmented by deposit technology. This will allow banks to reduce the number of branches required by more than 30%. 2) The other alternative is to keep the branch numbers high, but reduce the footprint and expense base of each branch. Instead of investing $1mm+ in fixed costs and $600k in annual operating expenses, capital is now more efficiently used leveraging technology, enhancing marketing and developing a sales-oriented culture. Branches need to produce a 17% or better risk-adjusted (that is adjusted for direct/indirect costs, loan credit risk, operations, robberies, pilferage, etc.) return on capital in order to be accretive. Traditionally (as in during the 1990's), this would require the old 25-25-25 rule. Banks would need to produce some combination of $25mm in loans and $25mm of deposits within 25 months of opening. Now with higher real estate costs, greater operational costs (compensation), more branch competition and thinner margins, the breakeven for a traditional branch is now closer to a 55-55-55 rule. An efficient branch leveraged with technology, can reduce its average size to approximately 3,500 sq. ft and breakeven with just $15mm of loans and deposits. We have seen both branch strategies work effectively and the choice between the two really depends on a bank's market, orientation and demographics. After reviewing the profitability reports on more than 300 branches in the past month, we can tell you that traditional branching cannot sustain itself at the current pace. While swinging a golf club at a little white ball is a risky proposition, it is an essential part of the game. Since branching is essential to banks, addressing your stance may prevent your branch rollout from landing off the fairway.

BANK NEWS

M&A

Southern Michigan Bancorp ($330mm, MI) will acquire FNB Financial Corporation ($151mm, MI) for about $26mm or 2.1x book. The acquisition adds 8 branches.

Ag Growth

Despite strong competition from larger national institutions, small agriculture-focused banks have been experiencing steady growth. Last year, total assets for these banks grew 7.3% and the average ROA was 1.04%. Non-agriculture banks were at 1.01% ROA.

Leaving the Market

First Horizon ($39B, TN) said it will no longer fund subprime mortgages. Subprime loans make up about 2% of the company's loans.

Bill Pay

A recent survey by CheckFree found that consumers with internet access now pay 39% of their bills online. This is the first time that a survey found that more bills are paid on line that via mail or in person.

And the dominos start to fall

Subprime default problems are thought to be spreading to the Alt-A mortgage sector. Several Alt-A lenders have reported trouble in this market and late payments were 2.6% in January, up from 1.3% the previous year. This spillover contradicts what many economists have been saying about subprime woes not affecting other markets.

ID Theft

Zogby Interactive gives us another survey to support the premise that bank customers are concerned with ID Theft protection. The survey found 91% of the respondents are concerned about having their ID stolen and 34% said banks, retailers and finance companies are not doing enough to safeguard their personal info. Then again, many respondents said that they were not doing enough to help themselves, as 29% said they never read privacy statements and 32% said they only "sometimes" read them.