PART 1 OF 3 Â– A HEART OF STEEL

by Steve Brown

HEART OF STEEL:

Those looking for an example of an industry shakeout that took over a decade to play out with devastating effect, consider the integrated steel producers (ISPs) in the United States. About 25Ys ago U.S. Steel, Bethlehem, Wheeling-Pittsburgh and National, dominated the steel industry. Approximately 10Ys later, the industry had been witness to multiple bankruptcies, consolidation and sale to foreign producers. While the reason for the shakeout is simple, the explanation is complex (but that's always the case in hindsight). In short, steel producers failed to establish a differentiated, sustainable strategy to thwart a changing competitive environment. The reason a differentiated, sustainable strategy was crucial at that point in time was primarily because of three major competitive forces: 1) Electric Arc Furnace mills (Mini-mills), which have significant cost advantages over ISPs 2) high wage costs, and 3) the enormous legacy retirement and health care costs not carried by either foreign ISPs or U.S. Mini-mills. To us, the most interesting concept in the shakeout was that management at ISPs never considered Mini-mills as the competition. Board minutes and interviews demonstrate that senior management convinced themselves for years that they were not competing directly with anyone other than ISPs. Management did not understand the competitive forces at play within their own industry (in many cases the very same industry they helped create a few decades before). Although the ISPs could no longer compete effectively in this new environment, none were willing to make the difficult but necessary strategic decision that would potentially allow them to do so: change their core competency. Over the past 20Ys, 70% of the U.S. ISPs have disappeared and over 10k employees have lost their jobs. Is there a parallel in the banking industry? Indeed there is. In 1993, FDIC-insured banks under $10B in asset size held 63% of all domestic loans. At that time there were only 64 banks larger than $10B and they held the remaining 37%. Since then, the percentage of domestic loans held by banks under $10B has been steadily declining Â– particularly over the last 15Ys. As of June 2007, in fact, banks under $10B held only 28% of all domestic loans (down from 29% in 2005, 33% in 2003, 41% in 1998 and 63% in 1993). As a side note, the percentage decline is the same for banks under $1B in asset size as for those that are $1B to $10B. Furthermore, the above numbers are a gross inaccuracy of the loan market, as the data speaks only to bank loans and does not consider securitized loans (CMBS), foreign bank loan origination or alternative-lender loans (GE Capital, CIT, insurance companies and others). But the purpose of this article is neither to recite Harvard Business School studies on the steel industry nor cover esoteric market share data. Instead, we would like to outline how the community banking industry can avoid following the steel industry. The answer lies in how each bank defines its core competency. If a community bank defines its major strength in a way that is fundamentally undifferentiated from its competitors (i.e. "a commercial lender"), then that bank is dealing in commodities (not dissimilar to steel). A better strategy is to differentiate products and couple that with intelligent use of marketing. This will help a bank fine-tune its core strength and improve focus on offering products and services that can overcome an onslaught of competition. In tomorrow's publication we will outline how banks should perform strategic marketing analysis to define their products and positioning.

BANK NEWS

M&A

First Defiance Financial ($1.5B, OH) will acquire the HC of Bank of Lenawee ($290mm, MI) for $55.7mm, or about 1.8x book. The move expands Defiance's geographic market and adds 8 branches to its network.

M&A

Shore Bancshares ($928mm, MD) has acquired 2 regional insurance agencies for an undisclosed sum.

M&A

Huntington ($36B, OH) will acquire a regional insurance agency that sells personal and commercial insurance.

Rural Loans

The SBA is testing a new program that is aimed at encouraging community banks and credit unions to make more government-guaranteed loans in rural markets. The program will be tested in 6 states (CO, MT, SD, ND, UT, and WY) and will feature a streamlined application process for loans less than 350k; a turnaround time of 3-5 days on routine loans; an 85% guarantee for loans less than 150k; and specialized assistance for lenders on complex eligibility issues.

Credit Quality

A recent community bank analyst report projects credit quality will be a major issue in Q3 earnings reports. The report predicts that nonperforming assets as a percentage of loans will rise 3 to 5 bps. In addition, the report noted that delinquency trends have spread beyond mortgages and are now affecting credit cards, student and auto loans, and other consumer-related areas.

Payment Comp

MoneyGram reported that it agreed to purchase PropertyBridge that specializes in setting up rent payments online via ACH in order to make renters, management companies and mortgage lenders more efficient. In separate news, CardIt said it would begin processing mortgage payments via credit card.