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A top banking performance challenge is dealing with impaired branch capacity. A strong market context will be needed in exploring ways to avert closures "at total loss."

Avoiding Branch Fatalities

BY DAVE KAYTES AND KEVIN TRAVIS

Do banks face a hopeless situation with failing branches? It is a pressing question as the industry gears up for 2012. Everywhere you look, networks are being dragged down by branches that were crippled during the recession and may never recover.

Based on a recent Novantas study of the entire U.S. branch system, nearly 16,000 units are facing closure over the next three years. Representing about 18% of the industry total, these "zombie branches" simply are not doing enough business to justify their existence, and the chances of revival are slim to none under current ownership.

Many banks have put off questions about branch closures, hoping that interim cost cuts would tide them over until market conditions improve. But even under optimistic market growth scenarios, our analysis offers little hope for today's crop of zombie outlets if they try to continue under present circumstances.

One immediate implication is a rising pace of U.S. branch closures. Yet the situation is not hopeless. Instead of shuttering outlets "at total loss," we estimate that roughly 11,000 of the impaired branches, or two-thirds of the total, could be salvaged by transferring them to better-managed banks and more solid local networks.

Nationally, about three-fourths of all local markets are in need of branch consolidation. The major options include in-market mergers; spinoffs of various local networks; and targeted sales of individual branches.

All of the options depend on a clear understanding of local market opportunity and the role of network presence in winning customer patronage. Area networks perform best with adequate density of coverage, and this "density factor" will be a critical guide in helping acquirers to optimize customer share of market.

It will take time to sort through the options and deal possibilities. That is why banks will need interim strategies to slash overhead at zombie branches. Quick moves include adjusting staffing levels and hours of operation, based on an understanding of emerging customer transaction patterns and preferences for service.

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CONSIDERING THE OPTIONS

From a strategic perspective, the most aggressive option for dealing with zombie branches is in-market consolidation, where a bank buys smaller and/or weaker competitors purely to grow customers and reduce distribution capacity within the current network footprint. There have been few such transactions in recent years. However, within the 75% of U.S. markets where we expect to see significant net branch consolidation, at least 55% have regional or super-regional banks which could be candidates for merger-based consolidation.

The second option is to identify entire markets for exit, for example, large city markets where the bank's network does not have adequate heft, or small rural markets where the bank is unable to earn a hurdle rate for branch investment. Time is of the essence in making such decisions. Given the ongoing deterioration in troubled branches, the longer the bank waits to exit a market, the less value the local network will bring.

The third option is to pursue targeted branch sales, an avenue that could be especially useful for smaller banking companies that need to retrench around a core market and customer base. Our analysis indicates that super-community and community banks have especially high percentage concentrations of impaired branches – 25% or higher in many cases – creating an especially pressing need to avoid closures at total loss.

After all other avenues are exhausted the fourth option is to close the "No Regrets" branches (units that may never meet the parent company's hurdle rate) in all markets. These could include marginal branches in low opportunity markets and isolated branches in good markets. Closures could also extend to de novo units opened as part of the recent real estate boom in branching, which will never achieve breakeven based on current forecasts of deposit growth and customer profitability.

Nationally, the performance drag posed by failing branches has been masked by a trend of improving credit quality, which has put earnings reports on steroids as banks slashed loan-loss provisions. But the peak benefits of this trend soon will be exhausted, fully exposing the industry's lackluster revenue dynamics and cost challenge of maintaining impaired branch network capacity.

Where some banks will go wrong, however, is in sweeping network cuts that only consider individual branch profits. Our national research continues to show material performance benefits for branches that operate within solid local networks, which offer more convenience for customers and carry more brand impact.

This local market perspective not only provides a much stronger context for decisions about necessary branch cuts, but also will be essential in crafting merger and spinoff transactions that will help to avert closures "at total loss."

Dave Kaytes is a Managing Partner and Kevin Travis is a Partner at Novantas LLC, a management consultancy headquartered in New York City.

NOVANTAS
www.novantas.com

New York City / 212-953-4444
485 Lexington Avenue
New York, NY 10017

Chicago / 312-924-4444
311 South Wacker Drive
Chicago, IL 60606

Toronto / 416-642-3091
40 King Street West
Toronto, Ontario M5H 3Y2

Boston / 617-342-7312
175 Federal Street
Boston, MA 02110

Madrid / +34 (91) 702-4792
c/Fernández de la Hoz 33, 5° Planta
Centro Derecha Madrid, 28010 Spain