

Multi-channel M&A: **WHERE DO BRANCHES FIT?**

BY KEVIN TRAVIS

In-market acquirers typically rely on back office and branch combinations for savings to off-set takeover premiums. They also look for pricing power as they bulk up in local markets. In other cases, acquirers seek geographic market expansion.

These familiar merger concepts assume that branches are the core of franchise. But these former stars of the show are being relegated to more of a supportive role in retail banking. Novantas research suggests that up to a fourth of all supposed branch customers actually transact the majority of their

Familiar merger strategies are becoming obsolete as branch networks transition to a more supportive role in retail banking. As the retail banking revenue drought drags on, regional players face growing pressure for another round of merger-based consolidation. Based on a recent Novantas analysis of the U.S. branch system, roughly 16,000 outlets or 18% of the current total, will either need to be closed or reworked within the next three years in order to remain efficient. Traditional merger models will prove insufficient to meet this challenge. Beyond deal factors are critical issues of location, configuration, staffing and relationship building in alternative channels.

banking business through remote channels, including online, mobile, call centers and automated teller machines, and at least 20% are “thin network ready,” caring about branches but rarely using them.

This profound customer migration is accelerating, and has serious implications for merger strategy in 2012 and beyond. Banks will need to reconsider the entire branch decision chain — including what they are worth.

Traditional networks are in danger of becoming wasting

assets. It is not clear that acquirers and their investment bankers have factored this trend into valuation models.

Beyond deal factors are critical questions about repositioning branches for a very different future, including how location, configuration, staffing and relationship building through alternative channels. Acquirers will need a strong multi-channel vision for the merged entity, backed by appropriate developmental resources and an innovative sales and service culture.

From this multi-channel perspective, a regional merger could begin life with a serious competitive handicap if the predecessor companies had not already started transforming their networks. There still would be initial cost savings from capacity reduction, but the merged entity would be forced to spend heavily to catch up elsewhere, while facing an extended disadvantage in winning customers and building revenues.

There are three major steps that potential acquirers should take. The first is assessing the growing base of “virtual customers,” both in the current and target network. The second is identifying and aggressively addressing any competitive gaps in multi-channel capabilities. The third is incorporating these factors into decisions about the post-merger branch network.

CUSTOMER MIGRATION

Novantas research shows that in the realm of everyday banking transactions, the center of gravity is clearly shifting away from the physical branch. Consumers frequently roam between distribution channels to fulfill their banking needs.

Based on our national survey, for example, 70% of consumers first go online when researching banking products and services, up from 42% five years ago (Figure 1). The internet is now the favored channel for reviewing deposit balances among 68% of consumers, up from 40%. Consumers increasingly look beyond the branch for financial advice as well, with 35% of survey respondents saying they first turn to the online channel or to the call center.

When transferring funds, 60% of consumers primarily use the online channel, twice the rate of five years ago. Up from 19%, 26% now primarily use ATMs for depositing funds. Various flavors of online deposit also have gained popularity, with 15% of consumers now saying they prefer channels such as automated clearinghouse transactions, person-to-person payments, and remote deposit capture.

Consumers are also making greater use of mobile channels for basic banking services, such as account information and balance transfers, strengthening the tilt away from branch-delivered basics. More than a third of consumers now have smart phones.

These trends have significant implications for M&A, given that the physical branch has become an extremely thin tether for a large, growing and valuable portion of retail customers. As more relationships take on a virtual life, there is a growing risk of overpaying for physical capacity.

There is also the question of how to retain and grow virtual (i.e., non-branch) customer relationships under the disruptive conditions that accompany mergers. Bankers generally know about the relationship “stickiness” that comes with electronic services such as online banking and bill pay. What the industry is only beginning to think about, however, is the relationship “slipperiness” that builds when customers heavily embrace alternative delivery and begin to lose the branch frame of reference.

While switching costs and frictions don’t go away in the online space, they often are dramatically lowered. Also there are different provider choices (such as online banks and brokers) for virtual banking customers, and different decision factors about where to place accounts as well. This is a huge new aspect of merger strategy.

DEMAND ENGINEERING

While the branch will continue to play a powerful role in retail banking, the rules of the game have clearly changed. Along with a nearly \$40 billion gap in revenues created by regulatory and economic conditions, the U.S. branch system is experiencing annual declines in productivity for sales and transaction services.











Between 2003 and 2010, the average U.S. branch experienced a roughly one-third decline in the number of daily sales generated by each non-teller staff member, according to Novantas research. Meanwhile, branches overall are experiencing a 4% annual decline in teller transaction productivity. Over the next three to five years, a fourth to a third of full-time teller staff may become surplus to network requirements.

This problem cannot be cleanly solved by pulling the internal levers of branch cost reduction. Major customer-facing adaptations are needed as well. Specifically, banks must work to accelerate the pace of customer online migration so that technology-enabled channels become an ever-stronger substitute for physical branch transactions.

In the new era of “demand engineering,” there is a pressing need to consider trends in customer behavior and identify opportunities to change activity patterns, or “bend the cost curve” in the bank’s favor. The idea is to study specific categories of customer branch activity, including major types of customer transaction behaviors and the value associated with them, and then establish migratory paths that proactively guide customers into new arrangements.

Fig. 1: Customers Embrace Multi-channel Banking

Customers increasingly are turning to non-branch alternative channels for basic banking activities. High-value activities are migrating online as well.

Type of Activity	Primary Customer Emphasis	5-Yr Change
Research products: Online	70% 	↑ 28%
Check balance: Online	68% 	↑ 28%
Withdraw funds: ATM	65% 	↑ 13%
Transfer funds: Online	60% 	↑ 29%
Resolve issue: Phone	49% 	↑ 11%
Replace card: Phone	38% 	↑ 8%
Deposit funds: ATM	26% 	↑ 7%
Buy products: Online	22% 	↑ 9%
Get advice: Online	19% 	↑ 7%
Open account: Online	16% 	↑ 8%

Source: U.S. National Consumer Survey by Novantas, LLC.

In the best outcome, efficiency (and/or revenue) improves; customers are more satisfied; and job assignments are more valuable and rewarding for employees.

An example outside of banking is airline self-service, where customers routinely book their own flights, reserve seats, print their own boarding passes, and participate in baggage check-in. Not only have air passengers adapted to these changes relatively quickly, but most strongly prefer the new arrangements, which have given them more control over transactions and save time.

Another example is NIKE's "customize" program, which allows online shoppers to tweak the designs of shoes, garments and sports gear. Such "co-production" enables customers to produce tailored outcomes by interacting directly with the provider's systems, strengthening ties between customers and organizations.

So how does this apply to branch banking? Consider the burden of manual deposit-taking and check-cashing, which accounts for roughly 80% of the daily activity in a typical teller line. We believe that retail banks should strive to convert at least 50% of that manual activity to customer self-service over the next three to five years, keeping in mind that this can't be a dictated outcome — customers must see an advantage in electronic alternatives, learn the particulars of how to fulfill various transactions, and incorporate new arrangements into their banking routines.

The journey starts with a customer-based transaction segmentation, which helps the bank analyze key groups such as

check-only depositors and everyday small business cash depositors. This research provides key guidance in matching customers with new technologies for branch self-service.

Banks will need specific campaigns to deploy and promote self-service alternatives. Examples include: 1) promotion of bank-at-work programs and technology that permits remote deposit capture for small businesses; 2) revised policies that provide immediate balance credit on remote deposits, placing funds immediacy on par with in-branch transactions; and 3) significant promotion of online transaction alternatives, with emphasis on customers with high transaction intensity. Such customer-facing initiatives are critical in permitting banks to decisively lower the branch operating burden.

RE-MAPPING THE NETWORK

Ongoing trends in customer channel migration also have major implication for the shape of the physical network, not only today but in every year hereafter. As more sales and service transactions shift online, merger partners need to understand the implications for network configuration. Branches still have an important role to play, but there is a clear need for new strategies to maintain local market presence at much lower cost.

Sweeping measures, such as simply shutting the bottom 10% of branches, will prove too blunt, risking gutting local market presence. A better approach is to steadily introduce more efficient physical touch-points into the overall network mix, including small footprint branches, storefront-style ATM installations, and in-store branches and ATMs — all of which reduce the overhead for staffing and facilities.

To guide such efforts, acquirers will need a detailed understanding of the combined franchise, ranging from regional variations to micro-markets. In our experience, banks are greatly in need of improved network diagnostics to precisely identify the market potential and customer requirements in each cluster of local branches within the overall network.

By framing the analysis around future revenue potential, acquirers can develop appropriate treatments for various parts of the network. Some areas may need to be carefully protected, even augmented. Others are definitely in need of stringent cost reduction in light of insufficient customer demand and/or tenuous competitive stance.

The network analysis should be supplemented with a thorough exploration of staffing possibilities. Improved product

cross-training enables the branch to maintain full service with a leaner staff. Also there are substantial opportunities for flexible staffing arrangements that lower the FTE burden while providing quality part-time employment. Hours of operation also can be artfully trimmed.

MULTI-CHANNEL PERSPECTIVE

While all of these branch-related issues are important, the larger questions revolve around the multi-channel vision and strategy for the merged institution. What is the competitive proposition for the customer?

So-called “alternative channels” are becoming primary channels for a large and growing segment of the customer base. In turn, progressive banks are beginning to upgrade online/mobile functionality and blend channel features to serve the cyber crowd more fully and keep people firmly engaged with the overall bank. Examples include:

- Continued investment in mobile banking, moving from account information to transaction capabilities to integrated functionality that supports customer decision-making and transactions at the point of sale.
- Streamlined experience cross-channel integration, so a customer could start an application on the iPad, a call center or chat agent, or in the branch.
- Use of smart phone location services to tailor service for high-potential customers arriving at branches.
- New infrastructure that enables customers to shape their branch experience before they arrive. An example is making an appointment for advice via mobile phone, or checking wait times in the teller line.

Some banks are considering managing non-branch-oriented customer groups independently from the branches, with separate reporting lines, budgets and dedicated resources.

It will be important for these teams to keep sight of potential revenue-enhancing offerings and the customers who might actually use them. Otherwise, scarce resources could be wasted on features and functionality that ultimately do not improve customer acquisition, retention or profitability.

An example of this balancing act is mobile banking, where there is a tendency to design offers to suit the tastes of the Generation Y crowd, the leaders in smart phone adoption. As underscored by Novantas research, this approach can go wrong by ignoring the preferences of other customers who potentially could make more extensive and financially meaningful use of mobile banking.

We identified a select group of “ultra-connected” mobile customers who defy the Generation Y stereotype. Having a more affluent profile and spanning the age brackets, these customers are adept at all forms of consumer communications

technology. They are also far more willing to undertake complex financial services transactions via remote channels.

The Gen Y segment may be quite happy to seek guidance from “the cloud,” based on ratings, user comments and feedback from friends. But in providing and promoting this arrangement, for example through a social network link, the bank could be turning off the ultra-connected, a group that is hungry for more expert advice and would be much more trusting of a personal advisor at the bank.

The upshot is that acquirers will need to do far more homework on customers as they consider alternative channel applications and innovations, particularly products that are expensive to build and complex to manage.

FUTURE CUSTOMER BASE

As banks consider their merger options for 2012, there is a clear need to look beyond traditional branch-centric plays based on cost reduction and market expansion. Acquirers could merely wind up with a tighter rendition of yesterday’s obsolete network configuration.

Successful acquirers will be those that correctly value both the network and the customer base within it. When performing due diligence, for example, it is critical to understand how many of the target bank’s customers are de-linked from the network. For example, what percent of customers visit the branch less than 12 times a year, or once a month? Which branches and markets have the largest concentrations of such customers? What about future waves of virtual customers?

Acquirers should also diagnose the current and planned capabilities of the target’s online and mobile platforms. How far from “market parity” are these systems? How much investment will be needed to not only integrate the two franchises, but also to be competitive from a call center, online and mobile perspective?

Lastly, potential acquirers should understand the true economics of the physical branch network, netting out the revenues and expenses assigned to virtual customers. What is the cost-to-serve for the “branch-centric” customer segment? What is the rate of customer attrition in this segment? Is there really significant “customer gravity” in all the branches, or are some deteriorating faster than others? Such customer-informed navigation will provide critical guidance in repositioning the combined franchise for multi-channel competition.

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