

NIGHT OF THE ZOMBIE BRANCHES

Rescues Possible?

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The U.S. banking industry is facing a burning issue that may well determine the future of many institutions over the next few years. The problem is a huge overhang of “zombie branches” that were crippled during the recession and may never return to financial viability under current ownership.

Like the living dead, these failing units have all the appearance of a normal branch, but no pulse. Based on a recent Novantas analysis of the entire U.S. branch system, nearly 16,000 outlets, or about 18% of total branches, may need to close over the next three years. This poses a major additional burden for an industry that is already mired in a sluggish post-recession economy and restrictive new regulations.

One saving grace has been the 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 will soon be exhausted, fully exposing the industry’s dismal revenue dynamics and the cost challenge of maintaining impaired branch capacity.

The situation clearly foretells an accelerating pace of branch closures over the next few years. Yet the situation is not hopeless for banks that can think innovatively about the full range of options for dealing with zombie branches.

Nationally, Novantas estimates that about two-thirds of the impaired branches — roughly 11,000 in all — may be of value under different ownership. Major possibilities include in-market mergers; the spin-off of local networks as part of market exits; and the selective sale of individual branches to other players in local markets.

All of the options depend on a clear understanding of local market opportunity and the role of network presence in winning customer patronage. Even as the customer online migration continues, area branch networks still perform best when they provide adequate density of coverage. This “density factor” is the key to branch consolidation and divestment options that create value by helping acquirers to optimize customer share of market. It also is a guidepost in making decisions about individual branch closures.

Realistically, it will take time to work through all of the options and deal possibilities, and that is why banks will

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need interim strategies to slash the overhead associated with zombie branches. The most immediate possibilities are adjusting staffing levels and hours of operation, based on a deep understanding of evolving customer transaction patterns and preferences for service.

DIFFERING IMPACT

Although the branch crisis is a nationwide problem, the impact is quite different among various markets and types of institutions. There is much more at work in the crisis than simple overcapacity. Often, for example, problems are traceable to local market network presence and the management strength of the parent company.

To diagnose the situation, we began by evaluating the current profitability of each of the nation's roughly 94,000 branches. Factors included local market share of loans and deposits; interest rate margins based on the performance of the parent company; likely occupancy and staffing expense based on standardized cost estimates; and additional likely operating expenses as indicated by other Novantas research.

Then to build context, we looked at the projected growth trend in each local market to see if there was hope on the horizon. Additionally, we evaluated how each branch fit within the local network operated by the parent company; overall market presence and local competitive stance; and the overall financial performance of the parent company (as an indicator of management strength).

Putting all of this together, we identified about 16,000 branches that are on a course for closure over the next three years, if they remain under current ownership (Fig 1). These units are unprofitable to such an extent that they could not be revived even if they were able to freeze costs while keeping pace with expected growth in their respective markets (de novo branches that have been operational for fewer than five years were exempt from closure).

Market perspective. In terms of numerical concentration of zombie branches, the hot spots are in major cities, including (in descending order) New York, Chicago, Philadelphia, Atlanta, Dallas and Washington, D.C. Novantas analysis indicates that about 75% of U.S.

banking markets will require a net reduction in branches (closures outpacing de novo expansion) over the next three years.

Underscoring the importance of local market presence, nearly a third of troubled branches are owned by good-performing parent companies, yet these units are handicapped by subscale network presence in their respective local markets. Many are owned by regional and super-regional banks, suggesting a particular need to rationalize networks on a market-by-market basis, instead of branch-by-branch.

In many other cases, branches simply are not living up to the potential of the markets in which they are situated. These units are more concentrated among under-performing parent companies, some of which are likely takeover targets.

Peer group perspective. In terms of proportion, the four largest U.S. mega-banks have the lowest exposure to zombie branches, roughly 3% of their combined networks, or about 600 units. Helped by their strong network planning functions, these banks have aggressively optimized their local branch systems. As a result, most of their branches are situated in local networks with at least threshold density levels, critical in providing customer convenience and building market visibility.

With a 10% concentration of troubled branches, by contrast, super-regional banks have a much more difficult case load of about 2,200 units. The proportionate burden is still greater among regional banks, which have a 21% concentration of troubled branches, or roughly 2,300 units.

Fig 1: Branches in Failing Financial Condition

Nearly 16,000 U.S. branches have lost financial viability and face closure over the next three years. However, about 11,000 could be valuable in mergers, market spinoffs and standalone sales.

Peer Group	# of Branches at Risk	% of Frequent Branch Users
National	602	3%
Super-regional	2,235	10%
Regional	2,286	21%
Super-community	5,046	26%
Community	5,249	32%
Unit & non-network	444	23%

Source: 2011 U.S. branch study by Novantas, LLC.

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Regional banks are the most likely to still run their networks as a series of regional domains with separate management teams. This often leads to a “sharing” arrangement for branch investments (if Tampa gets two, then Gainesville should have two), which can override important distinctions between local markets. Depending on network presence and market opportunity, continuing with this example, Tampa hypothetically may have needed six additional branches, accompanied by a net reduction of two outlets in Gainesville.

The situation is even more pressing among super community banks (from 10 to 75 branches), which rarely have a fully competitive network presence in the local markets they serve. Within this peer group, about 5,000 branches appear eligible for closure under current ownership, or 26% of the peer group total. Finally, community banks (up to 10 branches) are burdened with the highest concentration of troubled branches, about 5,250 units, or 32% of the peer group total.

AVOIDING CLOSURES “AT TOTAL LOSS”

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To judge whether a network in any city was a strong candidate for branch consolidation (as opposed to outright closure), we looked at two factors, including:

1) Networks belonging to any bank that are subscale on their own, but which would be attractive to another leading market player as a consolidation target. Acquirers primarily would be looking to weed out duplicative branch capacity, but in some cases also would be able to beef up networks in select local markets.

2) Networks specifically belonging to underperforming banks which could be likely takeover targets in the future.

Based on these filters, we estimate that 11,000 of the total 16,000 troubled U.S. branches have an inherent value to someone other than their current owner, either to improve an existing network, or to reduce market over-branching.

As a result, we expect to see a series of specific market exits — entire companies sold; spin-offs of various local networks; sales of individual branches — where banks can

realize greater value from a sale of branch capacity than from an ongoing investment in it.

The most aggressive option 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 markets where we expect to see significant net branch consolidation nationally, 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 is terminally sub-scale, 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 strategic option is to pursue closure of 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.

IMPROVING NETWORK ECONOMICS

These strategic options may require significant time to undertake and in some instances may prove extremely difficult from a political or cultural standpoint. Wholesale market exits, for example, have been historically rare in the U.S. banking industry. Even after decisions are made and deals are struck, it will take a period of months or years for the benefits of those actions to fully flow through to the bottom line.

This increases the urgency for banks to take immediate, tactical actions to improve the economics of the network now. Staffing levels and hours of operation are the most immediate levers for expense reduction and productivity gains, based on a deep understanding of evolving customer transaction patterns and preferences for service.

With in-branch transaction volumes falling by 4% annually across the industry, there are widespread opportunities

to further reduce teller staff. Trends in facilities utilization will improve as banks learn to treat hours of branch operation as a flexible resource (reducing hours in some locations, increasing elsewhere). The goal is to reduce expenses and boost sales by moving hours from low- to high-potential areas.

The mix of activities carried out in branches is evolving as well. Banks will need to carefully study the accelerating changes in customer behavioral patterns, including the rise of the “virtual-domiciled” customer, to accurately forecast the changing mix of branch utilization. Where appropriate, customers can be encouraged to make even faster shifts away from the branch, for example, by re-directing deposit transactions away from tellers to automated teller machines; mobile devices; and even to fully electronic formats.

By understanding and proactively managing these shifts, the bank can not only refine the plan for tactical staffing changes, but also lay groundwork to reconfigure the network. The goal is to identify which locations in the network primarily will be service and transaction hubs, and which ones will be sales and advice locations.

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At every location in the network, a detailed outlook for future transactions (volume, type and complexity) can be used to determine whether the facility at that site should change, either in format, or in staffing and hours, or both. For some locations, downsizing the format and staffing can provide cost savings, particularly if the excess space is converted to revenue producing real estate assets, such as offices or retail space.

As banks begin to shrink the branch footprint at each location, finding suitable partners to “move in with” will matter. One set of partners includes linked financial services (tax preparation, accountants, insurance agents, registered investment advisors). These services would fit with branch locations that are focused on sales and advice. For transaction locations, where the emphasis is on access and convenience for everyday customer transactions and service, high-traffic retail and service industry co-tenants may make sense: dry cleaners, coffee shops, and pharmacies.

PARSING THE OPTIONS

Many of pressing questions have been asked about the future of the branch: do we need them; who is using them; can we close them? Almost all of the answers start with “it depends” — it depends on which segment you serve; it depends on which markets you serve; it depends on what you want to sell. But there is one answer that does not “depend” on anything: money-losing or marginally profitable branches, in low opportunity or over-branched markets, look ripe for action now.

The bad news is that the overhang of zombie branches is significant: about 16,000 units spread across the country. The good news is that perhaps two-thirds of them, or about 11,000, could prove valuable under different ownership.

In parsing the options, banks need to look beyond the question of individual branch profitability. A strong market context will be needed in crafting merger and spin-off transactions that will help to avert closures “at total loss.”

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