

Understanding the Endgame: Geography ... Selectivity... Diversity: More Traits that Rate

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Second of three parts

Every conversation about who will survive the banking industry's ultimate consolidation coalesces around five companies: Citigroup Inc., Bank of America Corp., JPMorgan Chase & Co., Wachovia Corp., and Wells Fargo & Co.

These companies are generally acknowledged to be in the best position to remain preeminent national banking companies decades from now. Beyond the Big Five, the endgame contenders seem either aspirational or delusional.

Size may not be predictive in the case of Washington Mutual Inc., the sixth-largest company in the U.S. banking industry. Despite its \$348 billion balance sheet, Wamu does not get a lot of consideration as an endgame player. Maybe it is because the industry has an entrenched prejudice against thrift companies; maybe it is because the company's mortgage-bloated loan portfolio makes it less diversified, and seemingly smaller, than companies with half its assets.

Real estate loans, the vast majority of them home loans, make up 72% of Wamu's assets. Mortgage-backed securities make up another 7%, and a \$25 billion portfolio of loans held for sale makes up another 6%. The October purchase of Provident Financial Corp. gave

Wamu a card portfolio that now makes up 2% of its assets. Commercial loans make up under 1%, or just over \$2 billion.

Wamu gets some recognition for its advances in retail banking, not the least of which is its Occasio line of branches - "They're so original, we took out a U.S. patent on them," the company advertises on its Web site - and it has \$210 billion of deposits, making it the country's sixth-largest depository institution by that measure. But 97% of its deposits are in nontransaction accounts, according to Federal Deposit Insurance Corp. data, and its retail innovations have done little to enhance perceptions of the company's prospects.

Many of the industry's most persistent merger and acquisition rumors involve Wamu - as prey rather than predator. But its natural acquirers are relatively few, given its size. Citi and HSBC Holdings PLC have been identified as buyers in rumors that are based less on specific intelligence than on perceived strategic fit.

Wamu would not make Kerry Killinger, its chairman and chief executive, available for an interview.

"We believe that achieving the five-year targets of our present strategic plan will result in top-quartile industry performance, which should lead to superior long-term shareholder return," a spokeswoman for the Seattle company wrote in an e-mail. "Wamu's board of directors recently concluded that successful execution of our strategic plans would likely lead to the creation of significant shareholder value and instructed management to execute those plans as an independent company."

CULTURE VULTURES AND SNOWBIRDS

The largest U.S. commercial banking companies not considered to be odds-on survivors are U.S. Bancorp, with \$213 billion of assets, and SunTrust Banks Inc., with \$181 billion. They are regularly rumored to be acquisition fodder, even though they are staking their own claims to survival.

A decade ago U.S. Bancorp was considered one of the country's preeminent banking companies, but after a string of value-destroying deals, it lost its status as an industry darling and became just another example of acquisitive excess.

SunTrust is known for its conservative credit culture, and despite its enthusiasm for M&A, it is better remembered for the acquisition it could not get done - a hostile bid for the old Wachovia Corp. - than for the ones it has made.

Both companies have expanded their fee-income businesses, including asset management and mortgages. But SunTrust makes money from an investment-banking subsidiary and reports little processing income; U.S. Bancorp's foray into investment banking was ill-fated, but the company has made a name for itself as a processor.

Jerry Grundhofer, U.S. Bancorp's CEO, is generally admired - as is L. Phillip Humann, SunTrust's CEO. Neither would speak for this story.

U.S. Bancorp has named Richard Davis, 48, who is considered a charismatic and inspirational leader, as a successor to Mr. Grundhofer. SunTrust's succession plans are less clear.

Bench strength and clarity of succession can play a part in making it to the endgame.

"Many of the transactions of the last year or two have occurred because there was no successor management," said David Daberko, the chairman and CEO of National City Corp. "That

may have been a choice of the board not to worry about it, and just rise with the current guy and sell."

Investors, too, read the executive-office tea leaves closely.

"What an acquirer is typically looking for is a management team that is ready to cash out," said Tim Woolston, a portfolio manager with Boston Advisors LLC. "If you've got a young guy that just came in and just started running his own show, it is unlikely he is going to want to sell out, even though it may make sense."

There are other interesting points of comparison, and other obvious points of departure, between SunTrust and U.S. Bancorp, but their different business mixes, operational philosophies, and succession planning may be relative subtleties in handicapping their chances of survival.

Ultimately, it may come down to demographics.

SunTrust has an enviable base in the Sun Belt. U.S. Bancorp operates in some desirable markets but is generally perceived as competing in the Rust Belt. Stronger population and wealth growth may trump execution; more people and more money is a good recipe for profitable banking.

Bankers are not locked into their current markets, and they are willing to do surprising things to break out of their markets. Several have announced wholesale branching programs in new markets; others have paid six times tangible book value for an existing network in a hot market.

U.S. Bancorp may face an additional obstacle: After disappointing investors with previous acquisitions, executives have repeatedly vowed that they are not looking at transformative deals - a statement that leaves open the question of how to thrive without them.

For the same reason that SunTrust may have a better shot at the endgame than U.S. Bancorp, BB&T Corp. may have a better chance than Fifth Third Bancorp or National City.

Mr. Daberko has claimed that demographics are not a limiting factor for Nat City, which is also squarely in the Rust Belt. But his actions may speak louder than his words.

The day after its July 10 announcement that it was considering strategic alternatives for its mortgage subsidiary, the Cleveland company said it would pay 3.3 times tangible book value and 23 times earnings for Harbor Florida Bancshares Inc., a thrift company in Fort Pierce. Less than three weeks later Nat City said it would buy Fidelity Bankshares Inc., a thrift company in West Palm Beach, this time paying 3.7 times tangible book value and 30 times earnings.

Even with the deals - and a driving commitment to become the best possible retail banking company - few count Nat City among the endgame winners.

And there is a downside to having operations in attractive markets: Stumbling is usually lethal. With plenty of vibrant companies looking to get into those markets, not delivering on the promise of superior demographics may encourage shareholders to find a company and management team that can. Underperformers generally languish in unattractive markets; in hot markets, they get swallowed.

"It cuts both ways," said John Allison, the chairman and CEO of BB&T. "If you perform, it helps you. If you don't perform, it makes you more vulnerable, because someone else is going to want the franchise."

The evidence is plain: "How many [large] Florida banks are left?" asked H. Rodgin Cohen, a banking lawyer in the New York office of Sullivan & Cromwell LLP. "It's not just demographics."

NOT DEAD YET

Tweaking branch networks - or even remaking them through efforts to branch into new markets - is occasionally motivated by the endgame. But a fundamental rethinking of business lines and subsidiaries is much more central to endgame strategies.

Nat City is selling its mortgage subsidiary, as is KeyCorp. Bank of New York Co. decided to sell its retail operations to JPMorgan Chase in exchange for that company's corporate trust business.

Even though it lowered its stake in BlackRock Inc. through that company's deal to acquire Merrill Lynch Investment Managers, PNC Financial Services Group Inc. recommitted to asset management. It beefed up its investment bank by acquiring the middle-market firm Harris Williams & Co.

A couple of years ago U.S. Bancorp dumped its Piper Jaffray investment bank, and decided to focus instead on processing businesses.

Wamu is selling its asset-management arm, as is Comerica Inc. Citi already unloaded its unit in an asset swap with Legg Mason Inc.

Nat City admits that its wealth-management unit still has not justified its long-term existence. ("It remains to be seen whether we can really be a competitive force in that business," Mr. Daberko said.)

Each divestiture seems to trigger additional speculation that the vaunted financial services supermarket model is dead. Citi's swap with Legg Mason, combined with the sale of the last of its insurance-underwriting operations last year - the very operations for which it had fought so hard in 1998 - was seen as a particularly fitting nail in the coffin.

But the obituaries were either premature or based on a rudimentary understanding of the

supermarket model. Last year bankers recognized \$44 billion of fees from insurance sales, and \$28 billion from asset management, according to SNL Financial LC. Supermarkets do not manufacture all of their products; neither do banks. The model is based on fulfilling customer demand, and not on monopolizing the supply chain.

"We don't manufacture insurance products, and we don't manufacture mutual funds now," said Sallie Krawcheck, Citi's chief financial officer. "But by no means do we offer fewer products, or a less rich range of products, to our customers - in fact, the opposite. Through open architecture, we can offer our clients and customers the fullest range of products and services that are out there."

Mr. Allison said he has always found the supermarket analogy inaccurate.

It implies that "you just have one store through which you distribute a multitude of products," he said. "Financial services companies will sell multiple products through different distribution channels, [but] it doesn't look or feel like a supermarket."

The trend toward broader product suites and multiconstituency service, which is accelerating, does not exactly sound like the death knell for the premise that launched the supermarket model.

For the biggest of the big, the solution is easy: Offer everything to everybody. Citi's list of subsidiaries is 33 pages long and includes about 1,500 companies.

MIX MASTERS

Trying to develop Citi's or JPMorgan Chase's capacity in short order is not realistic, and most companies have to be tactical in their choices. There are enough ancillary businesses - asset management and trust banking, mortgage banking, credit cards, processing, insurance

brokerage, investment banking, factoring, equipment finance, online banking, merchant banking, trading - to supplement and diversify lending that bankers do not need to claim a special facility in each one.

The sale of various subsidiaries is the result of companies' choosing what businesses they believe they need, and in which ones they believe they excel. These are the kind of strategic decisions that shape the endgame.

Richard Fairbank, the chairman and CEO of Capital One Financial Corp. said bankers should be more ruthless in that discipline.

A "key strategic lever that banks have - I don't think they are using it very much - is to pick the businesses you are in," he said. "You need to be diversified, but you don't need to be in all of them. We are very carefully picking our businesses."

There are several prisms through which banking companies are making these decisions.

"To understand the terms of competition it is less useful to think about the traditional market segments - like commercial banks, credit card banks, mortgage banks, insurance companies, and investment banks - and more useful to think about who is originating assets, who is distributing assets, and who is holding assets," said Peter Fisher, a managing director at BlackRock and a former Treasury Department under secretary.

That is a good way for bankers to figure out comparative advantages, and in many cases it naturally overlaps with the decision between retail and wholesale businesses. U.S. banking companies that are not yet assured of the endgame - but are seeking it - are generally emphasizing retail.

"This is a retail-based economy," Mr. Daberko said. "Our tax incentives are retail and consumption-based; the population expands,

the need of individuals for financial services expands. You've got to be strong in retail banking if you are going to be a winner."

That is why Nat City's commitment to becoming "the best retail bank we can possibly be" is "more than anything else what I worry about," he said.

Emphasizing retail businesses is the logical result of bankers' doing what they know, but economics also dictate retail strategies.

"A regional consumer bank can establish size and scale being in two or three contiguous states," said William Harrison, JPMorgan Chase's chairman. "If they have a broad branch presence, and the product capability to deliver, they can be a leader in those states - and they get some of the benefits of operating scale."

However, "that works better in retail banking than it does in investment banking," he said. "In investment banking, if you really want to win, you've got to be global."

The big banking companies that find themselves at the top of investment-banking league tables generally have not gotten there by organic growth, and a wave of acquisitions in the sector in the late 1990s proved that buying capacity is not easy, either. Some of the transactions have been near disasters, so bankers are tentative about trying similar ones.

The industry's previous failures don't disprove the conceptual imperative behind the strategy. Cultures change - however slowly.

Banks are moving toward the mercenary culture of investment banks more than investment banks are moving toward the conservative culture of banks, but the common ground is broader than it was a decade ago. Evidence points to further convergence.

The career path of the commercial banker is not as conventional as it once was, when rookie bankers started in the branch making residential

loans and aimed for middle-market business lending. Success in the middle market led to large corporate lending, where lenders hoped to develop enough relationships to influence the bottom line - and eventually wield that influence as an executive.

Not anymore.

Members of the next generation of banking "don't care about managing people, they don't care about going to the corner office, and they are not going to be loyal to any institution or entity," said Rod Taylor, an executive recruiter in Atlanta who specializes in financial services.

"Their loyalty is to their customer relationships, and they are going to take care of their customers," he said. "They may let you be their employer and bring their customers to you, but if you don't want to pay them like they want to be paid - and if you can't assure them that they will have the products, service, and platform to take care of their customers - they'll go across the street to your competitor."

Mr. Taylor calls this next generation the "universal banker," and that fits squarely with the evolving terminology from financial supermarket to universal bank. The practical strategy is the same: Sell more products to more customers. Synergy and cross-selling are alive and well, and the Big Five - as well as the banking companies trying to stick with them - are committed to the notion that the whole of a broad product suite and a wide customer base is greater than the sum of their component parts.

The straight consolidation plays of the past remain in force. Bankers will slap two operations together and take out expenses, while occasionally promising - and less frequently delivering - revenue gains. But the deals that bankers find most attractive may be as much about expanding product capability as expanding geography.

"I think we will have to do another merger of equals," Mr. Allison said. It "might be with a bank with a similar market cap, or it might be with an insurance company - or it might be an investment bank."

Such a deal may not be imminent, he said, but he expects the opportunity to arise over the next decade. It is a possibility that all the banking companies not assured of survival must consider.

"Having a strong diversified mix of businesses and proving out the concept of universal banking is one potentially winning endgame view," said John Colas, who heads North American corporate strategy at Marsh & McLennan Cos.' Mercer Oliver Wyman. "It's not the only one, but it's the one that is available to the largest players."

It's the one that Wachovia has followed, guided in part by the experience of companies like MBNA Corp., Provident - and Golden West Financial Corp., which Wachovia is acquiring.

"There is example after example of great companies that basically have made the decision that to continue their growth rate, they need more product, and they need more customers," said G. Kennedy Thompson, the chairman and CEO of Wachovia. "That's why I think universal banking is going to be the endgame player."

Banking executives all opine about the eventual need for more product capacity.

What will distinguish the companies is which businesses they decide are core - and, of course, how well they run their businesses. Facing tough competition in all areas of financial services, executives have concluded that pretty good probably is not enough.

"You need to be a leader," Mr. Harrison said. "You don't have to be No. 1 or No. 2, necessarily, but if you're No. 8, you're not going to have the

operating dynamics to get the kind of growth and returns that you need."

That is as much about geography as it is about products.

"One premise that has not been proven, and I'm not a big believer in, is that you need to be a nationwide company to be a survivor," Mr. Daberko said. "But what you have to be is very strong and with good market shares in the markets that you choose to operate in geographically."

As bankers make choices about businesses, the Citi/Nat City playbook will be standard: Announcements of divestitures will be made in concert with deals or ventures to supplement or expand the enterprise. Once again, it's about not just size and growth, but size and growth supplemented by a coherent vision.

It is worth keeping in mind that executives at the largest banking companies tout the advantages of scale while acknowledging its diseconomies. Bureaucracies are necessary to manage large entities, but bureaucracies can kill the thrill of profit.

Operational and reputational risk multiplies. Employees are less committed to a business when they cannot discern their influence on it. Good ideas are left unexplored for fear they will not make a material difference. Local businesses suffer from national management. Mediocrity is tolerated. Mistakes fester. Waste breeds.

"There are diseconomies of scale," Mr. Harrison said. "When you are very big, you have to overcome bureaucracy, and increasing controls. If you're not careful, you may not be as innovative or as quick in responding to customers."

Or to regulators, for that matter.

And markets do not value conglomerates, apparently. Large banking companies seek to get larger, but investors do not always embrace

the result. Witness the regular calls for and speculation about breaking up Citi.

Charles Prince, its CEO, continues to deride such talk as "silly." But it is interesting that the question even has currency at all. Sanford Weill's vision for the company was so clear and

so absolute that few even bothered asking the breakup question when he was at the helm.

Friday: Some companies scratching for survival are eschewing the universal model, and endgame competition is coming from outside the banking industry. Also, is there really any such thing as a national bank?