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The Local Impact of Banking's New Realities

By: Arnold G. Danielson
Chairman
Danielson Associates Inc.

Banking has moved into a highly challenging phase in its continuing evolution from a protected and constrained business toward a competitive free market environment. Margins are sliding; revenue gains have become more difficult; new, unregulated competitors are growing in numbers; and investors seem to have lost interest in bank stocks. If the business headlines were not reporting new Dow highs and a continuing strong economy, banking in 1999 might seem like a rerun of 1990 and even like the forerunner of an economic downturn.

Who knows, the economy may be headed down since good things cannot go on forever, but the challenges banks face today are not economy-driven, but reflect the new realities that are shaping the direction of financial services in the early years of the 21st century. These realities are national in impact, but they will be felt first in highly-urbanized areas, which is most of Maryland, Southeast and Northern Virginia and the District of Columbia.

These new realities are both causal and reactive. Those that are causing change are:

- Financial services being in a period of sustained high growth with most banks not positioned to share in this growth.
- The rapid erosion of the competitive barriers that separate the various parts of the financial services industry

- Technological advances and a freer competitive environment making financial services available with more convenience at lower prices.

These causal realities have created reactions that impact every bank in the country, albeit some more than others. The reactions are:

- The combination of high growth, rapid technological advances and a changing environment creating opportunities for new, nontraditional competitors, rewarding the forward thinking and leaving traditional banks behind.
- The big getting even bigger.
- Existing banks having to adjust to the changing environment, or accept reduced sale and investment value.

These realities also could contribute to more margin slippage and slower revenue growth for traditional banks since the high growth attracts aggressive, innovative competition while size and technology improve productivity. In 1998, the largest bank holding companies, collectively, had their net interest income fall below 3% of average assets, and, at the same time, increased net operating income to record levels. Small banks have higher margins than the large for many reasons, but when banks that represent more than half of the industry can increase profits with net interest income falling below 3% of average assets, pressure on spreads is a result. Adding further to margin pressure is a reduced availability of loans as securitization moves from home mortgages and consumer loans to commercial real estate, which has been a primary source of high margin loans for many local banks.

There also is the likely "internet effect" on margins to be considered, which may be similar to what happened in the late eighties and early nineties when thrifts tried to outgrow their problems with high deposit rates and created earnings problems for everyone else. Many of those planning extensive use of internet banking will offer very high rates on deposits and then apply that funding to commodity loans and securities and count on low overhead to create a profit. Whether the internet delivers profits to those that go this route has yet to be proven, but this practice will be making insured deposits readily available to customers at high rates without geographic constraints, even without the big banks adding their muscle to the process.

With margins sliding, revenues growth slowing and the threat of internet hanging over banking, it is not surprising that investors are looking elsewhere for good returns. The negative view of bank stocks also has been increased by a FASB recommendation relative to poolings that could reduce acquisition prices by as much as a third. Meanwhile, the consolidation pressures remain stronger than ever even as the number of active large and mid-sized acquirers diminishes.

This negative investor perception, though, is not being applied to the large banks, albeit some such as First Union are no longer investor favorites. This is because most large banks are viewed as financial services firms whose earnings are not constrained by margins. As a group, the big banks are getting more than half of their revenues from fees.

Despite the threat to “business as usual,” these new realities present an opportunity for alert local banks to move on to bigger and better things. The game is no longer "protecting banking’s turf," but rather how to share in the financial services industry boom.

The Local Bank Response

Whether the local bank has \$40 million in assets in some small town in Virginia or is a \$6 billion regional like Mercantile, the proper response to these realities is the same. Banks have to lessen their dependence on spread income, and because spread income will never totally go away, improve the productivity in their spread business.

Productivity gains may be easier than diversification, but for most banks, it can be a very difficult cultural adjustment since high productivity requires a less paternalistic approach toward employees, an exiting of products and services that do not make money and, possibly, the reduction of the number of similar, local financial alternatives. As to the latter, one benefit of lower acquisition prices is that in-market equal or near-equal mergers may be easier to accomplish even though they, too, can be negatively impacted by changes in the pooling rules.

As to a lessening of the dependence on spread income, this requires a strong commitment to fee income, which can create problems since not all fee businesses are highly profitable and/or readily adaptable to banks of all shapes and sizes. Also, the most obvious fee businesses for banks, asset management and insurance, are different from banking in culture and expertise.

Despite the difficulties and the culture problems in adapting to these new realities, local banks have strong competitive advantages. The major advantage is that they are well-known in their communities and usually have a large market share that includes the best potential customers for fee products - businessmen and the upper end of the affluence ladder. Another plus is that the big banks will pave the way. When First Union is through "moving people to the mountain," customers will think banks are where you buy insurance.

If banks do not use their customer advantages aggressively, though, there will be no shortage of competitors without cultural "hang-ups" ready to serve these customers. Among these will be new entrants that are fully conversant with the most recent technological innovations.

Local Structural Impact

The impact of the banking realities on the make-up of the financial services industry, and which banks make a successful transition to the next stage of the industry's evolution, will vary by region. In the high-density Washington and Baltimore areas and in Southeast Virginia, size will count more and technology will have a quicker impact on who succeeds and who does not. In the outlying areas, the race will still go to the swift, but there will be a lot more size and time flexibility.

The large markets, though, have room for small financial institutions in that they, and probably only they, can support specialized financial services firms. Washington, for example, should be able to support several operations that specialize in small business lending and/or asset management.

While it may be easy to recognize the overall patterns of change that are likely to occur in financial services, what is not so clear is the timing of changes that can negatively impact value and which banks are most likely to make a successful transition. Value altering change will be when the present mode of operation no longer delivers annual revenue and earnings growth.

As to the timing, it is comfortable to think that change comes gradually to banking and that despite all the talk for the last twenty years about the end of bricks and mortar and a "checkless society," neither has happened. What is often conveniently forgotten, though, is that in 1978, there was a healthy and confident thrift industry, and by 1981, that industry was swimming in a "sea of red ink" and well on the road to extinction. Also, past transitions in banking did not have to

take into account interindustry alliances like Citigroup-Travelers, the impact of the internet and the securitization of commercial real estate.

In fact, gradualism may no longer be part of the game. The Schwab One Account and what it has done to the brokerage business should be a wake-up call to bankers. It is possible, and some would say likely, that within five years the traditional bank mix will be unable to deliver meaningful annual earnings gains. Banks may still have busy lobbies, provide substantial local employment and satisfy regulators with strong capitalization, but without good earnings growth, they will have little investor appeal and will be a shrinking part of what should be a “booming” financial services industry.

The existing banks that are most likely to make a successful transition to the 21st century banking environment, other than as product specialists, will have three primary characteristics. These are:

- A good franchise – i.e., high market share in a well-defined market;
- A strong commitment to fee businesses; and
- The ability to deliver a good ROE, probably above 14%.

Some indication of those with the best starting positions among regional leaders can be seen in present market shares, noninterest income as a percent of revenue and ROEs. The market-by-market look at the Middle Atlantic states that follows provides this insight relative to the region’s large and mid-sized banks, and what happens to them will have a ripple effect on smaller banks.

Washington Area

Washington is by far the biggest banking market in the Middle Atlantic region with almost as many deposits as the Baltimore area and Southeast Virginia combined. As such, Washington has been a magnet for out-of-area banks, and the market leaders - SunTrust, Bank of America and First Union - are three of the nation's ten largest banks, and the nation's largest financial institution, Citigroup, has become an increasingly important factor. These banks have a strong commitment to fee income and are at the "cutting" edge of the technological revolution, which assures the region a position in the forefront of banking change.

Despite the size of its large banks, Washington is still one of the country's most fragmented banking markets. This is a carry-over from the days before interstate banking when the District, Northern Virginia and the Maryland suburbs each had its own distinct banking structure, which still can be seen in the second tier banks - i.e., most of Riggs offices are in the District, the vast majority of First Virginia and Wachovia's branches are in Northern Virginia while Allfirst and Mercantile are concentrated in the Maryland suburbs. This fragmentation is a plus for customers, but it also means that consolidation is not over.

If a strong commitment to fee businesses and good ROE's are all it takes to be a survivor, most of the Washington area's major players would be around for a long time, but large banks normally leave the markets in which they are not among the leaders, and this tendency will increase as branding and scale grow in importance. Thus, while Citigroup may have the clout to become a major factor internally, Wachovia and BB&T have to acquire more coverage if they want to stay.

There also is a large gap between Washington's banking leaders and the other out-of-area large banks, which puts a premium on the positions of the three locally-based financial institutions - Chevy Chase, Riggs and First Virginia - that stand between them. The acquisition of any one of them by Wachovia or BB&T turns a "big three" into a "big four," and Chevy Chase seems to be well on the way to doing this on its own. Since the "big three" will not be acquiring in the area, any major future consolidation will focus on the second tier banks with a Wachovia-BB&T merger not being out of the question.

Deposit Share in Washington Area*

	Deposits 1998** (In mill.)	<u>Market Share</u> <u>June 30,</u>		Nonint./ Income Revenue***	<u>ROE***</u>
		<u>1998</u>	<u>1996</u>		
<u>Market Leaders</u>					
SunTrust	\$ 9,941	15.9%	9.8%	37%	13.79%
Bank of America	8,903	14.4	13.9	38	18.52
First Union	6,232	10.0	9.6	48	20.37
Chevy Chase	4,749	7.6	7.1	33	-
Subtotal	\$29,825	47.9%	40.4%		
<u>Second Tier</u>					
Riggs	\$ 3,634	5.8%	6.0%	34%	12.58%
First Virginia	3,032	4.9	5.3	21	14.14
Allfirst	1,984	3.2	3.1	37	8.31
BB&T	1,645	2.6	-	30	19.09
Citigroup	1,574	2.5	2.2	62	21.24
Mercantile	1,549	2.5	2.2	24	15.29
Wachovia	1,145	1.8	-	35	17.67
United	1,001	1.6	-	18	16.41
Subtotal	\$15,564	24.9%	18.8%		
<u>Other</u>					
Sandy Spring	\$ 846	1.4%	1.0%	20%	15.08%
FCNB	819	1.3	.6	23	12.30
F&M National	743	1.2	.6	23	13.33
F&M Bancorp	642	1.0	.8	27	12.59
Burke & Herbert	578	.9	.8	12	15.53
Provident	552	.9	.1	31	14.06
Subtotal	\$ 4,180	6.7%	3.9%		
Other Comm. Banks	\$ 3,343	5.4%	17.3%		
Other Thrifts	1,968	3.1	7.2		
Credit Unions	7,483	12.0	12.4		
Total	\$62,363	100.0%	100.0%		

*Calvert, Charles, Frederick, Montgomery, Prince George's, St. Mary's and Southern Anne Arundel counties in Maryland; Arlington, Fairfax, Loudoun, Prince William and adjoining independent cities in Virginia; the District of Columbia; and excludes Telebank Financial and Capital One Financial.

**Includes mergers in process.

***Twelve months ended March 31, 1999.

Source: SNL Securities LC, Charlottesville, Virginia.

Although an eventual sale is the most likely outcome for Chevy Chase and Riggs, this may be neither soon nor determined by normal industry pressures since each is pursuing a unique strategy. Chevy Chase with its extensive ATM system and the area's most attractive branches seems to be betting that while a physical presence may become less important for banks overall, there will be room for one that specializes in transaction services. Riggs is going in another direction with private banking and the accompanying fee income.

The outcomes for the other out-of-area banks with a Washington presence - United, Mercantile, Provident and the Allied Irish with its Allfirst affiliate - will reflect what happens in their home markets. Size would suggest that most of them eventually will be acquired with a possible local result being a sale of the Washington area branches unless the buyer already has a major area presence.

The largest of the area's small banks - Sandy Spring, FCNB, F&M, F&M National and Burke & Herbert – are vulnerable based on size, commitment to fee businesses and, in some cases, return on equity, but each is a major force in its immediate market and, as a group, they may have more staying power than the out-of-area fringe players. They need to adjust to the new realities, but they are able to present themselves as truly local, personal financial services alternatives rather than just smaller versions of the very large banks.

What will Washington area banking look like by 2007? This is a tough call that can be influenced by so many factors, and going back eight years, who would have thought the region's three biggest banks would be Bank of America, First Union and SunTrust, and that Wachovia and BB&T would be major players. In fact, just six years ago there were serious concerns as to whether Riggs and Chevy Chase would even survive.

Going forward, the key catalyst of change will be technology and not weaknesses caused by asset quality problems. This should favor the very large over the mid-sized and create a barbell effect with the likes of Citigroup, Bank of America and newcomers like Wells Fargo being the dominant factors. Local institutions such as Sandy Spring and Burke & Herbert will be among those supplying the local alternative if they adequately adjust their product mix.

Baltimore Area

Demographers have made Baltimore part of a common metropolitan area with Washington, but this official decree has not resulted in a single banking market. The only commonality is that Bank of America is a leading, if not the leading, force in each. The differences are that in Baltimore a) the rest of the leadership is true local banks, Mercantile and Provident, and a foreign-owned bank, Allfirst, that maintains strong local ties; b) there is a dearth of small community banks; and c) a vibrant contingent of neighborhood thrifts still exists.

How long Baltimore can be the only major East Coast city to retain its quasi-local banking domination by mid-sized banks depends on the determination of Mercantile and Provident to maintain their independence and of the Allied Irish to stand fully behind its Allfirst affiliate, and there are no signs of "give" for any of the three. If there is "give," it is a struggling First Union that in numbers ranks among the leaders, but still reflects the weaknesses of the franchises - Signet, Bank of Baltimore and Baltimore Savings - it absorbed.

If market position, commitment to fee businesses and high ROEs are key criterias to staying power, the local contingent is in pretty good shape. Allfirst has 37% of its revenues coming from noninterest income, Provident 31%, and Mercantile 24%. Provident and Mercantile also have ROEs in excess of 14% and the lower ROE of Allfirst is irrelevant with its foreign ownership.

The biggest change in the Baltimore banking market in the past year is the acquisition of Mason-Dixon, the parent of Carroll County Bank & Trust and the Bank of Maryland, by BB&T. This brings a large acquirer into the market that needs to buy one of the existing local leaders, splice together a series of smaller banks and thrifts or buy branches from a bank leaving the area if it wants to build the bulk to be a real factor in Baltimore.

For a BB&T or anyone else to expand through acquiring small banks and thrifts in the Baltimore area, the "pickings" are slim. Among local community banks, only Columbia has as much as 1% of the area deposits. This fewness of community banks when compared to a Washington or Philadelphia may reflect less customer dissatisfaction with two banking leaders because of their strong local ties.

Deposit Share in Baltimore Area*

	Deposits 1998** (In mill.)	<u>Market Share</u> <u>June 30,</u>		Nonint./ Income Revenue***	<u>ROE***</u>
		1998	1996		
<u>Market Leaders</u>					
Bank of America	\$ 5,016	15.9%	17.3%	38%	12.64%
Allfirst	<u>4,555</u>	<u>14.4</u>	<u>11.1</u>	37	8.31
Subtotal	\$ 9,571	30.3%	28.4%		
<u>Second Tier</u>					
Mercantile	\$ 3,081	9.7%	9.9%	24	15.29%
First Union	3,018	9.5	6.6	48	17.26
Provident	<u>2,459</u>	<u>7.8</u>	<u>6.1</u>	31	14.06
Subtotal	\$ 8,558	27.0%	22.6%		
<u>Other Large</u>					
SunTrust	\$ 1,265	4.0%	-	37%	12.34%
Susquehanna	648	2.1	2.5%	18	12.02
BB&T	624	2.0	-	30	19.09
Eastern Savings	398	1.3	1.4	17	25.79
Columbia	329	1.0	.8	16	13.12
Rosedale Federal	311	1.0	1.1	3	8.05
First Virginia	310	1.0	1.2	21	14.14
F&M	<u>258</u>	<u>.8</u>	<u>.3</u>	27	12.59
Subtotal	\$ 4,143	13.2%	7.3%		
Other Thrifts	\$ 3,643	11.5%	12.9%		
Other Comm. Banks	2,216	7.0	16.9		
Credit Unions	<u>3,472</u>	<u>11.0</u>	<u>11.9</u>		
Total	\$31,603	100.0%	100.0%		

*Baltimore City and Baltimore, Carroll, Cecil, Harford, Howard and Northern Anne Arundel counties.

**Includes mergers in progress.

***Twelve months ended March 31, 1999.

Source: SNL Securities LC, Charlottesville, Virginia.

The tide of consolidation spurred by technology, cost advantages and brand identification will, though, in time engulf Baltimore as well. The make-up of the region's future financial services leadership will be determined by the actions of Provident, Mercantile and the Allied Irish and is likely, but not certain, to create a structure similar to that of Washington. Entry into Baltimore, with Allfirst being such a major factor in South Central Pennsylvania, could as easily come from the north as the south. Further expansion in the Baltimore area by First Union, BB&T and SunTrust is possible, but equally possible are banks such as Fleet, PNC and Mellon, or their future owners, coming down from the north.

Southeast Virginia

As to how fast bank ownership can move from local to foreign, Baltimore need only look to Southeast Virginia. Less than two years ago, three Richmond-based banks - Crestar, Signet and Central Fidelity - were battling NationsBank for regional leadership. In just a matter of months, Crestar, Signet and Central Fidelity were sold and NationsBank, as a result of a supposedly "equal" merger, took the Bank of America name. Today, four of the nation's largest banks - Bank of America, First Union, SunTrust and Wachovia - have almost 60% of the Southeast Virginia deposits. In fifth place with about 6% of the deposits is North Carolina-based BB&T. The closest thing to a local with more than a 2% deposit share is First Virginia, and it is headquartered in the Washington suburbs.

The largest remaining true Southeast Virginia locals are thrifts, CENIT and Franklin, which have a combined 3% of the region's deposits, and close behind them with 1% or more of the deposits are James River and Old Point. This transformation from "bit players" to the largest locals creates opportunities, but only CENIT and Old Point, among them, have substantial fee income and double-digit ROEs.

This takeover of local banking and limited existing local alternatives has helped spawn the creation of many new banks in the region. The key ingredients for new bank creation - bank executives unhappy with or displaced by mergers, out-of-area banking leadership and the ready availability of capital - have resulted in five banks opening in or around Richmond, Norfolk and Charlottesville in the last three years with more on the horizon. These new banks are well on their way to becoming the primary local banking alternative in the region.

Deposit Share in Southeast Virginia

	Deposits 1998* (In mill.)	Market Share June 30,		Nonint./ Income Revenue**	ROE**
		1998	1996		
<u>Market Leaders</u>					
Bank of America	\$ 6,509	19.9%	15.7%	38%	12.64%
SunTrust	4,826	14.8	-	37	12.34
Wachovia	4,748	14.5	-	35	17.67
First Union	<u>3,159</u>	<u>9.6</u>	<u>3.6</u>	48	17.26
	\$19,242	58.8%	19.3%		
<u>Second Tier</u>					
BB&T	\$ 1,941	6.0%	1.6%	30%	19.09%
First Virginia	1,165	3.6	3.9	21	14.14
Franklin	535	1.6	1.5	5	8.65
CENIT	460	1.4	1.3	25	12.08
Centura	401	1.2	-	31	14.72
One Valley	373	1.1	-	21	13.25
James River	349	1.1	1.0	12	8.40
F&M National	345	1.1	.7	23	13.33
Old Point	<u>321</u>	<u>1.0</u>	<u>.8</u>	25	11.96
Subtotal	\$ 5,890	18.1%	10.8%		
Other Comm. Banks	\$ 3,298	10.1%	51.7%		
Other Thrifts	496	1.5	7.4		
Credit Unions	<u>3,764</u>	<u>11.5</u>	<u>10.8</u>		
Total	\$32,690	100.0%	100.0%		

*Includes mergers in progress.

**Twelve months ended March 31, 1999.

Source: SNL Securities LC, Charlottesville, Virginia.

With about two-thirds of the Southeast Virginia banking controlled by five banks, it might seem that the region is close to its end structure. It is certainly closer than most areas, but even more concentration is likely. The reduction of SunTrust, Wachovia and BB&T from three to two through a merger is possible, and the size of First Virginia argues against its long-term survival. Among the very large only Bank of America is immune to acquisition, and for First Union and whomever survives among SunTrust, Wachovia and BB&T, a change of signage to Bank One or Wells Fargo may be on the horizon.

Extended West Virginia

While most major metropolitan areas, Washington being an exception, are already there or rapidly moving toward two-thirds or more of their banking being controlled by three or four large banks, banking in the outlying regions is still decentralized. In the Middle Atlantic states, this is evident on both sides of the Appalachian Divide and around the Chesapeake Bay.

In West Virginia, including those portions of Virginia to its immediate south, just One Valley had more than 12% of the deposits as of mid-1998, and the only really large bank with a significant presence, Bank One, was no better than fourth in deposit size with a sliding 7% share. Standing between it and One Valley are two other West Virginia banks, United and WesBanco. Another West Virginia bank, City Holding, and Ohio-based Huntington were close behind Bank One.

This decentralization does not make banks in the region immune from the changes emanating from the new realities, but the dynamics will be different than in urban markets. Insurance, asset management, mutual funds and other financial products will be sold side-by-side with traditional bank products and services and remote access banking will play a major role in places like West Virginia, but they will not be coupled with a large physical presence from the big banks. This creates opportunities for regional banks to be part of the growth in a changing financial services environment.

The likelihood that regional banks will survive while the large banks exit West Virginia is contrary to the common wisdom of the early nineties. At that time, it was generally believed that Bank One, Huntington and other out-of-area banks would acquire their way into dominance in West Virginia. National City, Integra and Mellon were popular choices to be among those entering.

Deposit Share in Extended West Virginia

	Deposits <u>1998*</u> (In mill.)	<u>Market Share</u>		Nonint./ Income <u>Revenue**</u>	<u>ROE**</u>
		<u>June 30,</u> <u>1998</u>	<u>1996</u>		
<u>Market Leaders</u>					
One Valley	\$ 2,828	12.5%	12.2%	21%	13.25%
United	1,891	8.3	7.0	18	16.41
WesBanco	1,629	7.2	4.6	18	9.47
Bank One	1,591	7.0	9.7	46	16.52
City Holding	1,458	6.4	2.9	46	10.79
Huntington	<u>1,442</u>	<u>6.4</u>	<u>6.9</u>	29	14.73
Subtotal	\$10,839	47.8%	43.3%		
<u>Second Tier</u>					
First Union	\$ 865	3.8%	3.9%	48%	17.26%
First Community	772	3.4	2.9	17	12.81
First Virginia	750	3.3	1.4	21	14.14
First National -Keystone	648	2.9	1.3	54	-
BB&T	421	1.9	-	30	19.09
Putnam	344	1.5	1.5	2	11.12
Pocahontas	314	1.4	1.1	18	11.35
Huntington Federal	260	1.2	1.2	5	5.28
Bank of America	249	1.1	1.7	38	12.64
Community Trust	216	.9	-	21	9.12
Southwest Virginia	207	.9	.7	13	11.62
National Bank-Blacksburg	<u>200</u>	<u>.9</u>	<u>.9</u>	14	11.81
Subtotal	\$ 5,246	23.2%	16.6%		
Other Comm. Banks	\$ 4,863	21.4%	30.6%		
Other Thrifts	375	1.6	3.0		
Credit Unions	<u>1,395</u>	<u>6.0</u>	<u>6.5</u>		
Total	\$22,718	100.0%	100.0%		

*Includes mergers in progress.

**Twelve months ended March 31, 1999 or latest available.

Source: SNL Securities LC, Charlottesville, Virginia.

The recent acquisition of Matewan by BB&T lends some credence to the common wisdom of the past, but the ball is moving in the other direction. With

Bank One continuing to lose share and Huntington likely to sell to a larger bank, it is possible that both Bank One and Huntington will be gone from West Virginia within two or three years.

Who buys their West Virginia branches if they leave? BB&T is one possibility, but the more likely buyers are the West Virginia banks - i.e., One Valley, United, WesBanco and City Holding. They also will be the primary acquirers of smaller West Virginia banks that want to exit.

This suggests the sale of financial services in West Virginia will have three primary sources - third party access through the internet and telephone, regional chains and a plethora of single community or county banks in the smaller towns. At the high end, Citigroup, Bank One and others will have an “impossible to measure” share of the business with at most a couple of offices in the region. In the middle, will be three out of four among One Valley, United, WesBanco and City Holding with a merger of two of the group or a sale to BB&T causing the reduction. The small banks will be the third part, and a very substantial part.

In the short-term, though, BB&T could play a larger role in West Virginia by following its Matewan acquisition with the purchase of one of the larger banks in the state. This, however, could be only a temporary change as BB&T grows past \$50 billion or sells to a larger bank and takes on the mentality of the big banks, which is to not have a large physical presence in outlying markets.

Since the local banking leaders in West Virginia, in general, do not have high ROEs and a strong commitment to fee businesses - United is an exception of the former and City Holding of the latter - they would seem to be unlikely long-term survivors. They will need to have both, but because of the lack of interest in their market by outsiders, they will have plenty of time to make the necessary adjustments.

Shenandoah Valley

The difference between the outlying markets immediately to the east of West Virginia and extended West Virginia is that most of it is in Virginia and was part of the statewide coverage of the Richmond and Norfolk banks before they were acquired. As a result, their acquirers inherited substantial coverage in the western part of Virginia that they are unlikely to expand upon, but also not likely to relinquish totally. If Crestar, Signet and Sovran had not already been there, SunTrust, First Union and Bank of America would not have gone west on their own.

Wachovia and BB&T are different in their thinking relative to small towns and made deliberate decisions to enter the Shenandoah Valley with acquisitions of Jefferson and Main Street, respectively. Like BB&T in West Virginia, though, their interest in the region is likely to diminish as they themselves get larger or are acquired.

Despite the large bank's presence, the Shenandoah Valley, which in this analysis includes the West Virginia eastern panhandle and the adjacent Maryland counties, is, like all outlying regions, a highly fragmented market. First Union and Wachovia are the only banks with double-digit deposit shares, and, they, collectively, had just 24% of the area's deposits in mid-1998. SunTrust, Bank of America and BB&T had shares between 4% and 7%.

Going forward, the large banks will have a continuing direct presence as well as serving the area through remote access, but their local coverage should diminish. In some areas, this may involve branch sales with local banks doing the buying.

At least partially replacing the large banks as they retreat will be the local, or quasi-local, regionals - First Virginia, F&M National and One Valley. Any one of them could be acquired tomorrow by BB&T or Wachovia, but if they are independent three years from now, they will be around for a long time as BB&T and Wachovia are either sold or lose interest in small markets. First Virginia may have a more enduring appeal to large acquirers because of its Northern Virginia base, and if bought, its acquirer would reduce the coverage in the outlying parts of Virginia.

Deposit Share
Shenandoah Valley

	Deposits <u>1998*</u> (In mill.)	<u>Market Share</u> <u>June 30,</u>		Nonint./ Income Revenue**	<u>ROE**</u>
		<u>1998</u>	<u>1996</u>		
<u>Market Leaders</u>					
First Union	\$ 3,116	13.9%	10.7%	48%	17.26%
Wachovia	<u>2,278</u>	<u>10.2</u>	<u>-</u>	35	17.67
Subtotal	\$ 5,394	24.1%	10.7%		
<u>Second Tier</u>					
SunTrust	\$ 1,478	6.6%	-	37%	12.34%
First Virginia	1,231	5.5	5.5%	21	14.14
Bank of America	1,148	5.1	5.9	38	12.64
F&M National	1,100	4.9	4.8	23	13.33
One Valley	1,012	4.5	1.4	21	13.25
BB&T	<u>932</u>	<u>4.2</u>	<u>-</u>	30	19.09
Subtotal	\$ 6,901	30.8%	17.6%		
<u>Other</u>					
Keystone	\$ 528	2.4%	.9%	27%	12.65%
Susquehanna	463	2.1	2.1	17	12.02
First Citizens	374	1.7	.6	31	11.55
FNB	364	1.6	1.5	14	14.05
American National	331	1.5	1.6	19	13.96
Fulton	314	1.4	1.4	18	15.20
Virginia Financial	<u>311</u>	<u>1.4</u>	<u>1.3</u>	20	14.18
Subtotal	\$ 2,685	12.1%	9.4%		
Other Comm. Banks	\$ 5,733	25.7%	47.4%		
Other Thrifts	489	2.2	7.3		
Credit Unions	<u>1,142</u>	<u>5.1</u>	<u>7.6</u>		
Total	\$22,344	100.0%	100.0%		

*Includes mergers in progress.

**Twelve months ended March 31, 1999 or latest available.

Source: SNL Securities LC, Charlottesville, Virginia.

The end result for the sale of financial services in the Shenandoah Valley will be similar to West Virginia - i.e., a mix of remote access provided primarily

by large banks, a couple of regional chains and numerous single community or county banks. Most regionals and local banks do not have the commitment to fee income that the new realities will require, but again, time is on their side.

Chesapeake Region

Maryland's Eastern Shore and the Northern Neck and Middle Peninsula of Virginia have already experienced an almost total retreat of the big banks. First Union and its Signet predecessor have sold all of their offices in the region, and Bank of America and its predecessor banks have been reducing their coverage for years.

The diminishing status of the large banks has left two mid-sized regionals, Mercantile and First Virginia, as the Chesapeake Region's market leaders, and they only had about 25% of the deposits between them in mid-1998. Bank of America, SunTrust and the Allied Irish are also in the top six, but their deposit shares in mid-1998 were in the 5% to 7% range.

Unlike West Virginia and the Shenandoah Valley, there are no local regionals, and the regionals from adjacent markets with significant shares are from urban areas that makes their eventual sale probable. Mercantile and First Virginia are committed to independence, but their positions in Baltimore and Northern Virginia are so attractive to outsiders that they will be hardpressed not to succumb to the insatiable desire of investors to maximize value. This suggests small banks will be the long-term alternative to remote access banking in the Chesapeake Region.

While the small banks may be the survivors, the part of the Chesapeake Region that can be truly considered "outlying" will continuously shrink as suburban Washington, Richmond and Norfolk expand. This may already apply to the counties near the Bay Bridge on the Eastern Shore and near Routes 64 and 95 in Virginia's Middle Peninsula.

Deposit Share in Chesapeake Region

	Deposits 1998* (In mill.)	<u>Market Share</u> <u>June 30,</u>		Nonint./ Income Revenue**	<u>ROE**</u>
		1998	1996		
<u>Market Leaders</u>					
Mercantile	\$ 913	15.0%	14.2%	24%	15.29%
First Virginia	<u>591</u>	<u>9.7</u>	<u>6.4</u>	21	14.14
Subtotal	\$1,504	24.7%	20.6%		
<u>Other</u>					
Union	\$ 374	6.2%	5.3%	17%	10.02%
Allfirst	361	5.9	6.9	37	8.31
SunTrust	332	5.5	-	37	13.79
Bank of America	313	5.2	5.9	38	18.52
Eastern Virginia	297	4.9	2.6	11	13.18
Talbot	223	3.7	3.8	7	12.11
Calvin B. Taylor	<u>219</u>	<u>3.6</u>	<u>3.6</u>	8	10.02
Subtotal	\$2,119	35.0%	28.1%		
Other Banks	\$2,135	35.2%	44.4%		
Other Thrifts	165	2.7	4.4		
Credit Unions	<u>149</u>	<u>2.4</u>	<u>2.5</u>		
Total	\$6,072	100.0%	100.0%		

*Includes mergers in progress.

Source: SNL Securities LC, Charlottesville, Virginia.

Conclusion

The region-by-region look at the present state of banking in the Middle Atlantic shows that a) there are tremendous regional variations, b) most local banks are still overwhelmingly dependent on spread banking, and c) there is an abundance of traditional participants in a diminishing part of a growth industry. What these regional overviews do not show is the likely impact of out-of-area competition and a changing delivery system.

Even without that, though, there should be enough in this report to prompt bankers to ask the hard and relevant questions that are vital to the success of their

organizations. If not asked, their banks are likely to be among those that do not make it successfully through the next stage of the evolution of banking, and with disastrous results for investors. For starters, banks should ask themselves the following:

- Could the delivery of financial services change so much in the next few years that many, if not most, traditional banks will have minimal, if any, growth momentum.
- Did the bank's value reach a peak in 1998 that may not again be reached for many years, if ever.
- Is the bank capable of reinventing itself sufficiently to play a major role in the future delivery of financial services?

The first concern - the possibility that the delivery of financial services may change so that many banks will have minimal growth potential - is a key to everything else. A recent Business Week cover asked if "You're Merrill Lynch when Schwab.com comes along. You're Barnes & Noble when Amazon.com hits big.....What would you do?" Take the names out, and what is being asked is - If you are essentially a "middle man" and the need for the "middle man" is greatly diminished, - What do you do?

The internet is a threat to traditional banking as it is to any industry that is essentially transferring information at a cost, but it is only part of a change that will revolutionize the industry. Other elements include brand recognition, product bundling, lower costs, more convenience and better service. While local bankers like to point to better service as their strong point, they are only partially right. The service customers most value is being able to accomplish what they want without leaving home or office.

The internet threat also has to be put in its proper perspective in that it is not a threat to banking as an industry, but rather to individual banks. What the internet is likely to do relative to financial services is make deposits available nationally at standard prices and give the large banks the ability to use their cost and brand advantages in markets in which they do not have branches. In other words, it will be used primarily by banks against banks.

As to whether 1998 was a peak in bank valuations that may not soon be reached again depends on how well banks adapt to a changing environment, which

includes an evolving delivery system. In five years, a branch network dominated by teller stations and focusing on deposits and check cashing may be viewed as an altruistic undertaking with little investment value. Conversely, if a financial institution is providing services a customer needs and is willing to pay for, it is likely to attract the investor interest that goes along with being a relevant player in a high growth industry.

Unfortunately for banks, providing services that customers need and are willing to pay for in a day and age when there will be competitors that view market share as more important than profits, will be a challenge that may require reinventing themselves. This is no easy task in a ballgame that changes so fast that yesterday's product of the future can be today's albatross from the past.

It is not a stretch to think that the delivery of financial services could change so radically in the next few years that many local banks could become obsolete, and, if this happens, the negative effect on investment value will have them trying to explain away a stock price decline since 1998. The "flip-side" is that as some banks become out-of-touch, others will adjust. If there has been one consistent pattern in the evolution of the financial services industry, it is that the banks, as a group, always come out ahead because they have the resources and market capital to buy the competition if they cannot beat it.

Thus, for banks to reinvent themselves sufficiently to play a significant role in the future delivery of financial services - may be challenging, but most of the financial services institutions that are relevant and have a continuing investment value in the 21st century are likely to have bank origins. Whether your bank is one of them depends on the willingness and determination to do what it takes to adjust to the new realities.

Danielson Associates Inc.

Leaders in Acquisition Advisory Services

1996 to 1998 Bank Acquisitions Leading Financial Advisors – Nationwide – Sell Side*

<u>Rank</u>		<u>Number of Deals Announced</u>	<u>Aggregate Deal Value (in millions)</u>
1	Goldman, Sachs	15	\$150,942
2	Morgan Stanley	6	28,146
3	J.P. Morgan	3	20,467
4	Merrill Lynch	4	16,349
5	Keefe, Bruyette	23	11,891
5	Credit Suisse First Boston	3	11,891
7	Donaldson, Lufkin	5	3,817
8	Sandler O'Neill	9	2,459
9	Alex Sheshunoff	44	1,874
10	Danielson Associates	17	1,529
11	McDonald Investments	8	1,491
12	Hovde	15	1,411
13	Wheat First Union	4	1,198
14	ABN AMRO	14	1,191
15	Carson Medlin	21	1,093
16	Lazard Freres	2	1,082
17	Scott & Stringfellow	18	1,061
18	NationsBanc Montgomery	6	870
<u>19</u>	<u>Berwind</u>	14	862
20	Professional Bank Services	29	846

* Advisor for the selling bank only.

Source: SNL Securities LC, Charlottesville, Virginia.

6110 Executive Blvd., Suite 504, Rockville, Maryland 20852 • (301) 468-4884

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