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**Southeast Banking Report
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The Local Impact of Banking's New Realities

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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 in the high growth southeast includes most of Florida and more than half of the population of Georgia and the Carolinas.

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 South Carolina or is an \$8 billion regional like Centura, 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 Atlanta, Miami and Charlotte areas, 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. Atlanta, 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 state-by-state look at the Southeast 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.

Deposit Share
North Carolina

	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 Leader</u>					
Bank of America	\$ 19,653	18.6%	10.6%	38%	12.64%
BB&T	15,594	14.8	16.4	30	19.09
First Union	13,382	12.7	14.3	48	17.26
Wachovia	<u>12,641</u>	<u>12.0</u>	<u>13.6</u>	35	17.67
Subtotal	\$ 61,270	58.1%	54.9%		
<u>Other Large</u>					
First Citizens	\$ 6,954	6.6%	7.5%	31%	11.55%
Centura	5,439	5.2	5.9	31	14.90
CCB	5,275	5.0	5.3	26	18.49
Triangle	1,596	1.5	1.8	19	14.23
First Charter	1,083	1.0	.6	16	3.71
SouthTrust	782	.8	.8	25	14.65
Carolina First	609	.6	.4	20	12.89
Piedmont Federal	567	.5	.6	4	7.07
Southern Bancshares	531	.5	.6	20	9.89
LSB	525	.5	.5	19	12.83
Fidelity	<u>516</u>	<u>.5</u>	<u>.5</u>	18	7.41
Subtotal	\$ 23,877	22.7%	24.5%		
Other Banks	\$ 7,673	7.3%	5.0%		
Other Thrifts	3,122	3.0	5.8		
Credit Unions	<u>9,513</u>	<u>8.9</u>	<u>9.8</u>		
Total	\$105,455	100.0%	100.0%		

*Twelve months endings March 31, 1999 or latest available data.

Source: SNL Securities LC, Charlottesville, Virginia.

Deposit Share
South Carolina

	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 Leader</u>					
Wachovia	\$ 5,691	15.2%	15.9%	35%	17.67%
Bank of America	4,583	12.5	14.2	38	12.64
BB&T	<u>3,515</u>	<u>9.4</u>	<u>9.5</u>	30	19.09
Subtotal	\$13,789	37.1%	39.6%		
<u>Other Large</u>					
First Union	\$ 2,335	6.2%	7.5%	48%	17.26%
Carolina First	2,034	5.4	4.3	20	12.89
First Citizens	2,019	5.4	5.1	31	11.55
Synovus	1,186	3.2	3.1	56	19.24
First Financial	1,165	3.1	3.3	21	16.16
Anchor	1,011	2.7	1.0	17	11.59
Regions	960	2.6	2.4	26	15.00
CCB	950	2.5	3.0	26	18.49
First National	611	1.6	1.1	23	12.82
Palmetto	<u>502</u>	<u>1.3</u>	<u>1.2</u>	21	17.92
Subtotal	\$12,773	34.0%	32.0%		
Other Banks	\$ 4,319	11.5%	11.9%		
Other Thrifts	3,148	8.4	8.0		
Credit Unions	<u>3,335</u>	<u>9.0</u>	<u>8.5</u>		
Total	\$37,364	100.0%	100.0%		

*Twelve months endings March 31, 1999 or latest available data.

Source: SNL Securities LC, Charlottesville, Virginia.

Deposit Share
Georgia

	Deposits <u>1998</u> (In mill.)	<u>Market Share</u> <u>June 30</u>		Nonint. Income/ <u>Revenue*</u>	<u>ROE*</u>
		<u>1998</u>	<u>1996</u>		
<u>Market Leader</u>					
Bank of America	\$13,186	14.3%	16.8%	38%	12.64%
SunTrust	10,385	11.2	10.9	37	12.34
Wachovia	8,893	9.6	9.5	35	17.67
First Union	<u>7,896</u>	<u>8.5</u>	<u>9.3</u>	48	17.26
Subtotal	\$40,360	43.6%	46.5%		
<u>Other Large</u>					
Regions	\$ 5,520	6.0%	5.7%	26%	15.00%
Synovus	5,138	5.6	4.9	56	19.24
SouthTrust	4,014	4.3	4.8	25	14.65
Premier	1,498	1.6	-	39	21.81
BB&T	1,472	1.6	-	30	19.09
United Community	865	.9	.6	13	16.01
Century South	853	.9	1.0	18	12.43
Eagle	807	.9	.6	38	13.50
Monogram	673	.7	.4	42	9.08
Prudential	666	.7	1.0	42	(1.06)
Colonial	610	.7	.6	27	11.22
Fidelity National	577	.6	.7	34	7.18
ABC Bancorp	517	.6	.6	18	12.65
Flag Financial	<u>510</u>	<u>.6</u>	<u>.4</u>	24	2.33
Subtotal	\$23,720	25.7%	21.3%		
Other Banks	\$20,025	21.6%	21.3%		
Other Thrifts	1,676	1.8	3.5		
Credit Unions	<u>6,866</u>	<u>7.3</u>	<u>7.4</u>		
Total	\$92,647	100.0%	100.0%		

*Twelve months endings March 31, 1999 or latest available data.

Source: SNL Securities LC, Charlottesville, Virginia.
Deposit Share

Florida

	Deposits 1998 (In mill.)	Market Share June 30		Nonint. Income/ Revenue*	ROE*
		1998	1996		
<u>Market Leader</u>					
Bank of America	\$ 48,984	23.3%	28.8%	38%	12.64%
First Union	32,298	15.4	15.8	48	17.26
SunTrust	19,796	9.4	9.6	37	12.34
Subtotal	\$101,078	48.1%	54.2%		
<u>Other Large</u>					
SouthTrust	\$ 10,236	4.9%	4.9%	25%	14.65%
Washington Mutual	6,556	3.1	3.7	23	16.78
AmSouth	5,032	2.4	2.6	31	19.07
Union Planters	4,752	2.3	.5	30	8.36
Huntington	3,926	1.9	.7	29	14.73
Golden West	3,398	1.6	.6	9	15.06
Ohio Savings	3,029	1.4	.6	14	18.21
Citigroup	2,767	1.3	1.2	62	13.89
Republic Security	2,390	1.1	.4	21	(8.35)
Colonial	2,077	1.0	.9	27	11.22
Republic Bancshares	2,063	1.0	.7	36	(7.65)
Ocean	2,046	1.0	.6	20	20.57
Northern Trust	2,031	1.0	.7	69	19.39
BankUnited	2,012	1.0	.5	16	(3.90)
Regions	2,010	1.0	.8	26	15.00
BankAtlantic	1,813	.9	1.0	36	(2.14)
F.N.B.	1,317	.6	-	19	11.79
Hamilton	1,205	.6	.2	24	19.54
Compass	1,169	.5	.6	27	16.28
Capital City	1,139	.5	.5	31	12.18
Fidelity Bancshares	1,016	.5	.4	18	7.41
Wachovia	983	.5	.4	35	17.67
Subtotal	\$ 62,967	30.1%	22.5%		
Other Banks	\$ 23,764	11.4%	11.5%		
Other Thrifts	6,409	3.0	4.1		
Credit Unions	15,881	7.4	7.7		
Total	\$210,099	100.0%	100.0%		

*Twelve months endings March 31, 1999 or latest available data. 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.

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<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
19	<u>Berwind</u>	14	862
20	Professional Bank Services	29	846

* Advisor for the selling bank only.

Source: SNL Securities LC, Charlottesville, Virginia.

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