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THE ART OF POSITIONING
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The Business Banking Market

The vast majority of banks include at least some types of businesses among their target client groups, and an increasing number of credit unions are adding or augmenting their business banking offerings. However, the market for commercial or business banking services is not a single, monolithic entity. Rather, the market consists of several distinct types of businesses. Before crafting a strategy to pursue the business banking market, it is important to understand the scope and composition of that market.

Tier	Annual sales	Businesses	% of U.S. businesses	Typical service provider
Micro	< $1 million	4,400,000	68%	Branch manager
Small	$1M - $10M	1,700,000	27%	Business banker
Middle market	$10M - $50M	265,000	4%	Regional commercial banking
Large commercial	> $50M	45,000	0.7%	National / corporate banking department

Sizing the market

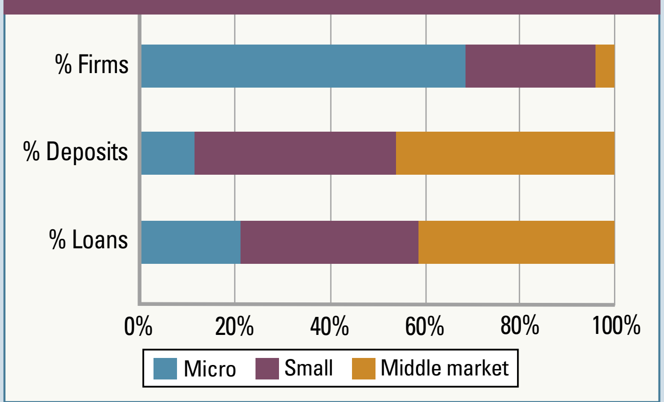
The U.S. Small Business Administration reports that there are 28 million businesses in the U.S., but this includes businesses of all forms, from small, part-time ventures to large corporations. Thus, the 28 million statistic includes more than 21 million sole proprietorships with no salaried employees. The vast majority of those small proprietorships are home based, part-time ventures with minimal revenues and no meaningful banking needs.

Thus, from a banking standpoint, a better indicator of market size would include only firms operating as full-time businesses with a distinct, non-residential address. By that definition, the count of U.S businesses falls to a more plausible nine million establishments. But even that count includes branch offices and franchises (i.e., each branch of your bank, each Walmart store, each Subway restaurant counting as a separate entity). This may be relevant to an air-conditioning firm – every McDonald's restaurant still needs the air filter changed – but not to a financial institution, as most banking decisions are reached at the corporate rather than store level. Franchises, though, present a distinct consideration: many service providers are franchised to independent owners; so while every Safeway grocery may use the same banking provider, every Dunkin' Donuts franchise owner can reach their own banking decisions.

Eliminating branch offices leaves a potential business banking universe of 6.5 – 7.0 million businesses, depending on how franchised stores are categorized. Even among the universe of full-time businesses, the distribution remains highly skewed toward smaller firms:businesses with annual sales of less than $1 million comprise 68% of all firms, and less than 1% of businesses report annual sales of more than $50 million. The table below shows a framework for classifying businesses by sales tier and banking service channel.

Although the distribution of U.S. businesses skews heavily toward the smallest sales tier, the distribution of balances shows an opposite pattern. Excepting the large commercial (continued on page 2)

Distribution of U.S. Business Balances



The Business Banking Market (continued from page 1)

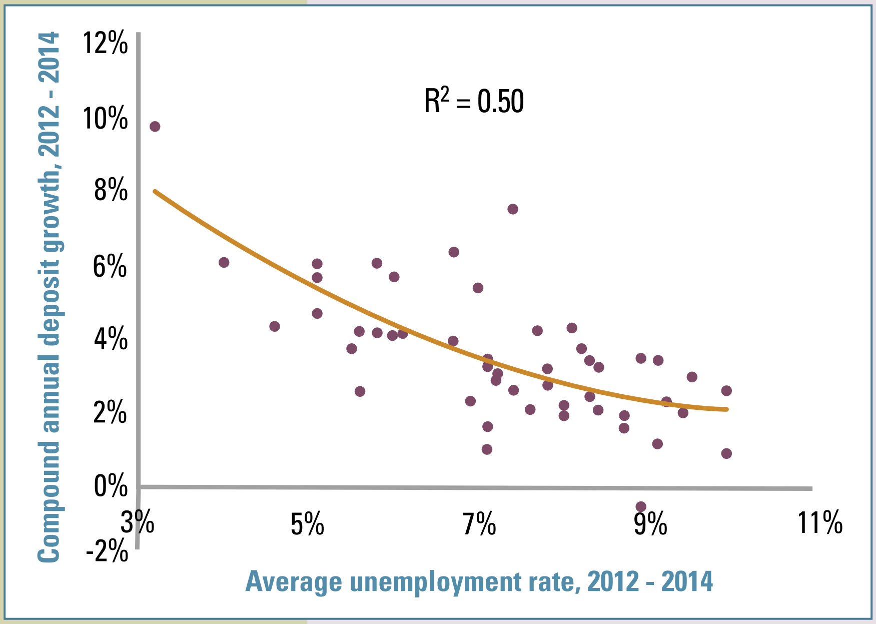
tier, which remain the near-exclusive province of a small cadre of money-center institutions, the U.S. business banking universe represents a $2 trillion lending market and an $880M deposit market. However, the middle market firms that account for only 4% of all businesses hold 46% of those deposits and 41% of those loans; while the micro firms that represent 68% of all businesses account for less than 20% of deposit and loan balances.

While sales volume presents an obvious means of segmentation, industry type offers an alternate view (or potentially, a cross-tabbed view, with sales). Of the 6.5 million businesses in the U.S., about two-thirds fall into the services or retail sectors, as defined by the Office of Management and Budget's Standard Industrial Classification.

The SIC framework includes more than 70 subcategories below the eight primary categories shown in the chart. Thus, while the service sector contains 43% of all U.S. businesses, that group is near evenly divided between the professional-services firms (e.g., healthcare, legal, engineering, accounting) many banks covet and the personal-services firms (e.g., restaurants, hotels) many banks shun. Despite the multitude of institutions that avoid small retail and service sector firms due to an aversion to large-scale cash handling, keep in mind that those attitudes create a less competitive environment for those banks and credit unions willing to pursue – and appropriately price – those sectors. However, the broader point to consider is the diversity of the business banking market, and the importance of crafting appropriate product and value propositions for whichever sales and industry segments your institution hopes to pursue.

Primary SIC	% Businesses
Services	43%
Memo: Professional services	21%
Retail	23%
Construction	10%
Finance / Insurance / Real estate	6%
Wholesale trade	5%
Manufacturing / Mining	5%
Transportation / Utilities	4%
Agriculture	3%

The Relationship between Employment Levels and Deposit Growth



The financial crisis of 2008 not only ushered in a period of high unemployment; it also brought about a period of languid deposit growth that persisted throughout the ensuing recession. But as the U.S. unemployment rate receded from its 2009 peak of 10% toward 6% in 2014, deposit growth rates rebounded, and that rebound in deposit growth has continued as the unemployment rate plummeted to 5% in the second half of 2015.

The correlation between the rates of employment and deposit growth is intuitive; increased employment creates increased wages, which provides more surplus income to deposit into checking, money market, savings and CD accounts. However, the strength of the correlation is impressive. The graph at the left compares the two measures and finds that for every one percentage point (continued on page 4)

A Road Map for Realignment: Evaluating and Prioritizing Branch Reconfiguration Projects

At a time of declining in-branch transaction volumes, most financial institutions have concluded that branches can operate with less space and fewer employees. Accordingly, the average size of new branches continues to decrease, and numerous institutions are testing pilot floor plans in the 800 – 1,600 square foot range. While designing a facility to house all core banking functions in a reduced space presents some challenges, architects designing new branches enjoy the luxury of a blank canvas, albeit subject to some site constraints. But the vast majority of opportunities to reduce occupancy burdens and staff costs lie in reducing the footprint of current branches, an expensive effort that may involve substantial interior reconfiguration and thus prove difficult to justify.

In one context, bankers can easily rationalize branch renovations and reconfigurations. Even if the institution can not achieve the desired floor plan in the current space and must relocate the branch, the project still will rarely carry incremental staffing costs; and in many cases will reduce those costs. However, any renovation or relocation still requires capital – about $125 per square foot in construction for a typical renovation or more than $300,000 for a 2,500 square foot branch before any new equipment costs – and it can be difficult to rationalize that capital request for an investment that does not avail the institution of any greater count of potential customers.

Consider a bank with ten branches and two prospective renovations, each costing $500,000. The bank can renovate two branches for a total cost of $1 million, but afterwards it would still have ten branches. Or, it could build one new small branch for $1 million, and now have 11 branches – serving 11 different potential groups of customers. Which option would you favor? When weighed against devoting the same capital to network expansion, renovations and relocations become difficult to justify. That noted, such ongoing network maintenance remains critical to maintaining an efficient and updated network, but substantiating those projects requires one of two analytic paths.

The cost equation

The simplest justification for a project occurs if it can immediately improve earnings, i.e., if the cost savings from any staff reductions realized from the renovation exceed the annual depreciation incurred from the capital outlays for the project. For example, a $500m renovation with a weighted average depreciation term of ten years would add $50m in annual expenses. If the redesigned branch could then operate with two fewer tellers, each at a fully loaded annual cost of $30m, then with the $60m annual staff savings more than offsetting the $50m gain in occupancy expenses, the project would prove irrefutably justifiable.

The revenue equation

However, if projected cost savings alone remains insufficient to offset increased depreciation expense, the institution must then determine the revenue gain to justify the project. Consider the previous example, but in a scenario where the renovation allows reduction of only one teller, i.e., $50m in expenses but only $30m in savings. In this case, the pertinent question becomes: "how much in incremental income does the branch need to generate to offset the incremental costs of the project?" To compute this, divide the net project cost (i.e., the overage after subtracting any staff savings) by the bank's gross margin, defining gross margin as net interest margin plus the ratio of noninterest revenue to deposits. The result of this equation yields the deposit gain required to turn the project breakeven. In the prior example, if the bank shows a 3.00% gross margin and earns 0.50% per deposit dollar in noninterest revenue, the branch would need to generate $571m in incremental deposits to achieve exactly the $20m in revenues needed to offset the project's net costs ($20,000 / (.0300 + 0.0500) = $571,428). Though, keep in mind that for the project to truly prove beneficial, those balances represent gains above and beyond what the branch could otherwise generate absent the renovation.

What constitutes balances above and beyond what the branch could have captured sans renovation remains abstract, and especially difficult to consistently ascribe across a network in order to prioritize reconfiguration projects. Thus, if an institution maintains more than eight to ten branches and wishes to recast all branches such that their size aligns with market demand (but lacks the capital to retrofit all branches at once), it will need a method of prioritization.

One approach for prioritizing renovations is to group branches into tiers based not only on the cost-benefit proposition but also on the role of each branch in the overall network. Thus, in addition to the profitability assessments described previously, consider categorizing each branch by its role in the long-term network, reserving the majority of renovation investments for two types of branches: anchor branches that carry sizable deposit bases in top potential submarkets, with a history of top sales performance; and rising sales engines, with low-to-moderate current balances, but in submarkets with the highest upside opportunity.

Even if striving to recast the entire network with new design and technology concepts, consider an approach that allocates a full renovation framework for the top-tier branches as described above, but a lesser program for branches that remain secondary drivers of revenue or hold limited upside potential. To maintain brand consistency and enthusiasm corporate-wide, be sure to allocate some level of investment to every branch; for example, complete transformation of the top-tier branches; modest technology investments in the second tier; and cursory merchandising in all others. In this way, an institution can effect the comprehensive retrofit its network requires while remaining within its capital budget.

NEWS

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reduction in the unemployment rate, markets experience a seven-tenths of a percentage point gain in their rate of deposit growth. The seven-tenths of a percentage point gain is more substantial than one might initially perceive. At a time when the U.S. overall shows 3.5% annual deposit growth, a market with an unemployment rate of 4% versus the nationwide 5% level could expect 4.2% annual deposit growth. For a $15 billion market (typical of many mid-sized metros such as Greenville SC, Dayton OH, Springfield MA and Tucson AZ), that disparity would bring more than $600M in additional deposits over a five-year horizon.

The graph at the bottom of page two shows the average deposit growth rate for each state from 2011 – 2014 compared to the average unemployment rate over the same period.

Thus, when considering branch expansion in a market, be sure to assess not only trade area demographics, but also overall market level economic conditions. A favorable or improving employment environment represents a harbinger of future balance growth, and will indicate an opportune time to undertake branch expansion.

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