Honesty Is the Best Policy:
Real Strategic Choice

Reading the local papers in Rochester this week brought home the value of honest strategic planning. Kodak and its iconic little yellow box have finally run out of luck. First, the company's debt was downgraded to one notch above junk bond status, and then shareholders found its dividend cut by over 70%, causing the stock to tumble 20%. This, mind you, after a fall of over 50% from its highs a few years ago. The stock is near a 20-year low. What for? In order to pursue yet another "new direction" for the company.

In analyzing the travails of Kodak, it is hard to avoid the conclusion that the planning process failed to honestly face the threat to film sales. It didn't take a lot of insight to realize as long ago as the mid to late 1980's that digital photography would overtake film. After all, everyone tossed out their Super-8 cameras when video-cameras came along. I myself have owned three different digital still cameras starting with the first in the early 1990's. What was the blind spot that Kodak (and honestly, Polaroid before it, not to mention Digital Equipment and now Sun Microsystems) fell subject to?

The answer, in my opinion, is human nature. Regardless of all of the folks preaching the idea that change is good, change is to be welcomed, change will make you strong, the fact of the matter is that people don't like change. We all seek routine. Sure, we enjoy novelty things that are new, but real change? Novelty is trying an unfamiliar dish at our favorite restaurant; change is becoming a vegetarian after a lifetime as an omnivore.

<u>Planning for Banking</u>

Now if everyone in the world knew that film was on the way out, what is it that everyone knows about banking but isn't admitting? For years, it has been said that banking, especially at the consumer level, is a mass-market retailing business. How many institutions have truly incorporated this fact into their planning? How many have redesigned their delivery systems with the convenience of the customer in mind? Have hours been changed? Who's open on Saturday? Sunday?

There are two main reasons we might consider for why most of the industry has disregarded the evidence. First, many bankers may not believe that the projections are true. Although it is hard for me to believe that anyone can hold this view, it is possible. I would suggest that most have bought into the idea that convenience and value for price paid (the two hallmarks of successful retailers) are the keys to success in retail banking. How else to explain the explosion in de novo branching over the past few years? In fact, take a look at the following chart which depicts the dollar market share against the number of branches market share in three upstate counties.

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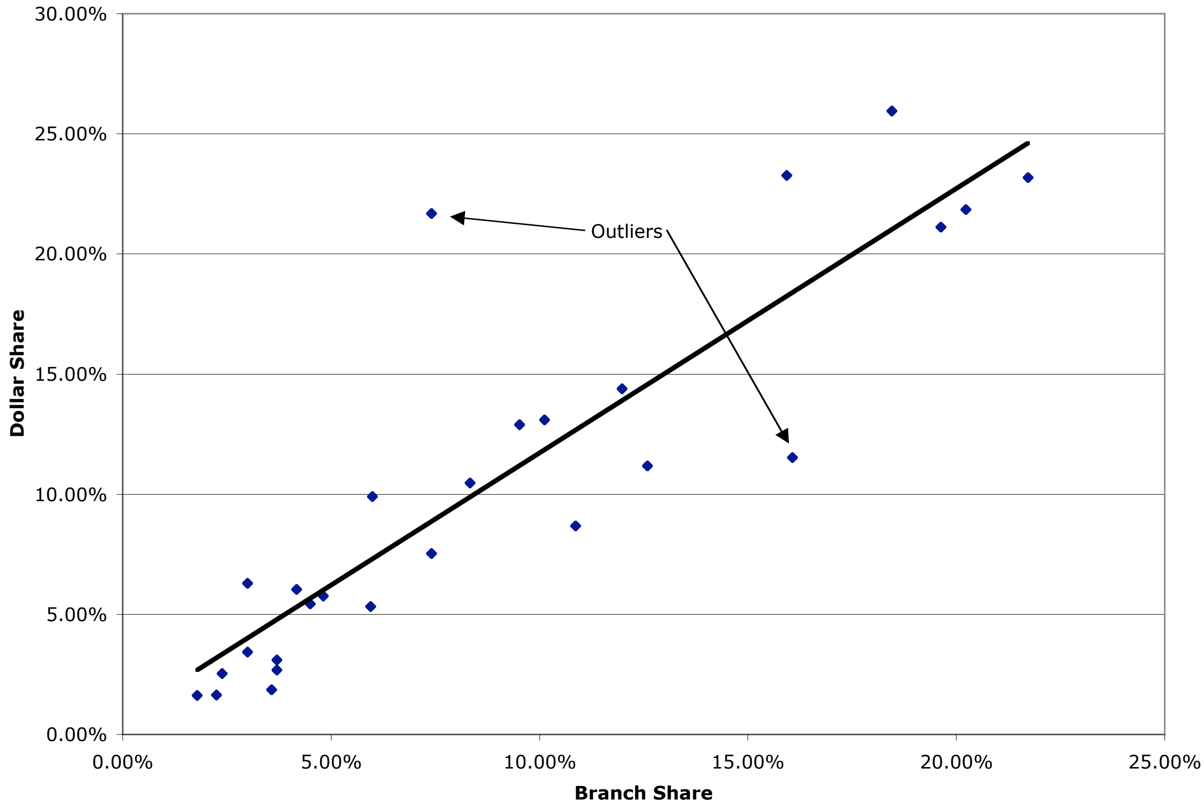

To me this chart pretty much puts to rest the idea that there is a better way of marketing to the consumer than simply having locations. There are two outliers (as labeled), but without naming names, I can easily identify the historical reasons for the different performance. The other key finding is that there are no institutions with a market share above 10% in dollars that have less than an 8% share in locations.

The second reason is a more likely explanation. In fact, it was discussed at length in an influential book by Clayton Christensen entitled *The Innovator's Dilemma*. The thesis was a simple enough insight. Successful companies do very well at marginally improving their performance over time by doing what they do a little better each year, by listening to customers and delivering. The problem is that when a truly new way of doing business (or a truly disruptive product) comes on the scene, the incumbent companies find that adopting the new will seriously erode their existing base. This is precisely why even after rate ceilings were eliminated, bankers didn't match rates with money market funds, allowing them to grow to over $2 trillion. The reason the industry as a whole has not embraced a truly retail strategy for the mass market is that the costs outweigh the near-term benefits.

This explanation is at once comforting and disturbing. It is comforting because it suggests that the reasons for holding back on a full bore retailing approach are grounded in fact and analysis as opposed to simple refusal to change. But it is disturbing because it implies that there may be no way out of the situation before more efficient competitors take over. As many wags have commented about banking, "better to be wrong with company than to be right by yourself."

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Facing Facts, Making a Choice

The story of Kodak fits the profile of knowing the situation but being unable or unwilling to cannibalize core business to move in a new direction before it is too late. But to be candid, it is easier to see the end in an industry that doesn't employ me directly. I believe that the next ten years will move retail banking into one of three models:

- Commerce Bank
- Wal-Mart
- Canada

The Commerce Bank model fully embraces retailing, starting from a banking perspective. Locations and extended hours are combined with an aggressive service and sales approach. Although I might question the short-term profitability of the core deposits gathered (see my most recent article for this newsletter), in the long run, the model captures customers who will be ripe for cross-selling. This is a volume game.

The Wal-Mart model is banking starting from a retail POV. They want to sell financial products like they sell everything else — always low prices. This model can work economically, the question is whether it will fly politically.

The Canadian model implies a small number of large banks that cover the entire country. As a result of the oligopolistic power they have, they can keep banking like it was. It's banking from the banking POV, but it results in only a few ultimate winners. In order for this scenario to play out, a massive amount of consolidation is necessary, once again raising a political question.

If a banker honestly looks at the landscape, I believe he or she will come to the same conclusion that I have. The days of avoiding the inevitable retailing of banking are well behind us. The options, depending on the way you see the end game playing out, are different than most are willing to face. They include:

1. Join the crowd with extended hours and more locations. Make it work through volume.
2. Sell to someone else. Be sure you're right if you take stock.
3. Resize the bank to concentrate on a defined niche focused on high levels of personal service and expertise. Defend your small slice ruthlessly.

Option 1 is the funnest, option 2 is the hardest, but option 3 may be the most realistic for most community banks. In my opinion, you will have to make a choice in the next five to ten years or it will be made for you. Strategic planning, properly pursued, can help you make it on your own terms.

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