Credit Union Facility Strategies, Planning and Management

A Three Volume Set

Volume Three:

Facility Acquisition and Management and Site Planning

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Table of Contents

Volume Three: Facility Acquisition and Management and Site Planning

ABOUT THE AUTHORS vi

ACKNOWLEDGEMENTS x

INTRODUCTION 1

HOW TO USE THIS BOOK 9

CHAPTER 1 Real Property Development and Real Estate Strategies 13

CHAPTER 2 Site Acquisition for Land, Land and Buildings, or Lease 15

CHAPTER 3 Market Expansion Through Mergers 39
By Glenn Christensen and Paul Seibert, CMC

CHAPTER 4 Consulting Services 45

CHAPTER 5 Budgeting 55

CHAPTER 6 Construction and Relocation Management 75

CHAPTER 7 Facility Management 97

CHAPTER 8 The Successful Facility Manager 119

GLOSSARY 129

BIBLIOGRAPHY 138

APPENDIX 141

RESOURCES 205

Volume One: Branch Strategies, Planning and Design

CHAPTER 1	Strategic Branch Planning	13
CHAPTER 2	Member/Market Analysis and Location Planning By Greg Stitt and Rich Nichols, Market ID, Inc.	35
CHAPTER 3	Unleashing the Power of Your Brand By Mark Weber, Weber Marketing Group	55
CHAPTER 4	Retail Branch Planning, Business Modeling and Prototype Development	69
CHAPTER 5	Branch and Alternative Delivery Systems	123
CHAPTER 6	Evaluating the Financial Side of Facility Investments By Glenn Christensen, Refection Point, Inc.	139
CHAPTER 7	Shared Branching and Its Effect on Branch Strategies and Facilities	159
CHAPTER 8	Site Planning and Design	165
CHAPTER 9	Technology Integration in Branches	197
CHAPTER 10	Ergonomics and High-Performance Service and Sales Environments	211
CHAPTER 11	Physical Security Planning	281
CHAPTER 12	Furniture and Equipment Analysis and Purchasing	301
CHAPTER 13	Feng Shui	317
CASE STUDIES		337

Volume Two: Operations Facility Planning and Design

CHAPTER 1	Strategic Operations Planning	13
CHAPTER 2	Operations Planning and Design	57

Chapter 3

Market Expansion Through Mergers

By Glenn Christensen and Paul Seibert, CMC

Increasingly, credit unions are recognizing that when there is good synergy and market potential, mergers can be an effective means for market expansion, growth, and profitability.

The value of merging is becoming increasingly clear for both the continuing and acquired credit union. When you evaluate the drivers of value for members—rates, fees, convenient locations, extended hours, phone support, electronic access, service quality, and product variety—it is evident that combining two credit unions can offer greater value, particularly when a small credit union merges with a large credit union.

The disparity in the value equation is most pronounced when between small and large credit unions and often provides the greatest benefits for both members and staff. Smaller credit unions are generally more inefficient, requiring significantly larger margins to support the operating expenses and thus returning less favorable rates and fees to their members. Larger credit unions typically offer vastly superior delivery systems and technology. Members recognize the value differences and vote with their dollars, which is why large credit unions are growing at about twice the rate of small credit unions. Staff often have greater opportunity to advance and increase their income, while the executive team can benefit from an attractive compensation package that could not be funded by a smaller credit union.

A smaller acquired credit union should recognize immediate improvement in value to its members. For an acquiring credit union, mergers can be a highly effective way of acquiring new fields of membership, branch facilities, deposits, and loans. In our work we often recommend incorporating the right mergers as part of credit unions' strategic branching strategies.

In recognition of the value of expansion through mergers, credit unions are increasingly offering lucrative retirement and severance packages to the target credit union's management team. Compensation package development is often a sensitive issue for both CEOs. A number of credit unions are finding it most effective to engage the services of advisory firms that are highly familiar with the credit union movement and the merger process.

Our team (Paul Seibert, CMC, Glenn Christenson, and Mark Weber) are helping acquiring credit unions determine the best credit unions to approach; complete analysis of members, markets, facilities and finances; negotiate the deal; and then assist in the implementation. We are also helping credit unions that wish to be acquired work with their boards to understand the benefits of merging and gain their buy-in, develop the RFP, evaluate the proposals and benefits to members, negotiate the executive compensation package, and assist in the implementation.

While a separate book could be written about the process, pros and cons, and potential benefits, we will limit our presentation to a review of key points with expansion on the facility-related issues. Following are some of the issues you should consider when evaluating potential merger partners:

Market Considerations

Market Area

The demographic characteristics of the market areas being served reveal the potential to improve the performance of the target credit union you may wish to acquire. In evaluating the attractiveness of the market areas being served, you, as the acquiring credit union, should evaluate such issues as market size, market penetration of the target credit union, bank and credit union competition within the market, growth of households within market, home ownership, age, and income.

Additionally, you must assess how well this market matches with your own target market segments. For instance, if your credit union's goal is to pursue the Upscale segment, yet the target credit union is primarily serving a low-income depositor segment, this will likely not be a good strategic fit. On the other hand, if the market offers significant Upscale households that could be served by enhancing the acquired credit union's delivery systems, there may be a big potential win.

For employer-based credit unions, the market size (total SEG employees), demographics of the SEG base, stability of SEG employment, employment growth of SEGs, penetration within SEGs, and branch proximity to SEGs play important roles in determining the value of a merger.

Facilities

Branch location within the markets being served by the target credit union impacts the value of the merger. Are the credit union branches located on high traffic corridors? Do they offer easy access? Are the branches highly visible? Also, are the branches conveniently located for your existing members residing or working within the market? What percentages of target members or potential members are located within easy access to the branch?

An acquiring credit union should also evaluate the quality of the branch facilities. The acquiring credit union needs to determine whether the branches offer sufficient capacity, provides adequate drive-thrus, parking, etc. Furthermore, the credit union must assess whether the branch facilities portrays a favorable image and assess the extent of enhancements that must be made to update the branch to the acquiring credit union's branching standards.

We are often asked to find a potential credit union partner in a new target market that will provide market positioning convenient to households or employment centers with target market characteristics (Middle Income, Upscale, Credit Driven, Funds Providers, Underserved, and so on) as well as offer existing support of the branches with an acceptable percentage of the current membership with desirable relationship characteristics. Branch market positioning is often one of the key merger drivers for acquiring credit unions.

We may find that a potential credit union partner operates branches in the right markets but made poor site selection decisions, causing poor performance. The causes may be that second- or third-tier retail spaces may have been selected causing the branches to not be visible, be hard to access, lack sufficient parking, suffer inappropriate neighbors, or appear unsafe, causing potential members to pass them up for the bank or credit union down the street in a more attractive, safe, or accessible setting.

The facility evaluation should also look at the financial condition of the facilities. What is on the books and what are the facilities worth? Do the leases support your long-term strategy or have they lapsed to month-to-month or require eight more years of occupancy in an undesirable market with limited ability to sublet?

The business model used by the credit union under consideration may have driven a poor design of the branches, requiring overstaffing or leasing of substantial underutilized space. The layouts may not allow effective promotion of key products and services due to poor placement. The plan may not provide a sense of security that makes members feel safe or privacy that ensures conversations are not overheard or their account information made visible on MSR monitors. There may not be an effective merchandising program that creates high awareness of the credit union's offerings, or the branch culture may not be motivated to deliver a high level of service or advisor sales.

Business Strategies and Operations

In the process of our work, we are often asked to audit a potential credit union for acquisition. These audits provide a great deal of information about the operations, deposits, loans, compliance, financial structure, facilities, member relationship segmentation, and so on. There are also a number of side benefits, as we look at the total picture and pose the questions: Why is this credit union performing or not performing well? What should be done to increase members and market performance after takeover? It may be that the credit union is operating very well under good CEO and board management, but is just having difficulties due to a small asset size, high competition, or a lack of resources. Some times it is the economy, SEG situation, a risky loan portfolio, only moderately effective strategies or marketing, competition, lack of funds, and so on. Other times we find the difficulties may be easily fixed. For instance, we audited a $50 million credit union that developed a branch location strategy that placed its four branches between where people worked and where they lived. They were suffering from very low branch usage and growth in deposits and loans. A good deal of money had been spent on building and operating the branches, which limited the amount of money that could be spent on marketing. After a few phone calls and branch audits, we found that the branches were only open between 8:30 a.m. and 5 p.m. five days a week. The location strategy, combined with the operating hours, eliminated convenient access for the majority of potential target members. The reason for limiting the hours was the cost of staffing. The acquiring credit union increased the hours and the branches became busy.

Like looking for undervalued stock, the reason a credit union may be underperforming could be as simple as the wrong operating hours, or it could be as significant as branches being located in the wrong markets and a loan portfolio generating a 4% delinquency ratio.

Marketing

The acquiring credit union will also want to evaluate the extent to which it can leverage its existing advertising dollars to serve the market area of the target credit union. Are members of the target credit union currently being exposed to newspaper, TV, radio, Web banners, billboards, and transit vehicle ads being used as part of your credit union's marketing mix? You must also understand how receptive the membership base of the credit union under consideration would be to your targeted advertising messages. These questions will help address to what extent your marketing efficiencies will improve performance in target markets.

You should also have a good understanding of your ability to convert more members of the target credit union into profitable members. As part of the process, the acquiring credit union must assess the gaps that exist in the target credit union's product mix. You must understand the impediments the target credit union has faced in creating product penetration and assess its own ability to cross-sell additional products. Are the issues related to product awareness, lack of products, non-competitive pricing, or inefficient product knowledge and sales skills by credit union employees? These questions can be clearly answered by completing a member relationship segmentation analysis that tells you which members have relationships that are non-productive, marginally productive, or very productive, and which households are most likely to increase their relationships and which should potentially be purged.

Financial Considerations

Evaluating the financial side of a merger is of critical importance. As the competition for merger partners increases and the resulting costs for buying out target credit unions continues to escalate, it has become necessary for credit unions to do a thorough financial analysis. This analysis will assess how much you are willing to pay and what the return on the investment will be. A credit union may wish to develop the analysis skills in-house or work with a firm that provides financial analysis services to credit unions.

The advantages to using in-house resources is that your staff have an in-depth understanding of your strategic direction and how the credit union under consideration will need to be merged operationally and culturally into your credit union. The advantage to using outside resources is that you gain the counsel of consultants that have a high level of experience with the process, can recognize issues that may have been experienced during other mergers, can help negotiate sensitive cultural, future employment, and compensation issues, and can relieve the acquiring credit union of the hundreds of hours of work required to complete a successful merger.

Following is a brief outline of some specific financial issues that will impact the valuation of a merger:

Fixed Assets

You must evaluate the target credit union's fixed assets, their remaining depreciable life, whether they have ongoing relevance, and if they can be liquidated. Contractual obligations need to be assessed for relevance, including early termination clauses.

The value of facilities has particular importance to the merger process. What is the market value of the credit union's facilities versus the book value? Can some of the target credit union's branches be closed and members more effectively served through the acquiring credit union's branch network? If so, can the credit union achieve gains on the sale of facilities?

What is the condition of the existing leases? Can you negotiate out of poor lease conditions or locations? Can the leases be restructured to match the acquiring credit union's long-range delivery strategies?

Earning Assets

You should evaluate whether you can generate more productivity out of the target credit union's cash and investments.

The loan portfolio is clearly one of the most significant determinants in the valuation of a merger. There are a number of questions the analyst must address. What is the quality of the loan portfolio? Are the underwriting criteria adequate? How would the borrowing members' credit rating be stratified into different segments of risk? Is there adequate security? Do the members have sufficient earning capacity? Have loans been priced according to risk, and does the price satisfactorily reflect the risk of loans? Does the credit union have adequate reserves for probable charge-offs? Would a strengthening of collections enable the credit union to see a reduction in charge-offs?

Liabilities

The target credit union's valuation will also be affected by ongoing lawsuits or potential legal action that could be brought against the credit union.

Income Statement Efficiencies

Fee income can be an area of improvement for the target credit union. Smaller credit unions often have below-market pricing on fees and may be lax on enforcement of policies.

Operating expenses are generally a key area for significantly improving the financial performance of the target credit union. Of course, personnel expenses represent the greatest area for improvement as many functions can be consolidated into the surviving credit union. There are typically huge differences between the productivity of small versus large credit unions. Additionally, the purchasing power of your credit union will help drive down the cost structure.

Organizational Considerations

The cultural and political aspects of a merger are oftentimes the most difficult part of a merger. Key issues for the target credit union are board representation, management roles in your new organization, and the accommodation of staff. The uncertainty for the staff of the target credit union will be cause for consternation, possibly affecting the quality of service if not handled properly. Likewise, your staff are likely to feel overburdened by all the additional work required to successfully pull off a merger. Some of the key issues that will need to be addressed include the following:

Governance

How will the target credit union board and committee structure be incorporated into your credit union? Will you offer permanent board positions or increase the board on a temporary basis? Will you perhaps establish a market advisory committee to provide target credit union board members a channel for representing their members' interests?

Management

Does the target credit union have key management that would benefit your credit union? Or do the economics of the merger dictate that members of the target credit union's management team must be laid off, albeit with attractive severance package? What type of severance or retirement packages must be provided in order to gain acceptance for and facilitate a smooth transition of the merger?

Staff

How will staff be compensated? How will their retirements be funded? How will vacations be administered? What are the cultural differences between the organizations? How will change be managed to introduce the new employees to your culture, product knowledge, and sales skills that are critical for your credit union to achieve a strong return on its merger investment?

In Conclusion

Mergers offer your credit union an efficient way to gain rapid access to new target markets, provide branch facilities, enable you to gain more efficiencies, and offer better member service.

Many smaller credit unions would benefit their members by merging into larger, more efficient credit union operations. For many credit unions, their small size is forcing them to consider merging as they are having increasing difficulties competing against both banks and other credit unions. But even large efficient credit unions are recognizing the strategic value of mergers. These large strategic mergers see the importance that critical mass has in being able to compete in the rapidly changing financial services marketplace. They recognize the constraints of their individual credit union's resources even if they are among the largest credit unions in the country.

The increasing proliferation of mergers and competition for these mergers, including banks acquiring credit unions and vice versa, is driving up the valuation of credit unions across the country.

In this new environment of mergers, credit unions wishing to be acquired must be diligent in finding the best value for all its stakeholders. The handshake agreement with the golf buddy needs to be replaced with an active solicitation of merger partners that will optimize the overall value.

Credit unions looking to merge with others must acquire merger and acquisition (M&A) expertise. This expertise can either be staffed and developed internally or outsourced to an experienced advisory firm that already has the needed experience, expertise, and history of successful mergers. Because of the high costs of maintaining this expertise internally, the infrequent nature of merger deals, and the political ramifications within the credit union community, many credit unions are finding that outsourcing to a highly experienced firm delivers the best deal to both credit unions, their members, and the management teams. If you would like to discuss your merger strategies, please give us a call.