

SUCCESS BY CHOICE

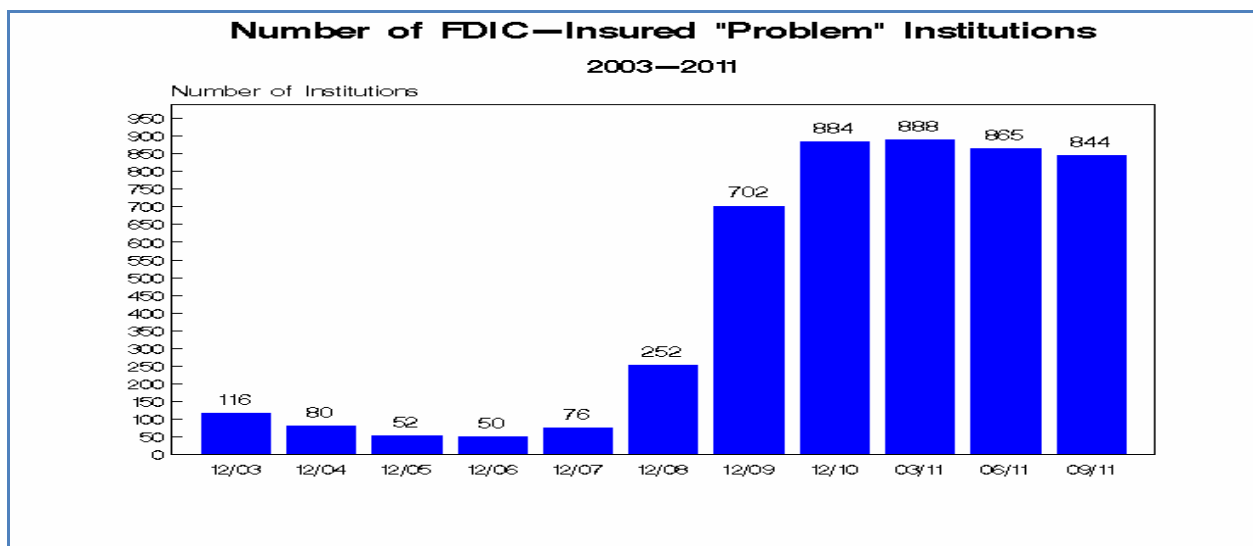
When a calamitous event clobbers an industry or the overall economy, companies fall into one of three categories: those that pull ahead, those that fall behind, and those that die. The disruption does not determine your category. You do.

The factors that determine whether or not a company becomes truly great, even in a chaotic and uncertain world, lie largely within the hands of its people.

from "Great By Choice", by Jim Collins and Morten Hansen

We have long argued that the economic recovery would be frustratingly slow, and recent economic reports seem to confirm this view; the need for individuals, businesses and governments to deleverage and the probability of continued turmoil in Europe (among other things) argue that any forward momentum is likely to remain subdued for at least the next couple of years. With no meaningful economic winds at our backs, we should expect only subdued growth in bank balance sheets, revenue and earnings. Furthermore, problem assets will probably not come off the banks' books either quickly or easily. In such a world, we are likely to see a widening gap between the winners, the losers, and also-rans in the community bank industry, in keeping with the first quote above. And in keeping with the second quote, whether or not a bank ends up in the winners column will largely depend upon its management and decisions being currently made.

In the new book "Great By Choice", management guru Jim Collins and his co-author Morten Hansen describe the results of a multi-year study into this issue, although they do not specifically focus on the banking industry or any individual banks. The authors make the point that companies which substantially outdistance their rivals over the long terms do so by thriving (not just surviving) in periods of chaos, which unfortunately still defines the banking environment. The next few years is likely to be a time in which good banks can move ahead at the expense of the weaker ones – and there are still plenty of weaker ones, as indicated in the following chart:



Source: Problem Bank List

This chart is based on an “unofficial” problem bank list regularly published in the Calculated Risk Blog; it shows about 100 more problem banks than does the FDIC, but both lists show a similar slow decline continuing throughout 2011. In either case, we’re talking about nearly one in eight of all insured depository institutions.

To summarize, the authors concluded that the traits that characterize the “10X” winners – those that far outdistance their rivals over the long term – are that they are more disciplined, more empirical, and more paranoid than their less successful competitors. We thought it might be interesting to apply these thoughts to the community bank industry, which seems almost certain to experience significant market share changes and widely divergent fundamental results over the next decade through organic growth or consolidation or (most likely) both.

LESSONS FROM THE BOOK

At the risk of sounding too much like a business school teacher or a management consultant, let’s take a look at the characteristics of the “10X” companies and see how they might apply.

Empirical Creativity. For us, the important part of this phrase is the empirical part; indeed, we believe that too much creativity can be a dangerous thing in banking, particularly when it is applied to “exciting new” business lines or practices, or expressed in overly creative loan structures. On the other hand, being very empirical (believing the data, not what you want the results to be) strikes us as an exceedingly valuable and under-used trait. We’re starting our discussion with this characteristic because we believe that relentless objectivity about your business, your franchise, your results is the key to making the other two traits (relentless discipline and productive paranoia) work for you.

In our opinion, bank managements should carefully (even intensively) examine everything the bank does and everything the bank is thinking about doing, applying the perspective of an outside and objective observer who has no emotional attachment to the bank’s activities. Many of today’s troubled banks got that way because their managements saw what they wanted to see in the bank’s results, rather than aggressively facing reality in a rapidly changing world.

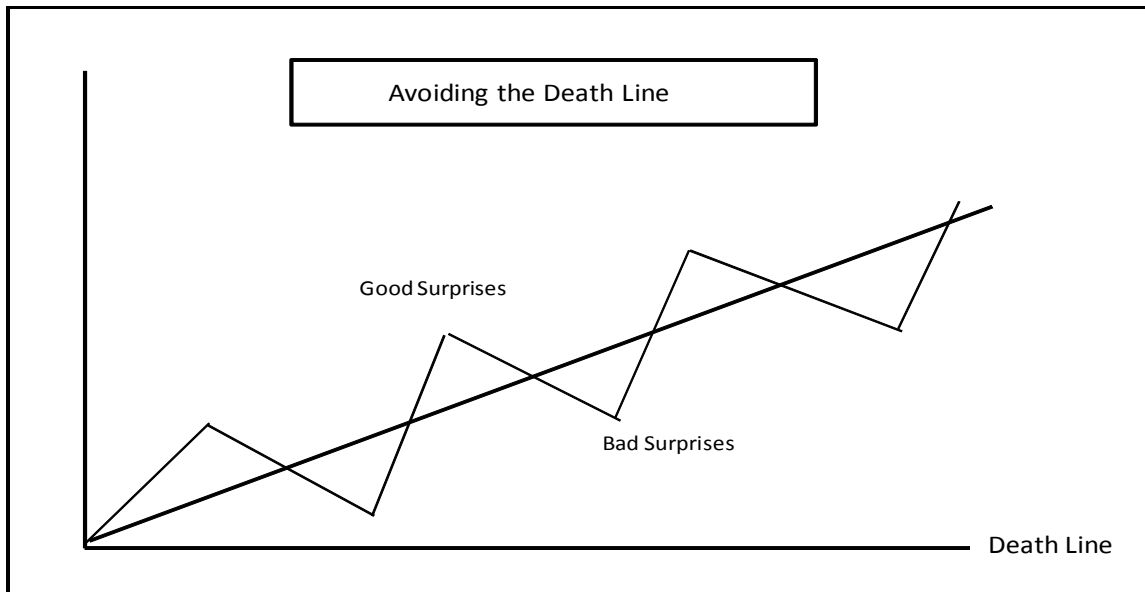
Relentless Discipline. To quote the book, “Discipline, in essence, is consistency of action – consistency with values, consistency with long-term goals, consistency with performance standards, consistency of method, consistency over time.” The authors introduced an interesting concept, the “20-Mile March”, borrowed from the real-life experience of two competing expeditions aimed at reaching the South Pole. One planned extensively, and held itself to a manageable 20-mile march each day, whether good conditions would have allowed for more or when very unfavorable conditions could have suggested less; the other group’s progress was much more inconsistent, and ended up putting the group in unexpected places that were distant from safe camps along the route. The first group made the trip successfully; the second did not, and in fact died on the journey.

Another quote: “The more turbulent the world, the more you need to be a 20 Mile marcher.” In such times, winning companies will need a plan based on empirical validation of what actually works, and (most importantly) the discipline to execute that plan. This plan needs to be methodical and consistent, a set of durable operating practices which the authors call its recipe. And the key to crafting a good recipe is to go directly to the practical, the empirical, and when possible the specific and concrete.

Interestingly, the less-successful companies tended to change their recipes much more frequently than the 10X companies. In the banking world, we have seen many managements jump on the latest strategic bandwagon (the current one is small business lending) without having the knowledge or skills, or having made the required investments, to pull it off. This is not a recipe for success. As the authors stated, “the signature of mediocrity is chronic inconsistency”.

The authors argue for great discipline in following the recipe, which leads to a couple of kinds of self-imposed discomfort: the discomfort of an unwavering commitment to high performance even in a difficult

environment, and the discomfort of holding back in a favorable environment. In contrast, poor performers and failures pursued much more aggressive growth plans and big-leap, radical changes in good times which put the companies in precarious positions when the environment turned negative. They quote a motto -- “Managing in good times so as to do well in bad times” -- from Southwest Airlines, the only airline to consistently turn a profit even in the year after the 2001 terrorist attacks. In their view, companies can accomplish this by putting clear boundaries around total risk, and by avoiding asymmetric and uncontrollable risk. By reining in the potential variability of results, companies can avoid the “Death Line” shown in the following chart; this strikes us as a useful concept for banks as well.



Productive Paranoia. The above discussion should not suggest that banks should be oblivious to changing conditions. As the authors say, “A great company must evolve its recipe, revising selected elements when conditions merit, while keeping most of its recipe intact.” To ignore, or be unaware of the fact that the world has changed can be the death of a company; many threatened or even failed banks are in that condition because they did not notice that the basic fundamentals of real estate finance had changed. In sum, management needs to keep one eye on the horizon to perceive these changes, and then take a rigorous look at itself to see how the company should adapt. The authors call it zooming out (examining, from a 10,000-foot high viewpoint, what’s happening in your environment that could disrupt your plans) and then zooming in (positioning your company to manage, even take advantage of those disruptions).

But the basic recipe, if well thought out and executed, should be amended only as necessary, rather than rushing to replace it wholesale in order to follow new fads in bank strategies. It is interesting to note that the “10X” companies changed their recipes far less often than their less successful competitors, but when they did, they executed those changes with great energy and discipline. The book contains an instructive example of Intel, which was facing ruinous competition in its important DRAM memory chip business. In an example of the empirical creativity discussed earlier, top managers asked themselves what a new management would do if it came into Intel; the answer was “get out of DRAMs”, and that’s what Intel did, shifting its energy toward its microprocessor business. But most importantly, it kept most of its recipe intact, in particular its commitment to the phrase “Intel Delivers”, and went on to be a super winner.

To us, this means that rigorous execution is more important than picking the “right” strategy. No one can truly predict the future, but one can be prepared to take advantage of whatever happens. To be this prepared, a company needs to be attentive and objective about both internal company results and external trends, and needs to regularly examine those trends and decide whether its basic recipe needs to be

amended (not abandoned) to cope with new conditions. It also must be willing to maintain irrationally large margins of safety around its risks.

IMPLICATIONS FOR COMMUNITY BANKS

We think there are several concepts here that can directly apply and be helpful to community banks. Some possibilities:

Assume an outsider's viewpoint. You may think a given loan is good, or that a specific unprofitable customer has considerable profit potential, but what would a knowledgeable outsider (with nothing invested in the questions) say about that? More broadly speaking, what would an outside investor think of your business practices? Would that investor want to invest in your bank? If not, why not?

Examine your "recipe". Develop a replicable operating plan that can generate consistent success and will make you a high performer. Your plan needs to be specific, concrete and practical; generalized plans (e.g., be the best bank in town) are of little use, and offer nothing to be measured against.

Zoom In. What parts of your business have consistently and objectively generated rewarding results, and are difficult for your competitors to duplicate? Viewed objectively and intensively, what in your business model has provided disappointing returns? What do you need to change in order to build up the good results and minimize the mediocre or bad results?

Zoom Out. Allocate some time and energy, on a regular schedule, to survey the world around your bank. Be alert to developments that may threaten your continuing success, as well as developments that may seriously weaken your competitors and create opportunity for you.

Adopt a "20-Mile March" mentality. Adopt ambitious but achievable goals, and hold yourself to them in both good times and in bad times. The discipline to forego easy but low-quality business in good times will pay off by positioning your bank with the strength to take market share in times of turmoil, which are the times in which real gains in franchise value (long-term earning power in the form of good customers and good bankers) can be achieved.

In sum, we feel that, in today's fluid and stress-loaded environment, there could well be a substantial reward for community banks that establish well thought-out plans and commit to rigorously execute those plans; such banks can emerge as clear winners in future years, putting a lot of open water between themselves and their competitors.

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