Trends

A look at some of the issues impacting the financial service center industry

Looking into a crystal ball is problematic at best. The view can be cloudy, often leading to a misinterpretation of what one sees, what the "facts" are, and what they mean. Nevertheless, we wanted to provide a brief look ahead at some of the "mega trends" that may well change the way we all do business over the next five to ten years. There may be other trends as well, but we have focused on the future of new competitors entering our marketplace, the regulatory environment and the corresponding cost of doing business, the changing customer base, consolidation of the industry through mergers and acquisitions, small-dollar micro loans, and immigration reform.

MERGERS MICROLOANS



To explore these topics we have tapped into the wealth of experience and expertise that exists among our members and have drawn upon the perspective of knowledgeable third party experts as well.

There can be no doubt that the financial service center industry will be buffeted by these winds of change. Some – such as a consolidation of the industry, or the evolution of micro lending – the industry and its individual members can somewhat control, and can even direct. Other trends, such as the impact of immigration reform and the changing regulatory environment, we will have far less ability to manage, if we have any influence over them at all. However, whether you are piloting the ship, or merely a passenger on it, its course and destination affect you all the same.

COMPETITION

Our first topic addresses an issue that is important to all operators – new competitors entering the marketplace. The perspective offered here reflects the insight of Mark Sproule, a vice president at Thomas Weisel Partners in New York. Mr. Sproule will be discussing the evolving competitive landscape of the alternative financial service provider industry at FiSCA's 2007 Annual Conference and Exhibition in Phoenix, AZ, on October 6.

Once again, the financial services market appears to have found a renewed interest in meeting the financial needs of lower income consumers. Expectations remain high among certain industry watchers and government officials that large service providers, such as Wal-Mart and Bank of America, will provide the "vaccine" that will allow 50 to 70 million consumers so-called "freedom" from check-cashing, money transfer and financial service providers. These new players in the unbanked and underbanked market space will help bring these individuals into the traditional retail banking/service model. While the vision may be appealing to some, the reality of market penetration is unlikely to be smooth.

While financial firms have long highlighted the positive opportunity for cross-selling services within the unbanked and underbanked markets, their limited relationships in local communities continue to hamper their penetration. Having said that, the gap between product demand and offerings has closed in recent months. Large branded players in lower end services, such as H&R Block and Western Union, have begun to step outside their traditional relationships (tax and money transfer, respectively) to add prepaid opportunities to their product platforms.

Additionally, alternative loan companies, such as Advance America, Dollar, and First Cash, have extended from mono-line credit platforms to broad service providers. Last, new products, such as prepaid debit cards, have allowed entry from large institutions historically absent in the market without requiring significant client interaction. These include MasterCard, American Express, and Bank of America. "The blending of product offerings will create new competition among low-end platforms, but will also present partnership and extension opportunities among previously disparate groups," said Sproule.

The key to any aggressive penetration into the underbanked market by new entrants, and to achieving positive results against smaller but experienced competition, will be the degree to which these companies are proactive about gaining an improved understanding of consumer tendencies and the reason why lower income groups utilize (or remain loyal to) non-bank providers. "As a matter of fact, I believe this is the true gap between the Point-of-Sale reality and Wall Street expectations," said Sproule.

A core element for anyone seeking to transition customer habits will be creating a positive value proposition for them. While improved convenience and functionality may be gained from credit/debit relationships, among the paycheck-to-paycheck community, electronic payments may not materially alter use patterns or save funds. For example, the average prepaid card costs 28% of deposited amounts through purchase fees, monthly fees, reload expenses and transaction fees, according to the Federal Reserve Bank of New York.

So, given their perceived limited value currently, can large firms with limited market presence make waves? Yes and no. Previous attempts to penetrate underserved communities have neglected to focus on the specific local and income-related preferences/demands of the consumer base. As large groups, such as H&R Block prepaid services and Wells Fargo check-cashing, begin to extend beyond their core platforms and provide demand-driven products that are specific to the customer, versus previous plans that tried to apply national products to low-end consumers, penetration will slowly develop. However, the limited historical relationships, and in many cases, small local presence, may create a greater emphasis on partnerships or acquisition opportunities in the near term.

Increased competition from industry goliaths does not mean the end of small service providers, but instead may drive the innovation and product enhancements that allow for the beginning of real customer loyalty or retention. As smaller retail players expand their offerings to lower income groups, they continue to expand the consumer interaction beyond the initial entry point of tax, payday loans, check cashing, and bill pay; and thus, enable the opportunity to develop enhanced loyalty.

The forced expansion due to competitive threats may lead to better customer experience, less regulatory issues (as consumers use services beyond potentially contentious loans), and increased security against larger retail engines. "Small regional players must adapt to the coming encroachment by larger institutions, but the increased attractiveness of their customer base may make them better partners, or targets, than competitors," Sproule concluded.



Ian MacKechnie

REGULATORY ENVIRONMENT/ COST OF DOING BUSINESS

Most companies would view government regulation as the bane of their existence - the necessary evil that must be managed as efficiently as possible so as not to unduly impede the business of business. That is certainly true for most members of the financial service center industry. To help put the current regulatory environment in context, as well as offer some insight into the

immediate future, we spoke with Ian MacKechnie, President and CEO of Amscot Financial.

When thinking about how government involvement in the industry has changed, and may continue to evolve, it is perhaps best to look at the different priorities government at all levels has, and their corresponding areas of regulatory focus. The first, of course, is the federal government, which has made the War on Terror its unconditional Number One priority. In a post 9/11 world, "following the money" will continue to be a main concern for all regulatory agencies, including FinCEN, OCC, FTC and the IRS, among others. The regulatory burdens facing the industry have increased substantially in the past few years, thanks to the Bank Secrecy Act and the USA PATRIOT Act. Complying with applicable laws must remain a priority for the financial service center industry.



With regard to AML regulations, members of our industry can expect the government to remain as tenacious in the future as it is in the present. And while the industry has undertaken a great deal with regard to self-certification and compliance efforts, such activities may continue to be seen as insufficient by regulators. As William Baity, Acting Director of FinCEN, noted in remarks before the Florida International Bankers Association in February 2007, "We cannot be unrealistic in our expectations as to the ability of financial institutions to identify financial crime or terrorist financing. We have been consistent in acknowledging the limitations, but we believe that effective anti-money laundering programs across the spectrum of financial industries cannot help but have a positive effect on combating the financing of terrorism, and cannot help but to ultimately improve the national security of the United States."

At the state level, many legislative and regulatory bodies have been and will continue to be focused on the issue of payday advances (PDAs) and other small-dollar, short-term loan products. Currently, 38 states plus the District of Columbia allow payday advances. Interestingly, in some states, such as Florida, relative harmony exists between companies offering the product, the regulators overseeing it, and the general public. In others, such as Virginia and Arizona, it is a hotly contested issue and is likely to remain so for some time. Why are the playing fields so different?

While the particulars of state regulation – databases, cooling off periods, transparency, etc. - can be debated endlessly, at the core, regulation of new products such as PDAs is about government trying to create an environment that ensures consumers are being

adequately protected. As MacKechnie said, "We have got to accept that we are not selling bottled water. Government and elected officials want to protect consumers when it comes to financial services. If it is done right, the industry becomes more dignified and everyone becomes more comfortable. Government doesn't want to think that companies are taking advantage of hard working people, and that's fair enough."

At the local level, municipal governments worry about the impact that business will have on their local communities. They are focused on maintaining safe and secure neighborhoods that enjoy escalating property values and stable tax rates. To the extent that our industry helps reinforce those desired traits, they enjoy strong relationships. To the extent that they are perceived as threatening those core qualities, either through the appearance of their stores, or the excessive number of stores in a certain area, the industry will continue to be subject to zoning restrictions and other attempts to limit, if not eliminate, their presence.

Interestingly, MacKechnie noted that there is an upside to regulation. While most business owners will no doubt look at such regulations as burdens, the flip side of the coin is that they help to differentiate the good guys from the bad guys. "As an industry, we do not want to do business with a drug dealer or anyone who is breaking the law," noted MacKechnie. "Government regulations help us identify the good and separate them from the bad." Regulation also helps professionalize the industry, as financial service providers must operate at a higher standard to comply

with various regulatory obligations.

Looking ahead, what can the industry expect from a regulatory perspective? Expect government preoccupation with AML-related issues to continue, at least until subsequent events internationally dictate a moderation of that stance. Government at both the federal and state levels will continue to explore how best to regulate small-dollar loans so that the business can continue to operate while still ensuring that adequate consumer safequards are in place.

At the same time, as the cost of regulatory compliance has continued to increase, many companies are looking to grow their

of opening stores where there already is significant competition, and thus the return on investment is somewhat uncertain, it is often easier to just buy a company that has stores in the desired area. For example, in March 2007, California Check Cashing Stores and Golden Gate Capital, a San Francisco-based private equity firm, announced that it had acquired Fast Cash Stores. This increased California Check Cashing's presence in the state from 62 stores to 95 stores, making it the largest multi-line provider in Northern California. In announcing the acquisition, Jim Ball, President of Fast Cash, said, "Both California Check Cashing Stores and Fast Cash

"...IT IS REASONABLE TO EXPECT THERE WILL BE A CONTINUATION, EVEN AN INCREASE, IN THE AMOUNT OF MERGER AND ACQUISITION ACTIVITY WITHIN THE ALTERNATIVE FINANCIAL SERVICES INDUSTRY."

business volumes in order to defray those burdens across a larger operation. As such, this could help spur mergers and acquisitions within the industry.

THE NEW TRENDS IN OWNERSHIP: MERGERS, ACQUISITIONS & CONSOLIDATIONS

Since its inception more than 50 years ago, a wide array of companies have entered the financial service center industry; large operators with hundreds of stores spread out across multiple states and family-owned operations with two or three stores in one city. A few are publicly traded companies, but most are privately owned. Yet in the past few years, undeniable trends have emerged that are affecting large and small operators alike. In fact, there are many industry experts and outside analysts who believe the check-cashing and payday advance industries are ripe for consolidation, according to a Mergers & Acquisitions Report, Check-Cashing Consolidation Heats Up, April 9, 2007.

WHY IS THIS OCCURRING NOW?

Actually, there seems to be not one factor but rather a number of factors contributing to these trends. First, the industry is experiencing larger companies purchasing smaller ones in desirable markets in order to increase market share and regional presence. In many locales, it is difficult to find suitable locations to open new stores because the target market is saturated. Rather than assume the risk and expense

have a strong history of great customer service. The combination allows us to continue providing our customers with great service with even more convenient locations."

Similarly, late last year Dollar Financial Corp. announced that it was buying 23 stores, predominantly in Southwest Florida, for \$28.6 million. Commenting on the acquisition, Jeff Weiss, the company's Chairman and Chief Executive Officer stated, "This acquisition serves to initiate the expansion of our financial services store network into the state of Florida. Florida has a favorable regulatory framework, attractive demographics, and a growing services sector workforce."

Such transactions are not limited to the United States. For example, in May of this year, Cheque Centre, a Scottish checking cashing and payday advance company with 105 branches across Scotland and England, announced that it had secured funding from Check n' Go that will allow it to double the size of its operations by the end of the year.

A second factor, in addition to the California Check Cashing example discussed earlier, is that private equity firms looking for new investment opportunities are purchasing many companies. For example, last year, JLL Partners Inc. bought Ace Cash Express for \$455 million. JLL is a New York-based firm with \$3.2 billion of capital under management. Diamond Castle Holdings,

also a New York-based firm, purchased Buckeye Check Cashing for \$282 million. And it was just announced as we went to press that The Pay-O-Matic Corp., the market leader in New York, has entered into a merger agreement with Founders Equity and Berkley Capital, LLC. Other similar acquisitions are anticipated within the next few months.

Private equity firms investing in the alternative financial services industry all share similar strategic goals: they seek partnership opportunities with companies that have strong leadership teams in place and where there is a significant opportunity to increase the company's overall value.

As a third trend, the increasing regulatory

burdens associated with the industry are also driving many small players to leave the industry. These burdens include federal reporting requirements stemming from the USA PATRIOT Act and the Bank Secrecy Act. Such burdens are especially hard for smaller operators to manage. In many states where fees are capped by law, there have been no rate increases to help offset the increased compliance costs that have arisen since 9/11. These additional costs are often more easily absorbed by larger entities.

In addition, as a result of the first three factors, many companies are looking to improve overall efficiency of their operations while also generating additional profits by

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creating economies of scale. Acquiring additional stores helps them achieve that because they can defray their overhead and regulatory costs over a larger number of stores and greater gross income.

Some companies also are investing in new product and service arenas. For example, this past fall, Cash America International purchased CashNetUSA, the online payday advance company, for \$35 million. This acquisition gives Cash America International 758 stores with online operations in 27 states. As Daniel R. Feehan, President and Chief Executive Officer of Cash America International, said, "This transaction also opens the longer term opportunity to explore ways to further expand our product offerings and market penetration through Internet technology and its related electronic distribution advantages."

As the industry continues to evolve to keep in line with everchanging consumer tastes and regulatory demands, it is reasonable to expect there will be a continuation, even an increase, in the amount of merger and acquisition activity within the alternative financial services industry. That provides new opportunities, both for those looking to sell their operations as well as for others looking to expand their market presence.

SMALL-DOLLAR, SHORT-TERM LOANS

Small-dollar, short-term loans (SDLs) are at the forefront of new products being offered by the alternative financial services industry. In recent years, payday advances have become an increasingly popular choice for American consumers in need of small-dollar short-term credit, and 38 states (and the District of Columbia)

have laws permitting these loans. Today, there are more than 20,000 locations that offer PDAs nationwide, extending at least \$40 billion annually in short-term credit.

However, PDAs are also controversial, with several states currently looking at how to regulate or even ban the product. So, what is the future of small-dollar, short-term loans?



Don Gayhardt

To help us answer this question, Don Gayhardt, President of Dollar Financial Group, provided us with some of his insights into the future of SDLs. Given the consumer appetite for small-dollar, short-term credit, there seems to be no doubt that these loans will continue to be a cornerstone of the alternative financial service provider's product offering. This includes the current payday loan product as well as the evolution of other installment products.

For example, Gayhardt sees an SDL product being tied to a debit card. It would function similarly to a bank-issued debit card that has overdraft protection except that consumers could obtain such a debit card/loan combination through a financial services provider.

When considering new products, it is important not to get too far ahead of consumers and offer products they are not ready to accept. Says Gayhardt, "The key is to listen to the customer and



give them a product they like. Lots of times the technology is such that businesses create a product seeking to create demand for it. We know that customers will vote with their feet. They know and like the payday product. We think they will like variations of that, but not if we try to do things too far ahead of them." Gayhardt offers the debit card as an example of a product that was at least somewhat ahead of the customer.

One area that will no doubt see significant growth in the next five years is Internet lending. Right now it represents approximately 12.5% of all small-dollar, short-term loans, and more and more companies are able to conduct Internet transactions. At the same time, consumers are becoming more comfortable using the Internet for such loans. However, at the moment, the online market lacks sufficient regulation, so it is difficult for companies to operate in such an uncertain environment. While there seems to be little doubt that the online market will continue to grow, its rate of expansion depends on how quickly the market gains regulatory definition.

Overall, Gavhardt sees the market for SDLs growing 7%-9% per year. "We're relying on wage growth and a sound economy, like a lot of businesses, but if we have healthy macro-economic trends, the market will absolutely continue to grow."

Obviously, government oversight of SDLs could play a huge role in the evolution of products, and it is important to keep open the lines of communication with regulators and let them know of the different products being developed. Says Gayhardt, "If we (the industry) do things in the same sensible, transparent fashion, I think we'll be OK with the regulators who have a real interest in learning about the product and ways to regulate the short-term marketplace." At the same time, it is important not to lose sight of the business of running your business. As Gayhardt says, "People tend to focus too much attention on regulations. What gets lost in the discussion is competitive issues. There is not enough focus on competitive issues. Seventy percent of the questions we get focus on regulation, vet seventy percent of what is going to make

GOVERNMENT OVERSIGHT OF SDLs COULD PLAY A HUGE ROLE IN THE EVOLUTION OF PRODUCTS.

a business succeed is based on competitive pressures and size of market, not regulation."

IMMIGRATION

Immigration has become one of the most controversial public policy issues in the country. The powerful lure of the American dream - plentiful jobs with good wages coupled with political freedoms - is as strong as ever. As of this writing, the U.S. Congress is considering legislation to implement comprehensive immigration reform, addressing both those already living in this county and those who wish to emigrate here. Currents plans to examine this in detail in a future issue to determine the consequences the immigration reform measure that is ultimately adopted will have on the financial service industry, both from a customer and a regulatory/compliance perspective. We will also look at the immigrant customer base and discuss the different products and services, not to mention different business operations, that Financial Service Centers must offer in order to keep and augment their business with this key customer segment.

CONCLUSION

One axiom of business is that change is constant. As this article has briefly discussed, the alternative financial services industry will continue to grow and change in the next few years. This will occur from a combination of internal and external forces. The entry of new competitors into the marketplace and government regulatory pressures will force existing providers to adapt both their offerings and their methods of doing business. An expected contraction of the industry will leave fewer, larger players. And, as the industry continues to develop new products to address evolving consumer demands, it will constantly need to keep in continual contact with both customers and regulators. Overall, financial service center operators can expect the next five years to be filled with new opportunities - and new challenges. Who can ask for more than that? ■

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