Riding the 2006 Wave:

WHERE IS THE INDUSTRY HEADED AND WHAT ARE LEADERS DOING TO LEAVE THE COMPETITION IN THEIR WAKE?

BY RICK LYKE

Change is nothing new to the financial service center industry. As a matter of fact, the evolution in consumer demand for products and services has been at the center of an amazing period of growth for the category. The velocity and amount of change have reached high tide on a number of fronts and are likely to continue as the industry heads into 2006.

Setting a successful course for the future demands more than the gut instinct of a good captain, which remains an important component of any profitable business. More than ever, up-to-date forecasts and accurate charts on trends in the industry are critical to avoiding the shoals and heading for clear sailing.

MAPPING THE COURSE

To get a crow's nest view of the 2006 horizon, *Currents* spoke to industry leaders, attended sessions at the FiSCA National Conference, examined the Securities and Exchange Commission filings of a number of public companies, and reviewed other public documents filed with regulators. The picture that emerges is of an industry that has rapidly grown in recent years and is becoming increasingly mainstreamed in the financial lives of millions of Americans. At the same time, the very size of the market being served is attracting attention from a range of competitive businesses – some inside and some outside of the traditional financial services sector.

The changing ethnic composition of American consumers is one of the forces that will drive business for Financial Service Centers in 2006 and beyond. According to data from the U.S. Census, by 2020 the

number of Hispanic households in the U.S. will increase by 111 percent, Asian-American households will grow by 94 percent, and African-American households will be up by 64 percent. Traditionally underserved by banks and often distrustful of deposit institutions, these minority groups have become a major economic force in America and offer significant business opportunities for Financial Service Centers.

The size of the potential market is illustrated by the impressive numbers in money transfers to Latin American and Caribbean nations. According to the Inter-American Development Bank (IADB), remittances by workers from the regions working abroad to their home countries totaled $55 billion in 2005, up $10 billion in just one year. Mexican workers sent $20 billion home, while workers from Central America and the Dominican Republic sent $12 billion home to families. Bolivia, Colombia, Ecuador and Peru were on the receiving end of approximately $11 billion. According to the IADB, most of the transfers range between $50 and $300 and the fees charged for the transfers have been declining – down from 12.5 percent to an average of 7 percent.

The amount of money being handled is attracting the attention of banks large and small in the U.S. and in developing countries where many of the workers are remitting funds. Bank of America recently announced a program offering free transfers for account holders to 4,500 locations in Mexico, while others have been cutting fees for remittances to certain countries.

DREADNAUGHTS

In the fall, *Forbes* magazine ranked ACE Cash Express as one of America's 200 best-run small companies. ACE has 1,389 stores (1,163 company-owned and 226 franchised stores) in 37 states and the District of Columbia. It's hard to argue with the selection when you look at ACE's numbers from the fiscal first quarter of 2006. Company-owned stores had 10.2 million customer visits during the period and rang up $2.4 billion in transactions. These stores earned $29.6 million in fees from cashing 3.3 million checks and processed 563,000 loan transactions worth $181 million, generating fee and interest income of $25.2 million. Along the way, ACE company-owned stores processed more than 1.9 million bill payment and credit card transactions and sold 42,000 prepaid debit cards. All of this while 22 of these stores were impacted by Hurricane Katrina.

Dollar Financial Corp., which has a network of 1,316 stores in 36 states, Washington, D.C., Canada and the United Kingdom, says its fiscal first quarter 2006 revenue increased 12.6 percent to $74.5 million. Income from check cashing hit $4 million, with the average face amount of checks cashed increasing to $439 and the average fee collected per check cashed climbing to $16.45.

CONSOLIDATION

ACE's acquisition of Banco Popular's 111 Popular Cash Express locations in 2005 was part of an overall trend in the industry that points toward consolidation. Most observers believe that 2006 will see further mergers and acquisitions.

"Absolutely," agrees Bob Wolfberg of PLS Financial, which has locations in the Midwest and South. "The fact that we are constantly looking for new peripheral products signals that there is not enough of our core business to go around. I believe the strong and well capitalized will survive and the rest will either sell or be forced to close their doors." He adds, "While we are all constantly looking for new products in

continued on page 20

***Riding the 2006 Wave** continued from page 19*

order to improve our revenue, the truth is that all these products are marginal. We are check cashers and consumer lenders. The more we stray from what we do best, the more we lose our focus, the more likely we are to lose our competitive edge in those areas which are our primary sources of revenue. In short, FiSCA members ought to aggressively market check cashing and payday lending."

ALTERING COURSE

ACE Cash Express says that it expects the Federal Deposit Insurance Corp.'s revised guidelines for payday lending issued in July 2005 will adversely impact the company's payday lending business. To deal with the new guidelines, ACE has altered the way it offers loans in some states. In 20 states and Washington, D.C., ACE offers short-term loans under state regulations. In Texas, Arkansas and Pennsylvania, loans with an average term of 14 days are offered at ACE stores by Republic Bank of Kentucky. In these states, ACE also began offering loans made by First Bank of Delaware that carry a 20-week term.

In response to the FDIC guidelines, Dollar Financial launched a new installment loan product in California, Texas, Ohio and Washington. These states represent 199 of the company-operated stores or nearly 60 percent of U.S. operations. The new loan product has a term of four months and is for amounts of $300 to $1,500.

In November, County Bank of Delaware announced it was ending its eight-year involvement with payday lenders. At one point County Bank had served as many as 20 companies involved in payday lending. The bank made the decision even though $3.6 million of its projected $8 million in 2005 profits came from servicing payday loans.

In its third quarter 2005 results, QC Holdings reported a 31.2 percent increase in net revenues, but still had a net loss of $976,000. A major culprit was charges for closing 19 stores in North Carolina as a result of a negative regulatory climate in the state and write-offs for bad loans. "While our revenue and store growth continue to be very strong, our rate of loan losses was unacceptably high during the quarter," said Don Early, QC's Chairman and Chief Executive Officer. "This performance reflects our own struggles, as well as an increasingly difficult collections environment due to several factors, including higher energy costs, increased bankruptcy filings and a general degradation in consumer credit."

Advance America, which claimed third quarter revenues were up 13.7 percent to $172.6 million, said it began operating as a credit service organization in Texas, while it began offering an installment loan alternative to payday loan customers in Pennsylvania, North Carolina and Arkansas. However, the company halted making loans at 117 centers in North Carolina and 86 in Georgia based on legal actions taken by those states.

Joe Doyle of Check Cashing USA in Florida says that, while more positive regulations for the industry may be on the horizon in some areas, he expects to see some further tightening of rules for payday advances, especially when it comes to providing these services to military personnel. He also sees growth in the number of local zoning ordinances that restrict the location, hours of operation and other aspects of Financial Service Centers that will make it more difficult to open new locations.

STORM CLOUDS CLEARING?

One of the biggest issues facing Financial Service Centers during the last three to four years has been that fewer banks are willing to provide commercial banking services to the industry. The practice of blanket bank discontinuance of financial service center businesses by a number of major banks was the subject of intense efforts by FiSCA to raise the profile of the issue with federal and state regulators and elected officials. As a result, the Federal Deposit Insurance Corp. and other U.S. Treasury Department units, including the Office of the Comptroller of the Currency and the Financial Crimes Enforcement Network, issued a guidance for banks and made strong statements on the importance of a healthy financial service center industry.

According to many, the pace of bank discontinuance has slowed since these statements were issued. However, the problem has not entirely disappeared. Michael Lynch of Banco Popular, which earned $8.5 million in 2005 serving the needs of Financial Service Centers, put it this way at a forum on the topic during the FiSCA Conference: "Check cashers were defined as high-risk before, they were defined as high-risk in the guidelines,

continued on page 22

Riding the 2006 Wave *continued from page 20*

and they're still considered high-risk. And actually I think that's a misperception. Check cashers are actually much easier to monitor than most other businesses. We have their bank statements. We know their revenues. We know the amount of their deposits. We know their amount of cash deposited. So it's much, much easier to monitor an MSB because they've got to put all their sales through the bank," Lynch said. "Comparing that to legal practices, accounting practices, or any retail business where you're dealing with large volumes of cash, where they don't necessarily put all the sales through their bank – those are much higher-risk businesses to monitor than the MSBs."

"A lot more scrutiny is being directed at financial transactions, and some banks have announced they're pulling out of the business entirely. It has been a stressful time for many," New York Banking Superintendent Diana Taylor told FiSCA members at the New York Conference. "This concerns us, the regulators, as much as it does you, because as I mentioned before, you perform an important function for your customers who might not have many other alternatives." She said that in New York, regulators have reacted to bank discontinuance by amending regulations to allow Financial Service Centers to get commercial banking services from out-of-state banks.

"The thing I like most about dealing with check cashers is, unlike people who talk about service, check cashers actually serve their customers in their neighborhoods," says Alonzo Primus of First Bank of Delaware. "Right now we have about 30 check casher customers and we are aggressively looking to grow."

LOW TIDE

The number of checks being cashed by Americans continues to decline. In reaction to the decline and to continue its effort to encourage banks to use electronic check collection, the Federal Reserve Board voted in November to increase fees charged in 2006 for check handling by five percent, while reducing the costs for electronic transactions by one percent.

Americans are embracing prepaid debit cards and gift cards as an alternative to checks and paper money. According to Mercator Advisory Group, a research firm based in Massachusetts, consumers are expected to load these cards with $3.62 billion in 2006, up from $400 million just two years ago.

One sign that Americans are more comfortable with making payments using debit cards and through electronic banking is that Deluxe Corp. of St. Paul, Minn., a check printing company, reported its third quarter 2005 revenue declined by $59 million to $413 million. A number of factors, including a lost contract, contributed to the drop, but Deluxe pointed out that the reduction in overall check usage contributed to the falling revenues. If consumers are more comfortable not writing checks for personal payments, it stands to reason that they are more likely to accept direct deposit or payroll cards in place of a paper paycheck.

The lower number of transactions comes at a time when financial service center operators are paying more for everything from compliance programs and employee health insurance to energy costs and bank fees. According to Doyle, Financial Service Centers have few options for dealing with the profit squeeze. "Employees and customers are paying more. The search for cost cutting is driving the industry consolidation movement." Doyle says.

BUCCANEERS

A survey conducted in September by Synergistics Research Corp. of Atlanta of 1,000 consumers found that less than half said a bank branch in a retail store would be attractive. However, when asked if a bank branch owned and operated by a retailer, such as Wal-Mart or a grocery chain, would be valuable to them, the number jumped to 58 percent. Wal-Mart's decision to get a bank charter in Utah in 2005 had the attention of many financial service providers, concerned that Wal-Mart could do to the category what it has done in the grocery sector. In fact, Wal-Mart's application for a banking charter has attracted a record number of letters to federal regulators in opposition to the bid.

For its part, Wal-Mart says it wants the charter to reduce the costs it was paying for credit card payment processing. It points out that it continues to sign 15-year deals with banks to operate in-store branches as proof that it does not have plans to roll out a national "Wal-Mart Bank." While it continues to sign agreements with banks, Wal-Mart pushes forward in a number of directions to offer what the chain calls "money services" at its locations. Wal-Mart's two-pronged approach involves in-store branches through approximately 300 bank partnerships across the country offering check cashing, money orders and money transfers, as well as installing automated teller machines and test-marketing the Wal-Mart debit card. The company charges a maximum of $3 to cash a check at its stores and counts on customers coming in to cash paychecks and then spending a portion of those funds on items they find in the stores. According to Wal-Mart, the company processes 1.2 million to 1.4 million financial transactions per week at its stores.

Wal-Mart is not the only organization motivated by the potential profits to offer financial services solutions to the unbanked – even if the bulk of the revenues do not come from the transaction fees for providing the core financial service. One Economy Corp. launched a program in partnership with two of the nation's largest rental property developers and Citibank that offers financial incentives to get consumers to pay rent electronically. Under the program, the housing management firms offer tenants a 3 percent rebate for electronic payments made through a new Citibank account. The program is aimed at speeding up the processing of rent payments, while helping the management firms avoid the 5-10 percent average loss on uncollected rents.

continued on page 32

Riding the 2006 Wave *continued from page 22*

HEADING FOR OPEN WATER

According to Jerry L. Robinson, president of Valued Services, while legislative uncertainty exists and "problems can show up at a moment's notice," the current business climate favors multi-line operators. He believes that the Internet poses both enormous challenges and opportunities for the industry and that Financial Service Centers need to look at legislative solutions to expand product markets.

> **"WHEN A STATE LIKE GEORGIA GOES DARK, THAT'S TROUBLING. IT'S NOT GOOD FOR ANYONE.**
>
> **HAVING LICENSING AND REGULATIONS FOR THE INDUSTRY ON A STATE LEVEL IS IMPORTANT FOR THE AMERICAN ECONOMY."**

Charles Horton, president and CEO of Fast Bucks, says he believes that increased governmental awareness of the importance of the industry and the needs of consumers will pay dividends for Financial Service Centers in 2006 and beyond. Horton believes new legislation in several states will help weed out unethical companies in the industry and help those who approach the business professionally. His company is actively looking for franchisees with successful multi-unit retail experience, such as fast food restaurant operators, to open new markets for the company.

"We work hard to educate local officials about our customers. We show them testimonials about our service and pictures of existing stores. We have nice stores that anyone would be proud to have in their community," Horton says. "When a state like Georgia goes dark, that's troubling. It's not good for anyone. Consumers need our services; now they have to go somewhere else that is perhaps not regulated to get services. Having licensing and regulations for the industry on a state level is important for the American economy."

According to data presented at the Unbanked Financial Services Innovation Conference held in September in San Francisco, approximately 56 million working Americans do not have a banking relationship. According to a study presented by Vero Corp. of Portland, Oregon, 35 percent of U.S. households have at least one adult who is unbanked. While the size of this market is attracting new competitors, Financial Service Centers are already serving these consumers and serving them well. Staying afloat and prospering in 2006 may very well depend on how well Financial Service Centers appeal to customers, both banked and unbanked, who need convenient and accessible financial services, while at the same time navigating the regulatory and business challenges. ■