2nd Annual Gen Z Financial Services Survey

Series 1 of 4: Banking

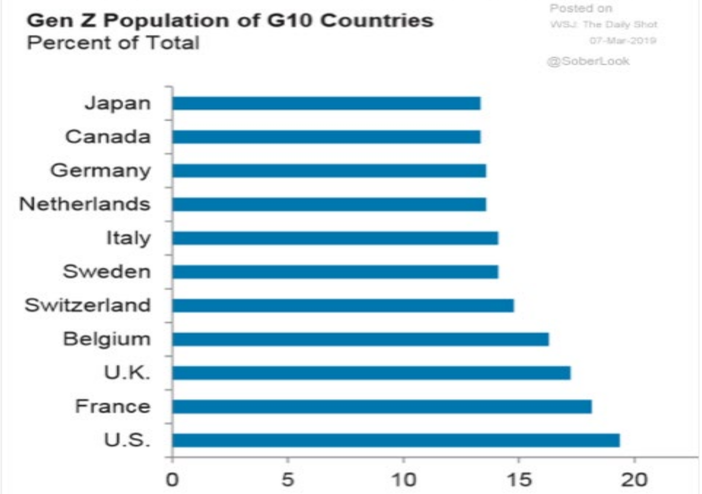
April 2019

Introduction:

Over the last few months, the 2019 interns of Manole Capital conducted a financial services survey, specifically targeting the thoughts of America's younger generations. Specifically, we sought out Gen Z (those born after 1996) and Millennials (born 1981 to 1996).

We feel it is important to understand the perspective of these younger individuals, especially since Gen Z now represents nearly 20% of the US population. This year, Gen Z will reach 61 million individuals and become the US's largest generation. This younger generation was born after the internet went mainstream and the oldest amongst them was only 10 years old when the iPhone was introduced by Steve Jobs. Most of Gen Z is still in school, but they have direct spending power of over $140 billion annually. Early analysis shows that Gen Z consumers are less concerned about brands, labels or even corporate names. They are quite entrepreneurial, ethnically diverse, socially tolerant and environmentally aware.

Gen Z population of G10 countries — percent of total



Source: United Nations, 2017, Morgan Stanley Research

Manole Capital exclusively focuses on the emerging Fintech industry. The goal of these research notes is to provide valuable insights, specifically in the financial services segment, into this growing category of younger individuals. In total, we were able to survey 195 individuals. Respondents were asked a series of questions on four financial subjects, which will be released in four distinct notes:

1) Banking
2) Payments
3) Brokerage
4) Cryptocurrencies

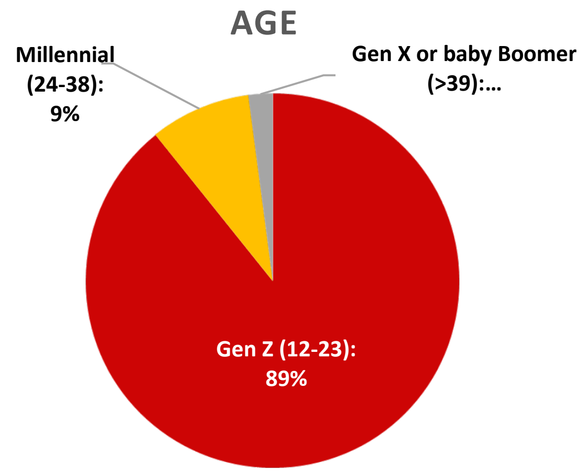
The questions we asked, as well as the information we received, is summarized below. Where possible, we have attempted to provide our conclusions and opinions. While some may be viewed as controversial, it is simply intended to serve as possible Gen Z and Millennial perceptions. This is the 2nd annual financial services survey performed by the interns of Manole Capital. Where we feel it is interesting to note, we will comment on large discrepancies and changes from last year's survey.

Our Goal:

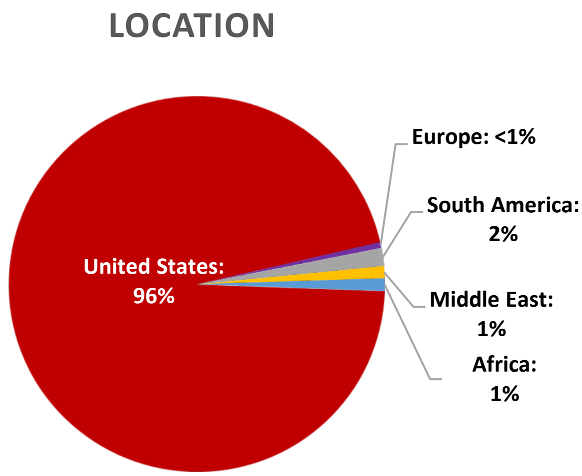
How Millennials and Gen Z make purchasing decisions and what they look for in a brand is shifting. However, we believe that personalization has become increasingly important in today's society. This requires a different set of tools. The scope of reinvention requires analysis and we hope this research provides some valuable insights.

Who We Surveyed:

Out of the 195 individuals that participated in our online survey, 89% were between the ages of 12 and 23 (Gen Z), while 9% were aged 24-28 (Millennials) and 4% of respondents were older than 39 (Gen X or Baby Boomer).



While we would have preferred the sample size exceeding 500, we are pleased to have 98% of those questioned under 38 years old. For the few Gen X's and Baby Boomers that participated, we appreciated your participation, but you ruined our age demographic. Way to go Mom & Dad!



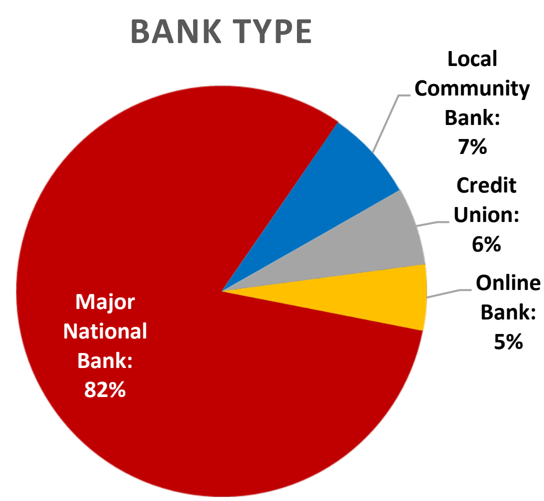
Geographically, 96% of the sample lives in the United States, while the other 4% are from South America, the Middle East, Africa, and Europe. Since we attend the University of Tampa, a high percentage of our survey is based in Florida.

Banking:

The beginning of our survey asked the respondents a series of questions regarding their thoughts, usage habits, and preferences on traditional banking services.

Q&A:

99% of our surveyed group had a bank account, which is right on par from last year's results. We then inquired what type of bank they used. 82% reported using a major national bank, which is just slightly below (just 3%) last year's levels. While it is not surprising that Gen Z prefers big banks, there was a slight uptick in online banking usage. This year, 5% of respondents reported their primary banking service as an online bank.



Our Conclusion:

Are Gen Z's making the switch over from traditional brick-and-mortar banks to online banking? Maybe so, but the results do not show a major shift occurring.

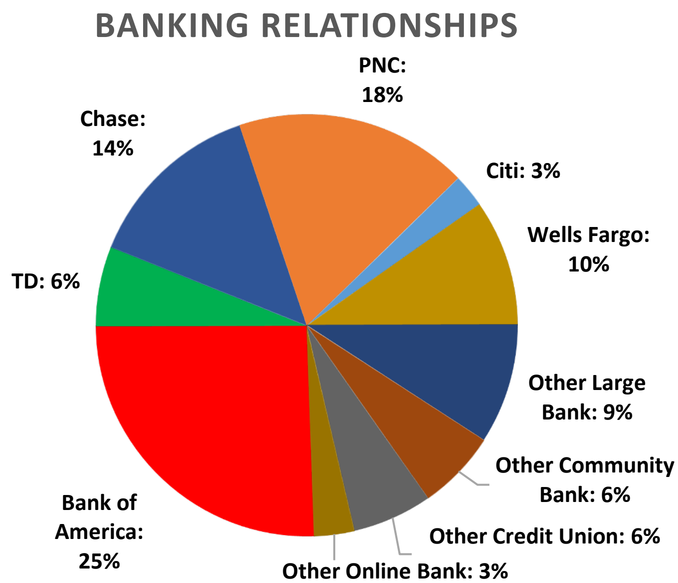
Brands:

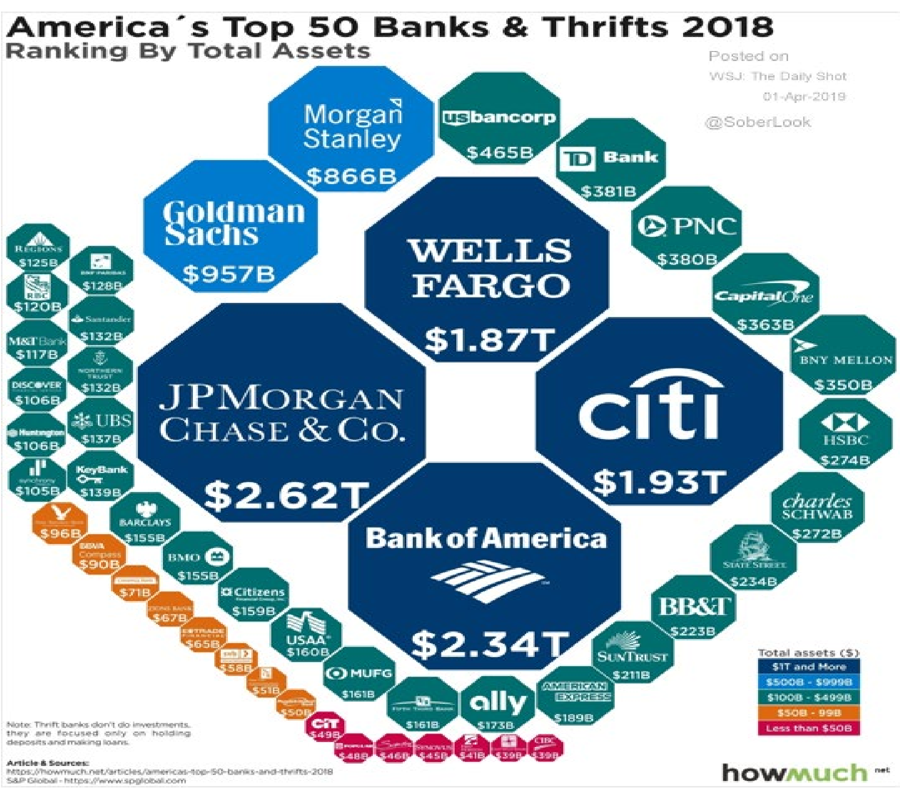
Q&A:

We wanted to find out which bank brands are most popular among Gen Z's. Our sample results found that a quarter of them use Bank of America, with PNC and Chase coming in second and third, respectively

Our Conclusion:

Bank of America is ¼ of the mix, which is fairly representative of a typical US city. JP Morgan's Chase has 14% of the survey, which is certainly within reason.

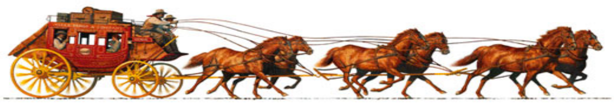
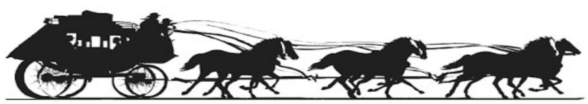




It is important to note that many of our surveyed participants attend the University of Tampa and those are all three of these banks have branch presences within a 5 mile radius of campus and downtown Tampa. These results may vary with different geographies and schools.

With that stated, we feel the varied relationships of our surveyed group represent a decent reflection of the US banking landscape.

Wells Fargo:

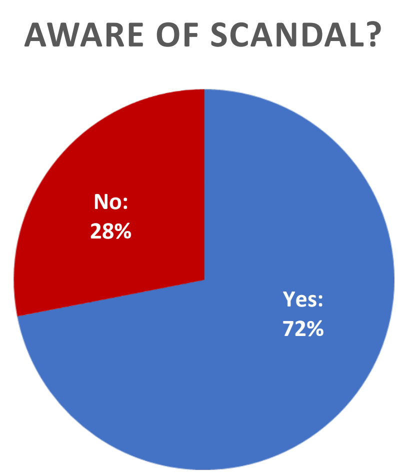

None of these early questions were surprising or terribly insightful. However, we did want to address "the elephant in the room", in terms of the ongoing Wells Fargo reputational issues. Maybe instead of "elephant", we should have said "horse"?

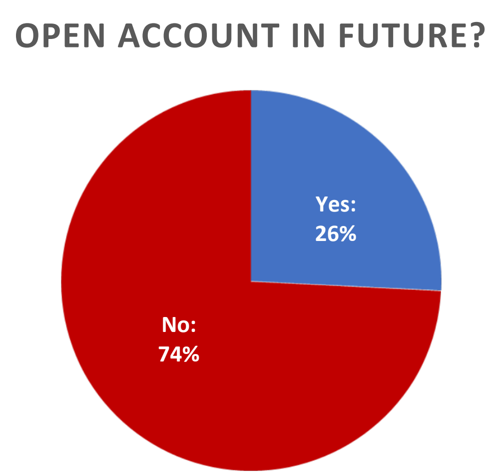
Wells Fargo was founded in 1852 and currently serves one in every three households in the US. It has nearly 260,000 employees, $1.9 trillion in assets, 7,800 branches and over 13,000 ATMs. In our survey, Wells Fargo garnered 10% market share.

With all of the news and noise surrounding Wells Fargo, we wanted to dive into the details plaguing the bank. We were interested to see if Gen Z was even aware of the recent troubles the bank has gotten into with its "phantom accounts" scandal.

<u>Q&A:</u>

We asked our survey if they were aware of the Wells Fargo controversy. 72% responded yes, that they were aware of Wells Fargo's troubles. Going further, we then asked: "If Wells Fargo has corrected their past mistakes and reformed….would you consider opening a bank account with them today?" A surprising and large percentage, 74% of those asked, reported they would <u>not</u> open an account with Wells Fargo.





Our Conclusion:

From our survey, it is clear that Gen Z simply does not trust Wells Fargo. Having its CEO Tim Sloan "retire" last week will not solve Wells Fargo's problems. The sales practice scandal from 2016 has now claimed the jobs of two CEO's. We agree with KBW bank analyst Brian Kleinhanzl, who recently commented "without a permanent CEO, the company is in wait-and-see mode." He later said that ongoing search for a new CEO and management team leaves Wells Fargo "like a ship without engines in high seas."

Changing its logo, as seen on the prior page, will also not solve this issue. Gen Z can get banking services from hundreds and even thousands of providers. With the passage of time, maybe this issue fades into the sunset. Maybe a new management team and CEO can inject some energy into this once powerful brand. However, we simply do not believe that Wells Fargo can maintain its current market share, especially in the valuable Gen Z and Millennial demographic.

Is some of this weakness already baked into Wells Fargo's stock? Absolutely! Since sanctions were imposed in February of 2018, WFC has fallen (24%) while the banking index, represented by BKX, is up +12%. What was once a fast growing and leading US financial institution, has become a bank on the decline (in terms of assets, accounts, market share, etc). The ongoing search for new leadership has us on the sidelines, as we wait to better understand what the revival plan looks like.

An Investing Icon:

On the Mount Rushmore of investors, Warren Buffett absolutely has 1 of our 4 spots. All investors can learn from his investing wisdom and guidance. Berkshire Hathaway is the single largest shareholders of the Wells Fargo, with an ownership stake of just under 10% of the company. In addition to Wells Fargo, Berkshire Hathaway owns large stakes in other banking franchises, like Bank of America, UB Bancorp, M&T Bank and JP Morgan. With billions more invested in those banks, Mr. Buffett clearly likes the fundamentals of the industry. To justify such a large weight, Mr. Buffett must believe that banking franchises are great businesses to own and that these financial institutions represent good value and long-term growth opportunities.

Are these investments based off of current events and results or were they made using historical performance? Following the Financial Crisis of 2007 and 2008, Wells Fargo emerged relatively unscathed. In fact, its CEO at the time, Dick Kovacevich did not want TARP funds and blasted the US Treasury and Federal Reserve response to the crisis as a "unmitigated disaster". Back in 2014, Wells Fargo had over $23 billion in profits, which exceeded JP Morgan's results that year and was more than 3x the profits posted by Bank of America. At the time, Wells Fargo was a market leader and even became the most valuable bank in the world, as measured by market capitalization.

In response, other banks responded. BAC and JPM both aggressively cut costs and focused their attention on becoming more efficient. It sure seems like Wells Fargo "rested on its laurels" and is only now getting around to cutting costs. Is it wise to be closing some of its 5,600 branches, which is the most of any US bank? Maybe Wells Fargo should be doubling down on a new concept, like Capital One (see our Branch section)? In our fast paced world, businesses simply cannot "get lazy".

MANOLE CAPITAL MANAGEMENT

The Buffet Way:

Manole Capital follows many of the same investing philosophies of Mr. Buffett. We attempt to emulate his investing process, strategy and philosophy. For example, the ideal characteristics we look for in an investment are very similar to Mr. Buffett's. The ideal characteristics we look for in any position are listed below.

- High barriers to entry and a "moat" around the franchise
- Market share leaders with durable competitive advantages
- Pricing power and flexibility to withstand market volatility
- Recurring revenues and sustainable business models
- Strong balance sheets with predictable free cash flow
- Excellent management teams properly allocating capital

We thought it would be interesting to run Wells Fargo through our "ideal characteristics" screen. With roughly 10,000 financial institutions in the US, one cannot argue that there are high barriers to entry. In fact, it appears that more online banks and FINTECH companies are entering the banking space every day. Decades ago, there might have been a "moat" around certain banking franchises, we believe that no longer exists.

Wells Fargo does have an attractive and strong market share, but our research indicates that market share is declining. What was once a durable competitive advantage appears to be dwindling away for Wells Fargo. The entire banking business has very little pricing power and one can easily argue that financials are the ultimate cyclical business. Since profits increase and decrease, based upon the market cycle and interest rates, this is not a predictable, sustainable or recurring revenue business. Lastly, we believe that Wells Fargo has a very strong balance sheet, but its free cash flow is not terribly predictable. We cannot state that it possesses an excellent management team and many of its capital allocation decisions are being restricted by its regulatory problems.

Unfortunately, Wells Fargo would fail our desired traits for an investment, at least our bosses "ideal characteristics". We believe our survey and research presents a completely different story than the one Mr. Buffett is aware of. Does he understand how younger generations perceive his bank? Is he basing his investment decision on prior performance? Maybe the Wells Fargo position is so large, that Mr. Buffett is unable to sell his stake without dramatically impacting the share price?

In terms of Wells Fargo, our survey results indicate that Gen Z and Millennials do not trust this financial institution. They clearly have a "bad taste" in their mouth, as one survey participant said. This younger generation values security and reliability in their banking relationships, and Wells Fargo is "not passing the test". Is it a cultural problem, as certain politicians have alluded to? We do not know, but we think it is best to avoid Wells Fargo right now.

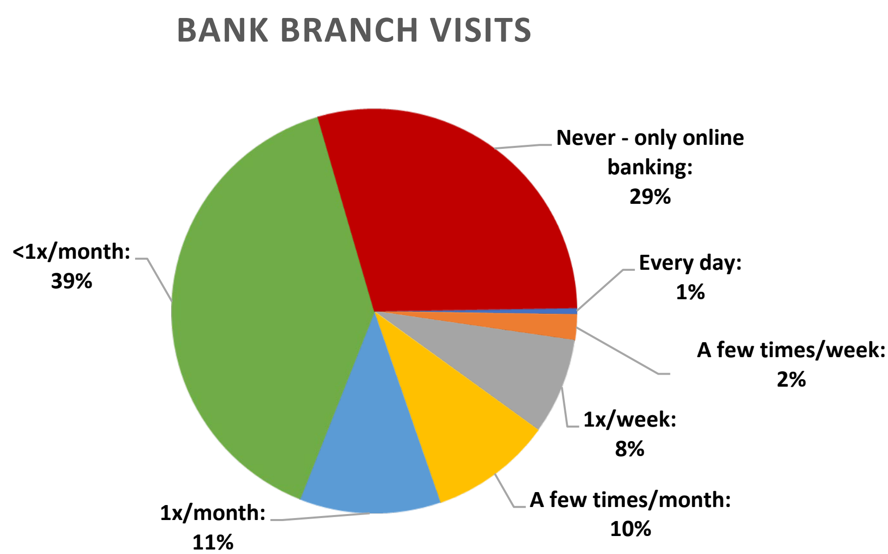
Branches:

Q&A:

We then asked about the frequency of visits to their bank branch or physical banking location. 29% of respondents reported never visiting their bank branch. Instead of bothering to go to a branch, these individuals would rather utilize the convenience of online and mobile services. 50% report physically visiting their branches only one time per month or less than one time per month.

Our Conclusion:

There was a surprisingly large move higher of those never visiting a bank branch. Last year, only 10% of those surveyed never visited a physical banking location. This doubled year-over-year. From these results, it is obvious that most Gen Z's do not find it necessary or useful to visit a physical bank branch. Instead, the needs of physical visits can be fulfilled through mobile check deposits and other online banking features. As long as these features continue to be secure, reliable, and convenient, Gen Z's will prefer these services versus wasting time visiting a bank branch.



Forward Looking:

Q&A:

One of our immediate takeaways and learnings from working at Manole Capital, is the constant focus on the future. Manole Capital is always looking forward and striving to anticipate events, as opposed to reacting. Along these lines, we wanted to ask our group to provide just "one word" which best describes their "vision of banking in the future".

Here are some of our most common responses:

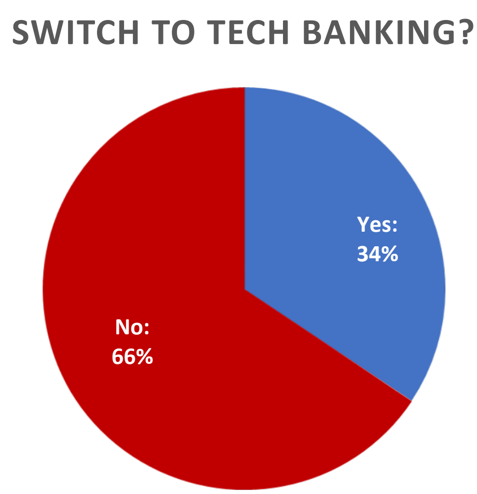
- Mobile
- Online
- Secure
- Reliable
- Digital
- Virtual
- Techy
- Innovative
- Convenient
- Instantaneous
- Simple
- Connected
- Efficient
- Automated
- Free

Our Conclusion:
Younger generations are accepting and using online and mobile banking features. Gen Z is comfortable using technology and online services. The need to visit a branch is dwindling and safe, online services can replace that "old school" traditional bank branch visit. In the event we are meeting bank management teams, one of our questions is whether or not you believe your institution could be described by any of these words.

Banking & Technology:

Q&A:
Once again, we have to admit that all of earlier questions and answers were not terribly surprising. We felt that Gen Z and Millennials would answer these questions exactly where they did. Since we are in this age demographic, it was fairly obvious that Gen Z would prefer technology and online services, right?

When then wanted to ask a more intriguing question. We asked our group, if they would consider moving their banking business to a major technology company like Apple, Google, Amazon, etc. 2/3rd's of our survey responded with a resounding NO.



Our Conclusion:
Not so fast, big tech! It appears that Gen Z is willing to adopt innovative banking technologies, but they don't necessarily want it provided by today's dominant technology companies. Just a few weeks ago, Apple launched a credit card with Goldman Sachs, with the underlying intention of driving business to its Apple Pay application. Maybe Apple won't see widespread adoption? Based on our findings, many large technology companies may find it difficult to invade the financial services space.

The Banking Experience:

Q&A:

Gen Z and Millennials like using new banking technologies and they definitely do not like the hassle of visiting a physical bank branch. However, 2/3rd's of them do not want to get their financial services from one of the larger, technology focused firms. So, what does this younger generation want? We asked whether or not people wanted additional services from their bank.

Our Conclusion:

The answer is clear. Younger generations want their banks to "wake up". Gen Z and Millennials are asking for an expansion of services and for banks to accommodate their needs, not their parents. We believe this can be as simple as creating a fresh experience, where younger people want to congregate.

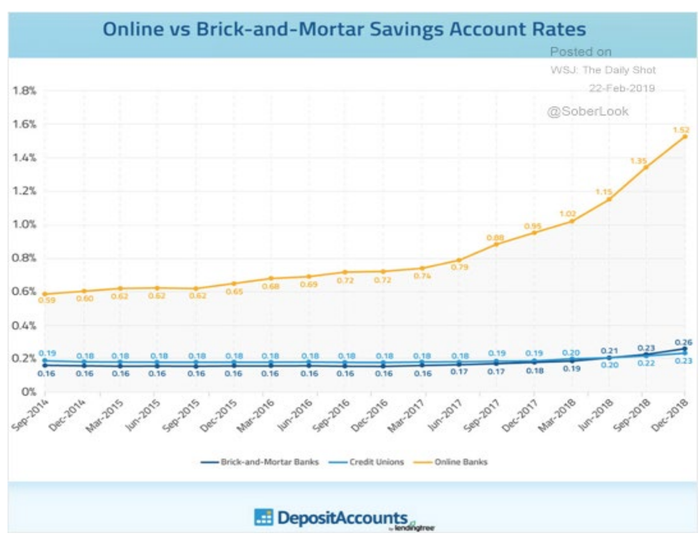
During the 1980s and 1990s, Starbucks sought to become a "secondary home" for people. It became a place to hang out, log onto the internet and enjoy a cup of $5 coffee. If banks are looking to drive consumer traffic, maybe they should create a fresh experience that will get younger people visiting bank branches.

Capital One's has a new slogan called "Banking Re-imagened". They are launching Capital One Café's, that create a Starbuck's like atmosphere. Free wifi, coffee, in a much more relaxed and friendly environment. When shown the above picture and asked if they would be positively inclined to visit a Capital One Café, 57% responded yes.

Interest Rates:

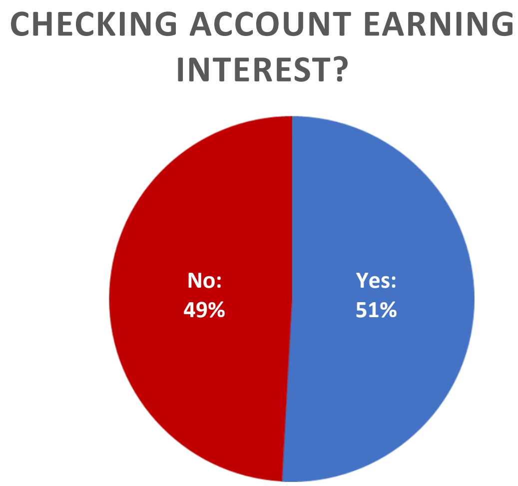
In a recent Economic class, we reviewed the cost of capital and the spread-based business models of banks. Quite simply, banks borrow from their checking account depositors and lend that capital to other clients, at a higher rate.

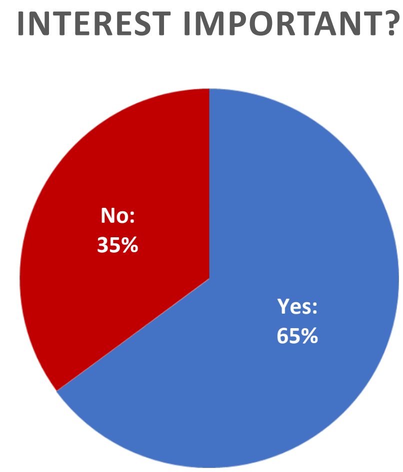
As the chart shows, brick & mortar savings account rates have barely budged in years. Even today, savings account rates at traditional banks is barely 25 basis points. Also, the chart shows how online banks are taking advantage of higher interest rates to their advantage. Online banks, with little physical costs (i.e. branches) can offer savings accounts in the 1.5% range.



Q&A:

We wanted to understand if savings account rates were important to Gen Z and Millennials. We asked our audience if they knew if they were receiving interest on their deposits. If they replied yes, we then asked if that was an important reason for where their account was situated. Roughly half of our survey is currently earning interest on their account and 2/3rds of the group felt it was important to their relationship.





Our Conclusion:

We believe the results should be eye opening for online banks. Younger generations have grown up in a low-to-no interest rate environment. Now that interest rates have gone up, these individuals would like to earn a little bit of interest on their deposit. If online banks can provide 4x to 5x the interest rate on deposits (1.5% to 0.25%), it could garner market share.

Lending:

Q&A:

Credit is very important to younger individuals, especially with rising student debt and the cost of tuition continuing to skyrocket. As a result, many Gen Z's place an emphasis on lending services and believe it is vital to their overall banking experience. It was not a surprise to learn that 64% of our respondents reported that consumer lending (i.e. student loans, personal credit, mortgages, etc.) is important in their banking relationship.

Our Conclusion:

Some interesting FINTECH lenders have emerged and are stealing market share from traditional lenders. Forbes recently reported that 36% of all US personal loans are made through Fintech lending companies. In addition, these firms have made over 80 million individual loans. Banks must adapt and provide a technological solution for an old service – lending.

Conclusion:

To summarize our banking survey, we found that Gen Z and Millennials are not terribly different from their predecessors in certain areas. They would like to receive interest on their checking accounts, and they want their financial institution to provide a wide array of services.

However, younger generations are definitely different in certain aspects too. For example, they have little desire to visit a traditional branch. If you provide free wifi, good coffee and a comfortable chair, you might be able to drive better traffic. Gen Z and Millennials are definitely more tech savvy and are comfortable using online services and mobile banking. Lastly, the biggest surprise was that “Big Tech” (like Apple, Amazon, Google, Facebook, etc) do not have the opportunity that they think they have. There seems to be a “separation of church and state” when it comes to banking and technology. The younger generation want their financial services provided by traditional banks and their social media provided by technology experts. At least in our opinion, that is somewhat surprising.

Larry Mazza, the CEO of MVBF (a publicly-traded West Virginia bank), perfectly summarizes our banking thoughts. He says banks are rapidly “becoming the yellow top taxis in an Uber world” and that the banking industry must “modernize or risk losing its relevance in the market.” We couldn’t agree more, but we think MVBF might be the bank exception. Banks need to be able to adapt and quickly adjust, but most are very conservative and slow to respond.

“Thank you” for your interest in our 1st piece of banking research. Please be on the lookout for our next note which will focusing on the emerging payments space.

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