1st Source (SRCE)

Updated April 27th, 2018 by Josh Arnold

Key Metrics

Current Price:	$53	**5 Year CAGR Estimate:**	8.5%	**Quality Percentile:**	N/A
Fair Value Price:	$49	**5 Year Growth Estimate:**	8.4%	**Momentum Percentile:**	N/A
% Fair Value:	108%	**5 Year Valuation Multiple Estimate:**	-1.6%	**Total Return Percentile:**	N/A
Dividend Yield:	1.7%	**5 Year Price Target**	$73	**Valuation Percentile:**	N/A

Overview & Current Events

1st Source was founded back in 1863 and since that time, has grown into a $6B+ asset regional bank. The company is headquartered in Indiana and has about 80 branches to service its customers. SRCE's market cap is $1.4B and it is expected to produce just over $300M in revenue this year.

SRCE's recent Q1 report was stellar as the company produced record net income. A lower tax rate helped boost net income but on an operating basis, SRCE's lending rates were higher, average loan balances were higher and leverage was seen on net interest margin due to low deposit funding costs. Higher noninterest expense and loan loss provisions offset some of these gains, but SRCE's Q1 was very strong overall.

Growth on a Per-Share Basis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
EPS	$1.37	$0.72	$1.10	$1.78	$1.84	$2.03	$2.17	$2.17	$2.22	$2.52	***$3.35***	***$5.00***
DPS	$0.58	$0.54	$0.55	$0.58	$0.60	$0.62	$0.65	$0.67	$0.72	$0.76	***$0.88***	***$1.35***

SRCE's EPS growth has been robust since the bottom in 2009 as this year should be nearly five times the amount of EPS it produced during the Great Recession. SRCE's recent growth has been fueled by gains in its asset base, averaging 3% in the past decade but 7% in the past three years. SRCE's strong balance sheet growth has been accompanied by expanding margins and prudent operating expenditures, allowing for a rise in returns on its asset base. Higher loan loss provisions, like what we saw in Q1, are a normal part of loan growth for a bank; new loans must be accrued against at the time they are booked. This is not a sign of weakness; rather, it is a sign of strong growth continuing for SRCE. In light of this, we are expecting robust 8.4% EPS growth going forward, achieved by a continuation of what SRCE has been doing for years. Higher lending rates and continued low deposit costs combined are a long term tailwind for SRCE's earnings growth.

We expect the dividend to grow at roughly the same pace as EPS and as such, the payout ratio should remain roughly flat. SRCE's rising PE multiple has meant a higher stock price and lower yield, and given that the outlook for growth is still strong, that doesn't look set to change anytime soon.

Valuation Analysis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Now	2023
Avg. P/E	15.7	21.5	14.5	10.9	11.3	11.8	12.8	13.9	15.3	18.4	***15.8***	***14.6***
Avg. Yld.	2.4%	3.5%	3.5%	3.0%	2.9%	2.6%	2.3%	2.2%	2.1%	1.6%	***1.7%***	***1.7%***

SRCE's P/E multiple has been fairly steady, all things considered, for the past decade. It is trading for just under 16 times earnings now and that is only slightly in excess of fair value. As a result, we are forecasting a mild 1.6% headwind to total returns in the coming years as we shouldn't see any drastic changes in the valuation of the stock.

Likewise, the yield should remain steady compared to today's 1.7% as the combination of rising EPS, a flat valuation and a rising payout should roughly offset and keep the yield where it is. SRCE was once an income stock with a 3%+ yield but it has simply grown too quickly in recent years and outpaced its payout growth to maintain that status. Surely, shareholders don't begrudge this development but it may be a very long time before new money sees a 3%+ yield in SRCE; it is certainly more focused on earnings growth than achieving a 3% yield at this stage.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
ROA	0.76%	0.56%	0.93%	1.10%	1.09%	1.16%	1.20%	1.11%	1.05%	1.16%	***1.25%***	***1.30%***
Debt/A	88%	88%	88%	87%	88%	88%	88%	89%	87%	90%	***90%***	***90%***
Int. Cov.	1.6	1.9	2.5	3.0	3.7	4.7	5.8	6.0	5.3	5.1	***5.3***	***5.5***
Payout	42%	75%	50%	33%	33%	31%	30%	32%	34%	30%	***26%***	***27%***
Std. Dev.	95.5%	67.3%	40.8%	45.2%	26.0%	20.6%	23.3%	24.4%	22.8%	22.1%	***25.0%***	***35.0%***

SRCE's quality metrics have improved in recent years, although growth in its return on assets has waned of late. The company came through the Great Recession relatively unscathed considering so many banks were losing money, and SRCE's ROA never fell below 56 basis points. It is now more than double that level and this year should see a move up not only from operating earnings growth for reasons mentioned above, but a lower tax rate as well. Sustained growth resulting from leverage from a higher asset base and improving spreads should continue to draw ROA up in the coming years. Its debt level is very steady around 90% of assets, which is more than acceptable for a bank. SRCE has ramped its loan production and acquisition in recent years, resulting in lots of growth, and it has done so largely without taking on interest-bearing debt, improving spreads as rates rise. The payout ratio should remain around where it is today given that dividend and earnings growth should be very similar in the coming years.

SRCE's competitive advantage is in its clean balance sheet, strong profitability metrics and strong market position in the areas it serves. The advantage of a community or regional bank is that it can generate sizable market share in lots of small markets, creating a strong competitive advantage. It is obviously not immune from recession but given its performance during the Great Recession, SRCE looks well positioned for when the next one hits.

Final Thoughts & Recommendation

We believe total returns for SRCE investors will be 8.5% annually, consisting of the current 1.7% yield, a 1.6% headwind from the valuation and 8.5% EPS growth. SRCE is a high-quality stock and is certainly worth holding for investors who already own shares. We recommend others wait for a price that's at a discount to fair value before buying in.

Total Return Breakdown by Year