1st Source (SRCE)

Updated July 20th, 2018 by Josh Arnold

Key Metrics

Current Price:	$55	**5 Year CAGR Estimate:**	7.8%	**Volatility Percentile:**	37.5%
Fair Value Price:	$49	**5 Year Growth Estimate:**	8.4%	**Momentum Percentile:**	62.7%
% Fair Value:	113%	**5 Year Valuation Multiple Estimate:**	-2.4%	**Valuation Percentile:**	41.7%
Dividend Yield:	1.8%	**5 Year Price Target**	$73	**Total Return Percentile:**	50.0%

Overview & Current Events

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

1st Source reported Q2 earnings on 7/19/18 and results were outstanding. Revenue was up 12%, driven by a 15% gain in net interest income. The bank increased its loans by 11% during the quarter and saw a small gain in noninterest income as well. Expenses rose more slowly than revenue at 12%, leading to operating margin gains. In total, earnings-per-share rose 31% against last year's Q2, capping another terrific performance for 1st Source. Further, it raised its quarterly dividend to 25 cents, a 32% increase over the prior payout. As a result of this, we've boosted our dividend per share forecast for this year, as well as for 2023.

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	***$1.00***	***$1.75***

Earnings-per-share growth has been robust since the bottom in 2009 as this year should be nearly five times the amount produced during the Great Recession. Recent growth has been fueled by gains in its asset base, averaging 3% in the past decade, but 7% in the past three years. 1st Source'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. In light of this, we are expecting robust 8.4% earnings-per-share growth going forward, achieved by a continuation of what 1st Source has been doing for years. Higher lending rates and continued low deposit costs combined are a tailwind for earnings growth.

We expect the dividend to grow more rapidly than earnings given the recent increase in the pace of dividend increases. Our expectation for the dividend has been raised to $1.75 in 2023, representing 35% of projected earnings.

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	***16.5***	***14.6***
Avg. Yld.	2.4%	3.5%	3.5%	3.0%	2.9%	2.6%	2.3%	2.2%	2.1%	1.6%	***1.8%***	***2.4%***

1st Source's price-to-earnings multiple has been fairly steady, all things considered, for the past decade. It is trading for 16.5 times earnings now, which is meaningfully above our estimate of fair value of 14.6. As a result, we are forecasting a 2.4% headwind to total returns in the coming years as the valuation normalizes over time.

The yield should rise substantially in the coming years as the valuation drifts lower while the payout is raised. 1st Source's current yield is quite low by historical standards and we see that condition as being rectified in the coming years. It 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 this stock; management 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%	***30%***	***35%***
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%***

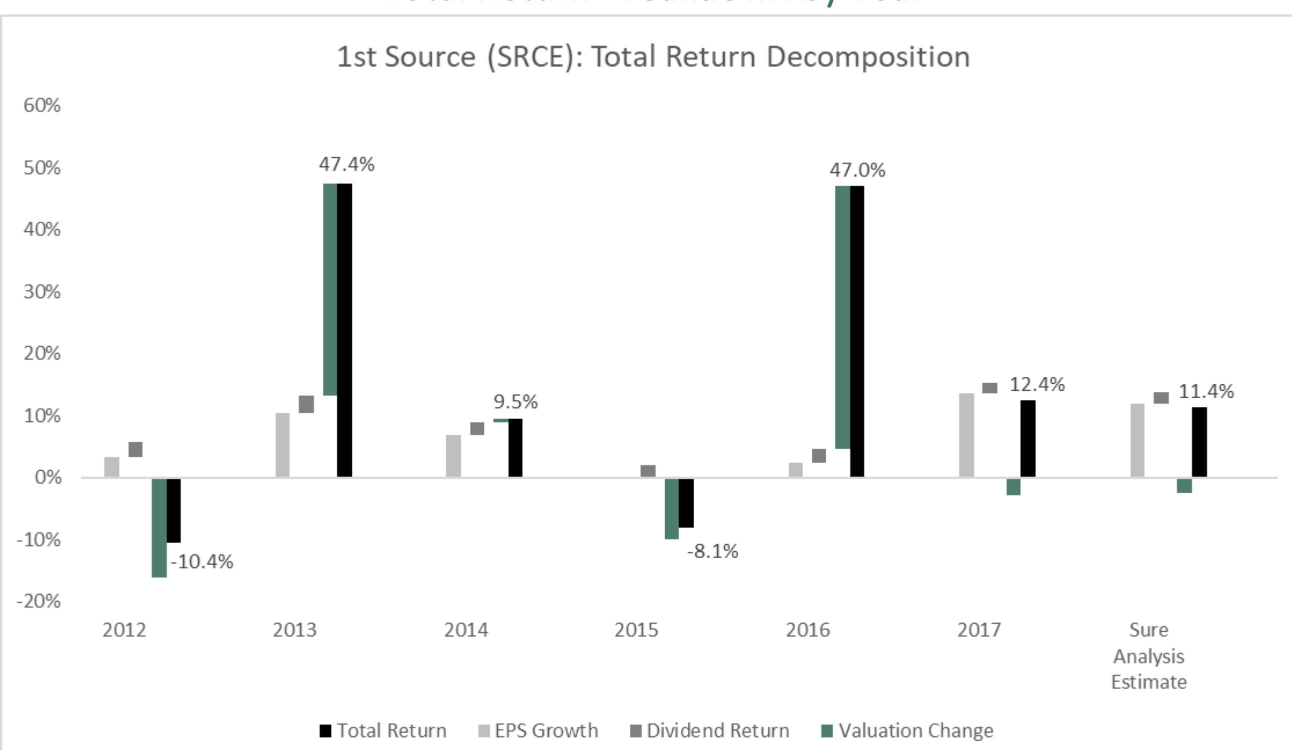
1st Source's quality metrics have improved in recent years, although growth in its return on assets has waned of late. The company came through the Great Recession relatively unscathed considering so many banks were losing money, and its return on assets never fell below 56 basis points. It is now more 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 be in the mid-30% range given that dividend raises should outpace earnings growth in the coming years.

1st Source's competitive advantage is in its clean balance sheet, strong profitability metrics and robust 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 sustainable competitive advantage. It is obviously not immune from recessions but given its performance during the Great Recession, 1st Source looks well positioned for when the next economic downturn arrives.

Final Thoughts & Recommendation

We believe total returns for 1st Source investors will be 7.8% annually, consisting of the current 1.8% yield, a 2.4% headwind from the valuation and 8.4% earnings-per-share growth. 1st Source 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



Disclosure: This analyst has no position in the security discussed in this research report, and no plans to initiate one in the next 72 hours.