# Community Bank System (CBU)

*Updated April 27th, 2018 by Josh Arnold*

## Key Metrics

| | | | | | |
|---|---|---|---|---|---|
| **Current Price:** | $57 | **5 Year CAGR Estimate:** | 6.6% | **Quality Percentile:** | N/A |
| **Fair Value Price:** | $44 | **5 Year Growth Estimate:** | 9.1% | **Momentum Percentile:** | N/A |
| **% Fair Value:** | 129% | **5 Year Valuation Multiple Estimate:** | -4.9% | **Total Return Percentile:** | N/A |
| **Dividend Yield:** | 2.4% | **5 Year Price Target** | $68 | **Valuation Percentile:** | N/A |

## Overview & Current Events

Community Bank System was formed in 1983 and since that time, it has expanded to become a diversified financial services company with 230 locations in the northeastern US. Its principal business is community banking but it also owns a large benefits administration business in addition to offering a variety of insurance products. Its market cap is $2.9B and it produces nearly $600M in annual revenue.

CBU's recent Q1 report was outstanding as revenue grew 27% and EPS was up 37%, the result of broad-based strength as a result of organic growth and recent acquisitions. CBU's fee revenue rose significantly, its net interest margin moved up six basis points and charge-off levels remained very low. CBU's Q1 report was really quite terrific and built on the strength of the past several years as management continues to execute its playbook for growth.

## Growth on a Per-Share Basis

| Year | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2023 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **EPS** | $1.49 | $1.26 | $1.89 | $2.01 | $1.93 | $3.38 | $2.22 | $2.19 | $2.32 | $2.55 | ***$2.95*** | ***$4.55*** |
| **DPS** | $0.86 | $0.88 | $0.94 | $1.00 | $1.06 | $1.10 | $1.16 | $1.22 | $1.26 | $1.34 | ***$1.40*** | ***$1.70*** |

EPS has been fairly volatile in the past decade but in more recent years, growth has been steadier. CBU saw a meaningful dip in earnings in 2009 but EPS recovered quickly and haven't looked back. This year should see EPS at roughly double the rate of 2008. We see continued strong growth in the years ahead as CBU has fully put the sins of the past behind it and is focused on profitable growth; we are forecasting robust 9.1% EPS growth annually going forward.

CBU will achieve this via several methods. This year will see a lower tax rate but operationally, it continues to see earnings tailwinds from higher net interest margin from very low deposit funding costs, organic revenue growth from its diversified revenue streams as well as a constant flow of acquisitions. In the past five years alone CBU has completed 10 sizable acquisitions, including two banks and a deal for some Bank of America branches and their deposits. Growth-by-acquisition is generally tough in the financial services industry but CBU has proven adept at executing such a strategy, and this should be the primary growth driver going forward. Higher rates will continue to improve margins as CBU's deposit funding rate is still near zero, and its wealth management, insurance and employee benefits businesses are performing well. CBU's constant investment in growth has paid off and will continue to do so in the years to come.

Dividend growth has been moderate and we expect that will continue as CBU focuses on earnings growth and not the payout. While we see mid-single digit growth in the dividend, it likely will not keep pace with earnings growth.

## Valuation Analysis

| Year | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | Now | 2023 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Avg. P/E** | 16.4 | 14.0 | 12.3 | 12.4 | 14.3 | 9.6 | 16.5 | 17.0 | 18.9 | 17.8 | ***19.3*** | ***15.0*** |
| **Avg. Yld.** | 3.5% | 5.0% | 4.0% | 4.0% | 3.8% | 3.4% | 3.2% | 3.3% | 2.9% | 2.5% | ***2.4%*** | ***2.5%*** |

CBU's P/E multiple has moved around significantly in the past decade as its fortunes have improved and deteriorated. However, recent years have seen investors pay much more for the stock, a situation that has left it trading in excess of fair value. Thus, we are forecasting a meaningful 4.9% headwind to total returns in the coming years from a valuation reset. We see the P/E multiple moving from the current 19 to something more like 15, which would be better aligned with its historical valuation. A lower valuation combined with dividend increases should lead to a slightly higher yield.

## Safety, Quality, Competitive Advantage, & Recession Resiliency

| Year | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2023 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Op Mrgn** | 25.6% | 21.3% | 31.9% | 34.7% | 33.0% | 32.0% | 35.7% | 35.6% | 36.0% | 30.1% | ***32.0%*** | ***34.0%*** |
| **Debt/A** | 89% | 90% | 89% | 88% | 88% | 88% | 87% | 87% | 86% | 85% | ***85%*** | ***85%*** |
| **Int. Cov.** | 1.5 | 2.0 | 2.7 | 3.4 | 4.5 | 9.1 | 20.7 | 22.2 | 24.3 | 22.9 | ***24.0*** | ***25.0*** |
| **Payout** | 58% | 69% | 48% | 47% | 53% | 32% | 51% | 54% | 53% | 53% | ***47%*** | ***37%*** |
| **Std. Dev.** | 61.9% | 53.1% | 33.8% | 36.5% | 19.6% | 17.4% | 20.2% | 21.3% | 22.1% | 23.4% | ***25.0%*** | ***28.0%*** |

CBU's quality metrics have improved in recent years as its operating margins and interest coverage have seen the biggest gains. Interest coverage has increased significantly as the cost of deposit funding has fallen dramatically in recent years. That has helped CBU improve its margins and thus, its earnings growth and we see that continuing as rates rise while deposit costs remain extremely low. CBU's operating expenses continue to leverage down due to higher revenue, a trend we also expect to continue. Finally, we see the payout ratio falling as earnings growth outpaces dividend growth.

CBU's competitive advantage is in its dominant market position in many of its service areas. CBU competes in areas that have sparse levels of competition and thus, it is more easily able to produce strong market share in those areas, with many at or above a third of total market deposits. That doesn't make it immune to recessions but its continued strong performance means it can be an acquirer during downturns, softening the blow of economic weakness.

## Final Thoughts & Recommendation

Overall, CBU looks poised for strong growth but the stock is trading in excess of fair value here. We see total annual returns of 6.6%, the product of the 2.4% current yield, 9.1% EPS growth and a 4.9% headwind from the valuation reset. CBU certainly looks attractive for those seeking earnings growth but value investors should look elsewhere. Likewise, the current yield is decent but dividend growth will not be a primary driver of investor interest in the stock. CBU does offer a fairly compelling mix of growth and current yield if one can wait and get a better entry price closer to fair value.

## Total Return Breakdown by Year