Community Bank System (CBU)

Updated August 5th, 2018 by Josh Arnold

Key Metrics

Current Price:	$64	**5 Year CAGR Estimate:**	5.8%	**Volatility Percentile:**	57.3%
Fair Value Price:	$48	**5 Year Growth Estimate:**	9.1%	**Momentum Percentile:**	65.2%
% Fair Value:	133%	**5 Year Valuation Multiple Estimate:**	-5.5%	**Valuation Percentile:**	13.2%
Dividend Yield:	2.2%	**5 Year Price Target**	$74	**Total Return Percentile:**	36.4%

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 capitalization is $3.2 billion, and it produces nearly $600 million in annual revenue.

Community Bank System reported record Q2 earnings on 7/23/18. Earnings-per-share rose 28% on an adjusted basis against last year's Q2, and 10% against this year's Q1. The bank's recent acquisitions – including Merchants Bancshares – provided a larger asset base that saw net interest income rise 18% and noninterest income increase 19%. Not only is the bank's asset base larger, but it continues to increase the average yield on its portfolio as deposit costs remain at rock-bottom levels. Further, expense growth was just 14%, creating operating leverage and improving margins. In total, Community Bank System's Q2 report was quite good; we've slightly increased our 2018 earnings-per-share estimate.

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	***$3.20***	***$4.95***
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***

Earnings-per-share has been fairly volatile in the past decade but in more recent years, growth has been steadier. The bank saw a meaningful dip in earnings in 2009 but earnings-per-share recovered quickly and haven't looked back. We see continued strong growth in the years ahead as the company has fully put the sins of the past behind it and is focused on profitable growth. We are forecasting robust 9.1% earnings-per-share growth annually going forward.

Community Bank System 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 as well as a constant flow of acquisitions. In the past five years alone, it 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 Community Bank System has proven adept at executing this strategy, and this should be the primary growth driver going forward. Higher rates will continue to improve margins as the bank's deposit funding rate is still near zero, and its wealth management, insurance and employee benefits businesses are performing well.

Dividend growth has been moderate, and we expect that will continue as the bank 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	***19.9***	***15.0***
Avg. Yld.	3.5%	5.0%	4.0%	4.0%	3.8%	3.4%	3.2%	3.3%	2.9%	2.5%	***2.2%***	***2.3%***

Community Bank System's price-to-earnings 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

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that has left it trading in excess of fair value. Thus, we are forecasting a meaningful 5.5% headwind to total returns in the coming years from a valuation reset. A lower valuation 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
ROA	0.97%	0.77%	1.16%	1.13%	1.03%	1.93%	1.22%	1.07%	1.20%	1.40%	***1.30%***	***1.35%***
Debt/A	89%	90%	89%	88%	88%	88%	87%	87%	86%	85%	***85%***	***85%***
LLP/Loans	0.40%	0.32%	0.24%	0.14%	0.24%	0.20%	0.17%	0.13%	0.17%	0.18%	***0.18%***	***0.17%***
Payout	58%	69%	48%	47%	53%	32%	51%	54%	53%	53%	***44%***	***35%***
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%***

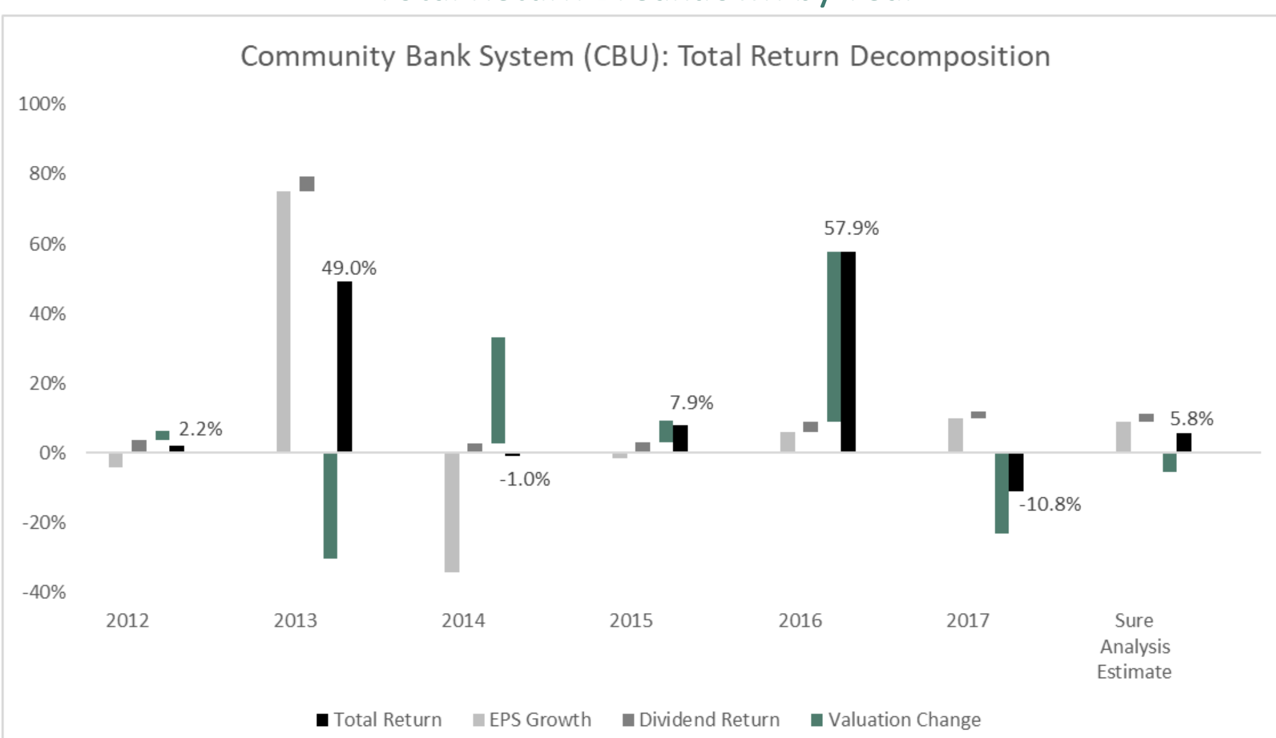
Community Bank System's quality metrics have improved in recent years as its operating margins and interest coverage have seen the most significant gains. Interest coverage has increased materially as the cost of deposit funding has fallen dramatically in recent years. That has helped the bank improve its margins and thus, its earnings growth and we see that continuing as rates rise. 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.

Community Bank System's competitive advantage is in its dominant market position in many of its service areas. It 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 does not make it immune to recessions, but its strong performance means it can be an acquirer during downturns, softening the blow of economic weakness.

Final Thoughts & Recommendation

Overall, Community Bank System looks poised for strong growth, but the stock is trading well in excess of fair value. We see total annual returns of 5.8%, the product of the 2.2% current yield, 9.1% EPS growth and a 5.5% headwind from the valuation reset. It 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. Community Bank System 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, but we rate it a hold for now because of the high valuation.

Total Return Breakdown by Year



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