Community Bank System (CBU)

Updated October 24th, 2018 by Josh Arnold

Key Metrics

Current Price:	$57	**5 Year CAGR Estimate:**	8.4%	**Volatility Percentile:**	53.8%
Fair Value Price:	$48	**5 Year Growth Estimate:**	9.1%	**Momentum Percentile:**	65.1%
% Fair Value:	119%	**5 Year Valuation Multiple Estimate:**	-3.4%	**Growth Percentile:**	86.2%
Dividend Yield:	2.7%	**5 Year Price Target**	$74	**Valuation Percentile:**	25.9%
Dividend Risk Score:	C	**Retirement Suitability Score:**	C	**Total Return Percentile:**	45.0%

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 $2.9 billion, and it produces nearly $600 million in annual revenue.

The bank reported Q3 earnings on 10/22/18 and results were strong once again. Adjusted earnings-per-share increased 17% over last year's Q3 thanks to very strong fundamentals and lower taxes. Deposit costs remain at rock-bottom levels, averaging just 13bps in Q3, while charge-offs were also outstanding at just 11bps. Total revenue rose 3.4% as net interest income increased 2.1% and noninterest income added 5.4%. Community Bank System saw its average loan yield rise 20bps thanks to rising rates, but an essentially flat deposit cost. We've improved our estimates for return on assets and loan loss provisions as a result of the strong Q3; our estimate for earnings-per-share remains unchanged.

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	***$1.52***	***$2.22***
Shares	31	33	33	36	40	41	41	41	44	49	***51***	***55***

Earnings-per-share have been fairly volatile in the past decade but in recent years, growth has been steadier. We see that continuing as the bank is focused on profitable growth and forecast 9.1% earnings-per-share growth annually.

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. Indeed, Q3 results support this growth outlook.

Dividend growth has been moderate, but management appears to be willing to spend nearly half of earnings on the dividend. We've boosted our forecast for long-term dividend growth as a result, bringing it to $2.22 by 2023.

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	***17.8***	***15.0***
Avg. Yld.	3.5%	5.0%	4.0%	4.0%	3.8%	3.4%	3.2%	3.3%	2.9%	2.5%	***2.7%***	***3.0%***

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 that has left it trading in excess of fair value. Thus, we are forecasting a meaningful 3.4% 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%	***1.40%***	***1.45%***
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%	***0.16%***	***0.15%***
Payout	58%	69%	48%	47%	53%	32%	51%	54%	53%	53%	***48%***	***45%***
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%***

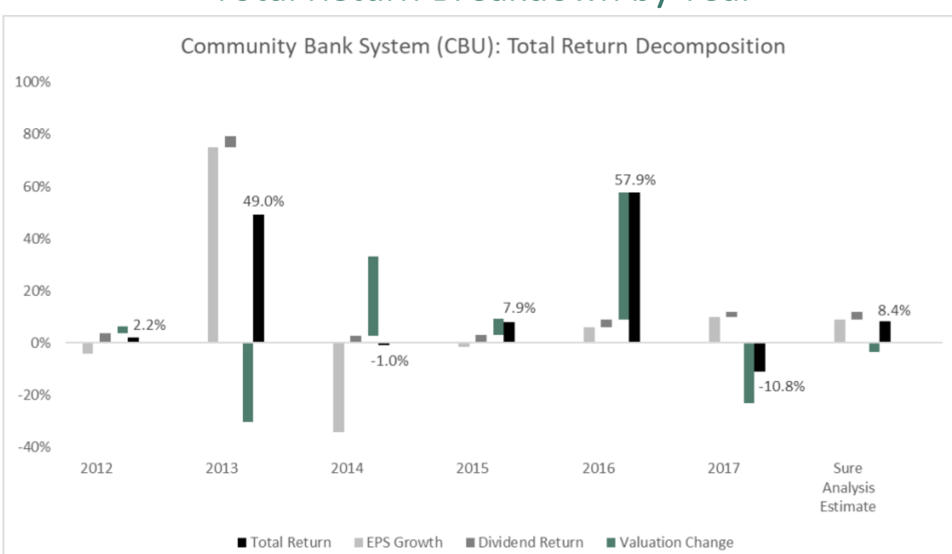
Community Bank System's quality metrics have improved in recent years as its return on assets and loan loss provisions have seen the most significant gains. Both of these metrics are critical to a bank's earnings growth and Community Bank System is tremendously productive with both. Operating expenses continue to leverage down due to higher revenue, a trend we also expect to continue. Finally, we see the payout ratio falling slightly, but remaining in the mid-40% area. Community Bank System is a superior operator among regional banks and its quality metrics continue to show it.

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 in excess of fair value. We see total annual returns of 8.4%, the product of the 2.7% current yield, 9.1% earnings growth and a 3.4% headwind from the valuation reset. It certainly looks attractive for those seeking earnings growth, but value investors should look elsewhere. The recent selloff has made the valuation and yield more attractive than they have been in the recent past. With that said, there are currently other opportunities within the financial sector that have higher expected returns. Community Bank System earns a hold recommendation at current prices.

Total Return Breakdown by Year



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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.

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Income Statement Metrics

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Revenue	222.0	249.04	270.48	298.73	329.67	427.61	363.45	371.72	429.52	518.10
SG&A Exp.	116.4	138.55	128.66	137.90	151.20	165.58	169.67	174.43	204.58	238.55
D&A Exp.	16.37	18.47	16.95	16.62	16.78	17.23	17.81	17.20	20.40	33.46
Net Profit	45.94	41.45	63.32	73.14	77.07	78.83	91.35	91.23	103.81	150.72
Net Margin	20.7%	16.6%	23.4%	24.5%	23.4%	18.4%	25.1%	24.5%	24.2%	29.1%
Free Cash Flow	45.51	30.24	81.37	84.77	97.58	89.33	108.73	107.17	123.33	178.86
Income Tax	10.75	11.62	23.07	30.39	31.74	32.20	38.34	40.99	50.79	9.25

Balance Sheet Metrics

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Total Assets	5175	5403	5445	6488	7497	7096	7489	8553	8666	10746
Cash & Equivalents	213.8	361.88	211.84	324.88	228.56	149.65	138.40	153.21	173.86	221.04
Accounts Receivable	26.08	25.14	26.14	28.58	32.31	25.48	24.65	25.90	31.09	36.18
Goodwill & Int. Ass.	328.6	317.67	311.71	360.56	387.13	390.50	386.97	484.15	480.84	825.09
Total Liabilities	4630	4837	4837	5714	6594	6220	6502	7412	7468	9111
Accounts Payable	N/A	N/A	N/A	88.12	135.85	80.00	126.15	135.10	144.01	180.57
Long-Term Debt	862.5	856.8	830.5	830.3	830.1	244.0	440.1	403.4	248.4	148.9
Shareholder's Equity	544.7	565.7	607.3	774.6	902.8	875.8	987.9	1140.6	1198.1	1635.3
D/E Ratio	1.58	1.51	1.37	1.07	0.92	0.28	0.45	0.35	0.21	0.09

Profitability & Per Share Metrics

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Return on Assets	0.9%	0.8%	1.2%	1.2%	1.1%	1.1%	1.3%	1.1%	1.2%	1.6%
Return on Equity	9.0%	7.5%	10.8%	10.6%	9.2%	8.9%	9.8%	8.6%	8.9%	10.6%
ROIC	3.3%	2.9%	4.4%	4.8%	4.6%	5.5%	7.2%	6.1%	6.9%	9.3%
Shares Out.	31	33	33	36	40	41	41	41	44	49
Revenue/Share	7.21	7.59	8.13	8.26	8.31	10.56	8.86	8.98	9.66	10.47
FCF/Share	1.48	0.92	2.45	2.34	2.46	2.21	2.65	2.59	2.77	3.62

Note: All figures in millions of U.S. Dollars unless per share or indicated otherwise.