# Community Bank System (CBU)

*Updated January 25th, 2019 by Josh Arnold*

## Key Metrics

| | | | | | |
|---|---|---|---|---|---|
| **Current Price:** | $60 | **5 Year CAGR Estimate:** | 7.4% | **Volatility Percentile:** | 50.6% |
| **Fair Value Price:** | $49 | **5 Year Growth Estimate:** | 9.0% | **Momentum Percentile:** | 85.8% |
| **% Fair Value:** | 123% | **5 Year Valuation Multiple Estimate:** | 4.1% | **Growth Percentile:** | 84.1% |
| **Dividend Yield:** | 2.5% | **5 Year Price Target** | $75 | **Valuation Percentile:** | 17.2% |
| **Dividend Risk Score:** | B | **Retirement Suitability Score:** | C | **Total Return Percentile:** | 29.1% |

## 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 more than 200 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 $3.1 billion, and it produces nearly $600 million in annual revenue.

Community Bank System reported fourth quarter earnings on 1/23/19 and results slightly missed expectations. Adjusted earnings-per-share came to 78 cents in Q4, a 16% increase over the year-ago period. Total revenue was up 1% year-over-year as net interest income rose 1.6% and noninterest income increased 0.5%. The bank's slightly lower earning asset base was more than offset by a 22bps increase in the average loan portfolio yield as loan rates rose more quickly than that of deposit costs. Community Bank System saw 7% growth in nonbanking noninterest revenue thanks to organic revenue gains in its employee benefits business. In addition, its wealth management and insurance businesses performed well, helping to offset the relatively weak performance from the core banking segment. We see 2019 as another year of relatively weak revenue growth barring a large acquisition.

On 1/22/19, Community Bank System announced it was acquiring Kinderhook Bank for a total consideration of $93.4 million. While acquisitions are a central tenet of Community Bank System's long-term strategy, we feel the Kinderhook acquisition was quite expensive and may ultimately reduce shareholder value as Community Bank System paid nearly 200% of tangible book value for Kinderhook.

Community Bank System also increased its dividend by 12%, producing the 26th consecutive year of dividend raises.

## Growth on a Per-Share Basis

| Year | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2024 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **EPS** | $1.26 | $1.89 | $2.01 | $1.93 | $3.38 | $2.22 | $2.19 | $2.32 | $2.55 | $3.23 | ***$3.25*** | ***$5.00*** |
| **DPS** | $0.88 | $0.94 | $1.00 | $1.06 | $1.10 | $1.16 | $1.22 | $1.26 | $1.34 | $1.44 | ***$1.52*** | ***$2.25*** |
| **Shares** | 33 | 33 | 36 | 40 | 41 | 41 | 41 | 44 | 49 | 51 | ***53*** | ***60*** |

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% earnings-per-share growth annually.

Community Bank System will achieve this via several methods. 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. 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, with the price paid for Kinderhook notwithstanding. 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, Q4 results support this growth outlook. We are a bit concerned about total revenue growth for 2019 as no major acquisitions have been announced to fuel that growth, but its nonbanking activities are performing well.

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 $2.25 by 2024.

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## Valuation Analysis

| Year | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | Now | 2024 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Avg. P/E** | 14.0 | 12.3 | 12.4 | 14.3 | 9.6 | 16.5 | 17.0 | 18.9 | 17.8 | 18.3 | ***18.5*** | ***15.0*** |
| **Avg. Yld.** | 5.0% | 4.0% | 4.0% | 3.8% | 3.4% | 3.2% | 3.3% | 2.9% | 2.5% | 2.4% | ***2.5%*** | ***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 4.1% headwind to total returns in the coming years from a valuation reset. Given the modest outlook for near-term growth, we see the valuation as a key risk to shareholders today. Over time, a lower valuation with dividend increases should lead to a slightly higher yield.

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

| Year | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2024 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Payout** | 69% | 48% | 47% | 53% | 32% | 51% | 54% | 53% | 53% | 45% | ***47%*** | ***45%*** |

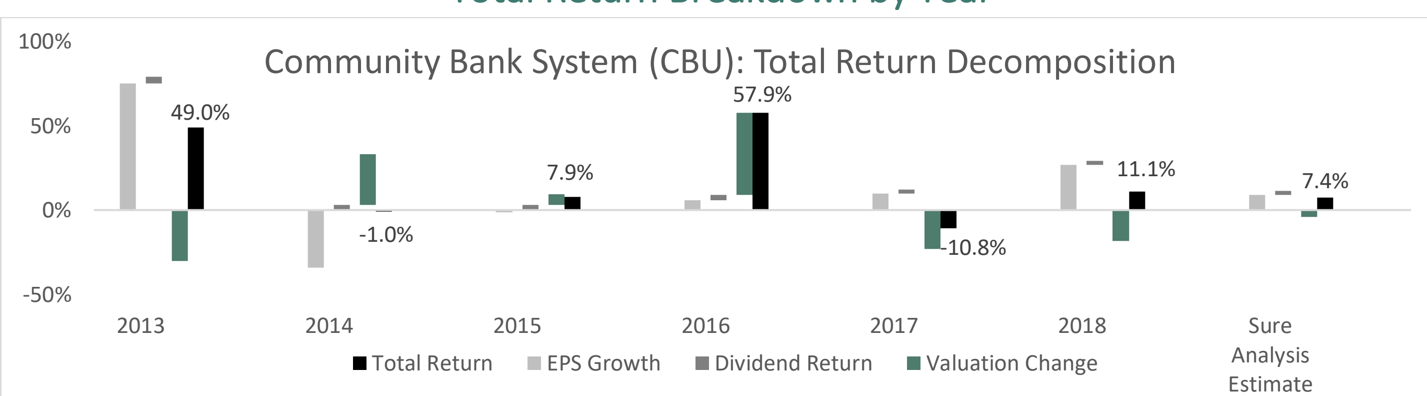
Community Bank System's quality metrics have improved in recent years as its return on assets and loan loss provisions have seen the most significant gains. Both of these metrics are critical to a bank's earnings growth and Community Bank System is tremendously productive with both. Operating expenses continue to leverage down due to higher revenue, a trend we also expect to continue provided acquisitions continue to flow into the bank. 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 7.4%, the sum of the 2.5% current yield, 9% earnings growth and a 4.1% 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. As a result, Community Bank System earns a hold recommendation at current prices given the elevated valuation.

## 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** | 249 | 270 | 299 | 330 | 428 | 363 | 372 | 430 | 518 | 569 |
| **SG&A Exp.** | 139 | 129 | 138 | 151 | 166 | 170 | 174 | 205 | 239 | 207 |
| **D&A Exp.** | 18 | 17 | 17 | 17 | 17 | 18 | 17 | 20 | 33 | N/A |
| **Net Profit** | 41 | 63 | 73 | 77 | 79 | 91 | 91 | 104 | 151 | 169 |
| **Net Margin** | 16.6% | 23.4% | 24.5% | 23.4% | 18.4% | 25.1% | 24.5% | 24.2% | 29.1% | 29.6% |
| **Free Cash Flow** | 30 | 81 | 85 | 98 | 89 | 109 | 107 | 123 | 179 | N/A |
| **Income Tax** | 12 | 23 | 30 | 32 | 32 | 38 | 41 | 51 | 9 | 44 |

## Balance Sheet Metrics

| Year | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 |
|---|---|---|---|---|---|---|---|---|---|---|
| **Total Assets** | 5403 | 5445 | 6488 | 7497 | 7096 | 7489 | 8553 | 8666 | 10746 | 10608 |
| **Cash & Equivalents** | 362 | 212 | 325 | 229 | 150 | 138 | 153 | 174 | 221 | 212 |
| **Accounts Receivable** | 25 | 26 | 29 | 32 | 25 | 25 | 26 | 31 | 36 | N/A |
| **Goodwill & Int. Ass.** | 318 | 312 | 361 | 387 | 390 | 387 | 484 | 481 | 825 | 807 |
| **Total Liabilities** | 4837 | 4837 | 5714 | 6594 | 6220 | 6502 | 7412 | 7468 | 9111 | 8894 |
| **Accounts Payable** | N/A | N/A | 88 | 136 | 80 | 126 | 135 | 144 | 181 | 157 |
| **Long-Term Debt** | 857 | 830 | 830 | 830 | 244 | 440 | 403 | 248 | 149 | 414 |
| **Shareholder's Equity** | 566 | 607 | 775 | 903 | 876 | 988 | 1141 | 1198 | 1635 | 1715 |
| **D/E Ratio** | 1.51 | 1.37 | 1.07 | 0.92 | 0.28 | 0.45 | 0.35 | 0.21 | 0.09 | 0.24 |

## Profitability & Per Share Metrics

| Year | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 |
|---|---|---|---|---|---|---|---|---|---|---|
| **Return on Assets** | 0.8% | 1.2% | 1.2% | 1.1% | 1.1% | 1.3% | 1.1% | 1.2% | 1.6% | 1.6% |
| **Return on Equity** | 7.5% | 10.8% | 10.6% | 9.2% | 8.9% | 9.8% | 8.6% | 8.9% | 10.6% | 10.1% |
| **ROIC** | 2.9% | 4.4% | 4.8% | 4.6% | 5.5% | 7.2% | 6.1% | 6.9% | 9.3% | 8.6% |
| **Shares Out.** | 33 | 33 | 36 | 40 | 41 | 41 | 41 | 44 | 49 | 51 |
| **Revenue/Share** | 7.59 | 8.13 | 8.26 | 8.31 | 10.56 | 8.86 | 8.98 | 9.66 | 10.47 | 10.94 |
| **FCF/Share** | 0.92 | 2.45 | 2.34 | 2.46 | 2.21 | 2.65 | 2.59 | 2.77 | 3.62 | N/A |

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