1st Source Corp. (SRCE)

Updated January 25th, 2019 by Josh Arnold

Key Metrics

Current Price:	$45	**5 Year CAGR Estimate:**	12.5%	**Volatility Percentile:**	43.4%
Fair Value Price:	$50	**5 Year Growth Estimate:**	8.0%	**Momentum Percentile:**	32.2%
% Fair Value:	90%	**5 Year Valuation Multiple Estimate:**	2.1%	**Growth Percentile:**	73.2%
Dividend Yield:	2.4%	**5 Year Price Target**	$73	**Valuation Percentile:**	65.4%
Dividend Risk Score:	A	**Retirement Suitability Score:**	B	**Total Return Percentile:**	69.6%

Overview & Current Events

1st Source was founded back in 1863 and since that time, has grown into a regional bank with $6 billion in assets. The company is headquartered in Indiana and has about 80 branches to service its customers. 1st Source's market capitalization is $1.2 billion, and it is expected to produce just over $300 million in revenue this year.

1st Source reported Q4 earnings on 1/24/19, and results were largely in line with expectations. Earnings-per-share rose 19% year-over-year to $0.84 as the bank saw somewhat mixed fundamentals offset by a lower tax rate. Net interest income was up 15% against the year-ago period as loan balances and rates were higher. Indeed, average loans and leases rose by nearly 9% in Q4, as did deposits, as 1st Source continues to expand its balance sheet. Noninterest income, however, fell 6% during the quarter, somewhat offsetting gains in net interest income. Noninterest expense increased fractionally, but more slowly than the rate of revenue growth, which improved profitability.

Return on assets was meaningfully higher, reflecting stronger profitability, as it rose from 1.23% in last year's Q4 to 1.36% this time around. Likewise, return on shareholders' equity increased from 9.93% to 11.22% in Q4. These gains are quite strong and reflect the impact of a lower tax rate. While we like 1st Source's fundamentals and execution, gains like these are not going to be recurring given that the lower tax rate was a one-time event for 2018, and is now part of the comparable base.

1st Source also declared a quarterly dividend of 27 cents, which is 23% higher than it was at this time last year, continuing its 30+ year streak of dividend increases. We are out with an initial estimate of $3.55 in earnings-per-share for this year, reflecting another year of strong growth thanks to loan balance growth and loan rate increases.

Growth on a Per-Share Basis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
EPS	$0.72	$1.10	$1.78	$1.84	$2.03	$2.17	$2.17	$2.22	$2.52	$3.16	***$3.55***	***$5.22***
DPS	$0.54	$0.55	$0.58	$0.60	$0.62	$0.65	$0.67	$0.72	$0.76	$0.96	***$1.08***	***$1.56***
Shares	27	27	27	27	27	26	26	26	26	26	***26***	***25***

Earnings-per-share growth has been robust since the bottom in 2009. Recent growth has been fueled by gains in its asset base, averaging 7%+ in the past four 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% 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. Charge-offs are a growing concern but overall, there is still a favorable growth outlook for 1st Source after 2018 results.

Our expectation for the dividend has been raised to $1.56 in 2023, representing 30% of projected earnings.

Valuation Analysis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Now	2024
Avg. P/E	21.5	14.5	10.9	11.3	11.8	12.8	13.9	15.3	18.4	16.4	***12.6***	***14.0***
Avg. Yld.	3.5%	3.5%	3.0%	2.9%	2.6%	2.3%	2.2%	2.1%	1.6%	1.9%	***2.4%***	***2.1%***

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1st Source's price-to-earnings multiple has been fairly steady, all things considered, for the past decade. It is trading for 12.6 times earnings after a recent selloff, which is quite low by its own historical standards as well as our estimate of fair value of 14 times earnings. As a result, we are forecasting a 2.1% tailwind to total returns in the coming years as the valuation rises slightly. The yield should decline moderately in the coming years as the payout ratio remains near 30% and the valuation moves higher. 1st Source's current yield is relatively high 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 do not 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	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
Payout	75%	50%	33%	33%	31%	30%	32%	34%	30%	30%	***30%***	***30%***

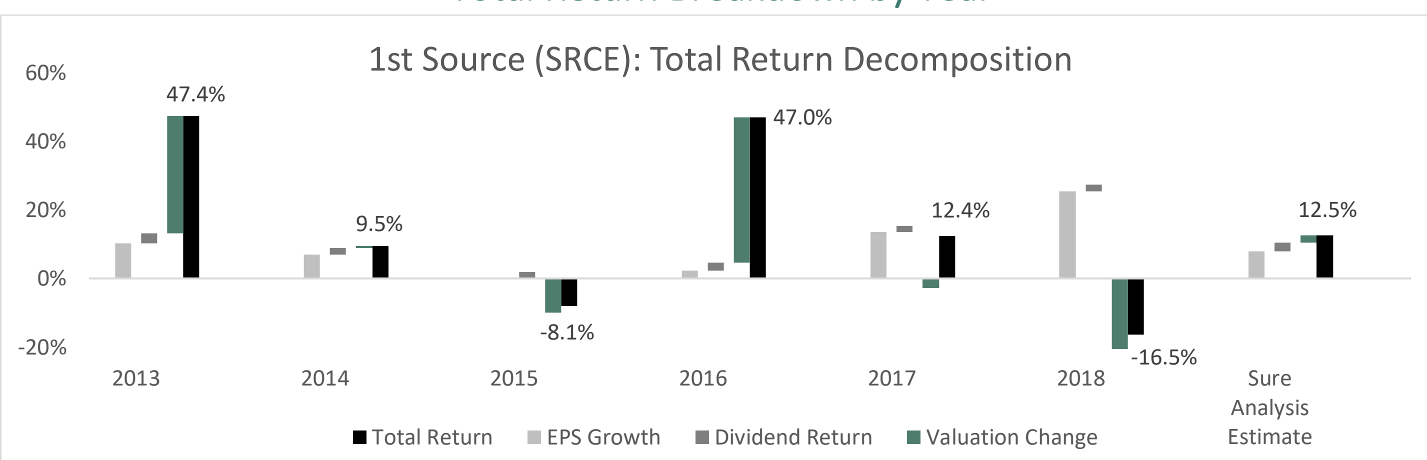
1st Source's quality metrics have improved in recent years, including a continued rise in return on assets. The company came through the Great Recession relatively unscathed considering so many banks were losing money, and its return on assets never fell below 56 basis points. We think 1st Source is likely near the top in terms of return on assets as 1.36% is very strong for a regional bank. Sustained growth resulting from leverage from a higher asset base and improving spreads should continue to drive earnings in the coming years. Its debt level is very steady around 90% of assets, which is more than acceptable for a bank. Loan production and acquisitions have ramped 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 area of 30% 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 12.5% annually, consisting of the current 2.4% yield, a 2.1% tailwind from the valuation and 8% earnings-per-share growth. 1st Source is a high-quality stock and after the recent selloff, we rate it a buy. The stock is much cheaper than it has been in recent years and we see it as attractive.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Revenue	214	234	229	233	234	238	250	259	284	311
SG&A Exp.	95	91	91	96	94	96	100	100	102	109
D&A Exp.	28	28	25	22	19	20	24	28	32	N/A
Net Profit	25	41	48	50	55	58	57	58	68	82
Net Margin	11.9%	17.6%	21.0%	21.3%	23.5%	24.4%	23.0%	22.3%	23.9%	26.5%
Free Cash Flow	15	107	103	86	59	37	37	59	66	N/A
Income Tax	6	19	26	26	29	26	31	31	33	23

Balance Sheet Metrics

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Total Assets	4542	4445	4374	4551	4723	4830	5188	5486	5887	6294
Cash & Equivalents	73	62	61	83	78	65	65	59	74	95
Goodwill & Int. Ass.	90	89	88	88	86	85	85	84	84	84
Total Liabilities	3972	3959	3850	3992	4137	4215	4544	4814	5169	5530
Long-Term Debt	136	134	145	140	250	222	219	262	138	216
Shareholder's Equity	465	486	524	559	585	614	644	673	719	762
D/E Ratio	0.24	0.28	0.28	0.25	0.43	0.36	0.34	0.39	0.19	0.28

Profitability & Per Share Metrics

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Return on Assets	0.6%	0.9%	1.1%	1.1%	1.2%	1.2%	1.1%	1.1%	1.2%	1.4%
Return on Equity	5.5%	8.7%	9.5%	9.2%	9.6%	9.7%	9.1%	8.8%	9.8%	11.1%
ROIC	3.9%	6.2%	7.5%	7.3%	7.2%	6.9%	6.8%	6.4%	7.6%	9.0%
Shares Out.	27	27	27	27	27	26	26	26	26	26
Revenue/Share	8.04	8.78	9.46	8.72	8.74	9.01	9.55	9.99	10.97	11.99
FCF/Share	0.57	4.01	4.24	3.22	2.19	1.39	1.40	2.28	2.54	N/A

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