1st Source Corp. (SRCE)

Updated July 21st, 2019 by Josh Arnold

Key Metrics

Current Price:	$45	**5 Year CAGR Estimate:**	11.0%	**Volatility Percentile:**	46.8%
Fair Value Price:	$46	**5 Year Growth Estimate:**	8.0%	**Momentum Percentile:**	17.3%
% Fair Value:	97%	**5 Year Valuation Multiple Estimate:**	0.6%	**Growth Percentile:**	75.9%
Dividend Yield:	2.4%	**5 Year Price Target**	$68	**Valuation Percentile:**	64.2%
Dividend Risk Score:	A	**Retirement Suitability Score:**	A	**Total Return Percentile:**	66.8%

Overview & Current Events

1st Source was founded back in 1863 and since that time, has grown into a regional bank with $6.5 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 about $325 million in revenue this year.

1st Source reported Q2 earnings on 7/18/19 and results were largely in line with expectations. Total revenue was up 4% and net interest income was up 6%, while noninterest income rose just 2.5%. Net interest margin was 3.73% in Q2, an improvement of four basis points year-over-year. 1st Source noted deposit rate competition and rate increases as headwinds for lending margins, but it performed well in Q2 anyway.

Average loans and leases rose 4.8% to $5 billion in Q2, while deposits grew 6.1% to $5.3 billion. 1st Source continues to lend out virtually all of its deposits, which is somewhat unusual in the post-financial crisis world. However, the bank has made it work and continues to post strong earnings growth, in part because it is fully utilizing a cheap deposit base.

Noninterest expense rose 4.5% on an adjusted basis, primarily due to higher salary expense. However, higher revenue helped drive 1st Source's already-low efficiency ratio even lower, falling 64bps to 54.07% of revenue. This is a very strong value and continues to show the operational effectiveness of 1st Source. Indeed, this helps the bank lend out almost all of its deposits and do so profitably as expenses are low.

1st Source saw a spike in net charge-offs compared to Q1 of this year due to one customer relationship, but its credit metrics remain strong. This is necessary given the high level of loans 1st Source has on its balance sheet, but we certainly aren't concerned as its credit quality remains excellent.

Earnings-per-share came to $0.91 in Q2, up from $0.84 in the prior Q2 and a new record for 1st Source. The bank has earned $1.76 in earnings-per-share thus far this year, and we reiterate our estimate of $3.55 for this year.

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 combined with continued low deposit costs 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 Q2 results, and despite what looks like a temporary move higher in charge-offs.

Our expectation for the dividend remains $1.56 in 2024, representing 30% of projected earnings, as it has for the past several years.

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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***	***13.0***
Avg. Yld.	3.5%	3.5%	3.0%	2.9%	2.6%	2.3%	2.2%	2.1%	1.6%	1.9%	***2.4%***	***2.3%***

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 today, which is essentially in line with its own historical valuations, as well as our estimate of fair value at 13 times earnings. Therefore, we see very little impact from the valuation on total returns in the coming years.

We see the yield remaining roughly where it is today in the mid-2% range as the valuation is near fair value, and the payout should grow at roughly congruent rates with earnings.

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%***

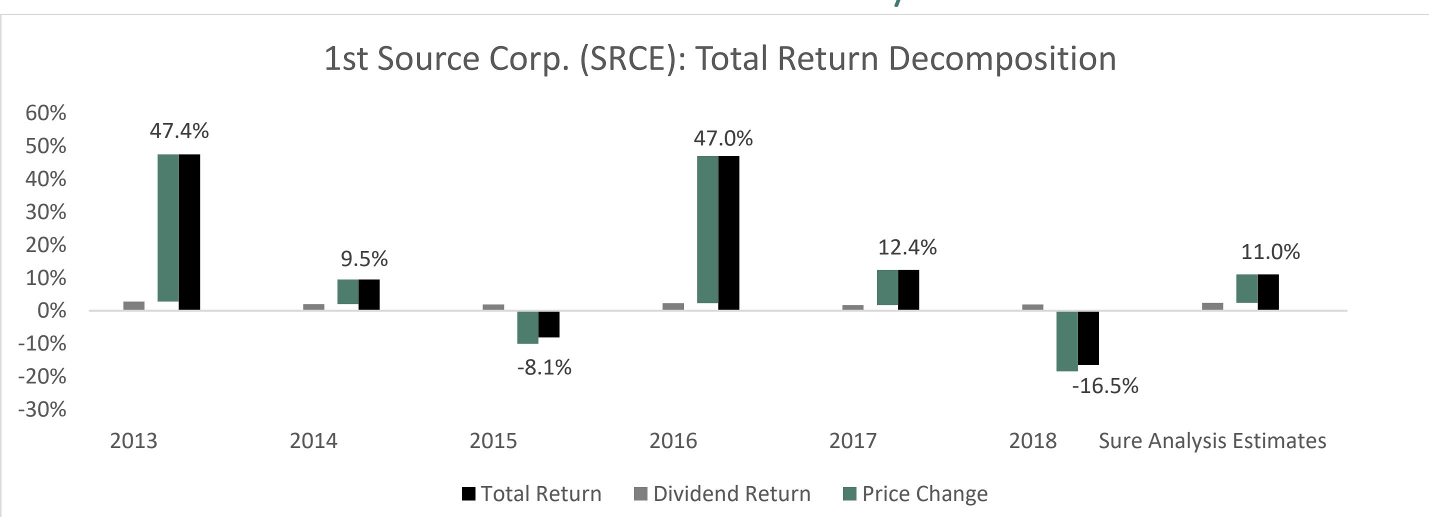
The payout ratio should be in the area of 30% given that dividend raises will likely be in line with earnings growth in the coming years. We see the dividend as very safe and with a lot of room to grow given 1st Source's commitment to raising the payout, as well as the low payout ratio, and the bank's strong earnings growth rates.

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 could be 11% annually, consisting of the current 2.4% yield, a 0.6% tailwind from the valuation and 8% earnings-per-share growth. 1st Source is a high-quality bank stock and despite shares trading at our estimate of fair value, we rate it a buy. 1st Source is one of the best regional banks in our coverage universe and we see the stock as attractive. It offers investors a robust growth outlook, a decent yield, and the prospects of high rates of dividend growth.

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	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
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	33
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	120
Income Tax	6	19	26	26	29	26	31	31	33	23

Balance Sheet Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
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	119	199
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	0.17	0.26

Profitability & Per Share Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
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%	7.7%	9.2%
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	4.63

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