Community Bank System (CBU)

Updated July 26th, 2019 by Josh Arnold

Key Metrics

Current Price:	$65	**5 Year CAGR Estimate:**	2.5%	**Volatility Percentile:**	51.7%
Fair Value Price:	$46	**5 Year Growth Estimate:**	7.0%	**Momentum Percentile:**	47.0%
% Fair Value:	142%	**5 Year Valuation Multiple Estimate:**	-6.8%	**Growth Percentile:**	99.8%
Dividend Yield:	2.3%	**5 Year Price Target**	$64	**Valuation Percentile:**	12.3%
Dividend Risk Score:	B	**Retirement Suitability Score:**	B	**Total Return Percentile:**	99.8%

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 $3.3 billion, and it produces nearly $600 million in annual revenue.

Community Bank System reported Q2 earnings on 7/22/19 and results beat expectations. Total revenue came in at $149 million, an increase of 3.9% from the year-ago period. Net interest income, or NII, rose 1.7% while noninterest income was up 7.3%. NII was up as the yield on earning assets rose, but was partially offset by higher funding costs. The increase in noninterest revenue was due to realized gains in the investment securities portfolio, which we caution won't be reoccurring. However, fees rose in all three of the company's non-banking business lines.

Provisions for loan losses were $1.4 million in Q2, a decline from the $2.4 million in last year's Q2. Non-performing loans were 0.39% of total loans in Q2, down from 0.47% as Community Bank System's credit quality remains excellent.

Operating expenses were up 5.9% in Q2 driven by acquisition-related expenses from the Kinderhook deal, as well as a 3.1% increase in salary and benefit expenses. There was also an additional payroll day in Q2 from a year ago.

Net interest margin improved from 3.73% in last year's Q2 to 3.80%, which is an outstanding number. The gain was due to a higher yield on loans, a much better yield on cash equivalents, and a slight increase in the cost of funds, which was attributable to higher deposit costs. The company notes that more deposits are in checking and savings accounts with low or no yield, which has improved its funding mix and is helping with margins.

Earnings-per-share came in at $0.80 on an adjusted basis in Q2, down from $0.86 in the year-ago period. The factors discussed above weighed, in addition to lower interchange revenue due to the Durbin amendment, as well as a higher effective tax rate weighed on earnings. We're reiterating $3.25 in earnings-per-share for this year after Q2 results.

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***	***$4.56***
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 we forecast 7% earnings-per-share growth annually. This is down from our prior estimate of 7% given interest rate headwinds present for the entire banking industry.

Community Bank System can achieve this via several methods. It continues to see earnings tailwinds from higher net interest margin, very low deposit funding costs, and 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. Community Bank System is performing well, but its lending margins are already best-in-class, so we think the inverted yield curve will see it struggle to continue to boost those margins. However, credit quality remains outstanding.

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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.

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	***19.9***	***14.0***
Avg. Yld.	5.0%	4.0%	4.0%	3.8%	3.4%	3.2%	3.3%	2.9%	2.5%	2.4%	***2.3%***	***3.5%***

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 6.8% 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 meaningfully 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%***	***49%***

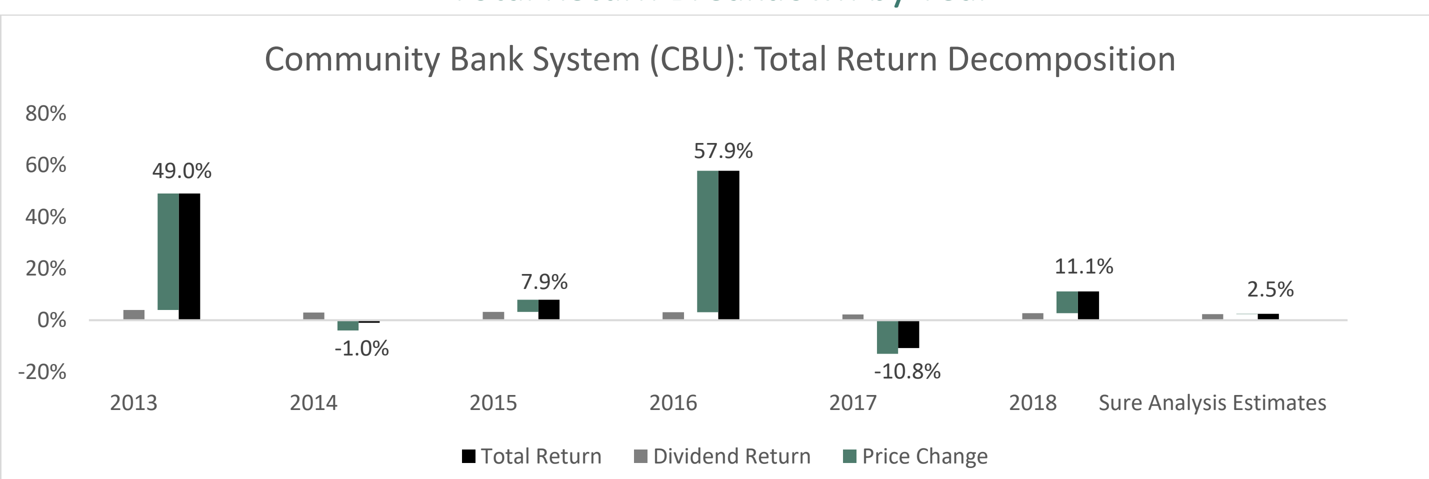
We see the payout ratio rising slightly, but remaining in the high 40% area. The bank's impressive dividend streak appears to be very safe at this point and we see many more years of increases coming, even if a recession strikes.

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 the company is able to hold strong market share in those locations, 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 our estimate of fair value. We see total annual returns of 2.5%, the sum of the 2.3% current yield, 7% earnings growth and a 6.8% headwind from the valuation reset. We are downgrading Community Bank System from hold to sell given very low projected total returns, due principally to the excessively high valuation. The stock hasn't been as expensive as it is today in the past decade and trades at 142% of fair value.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Revenue	249	270	299	330	428	363	372	430	518	569
SG&A Exp.	139	129	138	151	166	170	174	198	234	256
D&A Exp.	18	17	17	17	17	18	17	20	33	34
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	209
Income Tax	12	23	30	32	32	38	41	51	9	44

Balance Sheet Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Total Assets	5403	5445	6488	7497	7096	7489	8553	8666	10746	10607
Cash & Equivalents	362	212	325	229	150	138	153	174	221	212
Accounts Receivable	25	26	29	32	25	25	26	31	36	31
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			88	136	80	126	135	144	181	157
Long-Term Debt	857	830	830	830	244	440	403	248	149	154
Shareholder's Equity	566	607	775	903	876	988	1141	1198	1635	1714
D/E Ratio	1.51	1.37	1.07	0.92	0.28	0.45	0.35	0.21	0.09	0.09

Profitability & Per Share Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
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%	9.2%
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	11.00
FCF/Share	0.92	2.45	2.34	2.46	2.21	2.65	2.59	2.77	3.62	4.03

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