Community Bank System (CBU)

Updated October 24th, 2019 by Josh Arnold

Key Metrics

Current Price:	$67	**5 Year CAGR Estimate:**	2.0%	**Volatility Percentile:**	52.4%
Fair Value Price:	$46	**5 Year Growth Estimate:**	7.0%	**Momentum Percentile:**	71.7%
% Fair Value:	147%	**5 Year Valuation Multiple Estimate:**	-7.4%	**Growth Percentile:**	71.0%
Dividend Yield:	2.5%	**5 Year Price Target**	$64	**Valuation Percentile:**	10.9%
Dividend Risk Score:	B	**Retirement Suitability Score:**	C	**Total Return Percentile:**	14.4%

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 $3.5 billion, and it produces nearly $600 million in annual revenue.

Community Bank System reported Q3 earnings on October 21st and results were in line with estimates. Total revenue was up 4.5% year-over-year as net interest income rose 5.9% and noninterest income increased 2.3%. Net interest income gained due to the recently-completed Kinderhook acquisition and an increase in the yield on earning assets, which is impressive given how rates have been performing of late. Still, some of the gain was offset by an increase in the cost of funds, as well as long-term liabilities from the Kinderhook acquisition.

Provision for loan losses came to $1.8 million in Q3, $0.5 million lower than the comparable period last year. Nonperforming loans stood at 0.42% at the end of the third quarter, compared to 0.40% in last year's Q3.

Operating expenses in Q3 came to $97 million, up from $85 million in the year-ago period. However, much of the increase was due to acquisition-related expenses, and are therefore nonrecurring. Higher salaries and benefits costs drove an adjusted increase of 5.6% year-over-year.

Earnings-per-share came to $0.84 on an adjusted basis, up from $0.81 in the comparable period last year. After the Q3 report, we're reiterating our estimate of $3.25 in earnings-per-share for this year.

Community Bank System also announced its most recent acquisition on October 21st, stating it would buy Steuben Trust Corporation for $107 million, which will add 15 new branches and total assets of $577 million, in addition to $484 million in deposits. The bank expects the acquisition to add eight or nine cents to earnings-per-share annually.

The bank also raised its quarterly dividend by 8% to a new annualized payout of $1.64, bringing the yield to 2.5%. In addition, this is Community Bank System's 27th consecutive year of dividend increases.

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	***$1.64***	***$2.30***
Shares[1]	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. However, we are becoming more cautious 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

[1] Share count in millions

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.

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 $2.30 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	***20.6***	***14.0***
Avg. Yld.	5.0%	4.0%	4.0%	3.8%	3.4%	3.2%	3.3%	2.9%	2.5%	2.4%	***2.5%***	***3.6%***

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 our estimate of fair value. We are forecasting a meaningful -7.4% annual headwind to total returns in the coming years from a valuation reset. Given the outlook for near-term growth, we see the valuation as a key risk to shareholders today.

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%	***51%***	***51%***

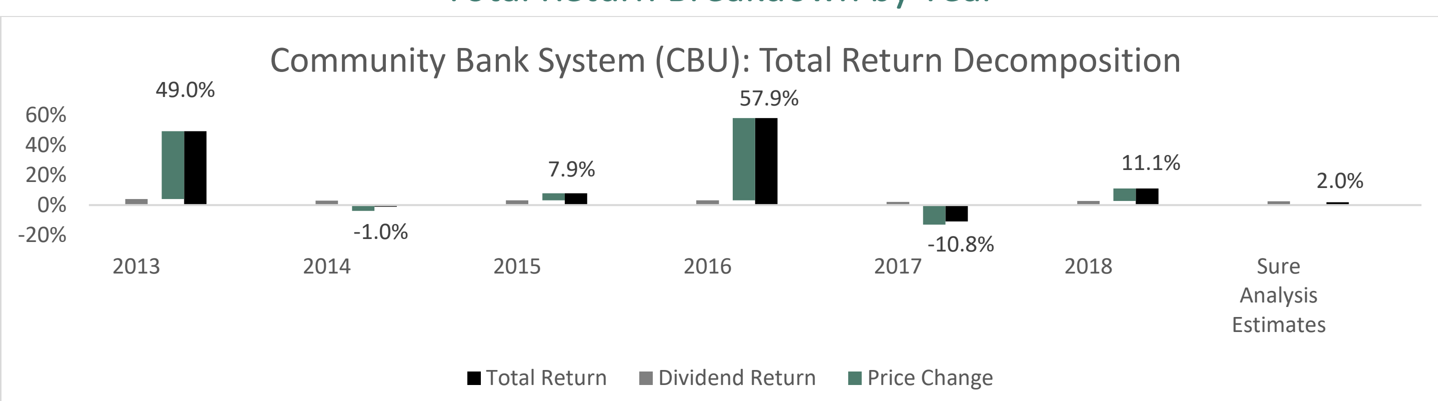
We see the payout ratio rising slightly, but remaining in the area of 50%. The bank's impressive dividend streak appears to be very safe at this point and we see many more years of increases coming, even if a recession strikes.

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%, the product of the 2.5% current yield, 7% earnings growth and an offsetting headwind from the valuation. We are reiterating Community Bank System at a sell rating principally due to the excessively high valuation. The stock hasn't been as expensive as it is today in the past decade.

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	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.