1st Source Corp. (SRCE)

Updated October 23rd, 2019 by Josh Arnold

Key Metrics

Current Price:	$51	**5 Year CAGR Estimate:**	6.8%	**Volatility Percentile:**	46.7%
Fair Value Price:	$46	**5 Year Growth Estimate:**	8.0%	**Momentum Percentile:**	51.7%
% Fair Value:	119%	**5 Year Valuation Multiple Estimate:**	-3.3%	**Growth Percentile:**	80.3%
Dividend Yield:	2.3%	**5 Year Price Target**	$63	**Valuation Percentile:**	48.2%
Dividend Risk Score:	A	**Retirement Suitability Score:**	B	**Total Return Percentile:**	57.9%

Overview & Current Events

1st Source was founded back in 1863 and since that time, has grown into a regional bank with $6.7 billion in assets. The company is headquartered in Indiana and has about 80 branches to service its customers. 1st Source's market capitalization is $1.3 billion, and it is expected to produce about $325 million in revenue this year.

1st Source reported Q3 earnings on 10/17/19 and results were in line with expectations. Total revenue was up 5.7% year-over-year to $83.1 million as the bank continued to grow its loan portfolio. Average loans and leases rose 5.6% year-over-year as seasonal reductions in auto and light truck loans were offset by growth in commercial real estate and solar loans. Deposits were up 5.4% year-over-year, and the bank's loan-to-deposit ratio is now 95%, which is very high.

Net interest income was up 5.2% from the year-ago period as 1st Source saw its net interest margin decline fractionally to 3.67% from last year's Q3. 1st Source managed to essentially maintain its net interest margin at a time when most banks are struggling to do so, a testament to the bank's ability to borrow and lend prudently.

Noninterest income was up 7.1% over last year's Q3 thanks to higher debit card income, improved mortgage banking income due to higher volumes, and stronger insurance income.

Noninterest expense was down -0.5% from last year's Q3 as 1st Source managed once again to grow its loans and revenue without expense growth, which improves margins.

Credit quality remains strong as the reserve for loan and lease losses stands at 2.14% of total loans, while the ratio of nonperforming assets to loans and leases was improved at 0.34% against 1.00% in last year's Q3.

After an in-line Q3, our earnings-per-share estimate remains at $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	***$1.16***	***$1.78***
Shares[1]	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 Q3 results, and despite what appears to have been a temporary move higher in charge-offs.

Our expectation for the dividend is now $1.78 in 2024 after the recent increase in the payout to $1.16 per share annually.

[1] Share count in millions

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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	***14.2***	***12.0***
Avg. Yld.	3.5%	3.5%	3.0%	2.9%	2.6%	2.3%	2.2%	2.1%	1.6%	1.9%	***2.3%***	***2.7%***

1st Source's price-to-earnings multiple has been fairly steady, all things considered, for the past decade. It is trading for 14.2 times earnings today, which is essentially in line with its own historical valuations. The recent rally in the stock, combined with a slight move down in our fair value estimate to 12 times earnings, means the valuation could cause a ~3% headwind to total annual returns.

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%	***33%***	***34%***

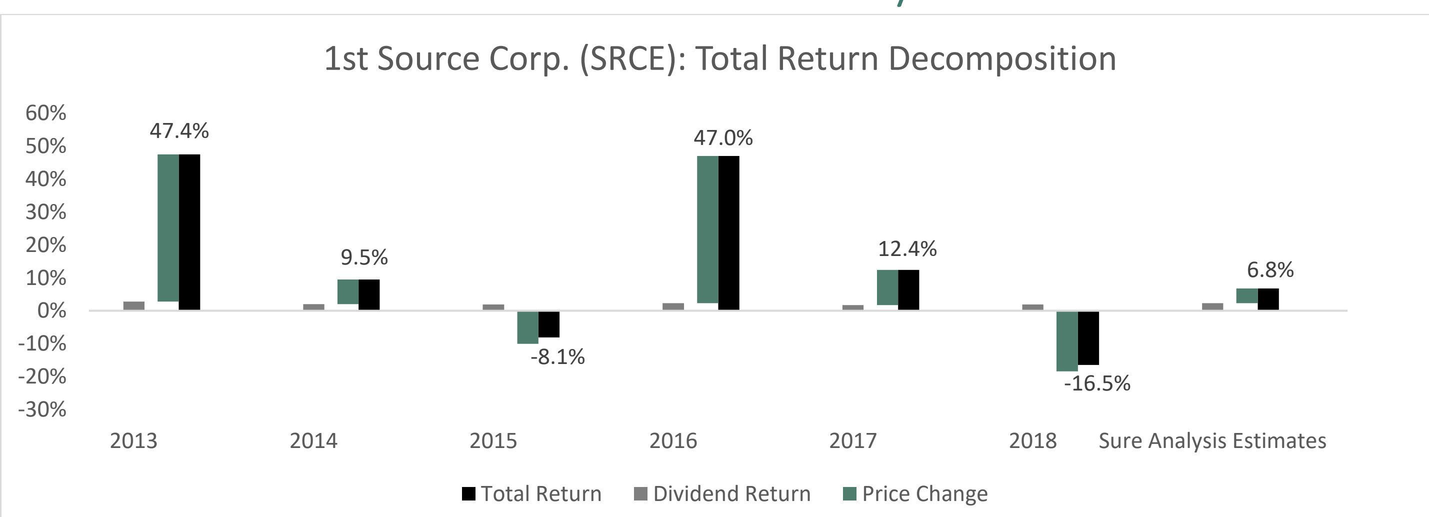
The payout ratio should be in the area of one-third of earnings given that dividend raises will likely be in line with earnings growth in the coming years. We see the dividend as very safe and with a lot of room to grow given 1st Source's commitment to raising the payout, as well as the low payout ratio, 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 6.8% annually, consisting of the current 2.3% yield, a modest headwind from the valuation and 8% earnings-per-share growth. 1st Source is a high-quality bank stock and with shares now trading in excess of fair value, we move our rating to a hold from buy. 1st Source is one of the best regional banks in our coverage universe and we see the company as attractive, but the valuation is too high in our view.

Total Return Breakdown by Year



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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.