Community Bank System (CBU)

Updated January 23rd, 2020 by Josh Arnold

Key Metrics

Current Price:	$70	**5 Year CAGR Estimate:**	-1.1%	**Market Cap:**	$3.63B
Fair Value Price:	$46	**5 Year Growth Estimate:**	4.0%	**Ex-Dividend Date:**	03/13/2020[1]
% Fair Value:	152%	**5 Year Valuation Multiple Estimate:**	-8.0%	**Dividend Payment Date:**	04/10/2020[2]
Dividend Yield:	2.3%	**5 Year Price Target**	$56	**Years Of Dividend Growth:**	27
Dividend Risk Score:	B	**Retirement Suitability Score:**	C	**Last Dividend Increase:**	7.9%

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 $3.6 billion, and it produces about $600 million in annual revenue.

Community Bank System reported Q4 and full-year earnings on January 22nd and results were as expected. Total revenue came to $150 million in Q4, up 5.8% year-over-year. Net interest income was up 6.1% while noninterest revenue rose 5.4%, showing a good balance between revenue sources, particularly in a low rate environment. Gains were accrued from the Kinderhook acquisition and organic growth in the loan book.

Cost of deposits rose slightly in Q4 but remains very low, and net interest margin came in at 3.77% in Q4. That's up from 3.71% in the prior fourth quarter, and is bucking the trend of other banks that are seeing lower NIM during this period of a flat yield curve. In addition, Community Bank System's NIM level is very high on an absolute and relative basis.

Operating expenses rose significantly in Q4 thanks to acquisition-related costs, as well as increased salary and benefits costs. In addition, the company incurred higher technology spending costs, which crimped margins in Q4.

Earnings-per-share came to $0.83 for Q4, up by a nickel against the year-ago period. For the full-year, the story was similar as earnings-per-share came to $3.28 on an adjusted basis. Our initial estimate for 2020 is for $3.30 in earnings-per-share as we see Community Bank System continuing to struggle with increased operating costs, as well as rising short-term rates, which crimp lending margins.

Growth on a Per-Share Basis

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2025
EPS	$1.89	$2.01	$1.93	$3.38	$2.22	$2.19	$2.32	$2.55	$3.23	$3.28	***$3.30***	***$4.01***
DPS	$0.94	$1.00	$1.06	$1.10	$1.16	$1.22	$1.26	$1.34	$1.44	$1.58	***$1.64***	***$2.30***
Shares[3]	33	36	40	41	41	41	44	49	51	52	***54***	***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 4% earnings-per-share growth annually. However, we are becoming more cautious given interest rate headwinds present for the entire banking industry. Given this, we've downgraded our outlook from 7% growth to the current 4%, as recent results have shown weakness.

Community Bank System could achieve this via several methods. It continues to see earnings tailwinds from 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 over time, and this should be the primary growth driver going forward. Community Bank System is performing

[1] Estimated date
[2] Estimated date
[3] Share count in millions

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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 pay out 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	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	Now	2024
Avg. P/E	12.3	12.4	14.3	9.6	16.5	17.0	18.9	17.8	18.3	19.5	***21.3***	***14.0***
Avg. Yld.	4.0%	4.0%	3.8%	3.4%	3.2%	3.3%	2.9%	2.5%	2.4%	2.5%	***2.3%***	***4.1%***

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 -8.8% 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 as shares are more expensive today than at any point in the past decade.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2025
Payout	48%	47%	53%	32%	51%	54%	53%	53%	45%	48%	***50%***	***57%***

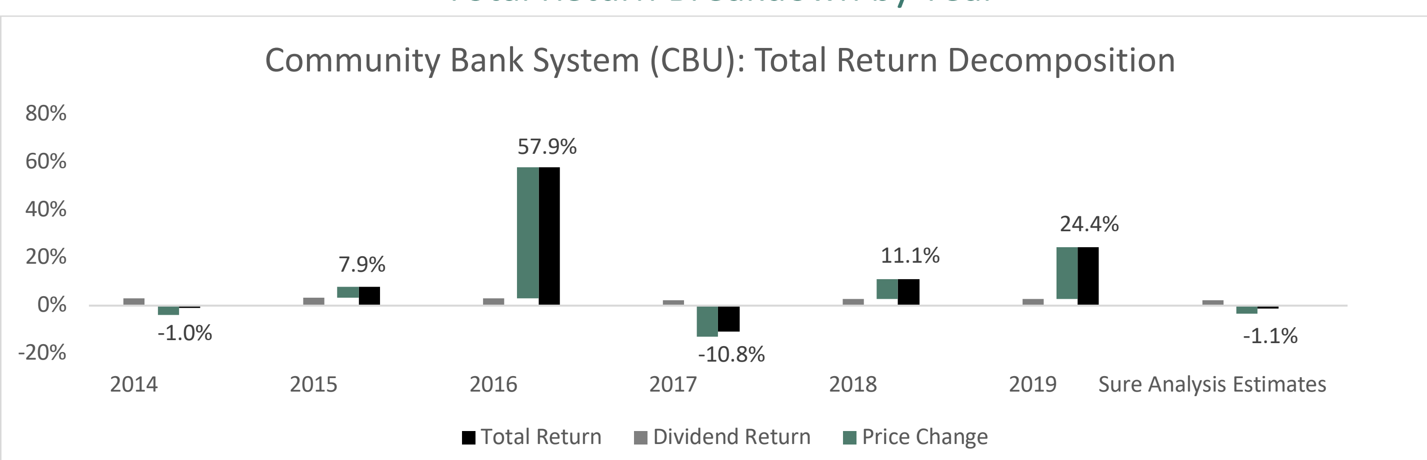
We see the payout ratio rising slightly, but remaining under 60%. The bank's impressive dividend streak appears to be very safe at this point and we see many more years of increases coming, even if a recession strikes.

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 can continue to grow, but the stock is trading well in excess of our estimate of fair value. We see total annual returns of -1.1%, the product of the 2.3% current yield, 4% 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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Income Statement Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Revenue	270	299	330	428	363	372	430	518	569	
SG&A Exp.	129	138	151	166	170	174	198	234	256	
D&A Exp.	17	17	17	17	18	17	20	33	34	
Net Profit	63	73	77	79	91	91	104	151	169	
Net Margin	23.4%	24.5%	23.4%	18.4%	25.1%	24.5%	24.2%	29.1%	29.6%	
Free Cash Flow	81	85	98	89	109	107	123	179	209	
Income Tax	23	30	32	32	38	41	51	9	44	

Balance Sheet Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Total Assets	5445	6488	7497	7096	7489	8553	8666	10746	10607	
Cash & Equivalents	212	325	229	150	138	153	174	221	212	
Accounts Receivable	26	29	32	25	25	26	31	36	31	
Goodwill & Int. Ass.	312	361	387	390	387	484	481	825	807	
Total Liabilities	4837	5714	6594	6220	6502	7412	7468	9111	8894	
Accounts Payable		88	136	80	126	135	144	181	157	
Long-Term Debt	830	830	830	244	440	403	248	149	154	
Shareholder's Equity	607	775	903	876	988	1141	1198	1635	1714	
D/E Ratio	1.37	1.07	0.92	0.28	0.45	0.35	0.21	0.09	0.09	

Profitability & Per Share Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Return on Assets	1.2%	1.2%	1.1%	1.1%	1.3%	1.1%	1.2%	1.6%	1.6%	
Return on Equity	10.8%	10.6%	9.2%	8.9%	9.8%	8.6%	8.9%	10.6%	10.1%	
ROIC	4.4%	4.8%	4.6%	5.5%	7.2%	6.1%	6.9%	9.3%	9.2%	
Shares Out.	33	36	40	41	41	41	44	49	51	
Revenue/Share	8.13	8.26	8.31	10.56	8.86	8.98	9.66	10.47	11.00	
FCF/Share	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.