1st Source Corp. (SRCE)

Updated January 26th, 2020 by Josh Arnold

Key Metrics

Current Price:	$50	**5 Year CAGR Estimate:**	3.0%	**Market Cap:**	$1.4B
Fair Value Price:	$41	**5 Year Growth Estimate:**	4.0%	**Ex-Dividend Date:**	02/03/20
% Fair Value:	120%	**5 Year Valuation Multiple Estimate:**	-3.5%	**Dividend Payment Date:**	02/14/20
Dividend Yield:	2.3%	**5 Year Price Target**	$50	**Years Of Dividend Growth:**	32
Dividend Risk Score:	A	**Retirement Suitability Score:**	B	**Last Dividend Increase:**	7.4%

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 $1.4 billion, and it is expected to produce about $325 million in revenue this year. 1st Source also has an exceptional dividend increase streak that stands at 32 years, which very few banks can match.

1st Source reported Q4 and full-year earnings on January 23rd and results were somewhat weaker than expected, as the bank missed top and bottom line estimates. Dollar-basis earnings for the year were up 11.6% to $92 million, but were up just 2.3% for the fourth quarter year-over-year. On a per-share basis, earnings came to $3.58 for the year, up 13% from 2018, and up 4.9% for the fourth quarter.

Net interest income was up 4.7% for the year against 2018, while it was up 5.9% for the fourth quarter. Average loans and leases rose by 5.2% for the year and 4.4% for the fourth quarter against the prior year periods, with higher balances helping to drive net interest income in the right direction. Average deposits also grew during the year, adding 6.3% for the full year and 6.4% for the fourth quarter.

Noninterest income was up 4.2% for the year and 5.9% for the fourth quarter, but excluding leased depreciation, those numbers increased to 7.3% and 11.2%, respectively. 1st Source continues to diversify its revenue streams away from traditional lending income and it showed once again in Q4 results.

Noninterest expense was up just 1.4% for the year and 3.5% for the fourth quarter, both of which were slower than the pace of revenue growth, providing operating leverage, and helping to boost earnings. Also helping to boost earnings were net charge-offs that remain at very low levels, with non-performing assets at just 0.37% of total loans as of the end of the year.

We see lending margins as being somewhat pressured this year given the very flat yield curve, and we see expenses rising at about the same rate as revenue. As such, we are forecasting roughly flat earnings-per-share for 2020.

Growth on a Per-Share Basis

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2019	2024
EPS	$1.10	$1.78	$1.84	$2.03	$2.17	$2.17	$2.22	$2.52	$3.16	$3.58	***$3.60***	***$4.38***
DPS	$0.55	$0.58	$0.60	$0.62	$0.65	$0.67	$0.72	$0.76	$0.96	$1.10	***$1.16***	***$1.63***
Shares[1]	27	27	27	27	26	26	26	26	26	26	***25***	***23***

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. However, we've lowered our growth estimate from 8% annually to 4% given the lending margin headwinds banks are facing, which are showing no signs of abating. 1st Source is trying to build more fee revenue, but its business is still heavily dependent upon lending margins, and we think growth will slow because of the unfavorable interest rate environment.

---

[1] Share count in millions

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.

1st Source Corp. (SRCE)

Updated January 26th, 2020 by Josh Arnold

Our expectation for the dividend is now $1.63 in 2025 after the recent increase in the payout to $1.16 per share annually, but also taking into account slower earnings growth.

Valuation Analysis

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	Now	2024
Avg. P/E	14.5	10.9	11.3	11.8	12.8	13.9	15.3	18.4	16.4	13.1	***13.8***	***11.5***
Avg. Yld.	3.5%	3.0%	2.9%	2.6%	2.3%	2.2%	2.1%	1.6%	1.9%	2.4%	***2.3%***	***3.2%***

1st Source's price-to-earnings multiple has been fairly steady, all things considered, for the past decade. It is trading for 13.8 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 11.5 times earnings, means the valuation could cause a -3.5% headwind to total annual returns.

We see the yield rising over time as the valuation moderates, sending the yield from 2.3% to 3.2%.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2025
Payout	50%	33%	33%	31%	30%	32%	34%	30%	30%	31%	***32%***	***37%***

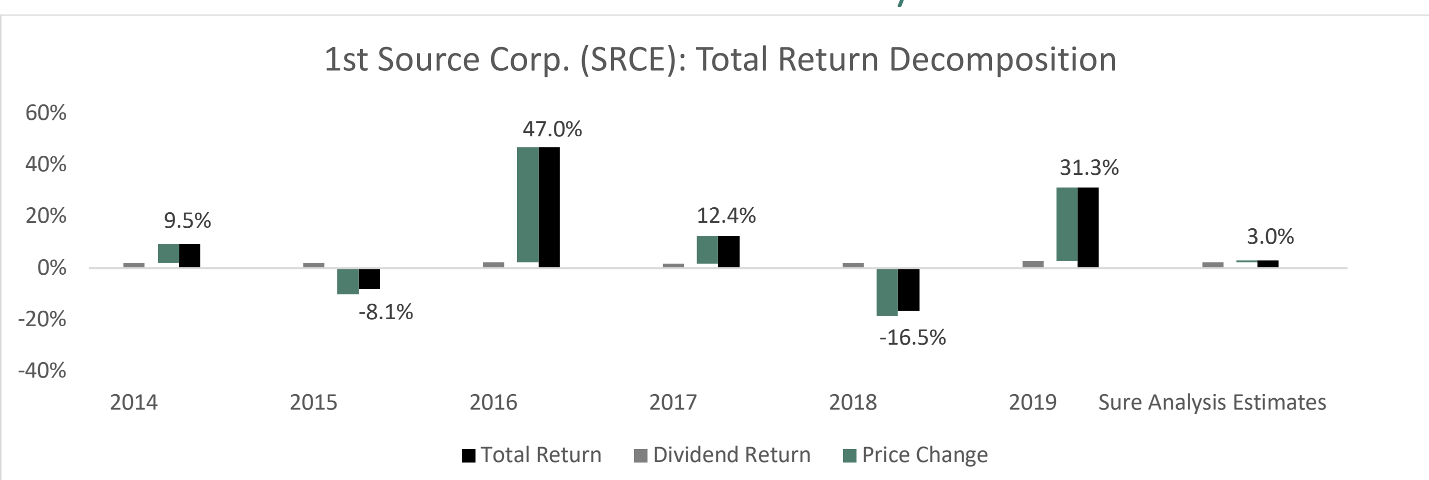
The payout ratio should be in the area of one-third of earnings given that dividend raises will likely be in line with earnings growth in the coming years. We see the dividend as very safe and with a lot of room to grow given 1st Source's commitment to raising the payout, as well as the low payout ratio, and the bank's decent 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 3% annually, consisting of the current 2.3% yield, a moderate headwind from the valuation and mid-single-digit earnings-per-share growth. 1st Source is a high-quality bank stock, but we have moved our rating to sell from hold. 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



[Click here to rate and review this research report. Your feedback is important to us.]

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.

1st Source Corp. (SRCE)

Updated January 26th, 2020 by Josh Arnold

Income Statement Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Revenue	234	229	233	234	238	250	259	284	311	325
SG&A Exp.	91	91	96	94	96	100	100	102	109	112
D&A Exp.	28	25	22	19	20	24	28	32	33	
Net Profit	41	48	50	55	58	57	58	68	82	92
Net Margin	17.6%	21.0%	21.3%	23.5%	24.4%	23.0%	22.3%	23.9%	26.5%	28.3%
Free Cash Flow	107	103	86	59	37	37	59	66	120	
Income Tax	19	26	26	29	26	31	31	33	23	28

Balance Sheet Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Total Assets	4445	4374	4551	4723	4830	5188	5486	5887	6294	6623
Cash & Equivalents	62	61	83	78	65	65	59	74	95	67
Goodwill & Int. Ass.	89	88	88	86	85	85	84	84	84	84
Total Liabilities	3959	3850	3992	4137	4215	4544	4814	5169	5530	5774
Long-Term Debt	134	145	140	250	222	219	262	119	199	156
Shareholder's Equity	486	524	559	585	614	644	673	719	762	828
D/E Ratio	0.28	0.28	0.25	0.43	0.36	0.34	0.39	0.17	0.26	0.19

Profitability & Per Share Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Return on Assets	0.9%	1.1%	1.1%	1.2%	1.2%	1.1%	1.1%	1.2%	1.4%	1.4%
Return on Equity	8.7%	9.5%	9.2%	9.6%	9.7%	9.1%	8.8%	9.8%	11.1%	11.6%
ROIC	6.2%	7.5%	7.3%	7.2%	6.9%	6.8%	6.4%	7.7%	9.2%	9.3%
Shares Out.	27	27	27	27	26	26	26	26	26	26
Revenue/Share	8.78	9.46	8.72	8.74	9.01	9.55	9.99	10.97	11.99	12.70
FCF/Share	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.