Community Bank System (CBU)

Updated April 25th, 2020 by Josh Arnold

Key Metrics

Current Price:	$60	**5 Year CAGR Estimate:**	3.0%	**Market Cap:**	$3.1B
Fair Value Price:	$49	**5 Year Growth Estimate:**	4.0%	**Ex-Dividend Date:**	06/12/2020[1]
% Fair Value:	122%	**5 Year Valuation Multiple Estimate:**	-4.0%	**Dividend Payment Date:**	07/10/2020[2]
Dividend Yield:	2.7%	**5 Year Price Target**	$60	**Years Of Dividend Growth:**	28
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 $3.1 billion, and it produces about $600 million in annual revenue.

Community Bank System posted Q1 results on April 20th, with revenue meeting expectations and profits coming in ahead of consensus. Total revenue was $149 million, up 4.3% year-over-year. Net interest income rose 3.7% to $90 million thanks to a 7.1% increase in average earning assets year-over-year. Net interest margin, however, declined 15bps as the company struggled to adapt to lower interest rates.

Noninterest revenue rose 5.3% due to higher mortgage banking and financial services revenues. Interest income and fees on loans rose 6.6% due to higher total loans outstanding, offset by a 17bps decline in average loan yield. Average cost of deposits was essentially flat at 25bps.

The bank recorded a $5.6 million provision for credit losses in Q1 and noted that the ultimate impact of COVID-19-related losses is as yet unknown.

Operating costs were $93.7 million in Q1, up 5.7% year-over-year thanks mostly to higher salary and benefit costs.

Diluted adjusted earnings-per-share came to $0.80 in Q1, down -5.9% from $0.85 in the year-ago period. We've cut our estimate for this year's earnings-per-share from $3.30 to $2.60 on COVID-19 related loss concerns.

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	***$2.60***	***$4.26***
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 under normalized conditions. However, we are becoming more cautious given interest rate headwinds present for the entire banking industry.

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 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. Indeed, some evidence of this was present in Q1.

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

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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 2025.

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	***17.1***	***14.0***
Avg. Yld.	4.0%	4.0%	3.8%	3.4%	3.2%	3.3%	2.9%	2.5%	2.4%	2.5%	***2.7%***	***3.9%***

We've used an earnings power estimate of $3.50 per share for Community Bank System, rather than temporarily depressed earnings of $2.60 for this year, which gives us a better look at long-term value. The estimate was computed using total assets of $11.8 billion, multiplied by return on assets of 1.6%.

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 -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, even when using earnings power rather than actual estimates for this year.

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%	***47%***	***54%***

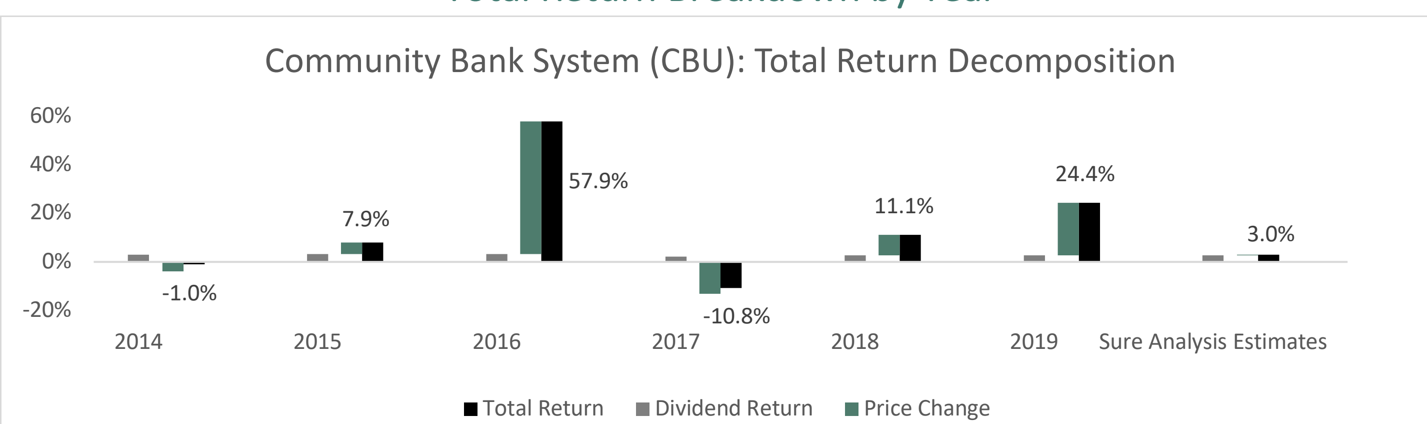
We see the payout ratio rising slightly, but remaining under 60%. The bank's impressive dividend streak appears to be very safe at this point and we see many more years of increases coming, even if a recession strikes.

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 3%, the product of the 2.7% current yield, 4% earnings growth and a largely offsetting headwind from the valuation. We are reiterating Community Bank System at a sell rating principally due to the excessively high valuation, and reduced near-term growth.

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	590
SG&A Exp.	129	138	151	166	170	174	198	234	256	273
D&A Exp.	17	17	17	17	18	17	20	33	34	32
Net Profit	63	73	77	79	91	91	104	151	169	169
Net Margin	23.4%	24.5%	23.4%	18.4%	25.1%	24.5%	24.2%	29.1%	29.6%	28.7%
Free Cash Flow	81	85	98	89	109	107	123	179	209	197
Income Tax	23	30	32	32	38	41	51	9	44	40

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	11410
Cash & Equivalents	212	325	229	150	138	153	174	221	212	205
Accounts Receivable	26	29	32	25	25	26	31	36	31	32
Goodwill & Int. Ass.	312	361	387	390	387	484	481	825	807	837
Total Liabilities	4837	5714	6594	6220	6502	7412	7468	9111	8894	9555
Accounts Payable		88	136	80	126	135	144	181	157	215
Long-Term Debt	830	830	830	244	440	403	248	149	154	103
Shareholder's Equity	607	775	903	876	988	1141	1198	1635	1714	1855
D/E Ratio	1.37	1.07	0.92	0.28	0.45	0.35	0.21	0.09	0.09	0.06

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%	1.5%
Return on Equity	10.8%	10.6%	9.2%	8.9%	9.8%	8.6%	8.9%	10.6%	10.1%	9.5%
ROIC	4.4%	4.8%	4.6%	5.5%	7.2%	6.1%	6.9%	9.3%	9.2%	8.8%
Shares Out.	33	36	40	41	41	41	44	49	51	52
Revenue/Share	8.13	8.26	8.31	10.56	8.86	8.98	9.66	10.47	11.00	11.29
FCF/Share	2.45	2.34	2.46	2.21	2.65	2.59	2.77	3.62	4.03	3.77

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

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