1st Source Corp. (SRCE)

Updated July 26th, 2020 by Josh Arnold

Key Metrics

Current Price:	$35	**5 Year CAGR Estimate:**	6.7%	**Market Cap:**	$885 M
Fair Value Price:	$38	**5 Year Growth Estimate:**	2.0%	**Ex-Dividend Date:**	08/03/20
% Fair Value:	91%	**5 Year Valuation Multiple Estimate:**	1.8%	**Dividend Payment Date:**	08/14/20
Dividend Yield:	3.3%	**5 Year Price Target**	$42	**Years Of Dividend Growth:**	32
Dividend Risk Score:	C	**Retirement Suitability Score:**	C	**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 $885 million, and it is expected to produce in excess of $300 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 second quarter earnings on July 23rd, with results beating expectations on the top and bottom lines. Net income came to $18.5 million, down -21% year-over-year. On a per-share basis, earnings fell from 91 cents to 72 cents. Return on assets was 1.04%, down sharply from 1.45% in the year-ago period, and among the lowest in our bank coverage universe.

Average loans and leases were up 9.2% quarter-over-quarter, and up 11.3% year-over-year. However, the bank noted substantially all loan growth was due to the Paycheck Protection Program, which will not be repeated.

Average deposits were up 10.2% from Q1, and up 10.4% year-over-year.

Nonperforming assets were 1.2% of total loans, which is quite high for a bank, and indicates a reasonable amount of credit quality risk.

Net interest income was down -4% year-over-year, and noninterest income was up 4.3%. Noninterest expenses were down -5.4% year-over-year, so margins were preserved somewhat.

We're reiterating our earnings-per-share estimate of $2.50 for this year, and we are using an earnings power estimate of $3.30 per share to account for unusual circumstances surrounding COVID-19.

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	***$2.50***	***$3.64***
DPS	$0.55	$0.58	$0.60	$0.62	$0.65	$0.67	$0.72	$0.76	$0.96	$1.10	***$1.14***	***$1.26***
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 the company's 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 4% annually to 2% 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.

Our expectation for the dividend is now $1.26 in 2026 as we think COVID-19-related economic weakness will force banks to conserve capital.

[1] Share count in millions

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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	***10.5***	***11.5***
Avg. Yld.	3.5%	3.0%	2.9%	2.6%	2.3%	2.2%	2.1%	1.6%	1.9%	2.4%	***3.3%***	***3.0%***

Since we see the reduction in earnings related to COVID-19 as temporary, we are using an earnings power estimate of $3.30 per share for our fair value and valuation calculations, rather than actual earnings projections for 2020.

1st Source's price-to-earnings multiple has been fairly steady, all things considered, for the past decade. It is trading for 10.5 times earnings today, which is below its historical valuations. The recent selloff in the stock means the valuation could produce a small tailwind to total annual returns.

We see the yield potentially falling over time as the valuation rises over time, sending the yield from 3.3% to 3.0%.

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%	***35%***	***35%***

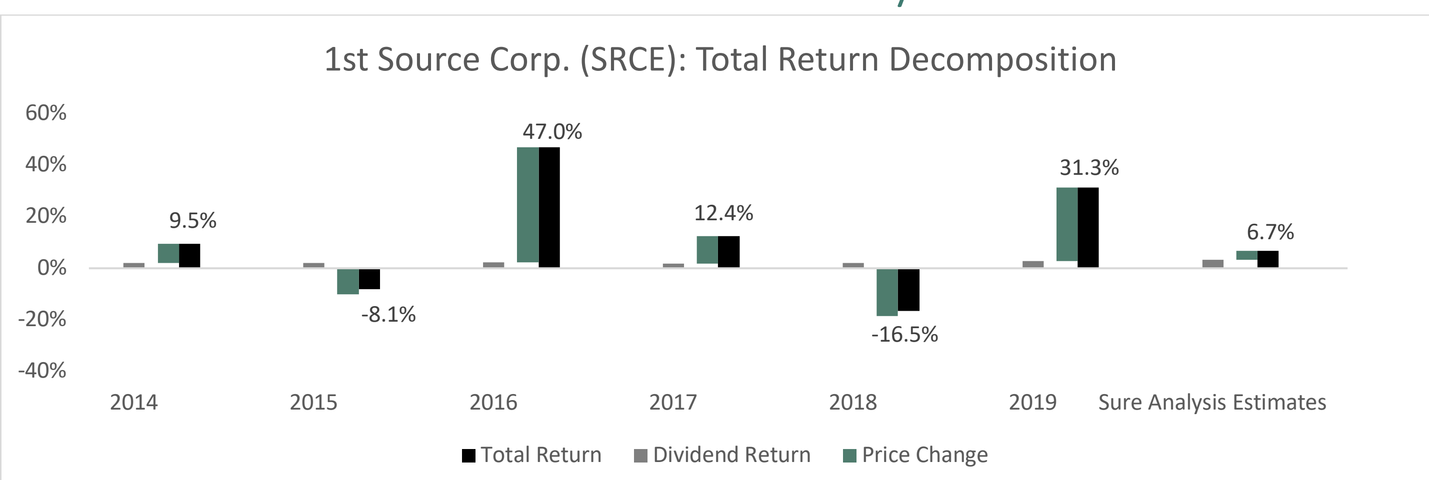
The payout ratio should be in the area of one-third of normalized earnings, given that dividend raises will likely be in line with earnings growth in the coming years. We see the dividend as safe and with a lot of room to grow given 1st Source's commitment to raising the payout, as well as the low payout 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 this economic downturn.

Final Thoughts & Recommendation

We believe total returns for 1st Source investors could be 6.7% annually, consisting of the current 3.3% yield, a moderate tailwind from the valuation and low single-digit earnings-per-share growth. 1st Source is a high-quality bank stock, but we are reiterating our hold rating. 1st Source is one of the best regional banks in our coverage universe and we see the company as attractive, but there are much cheaper bank stocks for this unique environment. In addition, some of the deterioration that took place in Q2 has us more cautious than we were after the first quarter.

Total Return Breakdown by Year



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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	35
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	88	135	154
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	3.40	5.23	6.02

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