1st Source Corp. (SRCE)

Updated January 27th, 2021 by Josh Arnold

Key Metrics

Current Price:	$42	**5 Year CAGR Estimate:**	3.2%	**Market Cap:**	$1.1 B
Fair Value Price:	$39	**5 Year Growth Estimate:**	2.0%	**Ex-Dividend Date:**	02/01/21
% Fair Value:	108%	**5 Year Valuation Multiple Estimate:**	-1.5%	**Dividend Payment Date:**	02/12/21
Dividend Yield:	2.8%	**5 Year Price Target**	$43	**Years Of Dividend Growth:**	32
Dividend Risk Score:	C	**Retirement Suitability Score:**	C	**Last Dividend Increase:**	2.7%

Overview & Current Events

1st Source was founded back in 1863 and since that time has grown into a regional bank with $7.3 billion in total assets. The company is headquartered in Indiana and has about 100 locations to service its customers. 1st Source's market capitalization is $1.1 billion, and it is expected to produce in excess of $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 fourth quarter and full-year earnings on January 21st, 2021 and both revenue and profits came in ahead of expectations. Total revenue was up 9% year-over-year to $88 million. Net interest income was up fractionally for the year, and was up $6.8 million, or 12% from the fourth quarter in 2019. Noninterest income rose $2.8 million for the year and was essentially flat for the fourth quarter year-over-year. However, excluding leased depreciation, noninterest income would have risen 10% for the year and nearly 8% for the quarter.

Noninterest expenses fell -0.9% for the year and -0.8% for the quarter, although on an adjusted basis, those numbers were slightly worse at +2% and +1.6% respectively. Still, 1st Source did a nice job of controlling costs in a tough climate.

Average loans and leases were up 9.3% for the year, and up 9.3% for the quarter as well. Average deposits were up 8.7% for the year and +10.3% for the fourth quarter. The bank ended the fourth quarter with a loan-to-deposit ratio of 92%, which is quite elevated against the bank's peers.

Net charge-offs were $9.2 million for the year and $3.7 million for the quarter, up from $5.1 million and $0.6 million, respectively, in the year-ago periods. This is consistent with other banks posting massive increases in charge-offs amidst business and consumer defaults due to COVID-19.

Provisions for credit losses were $36 million for the year, more than double 2019, and $5 million in Q4, up from $3 million in the same period last year.

Diluted earnings-per-share came to $3.27, down from $3.58 in the prior year. The fourth quarter showed improvement, however, with earnings of $1.03 per share against $0.86 in the year-ago period.

We see the combination of eroding credit quality, very low lending rates, and an elevated loan-to-deposit ratio as keeping earnings flat for 1st Source in 2021; our initial estimate is for $3.25 in earnings-per-share.

Growth on a Per-Share Basis

Year	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2026
EPS	$1.78	$1.84	$2.03	$2.17	$2.17	$2.22	$2.52	$3.16	$3.58	$3.27	***$3.25***	***$3.59***
DPS	$0.58	$0.60	$0.62	$0.65	$0.67	$0.72	$0.76	$0.96	$1.10	$1.13	***$1.16***	***$1.28***
Shares[1]	27	27	27	26	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 5%+ in the past decade. 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 are forecasting 2% growth, given the lending margin headwinds banks are facing, which are showing no

[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.

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. Q4 results showed this as noninterest income once again outperformed interest income.

Our expectation for the dividend is now $1.28 in 2026 as we think COVID-19-related economic weakness will force banks to conserve capital. This is particularly true for 1st Source given the earnings growth headwinds it is facing.

Valuation Analysis

Year	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	Now	2026
Avg. P/E	10.9	11.3	11.8	12.8	13.9	15.3	18.4	16.4	13.1	11.2	***12.9***	***12.0***
Avg. Yld.	3.0%	2.9%	2.6%	2.3%	2.2%	2.1%	1.6%	1.9%	2.4%	3.1%	***2.8%***	***3.0%***

1st Source's price-to-earnings multiple has been fairly steady, all things considered, for the past decade. It is trading for 12.9 times earnings today, which is somewhat above our estimate of fair value. Therefore, we see a slight headwind to total returns from the valuation in the coming years. This should keep the yield around 3% for the foreseeable future.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2026
Payout	33%	33%	31%	30%	32%	34%	30%	30%	31%	35%	***36%***	***36%***

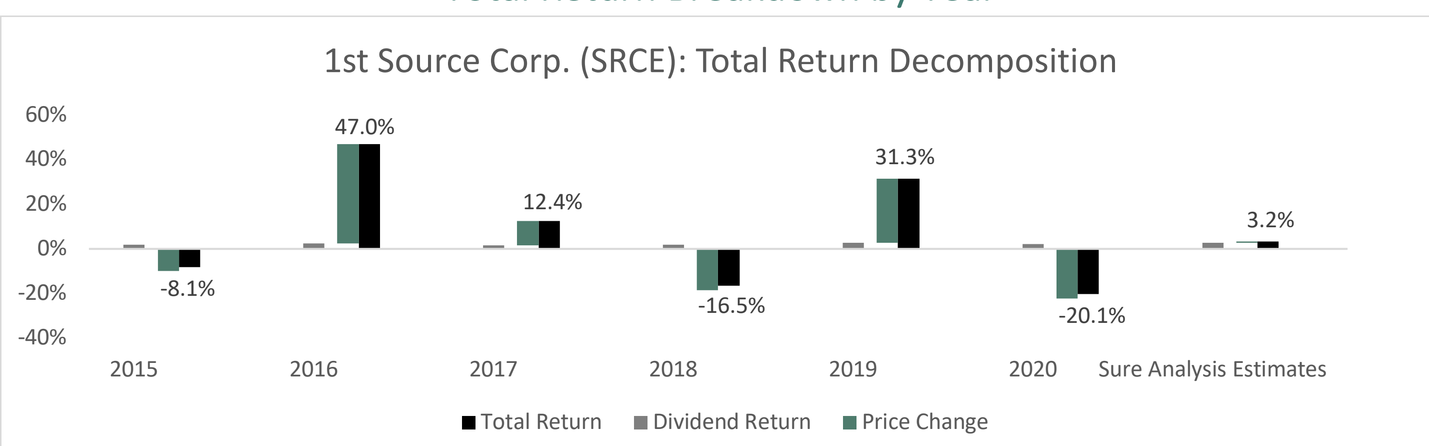
The payout ratio should be in the area of one-third of normalized earnings, given that dividend raises will likely be in line with earnings growth in the coming years. We see the dividend as safe and with a lot of room to grow given 1st Source's commitment to raising the payout, as well as the low payout ratio. We see the payout growing even if 1st Source isn't able to produce strong earnings growth.

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 did perform well in 2020 all things considered.

Final Thoughts & Recommendation

We believe total returns for 1st Source investors could be just 3.2% annually, consisting of the current 2.8% yield, a moderate headwind from the valuation and low single-digit earnings-per-share growth. 1st Source is a high-quality bank stock, but we are moving the stock from hold to sell on forecasted earnings headwinds, as well as the valuation.

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 27th, 2021 by Josh Arnold

Income Statement Metrics

Year	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Revenue	229	233	234	238	250	259	284	311	325	330
SG&A Exp.	91	96	94	96	100	100	102	109	112	114
D&A Exp.	25	22	19	20	24	28	32	33	35	---
Net Profit	48	50	55	58	57	58	68	82	92	81
Net Margin	21.0%	21.3%	23.5%	24.4%	23.0%	22.3%	23.9%	26.5%	28.3%	24.7%
Free Cash Flow	103	86	59	37	37	59	88	135	154	---
Income Tax	26	26	29	26	31	31	33	23	28	25

Balance Sheet Metrics

Year	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Total Assets	4374	4551	4723	4830	5188	5486	5887	6294	6623	7316
Cash & Equivalents	61	83	78	65	65	59	74	95	67	74
Goodwill & Int. Ass.	88	88	86	85	85	84	84	84	84	84
Total Liabilities	3850	3992	4137	4215	4544	4814	5169	5530	5774	6386
Long-Term Debt	145	140	250	222	219	262	119	199	138	148
Shareholder's Equity	524	559	585	614	644	673	719	762	828	887
D/E Ratio	0.28	0.25	0.43	0.36	0.34	0.39	0.17	0.26	0.17	0.17

Profitability & Per Share Metrics

Year	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Return on Assets	1.1%	1.1%	1.2%	1.2%	1.1%	1.1%	1.2%	1.4%	1.4%	1.2%
Return on Equity	9.5%	9.2%	9.6%	9.7%	9.1%	8.8%	9.8%	11.1%	11.6%	9.5%
ROIC	7.5%	7.3%	7.2%	6.9%	6.8%	6.4%	7.7%	9.2%	9.3%	7.9%
Shares Out.	27	27	27	26	26	26	26	26	26	26
Revenue/Share	9.46	8.72	8.74	9.01	9.55	9.99	10.97	11.99	12.70	12.92
FCF/Share	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.