1st Source Corp. (SRCE)

Updated January 23rd, 2022, by Josh Arnold

Key Metrics

Current Price:	$49	**5 Year CAGR Estimate:**	2.0%	**Market Cap:**	$1.2 B
Fair Value Price:	$48	**5 Year Growth Estimate:**	0.0%	**Ex-Dividend Date:**	02/07/22
% Fair Value:	103%	**5 Year Valuation Multiple Estimate:**	-0.6%	**Dividend Payment Date:**	02/16/22
Dividend Yield:	2.5%	**5 Year Price Target**	$48	**Years Of Dividend Growth:**	34
Dividend Risk Score:	A	**Retirement Suitability Score:**	A	**Last Dividend Increase:**	6.9%

Overview & Current Events

1st Source was founded in 1863 and since that time has grown into a regional bank with about $8 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 $1.2 billion, and it is expected to produce more than $320 million in revenue this year. 1st Source also has an exceptional dividend increase streak that stands at 34 years, which very few banks can match.

1st Source reported fourth quarter and full-year earnings on January 20th, 2022, and results were quite weak against expectations. Earnings-per-share came to $1.11, which missed estimates by three cents. Revenue also missed expectations, falling -5% year-over-year to $84 million.

Net income for the full-year was $118.5 million, a record for the company, and up 45% year-over-year. On a per-share basis, earnings were $4.70, a record as well.

Provisions for credit losses were a benefit of $4.3 million for the full year, a significant improvement over a cost of $36 million in 2020. The fourth quarter saw a benefit of $1.1 million, a huge improvement over the $5 million cost in the year-ago period. We note that the record earnings in 2021 will not be repeated given the lack of reserve releases that remain to drive earnings growth for 2022.

Fourth quarter net interest margin was 3.09%, a decline of 45bps year-over-year. Paycheck Protection Program loans had a 16bps positive impact on net interest margin, and the bank recorded $3.6 million in PPP loan fees in Q4. 1st Source said it does not expect a significant impact in 2022 from the PPP given widespread loan forgiveness in the program.

Our initial estimate for this year is $3.80 in earnings-per-share as conditions normalize.

Growth on a Per-Share Basis

Year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2027
EPS	$1.84	$2.03	$2.17	$2.17	$2.22	$2.52	$3.16	$3.58	$3.27	$4.70	***$3.80***	***$3.80***
DPS	$0.60	$0.62	$0.65	$0.67	$0.72	$0.76	$0.96	$1.10	$1.13	$1.21	***$1.24***	***$1.37***
Shares[1]	27	27	26	26	26	26	26	26	26	25	***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. With normalizing conditions in 2022, and a lower base, we've updated our earnings growth estimate from -5% to no growth. 1st Source is trying to build more fee revenue, but its business is still heavily dependent upon lending margins, and we think growth will be tough to come by because of the unfavorable interest rate environment. Normalized conditions for 2022 should help 1st Source at least maintain this year's level of earnings.

Our expectation for the dividend is now $1.37 in 2027 as we see 1st Source facing headwinds in its ability to grow earnings. However, we don't expect the bank to end its very long streak of dividend increases. We see the bank as being hesitant to boost its payout ratio much higher than it is at the moment.

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[1] Share count in millions

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Valuation Analysis

Year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Now	2027
Avg. P/E	11.3	11.8	12.8	13.9	15.3	18.4	16.4	13.1	11.2	9.9	***12.9***	***12.5***
Avg. Yld.	2.9%	2.6%	2.3%	2.2%	2.1%	1.6%	1.9%	2.4%	3.1%	2.6%	***2.5%***	***2.9%***

1st Source's price-to-earnings multiple has been steady, all things considered, for the past decade. It is trading for 12.9 times earnings today, which is ahead of our estimate of fair value. Therefore, we see a headwind to total returns from the valuation in the coming years. The yield could remain below 3% for the foreseeable future.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2027
Payout	33%	31%	30%	32%	34%	30%	30%	31%	35%	26%	***33%***	***36%***

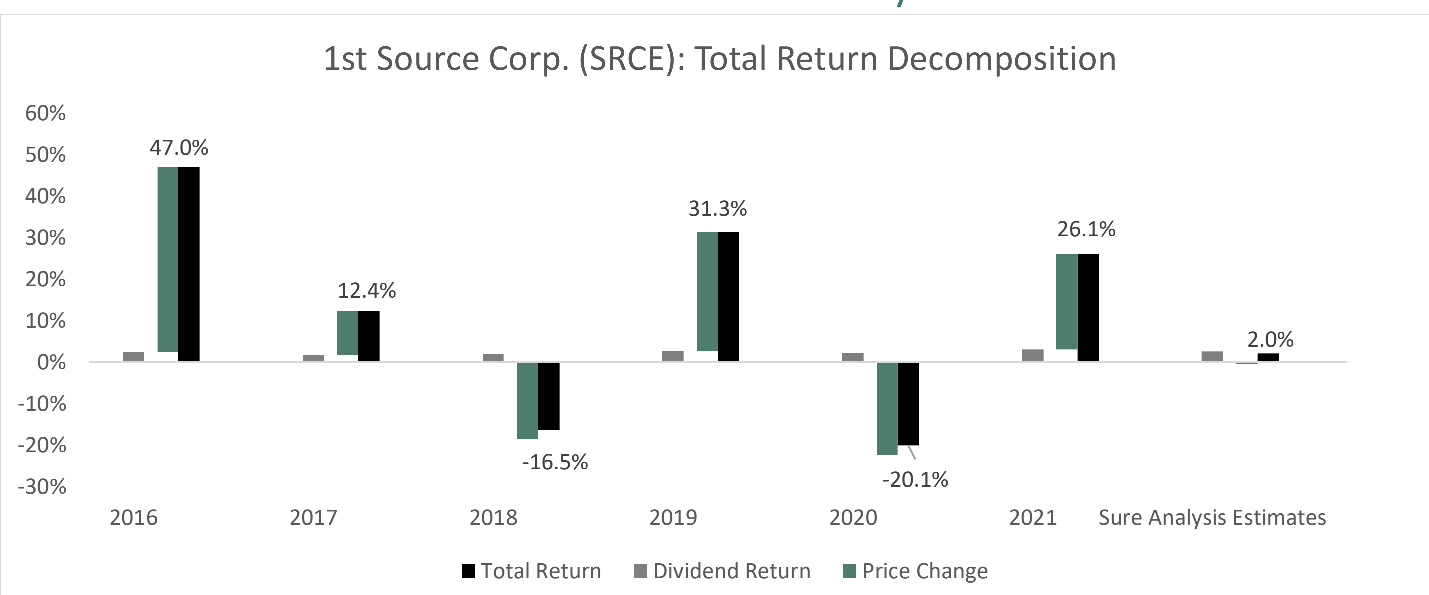
The payout ratio is around one-third of earnings and dividend raises will likely be somewhat modest in the coming years. We see the dividend as safe and with a lot of room to grow given 1st Source's commitment to raising the payout, as well as the low payout ratio. We see the payout growing even if 1st Source is not able to produce strong earnings growth, and indeed, that is what we're forecasting.

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 2% annually, consisting of the current 2.5% yield, a small headwind from the valuation and no earnings-per-share growth. Given that the bank's growth outlook is murky, and the fact that it has struggled to grow loans and leases organically, we think this, combined with perpetually low interest rates, will keep a lid on growth. Earnings are set to decline markedly this year, and the valuation isn't particularly attractive. We're reiterating the stock at a sell rating.

Total Return Breakdown by Year



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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.

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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.