Financial Institutions, Inc. (FISI)

Updated June 11th, 2024, by Aristofanis Papadatos

Key Metrics

Current Price:	$17	**5 Year CAGR Estimate:**	12.9%	**Market Cap:**	$265 M
Fair Value Price:	$22	**5 Year Growth Estimate:**	2.0%	**Ex-Dividend Date:**	6/14/24
% Fair Value:	76%	**5 Year Valuation Multiple Estimate:**	5.6%	**Dividend Payment Date:**	7/2/24
Dividend Yield:	7.1%	**5 Year Price Target**	$25	**Years Of Dividend Growth:**	13
Dividend Risk Score:	D	**Retirement Suitability Score:**	B	**Rating:**	Buy

Overview & Current Events

Financial Institutions was founded in 1817 and is headquartered in Warsaw, New York. It operates as a holding company for the Five Star Bank and Courier Capital, offering banking and wealth management services to its customers through 49 branches in 14 contiguous Upstate New York counties. Financial Institutions has a market cap of $265 million.

On March 11th, 2024, Financial Institutions announced that it incurred an after-tax loss of about $14.1 million due to fraudulent activity associated with deposit transactions executed by a business customer of the bank. In other words, that business customer deceived and essentially stole funds from the bank. Financial Institutions will do its best to retrieve part of its losses but the above check-kiting scheme proves the vulnerability of the business model of the bank.

In late April, Financial Institutions reported (4/26/2024) financial results for the first quarter of fiscal 2024. Both loans and deposits grew 5% over the prior year's quarter. However, net interest income dipped -4% over the prior year's quarter and net interest margin shrank from 3.1% to 2.8% due to a higher cost of deposits. Given also the impact of the aforementioned fraud incident, earnings-per-share plunged -86%, from $0.76 to $0.11. On the bright side, the check-kiting scheme is likely to prove a one-time incident. In addition, the bank provided guidance for an expansion of net interest margin from 2.8% in the first quarter to an average annual rate of 2.85%-2.95%. Given the one-time nature of the fraud and the guidance of management, we expect an approximate 8% decrease in earnings-per-share this year.

Growth on a Per-Share Basis

Year	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2029
EPS	$2.00	$1.90	$2.10	$2.13	$2.39	$2.96	$2.30	$4.78	$3.54	$3.15	***$2.90***	***$3.20***
DPS	$0.77	$0.80	$0.81	$0.85	$0.96	$1.00	$1.04	$1.08	$1.16	$1.20	***$1.20***	***$1.40***
Shares[1]	13.9	14.1	14.5	15.1	16.0	16.0	16.1	15.9	15.5	15.5	***15.5***	***15.5***

Financial Institutions has grown its loans by 6.3% per year on average over the last four years, primarily thanks to 8.7% average annual growth of commercial loans. The bank has also grown its deposits by 6.9% per year on average over the same period. Overall, the company has grown its earnings-per-share by 5.2% per year on average over the last nine years. This is a decent growth rate but we are concerned over the volatile performance record of the bank.

Even worse, the recent fraud incident is a reminder of the vulnerable business model of the bank. While we do not expect a similar incident to occur in the upcoming years, the small-cap bank appears riskier than most typical financial institutions. Given also the impact of 16-year high interest rates on the net interest margin of the bank via high deposit costs, we have assumed 2.0% average annual growth of earnings-per-share over the next five years. The bank may exceed our expectations but we prefer to be on the safe side.

Valuation Analysis

Year	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	Now	2029
Avg. P/E	11.6	12.9	13.3	14.6	13.3	9.9	8.6	6.3	7.8	6.0	***5.9***	***7.7***
Avg. Yld.	3.3%	3.3%	2.9%	2.7%	3.1%	3.4%	5.2%	3.6%	4.2%	6.3%	***7.1%***	***5.7%***

[1] 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.

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The stock of Financial Institutions has traded at an average price-to-earnings ratio of 7.7 over the last five years. Given the small market cap of the bank and its vulnerable business model, we view this earnings multiple as fair. The stock is currently trading at a 10-year low price-to-earnings ratio of 5.9 due to the aforementioned fraud incident and the impact of high interest rates on the net interest margin of the bank. We expect these headwinds to fade and the stock to revert to its fair valuation level over the next five years. In such a case, the stock will enjoy a 5.6% annualized gain in its returns.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2029
Payout	39%	42%	39%	40%	40%	34%	45%	23%	33%	38%	***41%***	***44%***

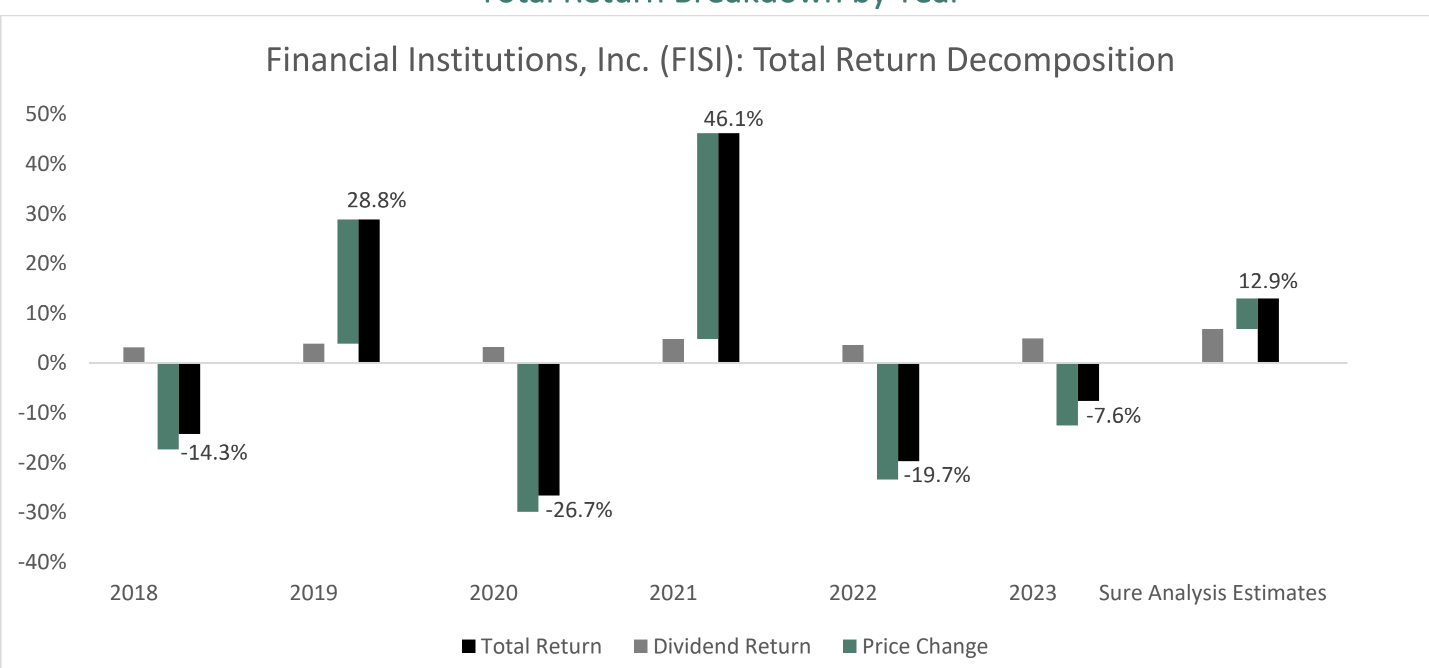
Financial Institutions has posted decent quality metrics over the last 15 years. During this period, its year-end non-performing assets have ranged from 0.17% to 0.58% while its annual net charge-offs have averaged 0.14%-0.54% of total loans. On the other hand, the bank has exhibited a volatile performance record and incurred a -22% decrease in earnings-per-share in 2020 due to the pandemic. Overall, the company is likely to be significantly affected in the event of a recession or a downturn of the financial sector.

On the bright side, Financial Institutions has raised its dividend for 13 consecutive years and is currently offering a 10-year high dividend yield of 7.1%. The high yield has resulted from the exceptionally cheap valuation of the stock, which has been beaten to the extreme by the market for the aforementioned loss of funds. Given the healthy payout ratio of 41% and our belief that such an incident will not recur in the upcoming years, we view the dividend as safe and hence we consider the stock suitable for income-oriented investors.

Final Thoughts & Recommendation

Financial Institutions has vastly underperformed the S&P 500 over the last five years (-37% vs. +85%), primarily due to the downturn of regional banks after the bankruptcy of Silicon Valley Bank, First Republic and Credit Suisse. The stock has become cheaply valued and hence it could offer a 12.9% average annual total return over the next five years thanks to 2% growth, a 7.1% dividend and a 5.6% valuation tailwind. It thus receives a buy rating, though some investors may prefer other banks which have more resilient business models, such as Bank OZK, F&M Bank and Community Trust Bancorp.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Revenue	120	125	138	147	158	170	182	200	212	212
SG&A Exp.	46	53	56	60	72	73	66	67	76	81
D&A Exp.	5	5	6	6	6	8	8	8	8	8
Net Profit	29	28	32	34	40	49	38	78	57	50
Net Margin	24.4%	22.6%	23.1%	22.8%	25.0%	28.8%	21.1%	38.9%	26.6%	23.7%
Free Cash Flow	30	36	39	39	62	54	39	64	125	8
Income Tax	10	11	12	10	10	11	7	20	14	13

Balance Sheet Metrics

Year	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Total Assets	3,090	3,381	3,710	4,105	4,312	4,384	4,912	5,521	5,797	6,161
Cash & Equivalents	58	60	71	99	103	113	94	79	130	124
Goodwill & Int.	69	67	76	75	76	75	74	74	73	73
Total Liabilities	2,810	3,087	3,390	3,724	3,915	3,945	4,444	5,016	5,392	5,706
Long-Term Debt	295	332	371	485	509	315	79	104	279	310
Total Equity	262	277	303	364	379	422	451	488	388	438
LTD/E Ratio	1.06	1.13	1.16	1.27	1.28	0.72	0.17	0.21	0.69	0.68

Profitability & Per Share Metrics

Year	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Return on Assets	1.0%	0.9%	0.9%	0.9%	0.9%	1.1%	0.8%	1.5%	1.0%	0.8%
Return on Equity	11.0%	9.9%	10.4%	9.6%	10.2%	11.7%	8.4%	16.0%	12.4%	11.7%
ROIC	5.2%	4.7%	4.9%	4.3%	4.5%	5.9%	5.9%	13.4%	8.7%	6.9%
Shares Out.	13.9	14.1	14.5	15.1	16.0	16.0	16.1	15.9	15.5	15.5
Revenue/Share	8.63	8.85	9.53	9.76	9.91	10.60	11.33	12.52	13.73	13.71
FCF/Share	2.14	2.52	2.70	2.55	3.90	3.37	2.44	3.99	8.09	0.51

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