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Citizens Financial Services, Inc. (CZFS – OTC Pink)

5003 Falls of Neuse Road

Raleigh
North Carolina
27609

919-876-8868 ph

www.equityresearch.com

John A. Howard, CFA
April 25, 2017

Price:	\$54.00	Diluted EPS 2015A:	\$ 3.79	P/E 2015A:	14.2x
52 Wk. Range:	\$46.78 - \$54.00	(FY: DEC) 2016A:	\$3.78	2016A:	14.3x
Div/Div Yld: *	\$1.68/3.1%	2017E:	\$4.00	2017E:	13.5x
Shrs/Mkt Cap:	3.3 mm / \$179 mm	Book Value: **	\$37.68	Price/Book Value: **	1.43 x

* Cash dividend is most recent regular quarterly dividend (annualized).

** Tangible book value is \$30.71; price to tangible book value is 1.76x. A 1% stock dividend was also paid on June 30, 2016.

Background

Citizens Financial Services, Inc. (“the Company”) of Mansfield, Pennsylvania, is a financial holding company for First Citizens Community Bank, a full service community bank. First Citizens Community Bank (the “Bank”) has been operating since 1932, and as of March 31, 2017, the Company had total assets of approximately \$1.2 billion. In December 2015, the Company completed the acquisition and conversion of The First National Bank of Fredericksburg (“FNB”), a bank with roughly \$230 million in assets that is based in the attractive and growing Lebanon Valley region of Pennsylvania. Including the locations of FNB, the Company has offices in Tioga, Bradford, Potter, Clinton, Union, Lebanon, Berks, Schuylkill and Lancaster counties in Pennsylvania and one location in New York State with an office in Wellsville (Allegany County). The region has a fairly diverse economic base, and has benefited from the Marcellus Shale, a section of sedimentary rock that extends throughout much of Appalachia that contains significant untapped natural gas reserves. Citizens Financial Services, through its subsidiaries, focuses on highly personalized service and offers a variety of products and services to individuals and small- to medium-sized businesses. Personal banking products and services include deposit accounts, personal loans, retirement services, CDs and IRAs, while examples of business products include business and agricultural loans and commercial services. Electronic services offered include mobile banking, ATMs, direct deposit, internet banking, OverDraft Protection, remote deposit, lockbox, on-line mortgage application and merchant card services. Through the Investment and Trust Services division, a variety of brokerage services are offered, such as professional asset management, estate planning, mutual funds and annuities, as well as life insurance, mineral management services, financial planning and trust administration. The Company’s stock is traded on the OTC Pink market under the symbol “CZFS.”

First Quarter of 2017 Was Another Excellent Quarter

Citizens Financial Services reported another strong quarter in the three months ended March 31, 2017. Earnings increased from the year-ago level and came in about 6% better than we had modeled, with stronger than anticipated comparisons in most major categories of the income statement. Based on that strength, we are boosting our earnings projection for the full year of 2017. Perhaps even more impressive than the earnings increase was the momentum in loan growth. Management began focusing much of its efforts on agricultural lending not long after it completed the transaction with First National Bank of Fredericksburg at the end of 2015. Since that time, it has built a growing team of agricultural lenders – many of whom are former farmers themselves – who not only address financial needs of agricultural enterprises but who have specific industry knowledge (e.g., swine, poultry, crops, dairy, etc.) that builds lender credibility and serves as a key point of differentiation. The results of this strategy have been quite impressive, as agricultural loans have more than doubled in the past year and grown four-fold from two years ago. Agricultural loans now represent 22% of the total loan portfolio, up from 7% two years ago at the end of 2015’s first quarter. Consistent with these strong results, CZFS shares recently reached a multi-year high.

SYMBOL: CZFS

TOTAL ASSETS: \$1.2 BB

HQ: MANSFIELD, PA

CONTACT:
GINA BOOR
(570) 662-2121

1ST QUARTER HIGHLIGHTS:

EARNINGS INCREASED FROM THE YEAR-AGO LEVEL AND WERE BETTER THAN EXPECTED

LOAN GROWTH WAS QUITE IMPRESSIVE, ESPECIALLY IN THE AGRICULTURAL LENDING AREA

CZFS STOCK RECENTLY HIT A MULTI-YEAR HIGH

EPS: \$1.00 vs. \$0.98

NET INTEREST INCOME WAS UP 9%, WHILE NONINTEREST EXPENSE INCREASED ONLY 4%

THE PROVISION INCREASED SIGNIFICANTLY BASED ON THE RAPID LOAN GROWTH

CITIZENS FINANCIAL'S ROAE WAS THE TENTH BEST OUT OF 70 PUBLICLY TRADED PENNSYLVANIA BANKS

WE EXPECT THE ROAE TO BE EVEN BETTER ONCE LOAN GROWTH (AND THE PROVISION) MODERATES

LOANS INCREASED 21% OVER THE PAST YEAR

THIS GROWTH CAME NOT ONLY FROM AGRICULTURAL LENDING BUT ALSO FROM OTHER TYPES OF LOANS, WHICH WERE UP 8% IN AGGREGATE

SOME OF THIS LOAN GROWTH HAS BEEN FUNDED THROUGH THE SALE OF SECURITIES, REDUCING THE PRESSURE TO BUILD DEPOSITS

NPAS/ASSETS: 1.04%

RESERVES/LOANS: 1.11%

**EPS:
2015A: \$3.79
2016A: \$3.78
2017E: \$4.00**

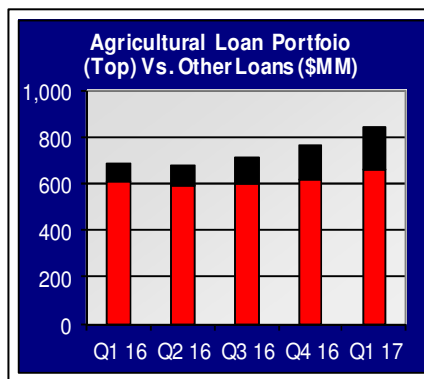
In terms of specific financial results, net income was \$3,303,000, or \$1.00 per diluted share, in the first quarter of 2017, versus \$3,283,000, or \$0.98 per diluted share, in the year-ago quarter. Unlike the comparisons for the past year, this quarter was the first one where the year-ago results *included* the FNB acquisition, so there was more comparability to these figures than in the past. Net interest income was up a commendable 9% to \$10.0 million in 2017's first quarter, versus \$9.2 million in the year-ago quarter. Also encouragingly, the net interest margin improved to 3.78% in 2017's first quarter, up from 3.75% in the fourth quarter of 2016 and 3.64% in the first quarter of 2016. Noninterest income, excluding security gains in both periods, was down slightly (about 1%), while noninterest expense increased about 4% to \$7.2 million in the first quarter of 2017 from \$6.9 million in the year-ago period. Finally, we would note that the earnings growth was achieved despite a large increase in the provision for loan losses, which grew to \$615,000 in 2017's first quarter, versus \$135,000 in the year-ago quarter.

A Brief Comment About ROE

Citizens Financial's annualized return on average equity ("ROAE") was 10.45% in 2017's first quarter, versus roughly 10.81% in the year-ago quarter. While Citizens Financial's ROAE is quite impressive (out of roughly 70 publicly traded banks in Pennsylvania with assets under \$10 billion, Citizens Financial had the tenth highest ROAE), that level is actually a bit below its historical levels (ROAE averaged 13.5% over the past five years). What is important to keep in mind is that there is often a short-term negative impact on earnings from rapid loan growth. That can come from the additional cost of lending teams, as well as from a higher provision for loan losses, both of which occurred at Citizens Financial. The important point, however, is that once the loans are adequately reserved, the provision tends to moderate, and as the loan portfolio grows, the earnings drag from the lending teams diminishes as their semi-fixed costs are absorbed over a larger loan portfolio.

Organic Loan Growth Was 21% in the Past Year

As was mentioned earlier in this report, Citizens Financial has done an excellent job building its loan portfolio (organic growth in the past year was 21%). And while much of this increase has come from agricultural lending, loan growth *excluding* agricultural loans was still up an impressive 8% over the past year. Since the Company has a significant investment security portfolio from which to fund these loans, it has not been forced to "chase" deposits. As a result, deposit growth has been modest, increasing 2% from the year-ago level. Total assets increased 3% in the past year. The capital position also remains strong, with shareholders' equity totaling \$125 million, or 10.2% of assets (8.5% on a tangible equity to tangible assets basis) at March 31, 2017.



Asset Quality Has Been Holding Fairly Steady

Nonperforming assets were \$12.7 million, or 1.04% of assets, at March 31, 2017, versus \$12.9 million, or 1.05% of assets, at December 31, 2016 and \$8.8 million, or 0.74% of assets, at March 31, 2016. The allowance for loan losses was \$9.4 million, or 1.11% of loans, at March 31, 2017, as compared to \$7.3 million, or 1.04% of loans, at March 31, 2016.

Projections Increased

Based on the strength of the most recent quarter, we are increasing our 2017 earnings estimate to \$13.3 million, or \$4.00 per diluted share. These projections could change significantly based on changing economic conditions.

ADDITIONAL INFORMATION UPON REQUEST

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