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

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July 25, 2019

| | | | | | |
|-----------------------|-------------------|---------------------------|---------|-----------------------------|-------|
| Price: | \$60.50 | Diluted EPS 2018A: | \$ 5.09 | P/E 2018A: | 11.9x |
| 52 Wk. Range: | \$54.96 - \$65.84 | (FY: DEC) 2019E: | \$5.30 | 2019E: | 11.4x |
| Div/Div Yld: * | \$1.76/2.9% | 2020E: | \$5.60 | 2020E: | 10.8x |
| Shrs/Mkt Cap: | 3.5 mm / \$213 mm | Book Value: ** | \$41.99 | Price/Book Value: ** | 1.44x |

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

** Tangible book value is \$34.97.

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 June 30, 2019, the Company had total assets of approximately \$1.45 billion. The Company has completed various acquisitions, such as the acquisition of The First National Bank of Fredericksburg (“FNB”) in 2015, and more recently, the S&T Bank branch located in State College, PA in December of 2018. The Company currently has offices in Tioga, Bradford, Potter, Clinton, Union, Lebanon, Berks, Schuylkill, Lancaster and Centre counties in Pennsylvania and one location in Wellsville (Allegany County), New York. The region has a fairly diverse economic base, and has benefited from the Marcellus Shale, an area 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. According to the American Bankers Association, it is the number two agricultural lender in Pennsylvania. Through its 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.”

Second Quarter Earnings Exceeded Estimates

Citizens Financial Services reported a solid quarter in the three months ended June 30, 2019. Earnings came in above expectations, thanks largely to the fact that net interest income was stronger than we had expected, while the provision for loan losses and expenses were lower than we had anticipated. Balance sheet growth was commendable but has been slowing, and likely will remain fairly modest, given that agricultural lending (which was the principal source of loan growth over the past few years) has stabilized. Notwithstanding the moderation in ag lending, we were heartened that commercial lending activity remains relatively robust. In terms of asset quality, it was a good quarter as well, as nonperforming assets increased only modestly from the previous linked quarter and are well within acceptable levels. Finally, we would note that profitability metrics remained excellent, with ROAE, ROAA and the efficiency ratio all much better than peer ratios.

Net income in the second quarter of 2019 was \$4,846,000, or \$1.38 per diluted share, versus \$4,691,000, or \$1.32 per diluted share, in the year-ago quarter. We had been projecting EPS of \$1.28, so the results were a full dime above our EPS estimate. Based on the results, we have increased our earnings projections for the year. Net interest income increased 5% to \$12,336,000 in the second quarter of 2019, versus \$11,751,000 in the year-ago quarter, with that improvement mainly due to growth in average earning assets, although the margin did increase to 3.74% in 2019’s second quarter from 3.70% in the year-ago quarter. Although the cost of funds on interest-bearing liabilities has increased more than the yields on earning assets, the Company has done a solid job of growing

SYMBOL: CZFS

TOTAL ASSETS: \$1.45 BB

HQ: MANSFIELD, PA

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2ND QUARTER HIGHLIGHTS:

**EARNINGS WERE BETTER THAN
PROJECTED**

EPS: \$1.38 vs. \$1.32

**THE STRENGTH IN EARNINGS
WAS DUE TO SOLID GAINS IN
NET INTEREST INCOME AND
NONINTEREST INCOME, AS
WELL AS A DROP IN THE
PROVISION**

**NET INTEREST INCOME WAS UP
5%**

NONINTEREST INCOME WAS UP 10%, WHILE NONINTEREST EXPENSE INCREASED 7% AND THE PROVISION INCREASED MODESTLY

ROATCE: 15.72%

SIX MONTHS HIGHLIGHTS:

EPS: \$2.62 vs. \$2.52

BALANCE SHEET GROWTH WAS GENERALLY IN THE MID-SINGLE DIGITS, ALTHOUGH EQUITY GREW 12%

CZFS SHARES ARE CURRENTLY TRADING AT 173% OF TANGIBLE BOOK VALUE, ALTHOUGH THAT IS IN LINE WITH ITS HISTORICAL MULTIPLE

A LARGE REASON IT TRADES AT A PREMIUM TO THE MARKET IS THE HIGH ROATCE THAT IT ACHIEVES

THIS PREMIUM, RELATIVE TO THE MARKET, IS LOWER TODAY THAN IT HAS BEEN OVER THE PAST TEN YEARS

NPAS/ASSETS: 1.14%

RESERVES/LOANS: 1.21%

EPS:
2018A: \$5.09
2019E: \$5.30
2020E: \$5.60

noninterest-bearing demand deposits, which has helped to mitigate the impact of the rising cost of funds. The provision for loan losses increased modestly, and noninterest income was up 10% to \$2,027,000 in 2019's second quarter, versus \$1,842,000 in the year-ago quarter, with notable improvement in fees from the Bank's brokerage and insurance business. Finally, noninterest expense increased 7% to \$8,237,000, versus \$7,702,000 in 2018's second quarter. Annualized ROAE was 13.09%, while the return on average tangible common equity was 15.72% and the annualized ROAA was 1.34%.

For the first six months of 2019, net income increased to \$9,251,000, or \$2.62 per diluted share, versus \$8,938,000, or \$2.52 per diluted share, in the year-ago period. Net interest income was up 5%, while noninterest income was up 8% and noninterest expense increased 7%. The provision for loan losses declined. As was mentioned earlier, the balance sheet growth was fairly modest, with gross loans and deposits increasing 6% over the past year, while assets were up 4%. Thanks in part to the high ROAE and a reduction in the Accumulated Other Comprehensive Loss account (i.e., there were lower unrealized losses), stockholders' equity increased 12% to \$148 million, or 10.2% of assets, at June 30, 2019, versus was \$132 million, or 9.5% of assets, at the year-ago date. This growing capital ratio puts the Company in an excellent position to maintain (or accelerate) its growth, pay special dividends or even pursue stock buybacks.

A Comment About the Relative Valuation of Citizens Financial Shares

One of the questions we are sometimes asked regarding Citizens Financial's valuation concerns its relatively high market to book value (or tangible book) ratio. While it is true that the shares do trade at what may seem like a high multiple, there are a couple of factors that should be kept in mind. The first is that Citizens Financial has unusually high returns on average equity ("ROAE") and tangible common equity ("ROATCE"). In fact, of roughly 70 public banks in Pennsylvania with assets between \$500 million and \$5 billion, Citizens Financial had the seventh highest ratios for each. High

| Historical Averages | Price to TBV | | | Price to Core EPS | | |
|-----------------------------------|--------------|----------|------------------|-------------------|----------|------------------|
| | CZFS | PA Peers | CZFS/Peers Ratio | CZFS | PA Peers | CZFS/Peers Ratio |
| Current | 173% | 132% | 131% | 11.5 | 12.6 | 91% |
| Ten Year Average (Using Year End) | 173% | 118% | 147% | 11.1 | 12.8 | 87% |

ROAEs and ROATCE tend to correlate closely with high multiples to book value, and in the case of Citizens Financial, this is no exception. The second point we would make is that CZFS shares have consistently traded at a premium to the market on the basis of tangible book value for the past ten years. The current price is in line with its historical multiple. The shares actually trade at a discount to the market, however, based on the multiple of core EPS. Today's premiums, relative to the market, are lower than they have been over the past ten years on the basis of the price to TBV multiple, while the discount on the basis of core EPS is slightly lower.

NPAs Increased But Reserve Position Remains Strong

Nonperforming assets were \$16.6 million, or 1.14% of assets, at June 30, 2019, versus \$16.1 million, or 1.11% of assets, as of March 31, 2019, and \$12.4 million, or 0.89% of assets, at June 30, 2018. As we stated in our last report, the Company has been doing a good job of transitioning problem credits to OREO, which should expedite problem asset resolution. At the same time, the Company has been building upon its reserve position. As of June 30, 2019, the allowance for loan losses was \$13.3 million, or 1.21% of loans, as compared to \$11.9 million, or 1.15% of loans, at June 30, 2018.

Projections

Based on the better than expected second quarter results, we are slightly increasing our 2019 earnings projections to \$18.7 million, or \$5.30 per diluted share, versus \$18.4 million, or \$5.25 per share projected previously. Our estimate for 2020 earnings is \$19.7 million, or \$5.60 per diluted share. These projections could change significantly based on changing economic conditions.

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