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

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John A. Howard, CFA
October 24, 2019

Price:	\$59.50	Diluted EPS 2018A:	\$ 5.09	P/E 2018A:	11.7x
52 Wk. Range:	\$54.96 - \$63.65	(FY: DEC) 2019E:	\$5.48	2019E:	10.9x
Div/Div Yld: *	\$1.80/3.0%	2020E:	\$5.70	2020E:	10.4x
Shrs/Mkt Cap:	3.5 mm / \$210 mm	Book Value: **	\$43.03	Price/Book Value: **	1.38x

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

** Tangible book value is \$36.02.

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 September 30, 2019, the Company had total assets of approximately \$1.48 billion. The Company has completed various acquisitions, such as the acquisition of The First National Bank of Fredericksburg (“FNB”) in 2015, the S&T Bank branch located in State College, PA in December of 2018 and it recently announced its intention to acquire MidCoast Community Bancorp, Inc. (“MidCoast”), which is based in Wilmington, DE. 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 (Allegheny 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.”

Third Quarter Earnings Were Much Stronger Than Expected

Citizens Financial Services reported strong earnings in the third quarter of 2019 that were much better than we had modeled. Interest expense was lower than we had anticipated, while noninterest income was higher than expected, the result being that the earnings growth of 13% eclipsed our 4% growth estimate. Key profitability metrics were also outstanding. Balance sheet growth remained positive, with low- to mid-single digit annual increases in gross loans, deposits and assets. One other major development in the quarter was the Company’s announcement of its intention to acquire MidCoast, a \$269 million bank with two branches in Wilmington, DE and one in Dover, DE. We expect this transaction to provide a number of key benefits, as is discussed in more detail on the opposite page.

Net income in the third quarter of 2019 was \$5,196,000, or \$1.48 per diluted share, versus \$4,581,000, or \$1.30 per diluted share, in the year-ago quarter. We had been projecting EPS of \$1.35, so based on the strength of the results, we have boosted our earnings projections for the year. Net interest income accelerated in the quarter, increasing 10% to \$12,889,000 in the third quarter of 2019 from \$11,770,000 in the year-ago quarter, with that improvement coming from both a higher margin (3.82% in 2019’s third quarter, versus 3.64% in the year-ago quarter) as well as growth in average earning assets, which were up 4%. (Some of the margin increase has come from a shift in the deposit mix towards noninterest bearing accounts.) The provision for loan losses was \$400,000 in 2019’s third

SYMBOL: CZFS

TOTAL ASSETS: \$1.48 BB

HQ: MANSFIELD, PA

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3RD QUARTER HIGHLIGHTS:

EARNINGS WERE UP 13%

EPS: \$1.48 vs. \$1.30

NET INTEREST INCOME SURGED, BENEFITTING FROM HIGHER MARGINS AND GROWTH IN AVERAGE EARNING ASSETS

THE NET INTEREST MARGIN IMPROVED TO 3.82% FROM 3.64%, PARTLY BASED ON A DROP IN THE COST OF FUNDS

CORE NONINTEREST INCOME WAS UP 6%, WHILE NONINTEREST EXPENSE INCREASED 8%, OR 5% EXCLUDING MERGER-RELATED EXPENSES

ROATCE: 16.42%

NINE MONTHS HIGHLIGHTS:

EPS: \$4.10 vs. \$3.81

EQUITY INCREASED 13%, THANKS IN PART TO THE HIGH ROAE

THE ACQUISITION OF MIDCOAST WILL:

- **EXPAND CITIZENS FINANCIAL'S FOOTPRINT INTO DELAWARE**
- **ADD ROUGHLY \$269 MILLION TO THE ASSET BASE**
- **LEVERAGE THE COMPANY'S CAPITAL BASE**
- **POTENTIALLY ACCELERATE LONG-TERM EARNINGS GROWTH**

ASSET QUALITY REMAINS GOOD

NPAS/ASSETS: 1.13%

RESERVES/LOANS: 1.23%

**EPS:
2018A: \$5.09
2019E: \$5.48
2020E: \$5.70**

quarter, versus \$475,000 in the year-ago quarter, while core noninterest income was up 6% to \$2,140,000 in 2019's third quarter from \$2,022,000 in the year-ago quarter. Nearly every major category of noninterest income increased. Noninterest expense increased 8% to \$8,414,000 from \$7,788,000, although 2019's third quarter included \$275,000 in merger-related expenses, the absence of which would have equated to an expense increase of less than 5%. Finally, we would note that profitability metrics were excellent. Annualized ROAA was 1.43%, annualized ROAE was 13.74% and annualized return on average tangible common equity was 16.42%, all of which were increases from the year-ago figures. The efficiency ratio was 52.1% in 2019's third quarter, an improvement from 54.7% in the year-ago quarter.

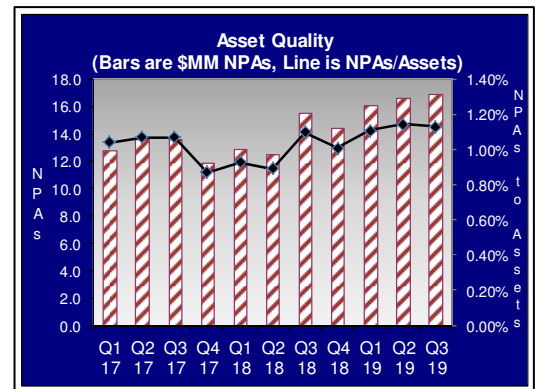
For the first nine months of 2019, net income grew to \$14,447,000, or \$4.10 per diluted share, versus \$13,519,000, or \$3.81 per diluted share, in the year-ago period. Net interest income was up 6%, while core noninterest income and noninterest expense both increased 7%. The provision for loan losses was \$1,150,000 in 2019's first nine months, versus \$1,300,000 in the year-ago period. As was mentioned earlier, the balance sheet generally grew in the low- to mid-single digits, with gross loans and assets increasing 5% from year-ago levels and deposits up 2%. The capital position remains quite strong, as stockholders' equity increased 13% to \$152 million, or 10.3% of assets, at September 30, 2019, versus \$134 million, or 9.5% of assets, at the year-ago date.

Citizens Financial Announces its Intention to Acquire MidCoast Community Bancorp Inc.

One of the most significant events of the quarter was the September 18, 2019 announcement that Citizens Financial was acquiring MidCoast. Based in Wilmington, DE, MidCoast had total assets of \$269 million at June 30, 2019 and serves the Wilmington and Dover, DE markets through three branch locations. Under the terms of the agreement, each MidCoast shareholder may receive cash of \$6.50 per share or CZFS shares based on an exchange ratio of 0.1065 shares of CZFS for each MidCoast share, which equates to "deal" multiples of 1.17x book value (tangible and stated are the same) and 12.5x aggregate earnings. The \$30 million transaction is expected to close in the second quarter of 2020. MidCoast has had fairly consistent balance sheet growth in the last few years, and its profitability has been improving. We expect a number of benefits for Citizens Financial from the transaction, such as expanding the Company's footprint, significantly growing its balance sheet and leveraging its capital base. Moreover, since MidCoast operates with higher expense ratios (partly due to its smaller size), we expect there to be meaningful earnings gains from improvements in efficiency.

NPAs Have Been Fairly Stable

Nonperforming assets were \$16.8 million, or 1.13% of assets, at September 30, 2019, versus \$16.6 million, or 1.14% of assets, as of June 30, 2019, and \$15.5 million, or 1.08% of assets, at September 30, 2018. Charge-offs have also been quite contained, and were only 0.01% (annualized) in the most recent quarter. At the same time, the Company has been building reserves. As of September 30, 2019, the allowance for loan losses was \$13.7 million, or 1.23% of loans, as compared to \$12.4 million, or 1.17% of loans, at September 30, 2018.



Projections Increased

Based on the better than expected third quarter results, we are increasing our 2019 earnings projections to \$19.3 million, or \$5.48 per diluted share, versus \$18.7 million, or \$5.30 per share projected previously. Our estimate for 2020 earnings has increased to \$20.1 million, or \$5.70 per diluted share. These projections exclude any impact from the addition of MidCoast's operation but they do include an assumption that there will be additional merger-related charges.

ADDITIONAL INFORMATION UPON REQUEST

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