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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
July 27, 2018

Price:	\$62.10	Diluted EPS 2016A:	\$ 3.60	P/E 2016A:	17.3x
52 Wk. Range:	\$52.13 - \$64.36	(FY: DEC) 2017A: *	\$4.18	2017A:	14.9x
Div/Div Yld: *	\$1.74/2.8%	2018E:	\$5.15	2018E:	12.1x
Shrs/Mkt Cap:	3.5 mm / \$220 mm	Book Value: **	\$37.66	Price/Book Value: **	1.65x

* Cash dividend is most recent regular quarterly dividend (annualized). 2017 EPS excludes \$0.44 per share deferred tax asset charge.

** Tangible book value is \$30.53.

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, 2018, the Company had total assets of approximately \$1.4 billion. The Company has completed various acquisitions, such as the acquisition of The First National Bank of Fredericksburg (“FNB”), a bank with roughly \$230 million in assets, 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 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, 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. 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, cash management 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.”

Second Quarter Earnings Reached an All-Time High; EPS Increased 35%

Citizens Financial Services reported record high earnings in the second quarter of 2018. Earnings per share grew 35%, which was well above our estimates, leading us to increase our earnings projections for the year. Key profitability metrics, such as ROAA, ROAE and the efficiency ratio were particularly impressive, each benefitting from a combination of strong net interest income and excellent cost control. These ratios were not only better than the year-ago figures, but were also quite good in comparison to other PA banks. Citizens Financial’s ROAE and efficiency ratios were the 5th best out of roughly 60 Pennsylvania-based publicly traded banks (with \$5 billion or less in assets), while the ROAA was the 7th highest. The Company was also selected by Forbes Magazine as the number one bank in Pennsylvania, based on various aspects of customer service (to be discussed further in our next report). Balance sheet growth was commendable as well, and while we expect a moderation in growth relative to the last couple of years (when agricultural lending was ramping up), we still expect solid overall growth going forward. Finally, asset quality remained excellent.

Performance Ratios at a Glance (%)		
	Q2 17	Q2 18
ROAA (Annualized)	1.12	1.34
ROAE (Annualized)	10.80	13.68
Net Int. Margin	3.82	3.70
Efficiency Ratio	54.36	53.82

SYMBOL: CZFS

TOTAL ASSETS: \$1.4 BB

HQ: MANSFIELD, PA

CONTACT:
GINA BOOR
(570) 662-2121

2ND QUARTER HIGHLIGHTS:

**EARNINGS GROWTH WAS
EXCELLENT**

**KEY PROFITABILITY METRICS
WERE QUITE IMPRESSIVE**

**BALANCE SHEET GROWTH WAS
GOOD AND ASSET QUALITY
HELD UP WELL**

EPS: \$1.34 vs. \$0.99

NET INTEREST INCOME WAS UP 13%

EARNINGS ALSO BENEFITTED FROM THE DROP IN THE PROVISION, REFLECTING FAVORABLE ASSET QUALITY TRENDS

NONINTEREST EXPENSE WAS UP 7%

FIRST HALF HIGHLIGHTS:

EPS WAS UP 32%

EPS: \$2.55 vs. \$1.93

WHILE WE EXPECT SOLID BALANCE SHEET GROWTH GOING FORWARD, IT WILL LIKELY MODERATE FROM THE PREVIOUS YEAR'S LEVEL

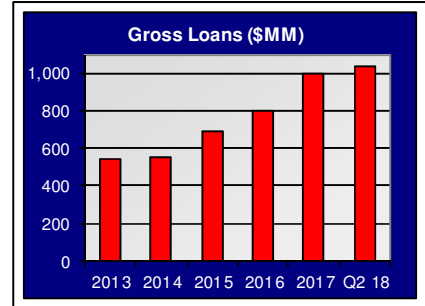
NPAS CONTINUE TO DECLINE

NPAS/ASSETS: 0.89%

RESERVES/LOANS: 1.15%

EPS:
2017A: \$3.60
2018A \$4.18 (EXCLUDING DEFERRED TAX ASSET CHARGE)
2018E: \$5.15

In terms of specific results, net income in the second quarter of 2018 was \$4,691,000, or \$1.34 per diluted share, versus \$3,468,000, or \$0.99 per diluted share, in the year-ago quarter. The largest factor in the increase in earnings, as it has been for the past several quarters, was net interest income, which continues to benefit from the surging loan volume from the past few years, as can be seen in the adjacent chart. Specifically, net interest income increased 13% to \$11,751,000 in 2018's second quarter from \$10,404,000 in the year-ago quarter. Although margins (at 3.70% in 2018's second quarter) were lower than in the year-ago quarter (3.82%), they were slightly higher than the 3.68% recorded in 2018's first quarter. Earnings also benefitted from a decline in the provision for loan losses, which dropped to \$325,000 in 2018's second quarter from \$625,000 in the year-ago quarter. Core noninterest income was down 1%, while noninterest expense was up 7% in 2018's second quarter relative to the year-ago quarter.



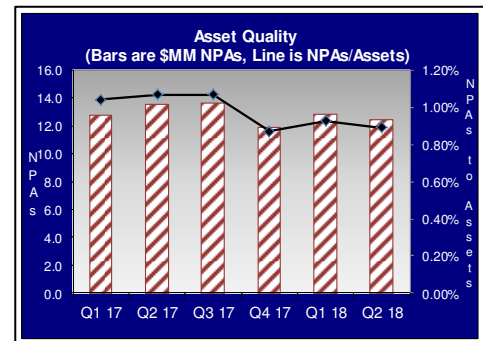
For the first six months of 2018, profitability was likewise strong, with earnings increasing to \$8,938,000, or \$2.55 per diluted share, versus \$6,771,000, or \$1.93 per diluted share, in the year-ago period. Net interest income was up an impressive 14%, while core noninterest income was essentially unchanged and noninterest expense increased 8%. As was the case with the quarterly results, the provision for loan losses declined, reflecting the improving asset quality metrics, and was \$825,000 in the first half of 2018, versus \$1,240,000 in the year-ago period.

Balance Sheet Growth Will Likely Remain Strong But May Moderate

As was stated earlier, momentum in the balance sheet was good in the quarter, with solid growth in most key areas relative to both the year-ago level and 2018's linked first quarter. As compared to the year-ago figures, gross loans at June 30, 2018 were up 17% to \$1.040 billion, while deposits increased 6% to \$1.119 billion and assets grew 10% to \$1.398 billion. Given the size of the agricultural loan portfolio, we expect the rate of loan growth to moderate somewhat, but we do believe loan growth will remain in at least the upper single digits. Finally, the Company's tangible equity-to-tangible assets ratio was 7.81% at June 30, 2018, versus 8.43% at the year-ago date.

Asset Quality Remains Quite Good

Trends in asset quality are favorable. Nonperforming assets were \$12.4 million, or 0.89% of assets, as of June 30, 2018, versus \$12.8 million, or 0.93% of assets, at March 31, 2018 and \$13.5 million, or 1.07% of assets, at June 30, 2017. Charge-offs have remained quite contained as well. The allowance for loan losses grew to \$11.9 million, or 1.15% of loans, at June 30, 2018, as compared to \$10.0 million, or 1.12% of loans, at June 30, 2017.



Projections Increased

Based on the strength of the second quarter results, we are increasing our 2018 earnings estimate to \$17.9 million, or \$5.15 per diluted share, up from our previous estimate of \$16.9 million, or \$4.85 per diluted share. Earnings in 2017 included about \$0.20 per share in security gains, versus nominal security gains so far in 2018. These projections could change significantly based on changing economic conditions.

ADDITIONAL INFORMATION UPON REQUEST

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