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

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January 27, 2017

Price:	\$51.00	Diluted EPS 2015A:	\$ 3.79	P/E 2015A:	13.5x
52 Wk. Range:	\$46.53 - \$53.50	(FY: DEC) 2016A:	\$3.78	2016A:	13.5x
Div/Div Yld: *	\$1.68/3.3%	2017E:	\$3.95	2017E:	12.9x
Shrs/Mkt Cap:	3.3 mm / \$169 mm	Book Value: **	\$37.13	Price/Book Value: **	1.37 x

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

** Tangible book value is \$30.15; price to tangible book value is 1.69x. 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 December 31, 2016, 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 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.”

Fourth Quarter Results Were on Target with Expectations

Citizens Financial Services reported excellent results in the fourth quarter of 2016. Earnings were right in line with projections, balance sheet growth was quite strong and asset quality held up well. The Bank continues to expand its agricultural lending activities, which has been a large part of its recent loan and balance sheet growth. While that loan growth has led to a higher provision for loan losses, the Company has nevertheless been able to report solid earnings comparisons relative to the year-ago figures. Moreover, we expect profits to build as the year progresses.

Net income was \$3,171,000, or \$0.95 per diluted share, in the fourth quarter of 2016, versus \$2,460,000, or \$0.79 per diluted share, in the year-ago quarter. There was a bit of “noise” in the quarter, meaning that there were some unusual factors that affected operating results. For example, the year-ago quarter included \$698,000 in nonrecurring merger-related expenses from the acquisition of FNB. Additionally, there was \$100,000 in gains on the sale of securities in 2016’s fourth quarter, not to mention a large increase in the provision for loan losses to adequately reserve for the loan growth. Bottom line, if we adjust for each of these items, we see that the “normalized” operating comparisons were quite favorable, with pretax income before nonrecurring charges and the loan loss provision

SYMBOL: CZFS

TOTAL ASSETS: \$1.2 BB

HQ: MANSFIELD, PA

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4TH QUARTER HIGHLIGHTS:

**EARNINGS WERE GOOD,
BALANCE SHEET GROWTH WAS
SOLID AND ASSET QUALITY
HELD UP WELL**

EPS: \$0.95 vs. \$0.79

**EARNINGS BEFORE THE
PROVISION AND
NONRECURRING ITEMS WERE
UP 21 %**

NET INTEREST INCOME WAS UP 23%, MOST OF WHICH WAS FROM HIGHER AVERAGE EARNING ASSETS

NONINTEREST INCOME EXCLUDING SECURITY GAINS WAS UP 6%

NONINTEREST EXPENSE INCREASED 7%

FULL YEAR HIGHLIGHTS:

EPS: \$3.78 vs. \$3.79

CZFS TRADES AT A SLIGHT PREMIUM TO THE MARKET BASED ON BOOK VALUE PEER METRICS

HOWEVER, WE BELIEVE THAT DIFFERENCE IS MORE THAN OFFSET BY THE HIGHER RETURN ON AVERAGE EQUITY

THE EFFECTIVE RETURN ON THE MARKET VALUE OF EQUITY IS AMONG THE HIGHEST OF PENNSYLVANIA BANKS

NPAs/ASSETS: 1.05%

RESERVES/LOANS: 1.11%

EPS:
2015A: \$3.83
2016A: \$3.78
2017E: \$3.95

reaching \$4.6 million in 2016's fourth quarter, up 21% from \$3.8 million in the year-ago quarter. The primary driver of the higher operating earnings was net interest income, which was up 23% to \$9.9 million in 2016's fourth quarter, versus \$8.0 million in the year-ago quarter. The net interest margin was fairly steady, and was 3.75% in 2016's fourth quarter, essentially unchanged from 3.73% in the year-ago quarter. Growth in average earning assets, on the other hand, was quite strong, increasing roughly 22%. While part of that increase was due to the addition of FNB, we estimate about a third of that growth was organic. Noninterest income, excluding the \$100,000 in security gains in 2016's fourth quarter, was up 6% to \$2.0 million from \$1.9 million. Noninterest expense increased to \$7.3 million in the fourth quarter of 2016 from \$6.8 million (including the merger-related charges) in 2015's fourth quarter. Finally, reflecting the strong loan growth, the provision for loan losses grew to \$750,000 in 2016's fourth quarter from \$120,000 in the year-ago quarter.

Quarterly Results (\$000s)	2015	2016
	Q4	Q4
Net Income	2,460	3,171
Pretax Income	2,981	3,960
Adjustments:		
Provision (Add)	120	750
Security Gains (Deduct)	1	(100)
One-Time Merger Expenses (Add)	698	-
Pretax Inc. Bef. Nonrec. Charges & Prov.	3,800	4,610

For the full year of 2016, net income was \$12,638,000, or \$3.78 per diluted share, versus \$11,626,000, or \$3.79 per diluted share, in 2015. Net interest income was up 22%, while core noninterest income was up 9% and noninterest expense grew 28%. The provision for loan losses was \$1.5 million in 2016, versus \$0.5 million in 2015.

CZFS's Relative Valuation Still Appears Quite Reasonable

While relative valuation metrics can be a good basis for assessing the attractiveness of a stock, it is usually most relevant in the context of performance. Obviously, no two banks are alike, and a better performing one, all else being the same, should trade at a premium to one that is less high performing. One way to incorporate both performance and relative valuation in the same metric is to divide the ROAE by the market-to-book value ratio, which provides a rough estimate of the return on the *market value* of equity. Everything else being equal, the higher the return, the more attractive the stock is. In the case of CZFS, the shares trade at a modest premium to its peers on the basis of market-to-book value, but when we divide its ROAE by its market to book value ratio of 1.36, we arrive at a return on the market value of equity of 7.61%, which is the fourth highest out of 32 Pennsylvania banks. We would also note that CZFS shares trade at a lower multiple of earnings and have a higher dividend yield than the typical Pennsylvania bank.

	ROAA MRQ	ROAE MRQ	Dividend Yield	Price/ Trailing EPS	Price/Book Value (P/BV)	ROAE/ (P/BV)
<i>Citizens Finl</i>	1.05%	10.12%	3.3%	13.5x	1.36x	7.61%
<i>Peer Median</i>	0.91%	8.37%	2.8%	16.7x	1.31x	6.17%

Asset Quality Remains Good

NPAs were \$12.9 million, or 1.05% of assets, at December 31, 2016, versus \$11.8 million, or 0.98% of assets, at September 30, 2016, and \$8.5 million, or 0.73% of total assets, at December 31, 2015. The allowance for loan losses was \$8.9 million, or 1.11% of loans, at December 31, 2016, compared to \$7.1 million, or 1.02% of total loans, at the year-ago date.

Projections Maintained

Based on the most recent quarter, we are retaining our 2017 earnings estimate at \$13.2 million, or \$3.95 per diluted share. We expect earnings growth to accelerate as the pressure subsides on the provision for loan losses.

ADDITIONAL INFORMATION UPON REQUEST

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