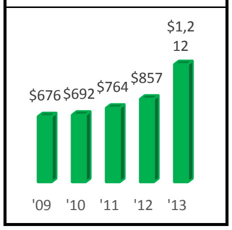
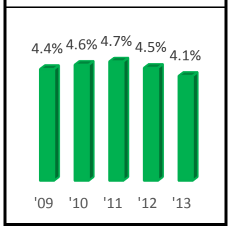
Penns Woods Bancorp
July 25, 2014

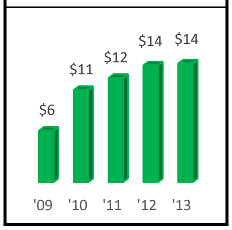
## General Overview

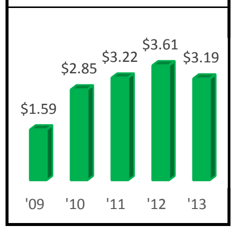
Penns Woods Bancorp (PWOD) provides banking services to individuals in small rural towns located throughout Pennsylvania. PWOD holds the number one position in terms of market share in Clinton, Lycoming, Jersey Shore, and Lock Haven counties. The dominant market share and small population of these areas has kept competition at bay allowing PWOD to earn uniquely high profits relative to capital employed. The average return on assets for PWOD is more than 2x the national average over the last 5 years.

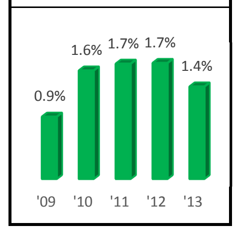
| Total Assets | Net Interest Margin | Core Earnings | EPS | Return On Assets |
|---|---|---|---|---|
| $1,211,995,000 | 4.13% | $14,084,000 | $3.19 | 1.36% |
| 5-Year CAGR = 15.7% | 5-Year AVG = 3.79% | 5-Year CAGR = 23.3% | 5-Year CAGR = 19.1% | 5-Year AVG = 1.46% |




*Purchase Logic*

PWOD is a stable and dominant regional bank earning outstanding returns on equity in excess of 15%. The dominant market position and small population centers where the bank serves has prohibited the competition from entering the region due to inadequate returns on new bank locations. We purchased our stake in PWOD at approximately 14x earnings which compares favorably to the average P/E ratio of 18x for an S&P 500 constituent. The company has historically paid out approximately 66% of earnings as a dividend and retained the remainder for future growth. At our purchase price the dividend yield was roughly 4.5% - an outstanding yield in this low interest rate environment. While PWOD is an exceptional bank the opportunities for growth are relatively limited and we are anticipating modest growth between 5-8% for the foreseeable future. We believe this position is superior to cash and will yield satisfactory results overtime, but would consider selling the position at a modest gain.

*Key Drivers*

The key drivers for PWOD are Assets Under Management, Return on Average Assets, Core Earnings, Net Interest Margin, and Non-Performing Loans to Total Loans. Each driver of success is described in greater detail below.

**AUM**

Assets under management is the terminology used to describe the total amount of money that is being managed by the bank. As new customers deposit funds at branch locations the total AUM for the bank increases. As the preeminent bank in the small towns where PWOD operates the company has maintained a dominant market share preventing the competition from entering the region. AUM is important because it clearly indicates the size of the bank and the banks' ability to generate earnings. The larger the bank the higher the earning power.

**Return on Average Assets**

ROAA is an important measure of a banks efficiency and profitability. The higher the ROAA the more profitable the business. An average bank typically has a ROAA of 0.75%, whereas PWOD has nearly doubled this national average for the last 5 years demonstrating the unique market position of the bank. ROAA is calculated by dividing TTM core earnings by TTM average assets.

Example

TTM core earnings = $14 million

TTM average assets = (Beginning of period assets + End of period assets) / 2 = ($1,211M + $856M) / 2 = $1,034M

ROAA = $14,000,000 / $1,034,000,000 = 1.35%

This metric is important because it is a clear indicator of how well PWOD is competing relative to its peers. If ROAA is significantly higher than the competition it is a demonstration of superior performance and execution. In the case of PWOD the outstanding ROAA can be attributed to the low cost deposits and dominant market share in the regions which the bank operates.

**Core Earnings**

We define core earnings as the net income without the after-tax impact of realized and unrealized securities gains and losses. In plain English, this metric is a measure of how much money the bank would earn excluding special one-time items, such as the gain on sale from investments. Core earnings is an important metric because it ultimately determines the value of the company. The more the business earns the more the business is worth.

**Net Interest Margin**

The net interest margin is defined as the interest rate spread between interest earnings assets and interest bearing liabilities. If a customer receives 0.5% interest on their checking account and the bank loans those funds as a home mortgage at 4.5% the net interest margin is equal to 4.0% (4.5% - 0.5%). The net interest margin is typically dictated by market forces, but PWOD has been able to maintain exceptionally low cost deposits by attaining a dominant market position for checking accounts in the regions where the bank operates. Checking accounts typically pay no interest and lower the banks cost of funds.

**Non-Performing Loans to Total Loans**

Non-performing loans occur when a bank extends credit to a borrower that does not repay. It is essential that all banking institutions minimize the number of loans that end up non-performing. Historically a value less than 1% is expected for a high quality bank during normal economic conditions. During the financial crisis this number climbed as high as 5% for some banks and many were forced to declare insolvency. PWOD was a notable exception during this time period. The geographic locations where PWOD operates were not impacted as dramatically as the rest of the nation and the non-performing loans remained well below 1%. This metric is important because a bank that extends low quality loans will eventually face insolvency.

### Historical Performance of Key Metrics

| Year | '09 | '10 | '11 | '12 | '13 |
|---|---|---|---|---|---|
| Total Assets | $676,204,000 | $691,688,000 | $763,953,000 | $856,535,000 | $1,211,995,000 |
| *Net Interest Margin* | 4.40% | 4.57% | 4.70% | 4.45% | 4.13% |
| Core Earnings | $6,093,000 | $10,929,000 | $12,362,000 | $13,850,000 | $14,084,000 |
| EPS | $1.59 | $2.85 | $3.22 | $3.61 | $3.19 |
| Non-Performing Loans to Total Loans | 0.1% | 0.3% | 0.4% | 0.3% | 0.3% |
| Return On Assets | 0.92% | 1.60% | 1.70% | 1.71% | 1.36% |
| Return On Equity | 9.52% | 16.37% | 16.81% | 15.90% | 12.71% |

### AUM

Assets under management have increased from $676 million in 2009 to more than $1.2 billion today. The healthy growth can be attributed to slight organic growth (5% per year) and the acquisition of Luzerne Bank – another small bank with dominant market share in regions around PWODs current operations. This equates to annualized growth of 15.7%. We anticipate the bank to continue grow organically at a rate of between 5-8% per the foreseeable future.

### ROAA

Since the financial crisis the return on average assets has been relatively steady between 1.3% and 1.7%. This return on average assets is sensational and more than double the national average. The high return on assets can be attributed to the large market share in the region where PWOD operates. The number of assets managed at each branch location is significantly higher than the national average, but not high enough to support additional banks from competitors. The bank is in a unique position earning above average profits with the ability to maintain market share. In 2013 the bank posted a relatively low 1.3% ROAA due to the acquisition of Luzerne Bank. We believe that once Luzerne is fully integrated into PWODs operations the bank will earn an average return on assets ranging from 1% to 1.75% with a 10-year average of approximately 1.5%.

### Core Earnings

Core earnings are the fundamental driver of value for PWOD and the source of dividend payments for the shareholders. In the last 5 years core earnings have increased at an average rate of 23.3%, but started from a relatively depressed level in 2009 with the financial crisis. We anticipate core earnings to continue to climb at a rate of between 3% and 10% over the next 10 years with an average rate of 8%.

### Net Interest Margin

PWOD outstanding profitability can be largely attributed to the exceptionally low cost of deposits for the bank. The company has a very healthy deposit base with a large percentage of non-interest bearing deposits (checking accounts) reducing the overall cost of capital. This low cost of capital has allowed PWODs to earn one of the highest net interest margins of any bank – typically between 4.1% and 4.8%. We anticipate PWOD to maintain industry leading net interest margins between 4.1% and 4.8%.

### Non-Performing Loans to Total Loans

PWOD has demonstrated outstanding underwriting when issuing loans to borrowers. The company made it through the financial crisis relatively unscathed. The geographic regions in Pennsylvania which PWODs operates are relatively stable with consistent real estate values – unlike some locations throughout the US (Florida or California). The stable real estate values coupled with strong underwriting standards has allowed PWOD to avoid the financial mistakes of many other institutions. We anticipate non-performing loans as a percentage of loans to remain less than 1% for the next 10 years.

Summary of Key Metrics

| Metric | Expectations |
|---|---|
| Assets Under Management | Growth ranging from 5% to 8% per year<br>Average of 6% over 5 years |
| Return On Average Assets | Fluctuating between 1% and 2%<br>Average of 1.5% over 10 years |
| Core Earnings | Growth proportional to AUM |
| Net Interest Margin | Fluctuating between 4% and 4.8%<br>Average slightly more than the competition |
| Non-Performing Loans to Total Loans | Fluctuating between 0% and 1% with an average less than 1% |

**The Moat Around The Metrics**

Dominant Market Share in Niche Markets

The moat around PWODs outstanding profitability is the dominant market position in relatively small markets. The counties in which PWOD operates have small populations that would not profitability support additional competition. The bank is able to earn above average returns on capital due to this unique market position. It is important that the company continues to focus on customer service and cutting costs to sustain this competitive advantage, but we firmly believe that PWOD management will continue to operate with excellence and dominant these niche markets.

**Risks**

All banks carry risk due to the highly leveraged nature of the business. As such, we intend to limit this position size to 7% of portfolio assets based on cost. Below are the primary risks we've assumed as owners of PWOD.

Short-Term Risks

- Interest rates increase sharply. This would reduce income for approximately 1 year. Management has intentionally reduced the net interest margin in the past few months by shortening the duration of the investment portfolio to protect against rising rates. In the event that rates do rise profitability would be compressed over the short-term, but return to normal levels in the long-term.
    - Low Risk
- Regional Recession. It is possible that the geographic regions where PWOD operates could experience short-term economic difficulties, such as the loss of a major employer in the region. In the event of a local recession or hardship we anticipate the bank to fully recover over the longer term.
    - Moderate Risk

Long-Term Risks

- Poor Underwriting Standards. In the event that PWOD underwriting standards are compromised and lower quality loans are issued the future of the business may be jeopardized. In the event of a material change in underwriting standards, such as the issuance of sub-prime loans, we would consider exiting the position immediately.
    - Moderate Risk
- Increasing Competition. It is possible that as the population of the geographic regions served by PWOD continue to rise competition will enter the area and bring down overall returns on capital. We believe this risk is low due to the exceptional management of PWODs and the fanatic approach to cutting costs and serving customers with excellence. As the population increases PWODs should be able to preemptively open new locations to keep competition at bay.
    - Low Risk
- Regulatory changes. It is possible that the government will enact changes to the banking sector, like the Dodd Frank Act, that would have material changes on the industry. We view this long-term risk as low. Historically when regulation changes businesses are able to adapt operations to maintain appropriate levels of profitability.
    - Low Risk

**Conclusion**

PWOD is a stable banking operation with outstanding returns on assets at nearly double the national average. The bank pays a hefty 4.5% dividend and is a superior investment to cash. Our purchase price of 14x earnings compares favorably to the average S&P 500 constituent which is priced at 18x earnings. We believe that PWOD will continue to payout approximately 66% of all earnings for the foreseeable future and prefer this investment to idle cash. Due to the relatively low prospects for growth we would be content selling this position for a modest gain.

**Works Cited**

1) *PWOD Annual Report - SEC Filing 10-K.* EDGAR, 2013.

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