

Orrstown Financial Services, Inc.

(ORRF - NASDAQ)

Rating/Risk: Outperform/Moderate  
Price: \$16.96  
Target Price: \$20.00 (Prior \$18.50)

**Reported 1Q15 Results: Reiterate Outperform Rating; Adjusting Estimates and Raising Target Price; "And They're Off..."**

**Investment Conclusion:** With the termination of its Written Agreement with the Federal Reserve of Philadelphia, Orrstown moves wholly into the next stage. Rather than straddling the line between spending resources on heightened regulatory compliance and growing in the market, the company can now look to growth. Additionally, the added compliance burden of the past few years, painful as it was, has made Orrstown a better bank, in our opinion, with the infrastructure, policies, and procedures of a \$3.0 billion institution, following the Russian proverb, "If trouble comes, make use of it". We believe taking this stronger institution full bore into a market facing disruption from two acquisitions, **S&T Bancorp, Inc.'s (STBA-\$27.43; Neutral)** completed purchase of Integrity Bancshares and **BB&T Corp.'s (BBT-\$37.86; NR)** pending acquisition of **Susquehanna Bancshares, Inc. (SUSQ-\$13.41; Underperform; TP: \$13.50)**, should bode well for the company and shareholders. As such we are maintaining our Outperform rating on shares of ORRF. Our new \$20.00 target price is based on a peer multiple applied to our estimate for year-end 2015 tangible book value of \$17.02.

**Key Points:**

- **Reported Results:** Orrstown reported 1Q15 Normalized Tax Operating EPS (NTOEPS) of \$0.16 vs. \$0.14 in the year-prior quarter. Our estimate was \$0.16. GAAP EPS were \$0.30 and included \$1.5 million in pretax securities gains.
- **Net Interest Margin (NIM):** On a sequential-quarter basis, NIM expanded one basis point to 3.18%. Comparing average and period-end balance sheets suggests the timing of loan growth and cash on the balance sheet was slightly unmatched, hindering NIM expansion somewhat. At present, we expect NIM to expand three bps per quarter through the modeling period as loan growth is funded by a shift in earning asset mix.
- **Balance Sheet Growth:** On a linked-quarter basis, period-end loans grew 14.0%. The purge of loans that no longer meet the company's risk tolerance appears done, and the past years' hires appear to be generating a solid pipeline. We expect loan growth will moderate to a 10.0% annualized rate for each of the next three quarters. Period-end deposits contracted 1.7%, annualized, as the company does not need to raise funding with a loan-to-deposit ratio of roughly 77.0%.
- **Asset Quality:** Asset quality was stable during 1Q15. **We anticipate further improvement and reduction of the ALLL/total loans ratio, which ended the quarter at 1.97%.**
- **Capital:** Orrstown ended 1Q15 with a TCE ratio of approximately 11.0%; in essence, over-capitalized. Orrstown announced they will reinstate a dividend for retail shareholders of \$0.07 per share, and we believe they will use additional capital to fund organic growth, acquisitions, and/or share repurchases, in that order of priority.
- **Earnings Outlook:** We are increasing our 2014 NTOEPS from \$0.77 to \$0.80, but reducing our 2016 estimate from \$1.17 to \$1.15. There are no major adjustments to our estimates, but rather a number of small tweaks that account for the adjustments.

April 24, 2015

**FINANCIALS**

**Normalized Tax Operating EPS Estimates**

Current	Q1	Q2	Q3	Q4	FY
2014A	\$0.14	\$0.21	\$0.41	\$0.24	\$1.00
2015E*	\$0.16	\$0.19	\$0.22	\$0.24	\$0.80
2016E	-	-	-	-	\$1.15
<i>*Q1 represents actual results</i>					
Prior	Q1	Q2	Q3	Q4	FY
2015	\$0.16	\$0.18	\$0.21	\$0.23	\$0.77
2016	-	-	-	-	\$1.17
Consensus	Q1	Q2	Q3	Q4	FY
2015	\$0.16	\$0.20	\$0.23	\$0.25	\$0.83
2016	\$0.23	\$0.25	\$0.28	\$0.29	\$1.11

**Market Data**

Current Price	\$16.96
52 Week Range	\$16.31 - \$17.50
Market Cap (mm)	\$140.63
Shares Outstanding	8,134,000
52 Week ADTV	5,482
Dividend Yield	1.7%
Institutional Ownership	35%

**Financial Data**

Total Assets (mm)	\$1,189
Total Deposits (mm)	\$946
Tang. Book Value per Share	\$16.21
Tang. Common Equity/Tang. Assets	11.06%
Net Interest Margin	3.18%
Efficiency Ratio	83.72%
ROAA	0.83%
ROAE	7.60%
NPAs/ Total Assets	1.38%
Annualized NCOs/ Avg. Loans	0.16%
Loan Loss Reserves/ Gross Loans	1.97%

Quarter ended March 31, 2015  
Source: SNL Financial and B&S Estimates

**Matthew Schultheis, CFA**  
610.832.5290  
mschultheis@boenninginc.com

**Scott Beury**  
610.862.5337  
sbeury@boenninginc.com

PRICE AS OF PRIOR DAY'S CLOSE

PLEASE SEE THE IMPORTANT DISCLOSURE APPENDIX ON PAGES 4 AND 5

## **RECOMMENDATION/VALUATION**

We are maintaining our Outperform rating and raising our target price from \$18.50 to \$20.00 on shares of ORRF. Our target price is based on a peer multiple applied to our year-end 2015 estimate for tangible book value of \$17.02. We believe the main catalyst for the shares will be a steady grind of loan growth and improving operating metrics (ROA, ROE, etc.).

## **RISKS**

We see two risks (no matter how slim the probability) to an investment in ORRF shares: (1) a general deterioration of economic conditions in the company's markets resulting in deteriorating credit quality and reduced earnings vis-à-vis expectations, and (2) the deployment of excess capital done imprudently through either irrationally priced loan growth or an ill-conceived merger.

	2013A			2014A			2015E			2016E		
	FY 2013	3/31/14A	6/30/14A	9/30/14A	12/31/14A	FY 2014	3/31/15A	6/30/15E	9/30/15E	12/31/15E	FY 2015	FY 2016E
<b>Average Balance Sheet (\$000)</b>												
Loans	683,313	672,364	677,923	686,644	698,229	683,790	713,330	741,767	759,654	777,972	748,180	807,713
Interest-Earning Assets	1,118,698	1,098,229	1,122,673	1,112,037	1,111,259	1,111,050	1,099,534	1,086,772	1,094,833	1,102,954	1,096,023	1,123,558
Total Assets	1,188,636	1,159,207	1,183,895	1,172,954	1,177,349	1,173,351	1,181,232	1,193,831	1,202,686	1,211,606	1,197,339	1,234,240
Common Equity	88,542	93,939	98,918	103,200	108,755	101,203	129,617	132,815	134,907	137,294	133,658	144,165
<b>Income Statement (\$000)</b>												
Net Interest Income (FTE)	33,882	8,942	8,901	8,776	8,874	35,493	8,619	8,721	8,868	9,017	35,225	37,586
Provision for Loan Loss	-3,150	0	0	-2,900	-1,000	-3,900	0	252	249	245	745	1,048
Fee Income	17,476	3,841	4,536	4,283	4,259	16,919	3,839	4,445	4,497	4,472	17,253	18,116
Sec. Gains & Other	332	597	602	469	267	1,935	1,529	0	0	0	1,529	0
Total Non-Interest Income	17,808	4,438	5,138	4,752	4,526	18,854	5,368	4,445	4,497	4,472	18,782	18,116
Non-Interest Expenses	43,247	10,976	10,765	10,898	11,129	43,768	10,506	10,599	10,392	10,218	41,714	40,271
Non-Recurring Costs	0	0	0	0	0	0	0	0	0	0	0	0
Total Non-Interest Expenses	43,247	10,976	10,765	10,898	11,129	43,768	10,506	10,599	10,392	10,218	41,714	40,271
Pretax Income	11,593	2,404	3,274	5,530	3,271	14,479	3,481	2,316	2,725	3,026	11,548	14,383
Taxes	1,589	426	401	353	-15,843	-14,663	1,019	394	463	514	2,390	2,445
Net Income	10,004	1,978	2,873	5,177	19,114	29,142	2,462	1,922	2,262	2,511	9,157	11,938
Preferred Dividends	0	0	0	0	0	0	0	0	0	0	0	0
Net to Common	10,004	1,978	2,873	5,177	19,114	29,142	2,462	1,922	2,262	2,511	9,157	11,938
Avg. Diluted Shares (000)	8,093	8,108	8,110	8,122	8,124	8,116	8,134	8,134	8,134	8,134	8,134	8,134
Reported EPS	\$1.24	\$0.24	\$0.35	\$0.64	\$2.35	\$3.59	\$0.30	\$0.24	\$0.28	\$0.31	\$1.13	\$1.47
Non-Recurring EPS	\$0.03	\$0.05	\$0.05	\$0.04	\$0.02	\$0.16	\$0.12	\$0.00	\$0.00	\$0.00	\$0.12	\$0.00
Operating EPS	\$1.21	\$0.20	\$0.31	\$0.60	\$2.33	\$3.43	\$0.18	\$0.24	\$0.28	\$0.31	\$1.00	\$1.47
Operating EPS (Normalized Taxes)	\$0.90	\$0.14	\$0.21	\$0.41	\$0.24	\$1.00	\$0.16	\$0.19	\$0.22	\$0.24	\$0.80	\$1.15
Margin (FTE) (%)	3.03	3.30	3.18	3.13	3.17	3.20	3.18	3.21	3.24	3.27	3.23	3.35
Net Charge-Off Ratio (%)	0.08	0.28	0.04	0.88	0.16	0.34	0.15	0.15	0.15	0.15	0.15	0.23
Efficiency Ratio (%)	84.19	85.86	80.11	83.45	84.74	83.54	83.00	80.50	77.75	75.75	79.25	72.38
Tax Rate (%)	14.33	17.72	12.25	6.38	-484.35	-112.00	29.27	17.00	17.00	17.00	20.07	17.00
ROA (%)	0.84	0.68	0.97	1.77	6.49	2.48	0.83	0.64	0.75	0.83	0.76	0.97
ROE (%)	11.27	8.42	11.62	20.07	70.30	27.60	7.60	5.79	6.71	7.32	6.85	8.26
Tangible Book Per Share (\$)	11.28	11.87	12.63	13.11	15.66	15.66	16.21	16.45	16.72	17.03	17.03	18.50
Tang. Com. Eq./Tang. Asssts. (%)	7.76	8.03	8.78	9.00	10.69	10.69	11.09	11.16	11.27	11.39	11.39	12.01

Source: Company reports and B&S estimates

## Disclosure Appendix

### Rating and Price Target History:



### Risk Factors:

The realization of any or all of the following risk factors, among others, may adversely affect the company's stock and prevent it from reaching our target price: downturn in the economy, change in the valuation of mid- and large-cap banks, regulatory changes, flatness or inversion of the yield curve and unanticipated large credit losses.

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Our three-tier investment ratings are based on a stock's return potential relative to a broad market index:

- **Outperform (Buy)**: The security's total return over the year or longer is expected to exceed the total return of the S&P 500™ over the identical period.
- **Neutral (Hold)**: The security's total return over the next year or longer is expected to be roughly equivalent to the total return of the S&P 500™ over the identical period.
- **Underperform (Sell)**: The security's total return over the next year or longer is expected to be less than the total return of the S&P 500™ over the identical period.

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- **Moderate**: The security has average fundamental predictability and/or average price volatility.
- **High**: The security has lower-than-average fundamental predictability and/or higher-than-average price volatility.
- **Speculative**: The security has very inconsistent fundamental predictability and/or very high relative price volatility.

## Ratings Distribution (12/31/14):

<u>Coverage Universe (b)</u>	<u>% of Universe</u>	<u>Investment Banking Clients (a)</u>	<u>% of Rating Group</u>
Outperform (Buy)	52%	Outperform (Buy)	18%
Neutral (Hold)	43%	Neutral (Hold)	9%
Underperform (Sell)	6%	Underperform (Sell)	0%

(a) Related to services provided within the past 12 months.

(b) Total may not add up to 100% due to rounding.

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## BOENNING & SCATTERGOOD INSTITUTIONAL CONTACTS

### ■ RESEARCH ANALYSTS

Financial Services	Matthew Schultheis, CFA	mschultheis@boenninginc.com	610.832.5290
Water and Agriculture	Ryan M. Connors	rconnors@boenninginc.com	610.832.5212

### ■ RESEARCH ASSOCIATES

Financial Services	Scott Beury	sbeury@boenninginc.com	610.862.5337
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### ■ INSTITUTIONAL SALES

Columbus	Nicholas Bicking	nbicking@boenninginc.com	866.326.8113
Columbus	Thomas Dooley	tdooley@boenninginc.com	866.326.8113
Europe/New York	Scott Seidl	sseidl@boenninginc.com	212.922.1459
Midwest	Ian Burke	iburke@boenninginc.com	610.832.5264
New England	Scott Spottiswoode	sspottiswoode@boenninginc.com	866.326.8094
New York	Peter Homsher	phomsher@boenninginc.com	610.832.5315
Northeast	Eugene Bodo	ebodo@boenninginc.com	610.862.5368
Northeast	Joseph Morrissey	jmorrissey@boenninginc.com	610.862.5361
Northeast/Southeast	Rich Farr	rfarr@boenninginc.com	610.684.5423

### ■ AGENCY TRADING

Brendan Kenny		bkenny@boenninginc.com	212.209.3903
Melissa Donahue		mdonahue@boenninginc.com	610.862.5330
Michael McCarthy		mmccarthy@boenninginc.com	610.862.5330
Thomas Bell		tbell@boenninginc.com	610.862.5330
Stephen Marcell		smarcell@boenninginc.com	212.209.3903

### ■ MARKET MAKING

Jeff McMurray		jmcurray@boenninginc.com	610.862.5360
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### ■ DERIVATIVE STRATEGY

Louis DePaul		ldepaul@boenninginc.com	610.832.5275
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4 TOWER BRIDGE \* 200 BARR HARBOR DRIVE \* SUITE 300 \* W. CONSHOHOCKEN, PA 19428-2979  
WWW.BOENNINGINC.COM  
MEMBER FINRA/SIPC