

PEOPLES FINANCIAL SERVICES CORP.

Form 424B3

October 10, 2013

Table of Contents

Filed Pursuant to Rule 424(b)(3)  
Registration No. 333-190587

**Joint Proxy Statement/Prospectus For 4,466,086 Shares of  
Peoples Financial Services Corp. Common Stock  
Merger Proposal Your Vote Is Very Important**

To: The shareholders of Peoples Financial Services Corp. and Penseco Financial Services Corporation

The boards of directors of Peoples Financial Services Corp. and Penseco Financial Services Corporation have each unanimously approved a transaction in which Penseco will merge with and into Peoples. Pursuant to the terms of the Agreement and Plan of Merger, dated as of June 28, 2013, as amended, Penseco will merge with and into Peoples, and Penn Security Bank and Trust Company, the wholly-owned subsidiary of Penseco will merge with and into Peoples Neighborhood Bank, the wholly-owned subsidiary of Peoples. The resulting bank will be named Peoples Security Bank and Trust Company.

In the merger, Penseco shareholders will receive 1.3636 shares of Peoples common stock for each share of Penseco common stock they own at the effective time of the merger, subject to adjustment in accordance with the merger agreement, and discussed in greater detail under Proposal: The Merger Terms of the Merger beginning on page 40. Penseco shareholders also will receive cash instead of any fractional shares they would have otherwise received in the merger. Peoples estimates that it will issue approximately 4,466,086 shares of Peoples common stock, \$2.00 par value per share, in the merger. Immediately following the merger, former Peoples shareholders are expected to own approximately 40.8% of Peoples common stock, and former Penseco shareholders are expected to own approximately 59.2% of Peoples common stock.

Peoples common stock is quoted on the OTCQB market place maintained by OTC Market Groups, Inc. under the symbol PFIS. On October 4, 2013, the closing price of Peoples common stock was \$35.00. The price of Peoples common stock will fluctuate between now and the closing of the merger. Penseco is quoted on the OTCQB market place maintained by OTC Market Groups, Inc. under the symbol PFNS. On October 4, 2013, the closing price of Penseco common stock was \$44.00. The price of Penseco common stock will fluctuate between now and the closing of the merger. We urge you to obtain current market quotations for both Peoples and Penseco common stock.

Peoples will hold a special meeting of its shareholders to vote on the approval and adoption of the merger agreement on November 15, 2013, 2013, at 10:00 a.m. at American Legion Post 357, 612 New York Avenue, Hallstead, Pennsylvania 18822. Penseco will hold a special meeting of its shareholders to vote on the approval and adoption of the merger agreement on November 21, 2013, at 2:00 p.m. at the Hilton Scranton and Conference Center, 100 Adams Avenue, Scranton, Pennsylvania 18503. We cannot complete the merger unless the holders of at least a majority of the outstanding shares of Peoples common stock entitled to vote at the special meeting of shareholders approve and adopt the merger agreement and the merger agreement is approved and adopted by the affirmative vote of the holders of at least 75% of the outstanding shares of Penseco common stock.

As a Peoples or Penseco shareholder, you have the right under Pennsylvania law to dissent from the merger and to demand and receive cash payment of a statutorily determined fair value of your common stock in the event that the merger is consummated. The statutorily determined fair value could be more or less than the value of the merger consideration. For more information regarding dissenters rights, refer to Q-14: Do I have the right to dissent from the merger? on page 5 and Proposal: The Merger Rights of Dissenting Shareholders beginning on page 92.

Each of the Peoples and Penseco board of directors unanimously recommends that you vote FOR the approval and adoption of the merger agreement. All shareholders of Peoples and Penseco are invited to attend their respective special meeting in person. However, whether or not you plan to attend the special meeting, please take the time to ensure your shares are voted by submitting a proxy, either by mailing the enclosed proxy card or by following the instructions for internet or telephone submission.

**Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of the common stock of Peoples to be issued in this merger or passed upon the adequacy or accuracy of this joint proxy statement/prospectus. Any representation to the contrary is a criminal offense.**

**The shares of Peoples common stock offered are not savings or deposit accounts or other obligations of either party or any of their banking or other subsidiaries, and they are not insured by any federal or state governmental agency.**

**Investing in Peoples common stock involves risks that are described in Risk Factors beginning on page 25.**

This joint proxy statement/prospectus is dated October 10, 2013 and is first being mailed to shareholders of Peoples and Pensco on or about October 11, 2013.

**Table of Contents**

**Peoples Financial Services Corp.**

**82 Franklin Avenue**

**Hallstead, PA 18822**

**Notice of Special Meeting of Shareholders**

**NOTICE IS HEREBY GIVEN** that a special meeting of shareholders of Peoples Financial Services Corp. will be held at 10:00 a.m., local time, on November 15, 2013 at American Legion Post 357, 612 New York Avenue, Hallstead, Pennsylvania 18822, for the following purposes:

1. To approve and adopt the Agreement and Plan of Merger, dated as of June 28, 2013, as amended, by and between Peoples Financial Services Corp. and Pensco Financial Services Corporation, which provides, among other things, for the merger of Pensco with and into Peoples, and the conversion of each share of Pensco common stock immediately outstanding prior to the merger into 1.3636 shares of Peoples common stock, all as described in the accompanying documents, and transactions in connection therewith;
2. To amend Article 4 of Peoples Articles of Incorporation to increase the number of authorized shares of Peoples common stock, \$2.00 par value per share, from 12,500,000 shares to 25,000,000 shares;
3. To approve on an advisory (non-binding) basis the golden parachute compensation payable to the named executive officers of Peoples and Pensco in connection with the merger;
4. To consider and vote upon a proposal to adjourn or postpone the special meeting of shareholders, if more time is needed, to allow Peoples time to solicit additional votes in favor of the merger agreement and the amendment to the articles of incorporation; and

5. To transact such other business as may properly come before the meeting or any adjournment or postponement thereof.

The Peoples board of directors unanimously recommends that you vote FOR the approval and adoption of the Agreement and Plan of Merger, FOR the approval and adoption of the amendment to the articles of incorporation, FOR the approval of the advisory (non-binding) resolution approving the golden parachute compensation payable to the named executive officers of Peoples and Pensco in connection with the merger, and FOR the approval of the proposal granting the Peoples board of directors discretionary authority to adjourn or postpone the special meeting, if necessary, as described in detail in the accompanying joint proxy statement/prospectus.

The Peoples board of directors has fixed the close of business on September 27, 2013, as the record date for determining shareholders entitled to notice of, and to vote at, the special meeting of shareholders.

***Your vote is important regardless of the number of shares you own. Peoples cannot complete the merger unless the merger agreement is approved and adopted by the affirmative vote of the holders of at least a majority of the outstanding shares of Peoples common stock entitled to vote on the merger agreement. If a Peoples shareholder does not vote by proxy or by attending the Peoples special meeting of shareholders and voting in person, it will have the same effect as voting against the merger.***

Whether or not you plan to attend the special meeting, the Peoples board of directors urges you to complete, sign, date, and return the enclosed proxy card as soon as possible in the enclosed postage-paid envelope. This will not prevent you from voting in person at the special meeting but will assure that your vote is counted if you are unable to attend. If you are a shareholder whose shares are registered in street name, you will need additional documentation from your broker in order to vote personally at the special meeting.

By Order of the Board of Directors,

Alan W. Dakey  
*President and Chief Executive Officer*

Hallstead, Pennsylvania

October 10, 2013

**Table of Contents**

**Penseco Financial Services Corporation**

**150 North Washington Avenue**

**Scranton, PA 18503**

**Notice of Special Meeting of Shareholders**

**NOTICE IS HEREBY GIVEN** that a special meeting of shareholders of Penseco Financial Services Corporation will be held at 2:00 p.m., local time, on November 21, 2013 at the Hilton Scranton and Conference Center, 100 Adams Avenue, Scranton, Pennsylvania 18503, for the following purposes:

1. a proposal to approve and adopt the Agreement and Plan of Merger, dated as of June 28, 2013, as amended, by and between Peoples Financial Services Corp. and Penseco Financial Services Corporation, which provides, among other things, for the merger of Penseco with and into Peoples, and the conversion of each share of Penseco common stock immediately outstanding prior to the merger into 1.3636 shares of Peoples common stock, all as described in the accompanying documents;
2. a proposal to approve, on an advisory basis, the compensation of the named executive officers of Penseco that is based on or related to the proposed merger; and
3. a proposal to adjourn the special meeting, if necessary, to solicit additional proxies in the event that there are not sufficient votes at the time of the special meeting to approve the proposal to approve and adopt the merger agreement.

In accordance with the Penseco's bylaws, only the business conducted at the special meeting will be the business brought before the special meeting pursuant to this notice.

The Penseco board of directors unanimously recommends that you vote **FOR** the proposal to approve and adopt the Agreement and Plan of Merger, **FOR** the proposal to approve, on an advisory basis, the compensation of the named executive officers of Penseco that is based on or related to the proposed merger, and **FOR** the approval the proposal to adjourn the special meeting, if necessary.

Shareholders of record of the Penseco common stock of at the close of business on September 27, 2013 are entitled to vote at the Penseco special meeting and any adjournment or postponement of the special meeting.

***Your vote is important regardless of the number of shares you own. Penseco cannot complete the merger unless the merger agreement is approved and adopted by the affirmative vote of the holders of at least 75% of the outstanding shares of Penseco common stock. If a Penseco shareholder does not vote by proxy or by attending the Penseco special meeting of shareholders and voting in person, it will have the same effect as voting against the merger.***

Whether or not you plan to attend the special meeting, the Penseco board of directors urges you to submit your proxy as soon as possible, either by completing, signing, dating, and returning the enclosed proxy in the enclosed postage-paid envelope or by following the internet and telephone instructions included in the attached materials. Submitting your proxy will not prevent you from voting in person at the special meeting, but it will assure that your vote is counted if you are unable to attend. If you are a shareholder whose shares are registered in street name, you will need to follow the instructions provided by your broker, and you will need additional documentation from your broker in order to vote in person at the special meeting.

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By Order of the Board of Directors,

Craig W. Best  
*President and Chief Executive Officer*

Scranton, Pennsylvania

October 10, 2013

**Table of Contents**

**HOW TO OBTAIN MORE INFORMATION**

This document incorporates by reference important business and financial information about Penseco that is not included in or delivered with this document. You can obtain free copies of this information through the SEC website at <http://www.sec.gov> or by writing or calling:

Penseco Financial Services Corporation

150 North Washington Avenue

Scranton, PA 18503

Telephone number 570-346-7741

Attention: Marie L. Luciani, Investor Relations Officer, or Joan Rotondaro

**In order to obtain timely delivery of the documents, you must request the information no later than five business days before the date of Penseco's special meeting. This means that Penseco shareholders requesting documents must do so by November 14, 2013 in order to receive them before the Penseco special meeting.**

See "Where You Can Find More Information" on page 181 and "Incorporation of Certain Information by Reference" on page 181.

All information concerning Peoples and its subsidiaries has been furnished by Peoples and all information concerning Penseco and its subsidiaries has been furnished by Penseco.

**You should rely only on the information contained or incorporated by reference in this proxy statement/prospectus when evaluating the merger agreement and the proposed merger. We have not authorized anyone to provide you with information that is different from what is contained in this joint proxy statement/prospectus. This proxy statement/prospectus is dated October 10, 2013. You should not assume that the information contained in this proxy statement/prospectus is accurate as of any date other than such date, and neither the mailing of this joint proxy statement/prospectus to shareholders of Peoples and Penseco nor the issuance of shares of Peoples common stock as contemplated by the merger agreement shall create any implication to the contrary.**

**Table of Contents****Table of Contents**

<u>Questions and Answers about the Merger</u>	3
<u>Summary</u>	8
<u>Selected Historical Consolidated Financial Data of Peoples</u>	17
<u>Selected Historical Consolidated Financial Data of Penseco</u>	19
<u>Selected Unaudited Pro Forma Combined Financial Data</u>	21
<u>Comparative Pro Forma Per Share Data</u>	23
<u>Risk Factors</u>	25
<u>A Warning About Forward-Looking Information</u>	34
<u>The Peoples Special Meeting of Shareholders</u>	34
<u>The Penseco Special Meeting of Shareholders</u>	37
<u>Proposal: The Merger</u>	40
<u>General</u>	40
<u>Background of the Merger</u>	41
<u>Certain Non-Public, Forward-Looking Information Exchanged by Peoples and Penseco</u>	47
<u>Peoples' Reasons for the Merger</u>	48
<u>Recommendation of the Peoples Board of Directors</u>	51
<u>Opinion of Peoples' Financial Advisor</u>	51
<u>Penseco's Reasons for the Merger</u>	59
<u>Recommendation of the Penseco Board of Directors</u>	62
<u>Opinion of Penseco's Financial Advisor</u>	62
<u>Terms of the Merger</u>	70
<u>Interests of Directors, Officers, and Others in the Merger</u>	83
<u>Accounting Treatment</u>	89
<u>Material U.S. Federal Income Tax Consequences</u>	89
<u>Resales of Peoples Common Stock</u>	91
<u>Application to be Listed on The Nasdaq Stock Market, Inc. or New York Stock Exchange</u>	91
<u>Rights of Dissenting Shareholders</u>	92
<u>Description of Peoples</u>	94
<u>General</u>	94
<u>Property</u>	106
<u>Legal Proceedings</u>	106
<u>Information about Peoples' Directors</u>	106
<u>Beneficial Ownership</u>	121
<u>Related Party Transactions</u>	122
<u>Changes in and Disagreements with Accountants on Accounting and Financial Disclosure</u>	122
<u>Management's Discussion and Analysis of Financial Condition and Results of Operations of Peoples Financial Services Corp. Six Months Ended June 30, 2013 and 2012</u>	124
<u>Management's Discussion and Analysis of Financial Condition and Results of Operations of Peoples Financial Services Corp. Years Ended December 31, 2012 and 2011</u>	133
<u>Management's Discussion and Analysis of Financial Condition and Results of Operations of Peoples Financial Services Corp. Years Ended December 31, 2011 and 2010</u>	159
<u>Qualitative and Quantitative Disclosures about Market Risk</u>	168
<u>Description of Peoples Capital Securities</u>	169
<u>Description of Peoples' Common Stock</u>	169
<u>Comparison of Shareholders' Rights</u>	171
<u>Number of Authorized Shares of Capital Stock</u>	172
<u>Share Certificates</u>	172
<u>Annual Shareholder Meeting</u>	172
<u>Special Meetings of Shareholders</u>	172
<u>Notice of Shareholder Meetings</u>	172



**Table of Contents**

<u>Fixing the Record Date</u>	172
<u>Composition of the Board of Directors</u>	173
<u>Composition of Board of Director Committees</u>	173
<u>Advance Notice Requirement for Nomination of Candidates for Director</u>	174
<u>Advance Notice Requirement for Business to be Conducted at Annual Meeting</u>	174
<u>Amendment of Articles of Incorporation</u>	175
<u>Amendment of Bylaws</u>	176
<u>Fundamental Changes</u>	176
<u>Anti-Takeover Provisions Applicable to Registered Corporations</u>	176
<u>Directors Duty to Consider a Merger or Combination with Another Corporation</u>	177
<u>Peoples Proposal No. 2: Amendment to Peoples Articles of Incorporation to Increase Authorized Number of Shares</u>	178
<u>Peoples Proposal 3: Advisory (Non-Binding) Vote on Golden Parachute Compensation</u>	179
<u>Penseco Proposal 2: Advisory (Non-Binding) Vote on Golden Parachute Compensation</u>	180
<u>Proposal: Adjournment or Postponement of Special Meeting</u>	180
<u>Experts</u>	181
<u>Legal Matters</u>	181
<u>Where You Can Find More Information</u>	181
<u>Incorporation of Certain Information by Reference</u>	181
<u>Other Business</u>	182
<u>Shareholder Proposals</u>	182
<u>Consolidated Financial Statements of Peoples Financial Services Corp.</u>	F-1
<u>Unaudited Pro Forma Combined Financial Information</u>	F-66
<u>Agreement and Plan of Merger, as amended</u>	Annex A
<u>Opinion of Boenning &amp; Scattergood, Inc.</u>	Annex B
<u>Opinion of Griffin Financial Group, Inc.</u>	Annex C
<u>Dissenters Rights Provisions</u>	Annex D

**Table of Contents**

**Questions and Answers about the Merger**

**Q-1: Why am I receiving this document?**

A: You are receiving this document because Peoples and Pensco signed an Agreement and Plan of Merger, dated as of June 28, 2013, as amended, which provides, among other things, for the merger of Pensco with and into Peoples, and the conversion of each share of Pensco common stock outstanding immediately prior to the consummation of the merger into 1.3636 shares of Peoples common stock.

**Q-2: What is the purpose of this document?**

A: This document serves as both a proxy statement of Peoples and Pensco and a prospectus of Peoples. This document serves as a proxy statement because the Peoples and Pensco boards of directors are soliciting your proxy for use at the Peoples and Pensco special meetings of shareholders called to consider and vote on the merger agreement. This document serves as a prospectus because Peoples is offering shareholders of Pensco to exchange their shares of Pensco common stock for shares of Peoples common stock in the merger.

**Q-3: What items of business will Peoples and Pensco ask shareholders to consider at the special meetings?**

A: At the Peoples special meeting, shareholders are asked to vote in favor of approval and adoption of the merger agreement with Pensco. In addition, shareholders will be asked to vote in favor of an amendment to the articles of incorporation, cast an advisory (non-binding) vote on the golden parachute compensation payable to the named executive officers of Peoples and Pensco in connection with the merger, and vote in favor of a proposal to adjourn or postpone the special meeting, if necessary, to solicit additional proxies if we have not received sufficient votes to adopt the merger agreement at the time of the special meeting.

At the Pensco special meeting, shareholders are asked to vote in favor of approval and adoption of the merger agreement with Peoples. In addition, shareholders will be asked to cast an advisory (non-binding) vote on the golden parachute compensation, that is compensation based on or related to the proposed merger, payable to the named executive officers of Pensco in connection with the merger, and vote in favor of a proposal to adjourn or postpone our special meeting, if necessary, to solicit additional proxies if we have not received sufficient votes to adopt the merger agreement at the time of our special meeting.

**Q-4: Why are Peoples and Pensco proposing to merge?**

A: The boards of directors of Peoples and Pensco believe that a merger of the two companies will create a stronger and more capable entity than either Peoples or Pensco is likely to be alone. Each board of directors believes the merger will provide an opportunity for each company to capitalize on its resources in the short-term and strengthen their prospects for the continued growth over the long-term. The merger also involves certain risks, which are described under Risk Factors beginning on page 25.

**Q-5: Will Peoples Neighborhood Bank and Penn Security Bank and Trust Company change their names after the merger?**

A: Yes. Following the effective time of the merger of Pensco with and into Peoples, Penn Security Bank and Trust Company will merge with and into Peoples Neighborhood Bank. The resulting bank will be named Peoples Security Bank and Trust Company.



## **Table of Contents**

### **Q-6: What do the Peoples and Penseco boards of directors recommend?**

A: The Peoples and Penseco boards of directors have approved the merger agreement and the merger, and each believes that the merger is in the best interests of Peoples and Penseco. Accordingly, the Peoples board of directors unanimously recommends that their shareholders vote FOR the approval and adoption of the merger agreement and the merger, FOR the approval and adoption of the amendment to the articles of incorporation, FOR the approval of the advisory (non-binding) resolution approving the golden parachute compensation payable to the named executive officers of Peoples and Penseco in connection with the merger, and FOR the approval of the proposal granting the Peoples board of directors discretionary authority to adjourn or postpone the special meeting, if necessary. The Penseco board of directors unanimously recommends that you vote FOR the proposal to approve and adopt the merger agreement, FOR the proposal to approve, on an advisory basis, the compensation of the named executive officers of Penseco that is based on or related to the proposed merger, and FOR the approval of the proposal to adjourn the special meeting, if necessary.

### **Q-7: When do Peoples and Penseco expect to complete the merger?**

A: Peoples and Penseco expect to complete the merger shortly after all of the conditions to the merger are fulfilled, including obtaining the approval of Peoples shareholders, the approval of Penseco shareholders, and the approval of the applicable regulatory agencies. We anticipate this will occur in late 2013. Peoples and Penseco cannot assure you that they will obtain the necessary shareholder approvals and regulatory approvals or the other conditions precedent to the merger can or will be satisfied.

### **Q-8: What will Penseco shareholders receive in the merger?**

A: Record holders of Penseco common stock will receive 1.3636 shares of Peoples common stock for every share of Penseco common stock they own on the effective time of the merger and will receive cash instead of any fractional share they would have otherwise received in the merger. The exchange ratio is subject to adjustment as discussed in greater detail under Proposal: The Merger Terms of the Merger, beginning on page 40.

### **Q-9: Why is Peoples proposing to amend its articles of incorporation?**

A: Currently, Peoples articles of incorporation only permit the issuance of 12,500,000 shares of common stock. However, in order to effect the merger, Peoples will have to issue an additional 4,466,086 shares of common stock in addition to the current 3,087,206 shares of common stock outstanding and 5,800 shares of common stock reserved for issuance. While, Peoples will have enough common stock shares authorized to issue to effect the merger under the current articles of incorporation, in order to provide flexibility, the board of directors believes it is in the best interests of Peoples and its shareholders to have more shares authorized for any future financings, investment opportunities, acquisitions of other companies, declaration of stock dividends, stock splits or other distributions, or for other corporate purposes.

### **Q-10: Why am I being asked to cast an advisory (non-binding) vote to approve the golden parachute compensation payable to certain officers in connection with the merger?**

A: The SEC, in accordance with the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, adopted rules that require the companies to seek an advisory (non-binding) vote with respect to certain payments that will or may be made to each company's named executive officers in connection with the merger.



## **Table of Contents**

### **Q-11: What will happen if shareholders do not approve the golden parachute compensation at the special meetings?**

A: Approval of the golden parachute compensation payable in connection with the merger is not a condition to completion of the merger. The votes with respect to the golden parachute compensation are advisory and will not be binding on either Peoples or Penseco (or the combined company that results from the merger) regardless of whether the merger agreement is approved and adopted. Accordingly, as the compensation to be paid to certain of the executives in connection with the merger is contractual, such compensation will or may be payable if the merger is completed regardless of the outcome of the advisory votes.

### **Q-12: Are there regulatory or other conditions to the merger occurring?**

A: Yes. The merger must be approved by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation (FDIC) and the Pennsylvania Department of Banking and Securities. As of the date of this joint proxy statement/prospectus, appropriate applications have been filed with these regulatory authorities. On October 7, 2013, Peoples received approval from the Federal Reserve Bank of Philadelphia, acting on delegated authority of the Federal Reserve Board, of its application to merge with Penseco.

Furthermore, the merger will only be completed if neither Peoples nor Penseco is in material breach of any of its representations, warranties, or obligations under the merger agreement. The merger is also subject to the condition that Peoples and Penseco each receive an opinion from their respective counsel that the merger will be treated as a reorganization under Section 368(a) of the Internal Revenue Code of 1986. The merger is also subject to certain other specified conditions. See Proposal: The Merger Terms of the Merger Conditions to Merger, beginning at page 77.

### **Q-13: What vote is required to approve the merger?**

A: Both Peoples shareholders and Penseco shareholders must adopt and approve the merger agreement in accordance with each of its articles of incorporation and bylaws. As the board of directors of Peoples has already approved the merger agreement by at least 66 2/3% of the board, the affirmative vote of the holders of at least a majority of the outstanding shares of Peoples common stock on the record date is necessary to approve and adopt the merger agreement. The affirmative vote of the holders of at least 75% of the outstanding shares of Penseco common stock on the record date is necessary to approve and adopt the merger agreement.

### **Q-14: Do I have the right to dissent from the merger?**

A: Yes. As a Peoples or Penseco shareholder, you have the right under Pennsylvania law to dissent from the merger and to demand and receive a cash payment of the statutorily determined fair value of your common stock in the event that the merger is consummated. The statutorily determined fair value could be more or less than the value of the merger consideration. In order to assert dissenters rights, shareholders must precisely follow the process described in Proposal: The Merger Rights of Dissenting Shareholders beginning on page 92 and in Annex D.

Generally, shareholders who wish to dissent must:

1. File with the corporation of which they are a shareholder a written notice of their intention to demand that they be paid the fair value for their shares of Peoples or Penseco common stock, as the case may be, rather than receive shares of Peoples common stock as described in the merger agreement prior to the respective vote of shareholders on the merger at the Peoples or Penseco special meeting called for such purpose.
- 2.

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The dissenting shareholders must effect no change in the beneficial ownership of their Peoples or Pensco common stock, as the case may be, from the date of the filing of the intention to demand payment through the effective time of the merger if the shareholders approve and adopt the merger and the merger agreement.

## **Table of Contents**

3. Dissenting shareholders also must vote against the merger, abstain from voting for the merger or not vote their Peoples or Penseco common stock at the special meeting called for such purpose.

You also are encouraged to consult with your own legal advisor as to your dissenters' rights under Pennsylvania law. Failure to strictly comply with these procedures will result in the loss of these dissenters' rights and your ability to receive cash for the fair value of your common stock of either Peoples or Penseco.

### **Q-15: What do I need to do now?**

A: After you have carefully read these materials, indicate on the enclosed proxy card how you want to vote your shares of either Peoples or Penseco. Then sign, date, and mail the proxy card in the enclosed postage-paid envelope as soon as possible so your shares will be represented and voted at either the Peoples or Penseco special meeting. Alternatively, you can submit your proxy by following the internet or telephone instructions included in the following materials and on your proxy card.

### **Q-16: Should Penseco shareholders send in their stock certificates now?**

A: No. Penseco shareholders should not send in their stock certificates at this time. Penseco shareholders will receive instructions from the exchange agent at a later time. Peoples shareholders will not need to exchange their certificates. See Proposal The Merger Terms of the Merger Exchange Procedures on page 71.

Please do not send any stock certificates to Peoples, Penseco, or the exchange agent until you receive instructions.

### **Q-17: Can I change my vote after I have submitted my proxy?**

A: Yes. There are three ways for you to revoke your proxy and change your vote:

1. You may submit a later-dated, proxy before Peoples' or Penseco's special meeting, as either relates to you.
2. You may revoke your proxy by written notice delivered at any time prior to the vote on the merger including delivery at the special meeting of shareholders. Peoples shareholders should deliver this notice to the Corporate Secretary, and Penseco shareholders should deliver this notice to the Secretary.
3. You may attend the Peoples or Penseco special meeting and vote in person. If you have instructed a broker to vote your shares, you must follow directions received from your broker to change your vote.

### **Q-18: What are the material U.S. federal income tax consequences of the merger to Penseco shareholders?**

A: The merger is intended to qualify as a reorganization within the meaning of Section 368(a) of the Internal Revenue Code of 1986, as amended, and the holders of Penseco common stock generally will not recognize any gain or loss for U.S. federal income tax purposes on the exchange of shares of Penseco common stock for shares of Peoples common stock in the merger, except with respect to any cash received in lieu of fractional shares. This tax treatment may not apply to all Penseco shareholders.



**We urge you to consult your tax advisor for a full understanding of the tax consequences of the merger to you. Tax matters are very complicated and, in many cases, tax consequences of the**

**Table of Contents**

merger will depend on your particular facts and circumstances. See **Proposal The Merger Material U.S. Federal Income Tax Consequences**, beginning at page 89.

**Q-19: What happens if my stock certificates are held in street name by my broker, bank, or other nominee?**

A: Your broker, bank, or other nominee will not vote your shares unless you provide instructions to your broker, bank, or other nominee on how to vote. You should fill out the voter instruction form sent to you by your broker, bank, or other nominee with this document.

**Q-20: Whom should I call with questions or to obtain additional copies of this document?**

A: If you have questions about your special meeting of shareholders or if you need additional copies of this document, you should contact:

**For Peoples Shareholders:**

Scott A. Seasock

Senior Vice President and Chief Financial Officer

Peoples Financial Services Corp.

82 Franklin Avenue

Hallstead, PA 18822

(570) 897-2175

**For Penseco Shareholders:**

Marie L. Luciani

Investor Relations Officer

or Joan Rotondaro

Penseco Financial Services Corporation

150 North Washington Avenue

Scranton, PA 18503

(570) 346-7741

In addition, you may also contact Regan & Associates, Inc., Peoples and Penseco's proxy solicitor at the following address and telephone number:

Regan & Associates, Inc.

505 Eighth Avenue, Suite 800, New York, New York 10018

(212) 587-3005

info@reganproxy.com

## **Table of Contents**

### **Summary**

*This summary highlights selected information from this document. It does not contain all of the information that may be important to you. You should carefully read this entire document and the other documents referred to in this document before you decide how to vote. Together these documents will give you a more complete description of the proposed transaction. Page references are included in this summary to direct you to more thorough descriptions of the topics provided elsewhere in these materials.*

### **The Special Meetings of Shareholders**

#### **Peoples special meeting of shareholders to be held November 15, 2013 (see page 34).**

Peoples will hold a special meeting of shareholders on November 15, 2013, at 10:00 a.m., local time, at American Legion Post 357, 612 New York Avenue, Hallstead, Pennsylvania 18822.

#### **Penseco special meeting of shareholders to be held November 21, 2013 (see page 37).**

Penseco will hold a special meeting of shareholders on November 21, 2013, at 2:00 p.m., local time, at the Hilton Scranton and Conference Center, 100 Adams Avenue, Scranton, Pennsylvania 18503.

#### **Peoples record date set at September 27, 2013; one vote per share of Peoples common stock (see page 34).**

If you owned shares of Peoples common stock at the close of business on September 27, 2013, you are entitled to notice of, and to vote at, the special meeting of shareholders. You will have one vote at the special meeting for each share of Peoples common stock you owned on September 27, 2013. On September 27, 2013, there were 3,087,406 shares of Peoples common stock outstanding.

#### **Penseco record date set at September 27, 2013; one vote per share of Penseco common stock (see page 37).**

If you owned shares of Penseco common stock at the close of business on September 27, 2013, you are entitled to notice of, and to vote at, the special meeting of shareholders. You will have one vote at the special meeting for each share of Penseco common stock you owned on September 27, 2013. On September 27, 2013, there were 3,285,145 shares of Penseco common stock outstanding.

### **The Companies**

#### **Peoples Financial Services Corp.**

**82 Franklin Avenue**

**Hallstead, PA 18822**

**(570) 879-2175**

Peoples Financial Services Corp., with assets of approximately \$689.0 million as of June 30, 2013, is the holding company for Peoples Neighborhood Bank. Peoples stock is quoted on the OTCQB market place under the symbol **PFIS**. For more information, visit Peoples Neighborhood Bank website at [www.peoplesnatbank.com](http://www.peoplesnatbank.com). The information on Peoples website is not incorporated into this joint proxy statement/prospectus.

#### **Penseco Financial Services Corporation**

**150 North Washington Avenue**

**Scranton, PA 18503**

**(570) 346-7741**



## **Table of Contents**

Penseco Financial Services Corporation, with assets of approximately \$919.7 million as of June 30, 2013, is the holding company for Penn Security Bank and Trust Company. Penseco stock is quoted on the OTCQB market place under the symbol PFNS. For more information, visit the Penseco website at [www.pennsecurity.com](http://www.pennsecurity.com). The information on Penseco's website is not incorporated into this joint proxy statement/prospectus.

### **We propose that Penseco merge with and into Peoples (see page 40).**

Under the terms of the merger agreement, Penseco will merge with and into Peoples. As soon as practicable but no earlier than the first business day after the merger, Penn Security Bank and Trust Company will merge with and into Peoples Neighborhood Bank, and the resulting institution will be named Peoples Security Bank and Trust Company. A copy of the merger agreement is attached to this document as Annex A and a copy of the plan of merger for the banks is attached as Exhibit 3 to the merger agreement.

### **The boards of directors of Peoples and Penseco are unanimously recommending a vote in favor of the merger and believe that a merger of the two companies will create a stronger and more capable entity than either Peoples or Penseco is likely to be alone.**

Both boards of directors of Peoples and Penseco are unanimously recommending its respective shareholders vote in favor of the merger. The reasons we are recommending approval of the merger include the potential revenue and cost synergies and the resulting increase in earnings and expansion of market diversity. Each board of directors believes the merger will provide an opportunity for the combined company to capitalize on its assets in the short-term and strengthen their prospects for continued growth over the long-term. We believe this growth will be sufficient to overcome the costs arising from the merger. Furthermore, since the two companies serve markets that are geographically complementary to the other, the combined entity would have a more diverse market concentration than either of the two companies on their own.

### **Penseco shareholders will receive shares of Peoples common stock (see page 70).**

At the effective time of the merger, each outstanding share of Penseco common stock will be converted into and become the right to receive 1.3636 shares of Peoples common stock. The exchange ratio is subject to adjustment as discussed in greater detail under Proposal: The Merger Terms of the Merger, beginning on page 70. Peoples will not issue fractional shares of its common stock as part of the merger and will instead pay cash for any fractional share of common stock a shareholder of Penseco would have otherwise received in the merger.

### **Peoples has received an opinion from its financial advisor that the exchange ratio is fair, from a financial point of view, to the shareholders of Peoples (see page 51).**

In connection with the merger, the board of directors of Peoples received a written opinion from Peoples' financial advisor, Boenning & Scattergood, Inc., as to the fairness, from a financial point of view, of the exchange ratio to the shareholders of Peoples. The full text of the opinion of Boenning & Scattergood, dated as of June 28, 2013, is included in this document as Annex B. We encourage you to read this opinion carefully in its entirety for a description of the procedures followed, assumptions made, matters considered, and limitations of the review undertaken by Boenning & Scattergood. The opinion of Boenning & Scattergood is directed to Peoples' board of directors and does not constitute a recommendation to you or any other shareholder as to how to vote with respect to the merger or any other matter relating to the proposed merger. Boenning & Scattergood will receive a fee for its services, including rendering the fairness opinion, in connection with the merger.

## **Table of Contents**

**Penseco has received an opinion from its financial advisor that the exchange ratio is fair, from a financial point of view, to the shareholders of Penseco (see page 62).**

In connection with the merger, the board of directors of Penseco received a written opinion from Penseco's financial advisor, Griffin Financial Group, LLC, as to the fairness of the exchange ratio, from a financial point of view, to the shareholders of Penseco. The full text of the opinion of Griffin, dated as of June 28, 2013, is included in this document as Annex C. We encourage you to read this opinion carefully in its entirety for a description of the procedures followed, assumptions made, matters considered, and limitations of the review undertaken by Griffin. The opinion of Griffin is directed to Penseco's board of directors and does not constitute a recommendation to you or any other shareholder as to how to vote with respect to the merger, the form of consideration to be received in the merger, or any other matter relating to the proposed merger. Griffin will receive a fee for its services, including rendering the fairness opinion, in connection with the merger.

**Peoples engaged Penseco's financial consultant to assist management in preparing *pro forma* financial information.**

In connection with the evaluation of a potential transaction with Peoples, Penseco engaged Cedar Hill Advisors, LLC to assist it in preparing certain financial modeling. Subsequently, in connection with the preparation of this joint proxy statement/prospectus, related registration statement and other regulatory applications, Peoples engaged Cedar Hill to assist management in the preparation of certain *pro forma* financial information related to the merger presented elsewhere in this document. Peoples and Penseco are aware of the potential conflicts that might arise from each of them engaging Cedar Hill in the same transaction, albeit for different purposes.

**Peoples Shareholder Vote Required (see page 35).**

*Approval and Adoption of the Merger Agreement.* Since Peoples' board of directors unanimously approved the merger agreement and merger, Peoples' articles of incorporation require the approval and adoption of the merger agreement and the merger by an affirmative vote, in person or by proxy, of at least a majority of the outstanding shares of Peoples common stock on the record date.

*Approval and Adoption of the Amendment to the Articles of Incorporation.* The affirmative vote of a majority of the shares of Peoples common stock voted at the special meeting of shareholders is required to approve and adopt the amendment to Peoples' articles of incorporation to increase the number of authorized shares of common stock from 12,500,000 to 25,000,000.

*Advisory (Non-binding) Vote Regarding Golden Parachute Compensation.* The affirmative vote of a majority of the votes cast by the holders of Peoples common stock entitled to vote on that matter at a shareholders' meeting at which a quorum is present, is required to approve on an advisory (non-binding) basis, golden parachute compensation payable to the named executive officers of Peoples and Penseco in connection with the merger.

*Discretionary Authority to Adjourn the Special Meeting.* The affirmative vote of the holders of a majority of the votes cast by the holders of Peoples common stock entitled to vote on the adjournment proposal is required to approve the proposal to grant discretionary authority to the Peoples board of directors to adjourn the special meeting if necessary to solicit additional proxies from Peoples shareholders in the event a quorum is present at our special meeting but there are insufficient votes to adopt the merger agreement.

Each holder of shares of Peoples common stock outstanding on the record date will be entitled to one vote for each share held of record. The vote required for approval and adoption of the merger agreement is a

## **Table of Contents**

percentage of all outstanding shares of Peoples common stock. Therefore, abstentions will have the same effect as a vote against the merger agreement and the merger. Brokers who hold Peoples common stock as nominees on your behalf will not have authority to vote your shares with respect to the merger agreement or the merger unless you provide voting instructions in accordance with the directions provided by your broker. Failure to provide your broker with voting instructions will have the same effect as a vote against the merger agreement.

### **Penseco Shareholder Vote Required (see page 37).**

*Approval and Adoption of the Merger Agreement.* Penseco's articles of incorporation require the approval and adoption of the merger agreement and the merger by an affirmative vote of at least 75% of the shares of Penseco common stock outstanding on the record date.

*Advisory (Non-binding) Vote Regarding Golden Parachute Compensation.* In accordance with Penseco's bylaws, the affirmative vote of a majority of Penseco shares represented, in person or by proxy, at the special meeting is required to approve, on an advisory basis, the compensation of Penseco's named executive officers that is based on or related to the proposed merger.

*Discretionary Authority to Adjourn the Special Meeting.* In accordance with Penseco's bylaws, the affirmative vote of a majority of Penseco shares represented, in person or by proxy, at the special meeting is required to approve the proposal to adjourn the special meeting, if necessary, to solicit additional proxies in the event that there are not sufficient votes at the time of the special meeting to approve the proposal to approve and adopt the merger agreement.

Each holder of shares of Penseco common stock outstanding on the record date will be entitled to one vote for each share held of record. The vote required for approval and adoption of the merger agreement is a percentage of all outstanding shares of Penseco common stock. Therefore, abstentions will have the same effect as a vote against the merger agreement and the merger. Brokers who hold Penseco common stock as nominees on your behalf will not have authority to vote your shares with respect to the merger agreement or the merger unless you provide voting instructions in accordance with the directions provided by your broker. Failure to provide your broker with voting instructions will have the same effect as a vote against the merger agreement.

### **Peoples directors and executive officers have agreed to vote in favor of the merger (see page 35).**

On September 30, 2013, the directors and executive officers of Peoples had sole or shared voting power over 222,791 shares, or 7.21 %, of the outstanding shares of Peoples common stock. These directors and officers of Peoples have agreed to vote these shares of Peoples common stock in favor of approving and adopting of the merger agreement.

### **Penseco directors and executive officers have agreed to vote in favor of the merger (see page 37).**

On September 30, 2013, the directors and executive officers of Penseco had sole or shared voting power over 413,701 shares, or 12.6%, of the outstanding shares of Penseco common stock. These directors and officers of Penseco have agreed with Peoples to vote these shares of Penseco common stock in favor of approving and adopting the merger agreement.

### **Peoples and Penseco directors and management may have interests in the merger that differ from your interests (see page 83).**

The directors and certain officers of each of Peoples and Penseco and their subsidiaries have interests in the merger as directors and employees that are different from or in addition to yours as a Peoples or Penseco

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**Table of Contents**

shareholder. These interests include, among others, provisions in the merger agreement regarding the resulting Peoples and Peoples Security Bank and Trust Company boards, as well as change in control agreements, employment agreements, supplemental executive retirement plans, deferred compensation plans, indemnification, insurance, stock options, restricted stock plans, and eligibility to participate in various employee benefit plans. For purposes of the Peoples agreements and plans generally, and for certain Pensco agreements and plans, the completion of the transactions contemplated by the merger agreement will constitute a change in control. Alan Dakey is expected to enter into a consulting agreement wherein he will assist with the integration of Penn Security Bank and Trust Company into Peoples Neighborhood Bank for a six month period following the merger for which he will be paid \$95,000. Mr. Ferretti will be offered a new employment agreement which will provide for a base salary of \$175,000, a maximum bonus of twenty (20%) percent of his salary, and a supplemental executive retirement plan providing for a benefit of \$40,000 for 10 years. If the merger would have closed on June 20, 2013, Mr. Dakey would have received approximately \$668,420 (subject to a gross down) as payment under his employment agreement and supplemental executive retirement plan and Mr. Ferretti would have received approximately \$381,537 as payment under his supplemental executive retirement plan and a retention bonus. Mr. Seasock will receive approximately \$151,943 as a payment under his supplemental executive retirement plan and Ms. Dissinger will become fully vested in her supplemental executive retirement plan which will pay her \$20,000 per year for 15 years beginning when she reaches age 65. The Peoples directors will become vested in a director retirement plan, if not already vested, which will pay each director \$150 for each year of service for ten years. Mr. Scanlon will receive approximately \$38,191 which represents the value of his vested account balance under Pensco's executive deferred compensation plan. These additional interests may create potential conflicts of interest and cause some of these persons to view the proposed transaction differently than you may view it as a shareholder.

Each of Peoples and Pensco's board of directors was aware of these interests and considered them in approving and recommending the merger agreement.

**Peoples and Pensco must obtain regulatory approval and satisfy other conditions before the merger is complete (see page 77).**

Peoples and Pensco's obligations to complete the merger and the bank merger are subject to various conditions that are usual and customary for this kind of transaction. These conditions include obtaining approval from the Federal Reserve Board, the FDIC and the Pennsylvania Department of Banking and Securities. As of the date of this document, appropriate applications for approval have been filed. On October 7, 2013, Peoples received approval from the Federal Reserve Bank of Philadelphia, acting on delegated authority of the Federal Reserve Board, of its application to merge with Pensco. In addition to the required regulatory approvals, the merger will only be completed if certain conditions are met. See Proposal The Merger Terms of the Merger Conditions to Merger .

**Amendment or termination of the merger agreement is possible (see page 79).**

Peoples and Pensco can agree to amend the merger agreement in any way, except that, after approval by Peoples and Pensco shareholders at their special meetings, Peoples and Pensco cannot change the amount of Peoples common stock Pensco shareholders will receive in the transaction from what is provided in the merger agreement. On September 17, 2013, Peoples and Pensco entered into an Amendment No. 1 to the Agreement and Plan of Merger which would permit Peoples to pursue a listing of its common stock on either The Nasdaq Stock Market, Inc. or the New York Stock Exchange following the merger.

Peoples and Pensco may agree to terminate the merger agreement and not complete the merger at any time before the merger is completed. Each company also may unilaterally terminate the merger agreement in certain circumstances. These include the failure to complete the merger by March 31, 2014, unless the terminating company's breach is the reason the merger has not been completed.



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## **Table of Contents**

### **Rights of Penseco shareholders differ from those of Peoples shareholders (see page 171).**

When the merger is complete, Penseco shareholders will automatically become Peoples shareholders. The rights of Penseco shareholders differ from the rights of Peoples shareholders in certain important ways. Many of these differences have to do with provisions in Penseco's articles of incorporation and bylaws that differ from those of Peoples. See [Comparison of Shareholders' Rights](#).

### **Material U.S. federal income tax consequences of the merger (see page 89).**

The merger is intended to qualify as a reorganization within the meaning of Section 368(a) of the Internal Revenue Code of 1986, as amended, and the holders of Penseco common stock generally will not recognize any gain or loss for U.S. federal income tax purposes on the exchange of shares of Penseco common stock for shares of Peoples common stock in the merger, except with respect to any cash received in lieu of fractional shares. This tax treatment may not apply to all Penseco shareholders.

**We urge you to consult your tax advisor for a full understanding of the specific tax consequences of the merger to you. Tax matters are very complicated and, in many cases, tax consequences of the merger will depend on your particular facts and circumstances. See [Proposal The Merger Material U.S. Federal Income Tax Consequences](#), beginning at page 89.**

### **Peoples and Penseco shareholders are entitled to dissenters' rights (see page 92).**

As a Peoples or Penseco shareholder, you have the right under Pennsylvania law to dissent from the merger and to demand and receive a cash payment for the statutorily determined fair value of your common stock in the event that the merger is completed. The statutorily determined fair value could be more or less than the value of the merger consideration. In order to assert dissenters' rights, shareholders must precisely follow the process described in [Proposal The Merger Rights of Dissenting Shareholders](#) and in Annex D. These sources describe provisions of Pennsylvania law related to dissenters' rights. You also are encouraged to consult with your own legal advisor as to your dissenters' rights under Pennsylvania law. Failure to strictly comply with these procedures will result in the loss of these dissenters' rights and your ability to receive cash for the statutorily determined fair value of your common stock of either Peoples or Penseco.

### **Peoples will pursue a Nasdaq or NYSE listing of its common stock (see page 91).**

Peoples and Penseco have agreed to use their commercially reasonable best efforts to obtain a listing for trading of Peoples common stock on The Nasdaq Stock Market, Inc. (Nasdaq) or the New York Stock Exchange (NYSE) as soon as practical after the effective time of the merger. However, Peoples common stock may not become listed on Nasdaq, NYSE, or any other exchange. See page 32 of [Risk Factors](#).

### **Peoples and Penseco will maintain a significant presence in their communities (see page 77).**

For at least three years after the effective time of the merger, the headquarters and loan operations of the companied company and bank will be located in Scranton, Pennsylvania, and the deposit operations and data processing of the companied company and bank will be located in Hallstead, Pennsylvania.

## **Market Price and Dividend Information**

### *Peoples*

As of September 30, 2013, there were 3,087,406 shares of Peoples common stock outstanding, which were held by approximately 1,044 holders of record and outstanding options that were exercisable on that date (or within 60 days of that date) for 5,600 additional shares of Peoples common stock. The number of shareholders does not reflect the number of individuals or institutional investors holding stock in nominee name through banks, brokerage firms, and others.

**Table of Contents**

Additionally, a substantial source of Peoples' income from which it can pay dividends is the receipt of dividends from Peoples Neighborhood Bank. The availability of dividends from Peoples Neighborhood Bank is limited by various statutes and regulations. It also is possible, depending on the financial condition of Peoples Neighborhood Bank, and other factors, that the applicable regulatory authorities could assert that payment of dividends or other payments is an unsafe or unsound banking practice. In the event that Peoples Neighborhood Bank is unable to pay dividends to Peoples, Peoples may not be able to pay dividends on its common stock.

Peoples common stock is listed on the OTCQB market place under the symbol PFIS. The following table shows, for the indicated periods, the high and low sales prices per share for Peoples common stock as reported on the OTCQB market place and dividends declared per share of Peoples common stock. These prices may include retail markups, markdowns, or commissions.

	High	Low	Dividend Declared
<b>2013</b>			
First Quarter	\$ 34.00	\$ 30.05	\$ 0.23
Second Quarter	39.90	33.00	0.23
Third Quarter	35.50	33.50	0.23
Fourth Quarter (through October 4, 2013)	35.00	34.00	
<b>2012</b>			
First Quarter	\$ 29.00	\$ 27.50	\$ 0.21
Second Quarter	30.00	28.00	0.21
Third Quarter	31.00	28.80	0.22
Fourth Quarter	31.00	29.50	0.22
<b>2011</b>			
First Quarter	\$ 28.00	\$ 26.31	\$ 0.20
Second Quarter	27.50	25.50	0.20
Third Quarter	28.25	26.90	0.20
Fourth Quarter	28.25	27.05	0.20

On June 28, 2013, the last full trading day before the public announcement of the execution of the merger agreement, and on October 4, 2013, the latest practicable trading day before the printing of this document, the high, low and closing sales prices for Peoples common stock were as follows:

	June 28, 2013			October 4, 2013		
	High	Low	Closing	High	Low	Closing
Peoples Common Stock	\$ 35.25	\$ 35.25	\$ 35.25	\$ 35.00	\$ 35.00	\$ 35.00
<i>Penseco</i>						

As of September 30, 2013, there were 3,285,145 shares of Penseco common stock outstanding which were held by approximately 1,075 holders of record. The number of shareholders does not reflect the number of individuals or institutional investors holding stock in nominee name through banks, brokerage firms, and others.

Penseco common stock is listed on the OTCQB market place under the symbol PFNS. The following table shows, for the indicated periods, the high and low sales prices per share for Penseco common stock as

**Table of Contents**

reported on the OTCQB market place and dividends declared per share of Penseco common stock. These prices may include retail markups, markdowns, or commissions.

	High	Low	Dividend Declared
<b>2013</b>			
First Quarter	\$ 38.00	\$ 37.00	\$ 0.42
Second Quarter	41.50	37.10	0.42
Third Quarter	45.50	40.50	0.42
Fourth Quarter (through October 4, 2013)	45.00	43.85	
<b>2012</b>			
First Quarter	\$ 40.00	\$ 36.58	\$ 0.42
Second Quarter	41.00	37.50	0.42
Third Quarter	38.35	36.90	0.42
Fourth Quarter	39.00	36.95	0.42
<b>2011</b>			
First Quarter	\$ 40.00	\$ 35.55	\$ 0.42
Second Quarter	39.25	37.00	0.42
Third Quarter	40.00	36.25	0.42
Fourth Quarter	39.00	36.87	0.42

On June 28, 2013, the last full trading day before the public announcement of the execution of the merger agreement, and on October 4, 2013, the latest practicable trading day before the printing of this document, the high, low and closing sales prices for Penseco common stock were as follows:

	June 28, 2013			October 4, 2013		
	High	Low	Closing	High	Low	Closing
Penseco Common Stock	\$ 41.50	\$ 38.00	\$ 41.50	\$ 44.00	\$ 44.00	\$ 44.00

Pursuant to the merger agreement, Peoples and Penseco have agreed to coordinate with one another with respect to regular quarterly dividends to ensure that holders of Penseco common stock do not receive two dividends, or fail to receive one dividend, for any quarter with respect to their shares of Penseco common stock and any shares of Peoples common stock received in the merger. In addition, Peoples and Penseco have agreed that for at least five years after the merger, Peoples will pay a quarterly cash dividend in an amount no less than \$.31 per share, provided that sufficient funds are legally available for payment of dividends and that Peoples and the combined bank remains well-capitalized in accordance with applicable regulatory guidelines. The post-merger quarterly dividend may only be reduced below \$.31 per share upon the approval of 80% of the board of directors.

**Comparative Market Value**

The following table sets forth the market value per share of Peoples and Penseco common stock and the equivalent market value per share of Penseco common stock on June 28, 2013 (the date of the public announcement of the merger) and October 4, 2013 (the latest practicable trading day prior to the date of this document). The equivalent market value is based upon an assumed exchange ratio of 1.3636 shares of Peoples common stock multiplied by the closing sales price of Peoples common stock on the specified date.

	Peoples Historical	Penseco Historical	Penseco Equivalent Market Value
June 28, 2013	\$ 35.25	\$ 41.50	\$ 48.07
October 4, 2013	\$ 35.00	\$ 44.00	\$ 47.73



**Table of Contents**

**Advisory (Non-binding) Votes on Golden Parachute Compensation (Pages 179 and 180)**

In accordance with SEC rules, Peoples and Pensco are providing shareholders with the opportunity to vote to approve on an advisory (non-binding) basis, certain payments that will or may be made to certain named executive officers in connection with the merger, as reported in the Summary of Golden Parachute Arrangements tables on pages 84 and 86, and the associated narrative discussions.

**Adjournment or Postponement Proposals (Page 180)**

You are being asked to approve a proposal to grant the Peoples and Pensco boards of directors discretionary authority to adjourn or postpone the special meetings, if necessary, to solicit additional proxies from their shareholders for the merger proposal in the event a quorum is present at the special meeting but there are insufficient votes to adopt the merger agreement.

**Table of Contents****Selected Historical Consolidated Financial Data of Peoples**

The following is a summary of consolidated financial information with respect to Peoples as of and for the six months ended June 30, 2013 and 2012, and as of and for the fiscal years ended December 31, 2012, 2011, 2010, 2009 and 2008. The results for the six months ended June 30, 2013 are not necessarily indicative of the results to be expected for the full year. This information is derived from, and should be read in conjunction with, Peoples' consolidated financial statements and the accompanying notes and Management's Discussion and Analysis of Financial Condition and Results of Operations of Peoples Financial Services Corp. for the Six Months Ended June 30, 2013 and 2012, Management's Discussion and Analysis of Financial Condition and Results of Operations of Peoples Financial Services Corp. for the Years Ended December 31, 2012 and 2011, and Management's Discussion and Analysis of Financial Condition and Results of Operations of Peoples Financial Services Corp. for the Years Ended December 31, 2011 and 2010, each of which can be found elsewhere in this joint proxy statement/prospectus. In the opinion of management of Peoples, all adjustments, consisting only of normal recurring adjustments, necessary for a fair statement of results for or as of the six month interim periods have been made.

Management's Discussion and Analysis of Financial Condition and Results of Operations of Peoples Financial Services Corp. for the Years Ended December 31, 2012 and 2011, and Management's Discussion and Analysis of Financial Condition and Results of Operations of Peoples Financial Services Corp. for the Years Ended December 31, 2011 and 2010, each of which can be found elsewhere in this joint proxy statement/prospectus. In the opinion of management of Peoples, all adjustments, consisting only of normal recurring adjustments, necessary for a fair statement of results for or as of the six month interim periods have been made.

(Dollars in thousands, except per share data)	Year Ended December 31,	(Unaudited) As of or for the 6 months ended June 30,						
		2012	2011	2010	2009	2008	2013	2012
<b>Condensed statements of financial performance:</b>								
Interest income		\$ 27,779	\$ 27,350	\$ 25,577	\$ 24,273	\$ 25,479	\$ 14,111	\$ 13,955
Interest expense		5,112	5,639	6,498	7,258	9,154	2,148	2,573
Net interest income		22,667	21,711	19,079	17,015	16,325	11,963	11,382
Provision for loan losses		1,695	1,794	2,202	1,735	713	330	1,035
Net interest income after provision for loan losses		20,972	19,917	16,877	15,280	15,612	11,633	10,347
Noninterest income (loss)		4,846	5,567	4,290	3,082	(1,809)	2,348	2,573
Noninterest expense		14,713	15,310	13,245	12,390	10,677	8,109	7,212
Income before income taxes		11,105	10,174	7,922	5,972	3,126	5,872	5,708
Provision for income tax expense		1,985	2,357	1,437	923	87	1,310	1,004
Net income		\$ 9,120	\$ 7,817	\$ 6,485	\$ 5,049	\$ 3,039	\$ 4,562	\$ 4,704
<b>Condensed statements of financial position:</b>								
Investment securities		\$ 147,780	\$ 139,899	\$ 121,772	\$ 130,506	\$ 107,589	\$ 138,758	\$ 128,596
Net loans		459,192	439,754	386,672	332,196	313,606	485,478	451,138
Other assets		64,551	41,751	50,143	53,781	51,181	64,738	58,980
Total assets		\$ 671,523	\$ 621,404	\$ 558,587	\$ 516,483	\$ 472,376	\$ 688,974	\$ 638,714
Deposits		\$ 574,311	\$ 494,283	\$ 438,734	\$ 410,038	\$ 371,268	\$ 596,935	\$ 538,111
Short-term borrowings		12,764	43,791	38,724	20,439	18,432	17,972	13,233
Long-term debt		13,130	18,927	27,336	38,750	39,691	2,717	18,533
Other liabilities		5,122	4,790	3,277	2,286	3,265	3,760	4,961
Stockholders' equity		66,196	59,613	50,516	44,970	39,720	67,590	63,876
Total liabilities and stockholders' equity		\$ 671,523	\$ 621,404	\$ 558,587	\$ 516,483	\$ 472,376	\$ 688,974	\$ 638,714



**Table of Contents**

Year Ended December 31,							(Unaudited) As of or for the 6 months ended June 30,	
	2012	2011	2010	2009	2008	2013	2012	
<b>Per share data:</b>								
Net income	\$ 2.93	\$ 2.49	\$ 2.07	\$ 1.61	\$ 0.97	\$ 1.48	\$ 1.51	
Cash dividends declared	\$ 0.86	\$ 0.80	\$ 0.79	\$ 0.76	\$ 0.76	\$ 0.46	\$ 0.42	
Stockholders' equity	\$ 21.46	\$ 19.11	\$ 16.07	\$ 14.34	\$ 12.69	\$ 21.89	\$ 20.48	
Cash dividends declared as a percentage of net income	29.40%	32.28%	38.24%	47.15%	79.53%	31.13%	27.81%	
Average common shares outstanding	3,117,098	3,136,663	3,139,606	3,133,518	3,128,170	3,085,216	3,118,269	
<b>Selected ratios (based on average balances) (unaudited):</b>								
Net income as a percentage of total assets	1.42%	1.33%	1.18%	1.07%	0.68%	1.37%	1.51%	
Net income as a percentage of stockholders' equity	14.91	14.80	13.87	12.62	7.53	14.02	16.02	
Stockholders' equity as a percentage of total assets	9.55	8.99	8.53	8.50	9.01	9.77	9.42	
Tier I capital as a percentage of adjusted total assets	9.17	9.42	9.19	9.92	9.31	12.11	11.88	
Net interest income as a percentage of earning assets	3.97	4.18	4.00	4.23	4.25	3.99	4.10	
Loans, net, as a percentage of deposits	87.03%	89.70%	84.67%	87.33%	86.38%	82.85%	91.12%	
<b>Selected ratios and data (based on period end balances):</b>								
Tier I capital as a percentage of risk-weighted assets	12.11%	11.57%	11.72%	12.30%	12.26%	9.54%	9.33%	
Total capital as a percentage of risk-weighted assets	13.36	12.69	12.68	13.18	13.10	13.38	13.07	
Allowance for loan losses as a percentage of loans, net (unaudited)	1.41	1.20	1.05	0.99	0.95	1.37	1.29	
Nonperforming loans as a percentage of loans, net (unaudited)	2.24%	2.30%	1.77%	0.99%	1.63%	2.39%	2.14%	
Note: Average balances were calculated using average daily balances. Average balances for loans include nonaccrual loans. Tax-equivalent adjustments were calculated using the prevailing statutory rate of 34.0 percent.								



**Table of Contents****Selected Historical Consolidated Financial Data of Penseco**

The following selected financial information for the fiscal years ended December 31, 2012, 2011, 2010, 2009 and 2008 is derived from audited consolidated financial statements of Penseco. The financial information as of and for the six months ended June 30, 2013 and 2012 is derived from unaudited financial statements. The results of operations for the six months ended June 30, 2013 are not necessarily indicative of the results of operations for the full year or any other interim period. Penseco's management prepared the unaudited information on the same basis as it prepared Penseco's audited consolidated financial statements. In the opinion of Penseco's management, this information reflects all adjustments, consisting of only normal recurring adjustments, necessary for a fair presentation of this data for those dates. You should read this information in conjunction with Penseco's consolidated financial statements and related notes included in Penseco's Annual Report on Form 10-K for the year ended December 31, 2012, and Penseco's Quarterly Report on Form 10-Q for the quarter ended June 30, 2013, which are incorporated by reference herein and from which this information is derived. Please see "Where You Can Find More Information" on page 181.

(in thousands, except per share amounts)

**RESULTS OF OPERATIONS:**

	2012	2011	2010	2009	2008	As of or for the 6 months ended June 30,	
						2013	2012
Interest Income	\$ 37,591	\$ 39,707	\$ 41,745	\$ 40,151	\$ 33,898	\$ 17,627	\$ 19,148
Interest Expense	5,362	7,339	8,356	9,580	10,830	1,994	2,888
Net Interest Income	32,229	32,368	33,389	30,571	23,068	15,633	16,260
Provision for Loan and Lease Losses	924	2,381	1,999	2,260	861	800	306
Net Interest Income after Provision for Loan and Lease Losses	31,305	29,987	31,390	28,311	22,207	14,833	15,954
Non-Interest Income	11,441	12,619	12,152	10,369	11,036	5,883	5,516
Non-Interest Expenses	29,099	29,041	28,689	28,640	22,384	13,981	14,601
Income Taxes	3,058	3,034	3,287	1,813	2,386	1,370	1,540
Net Income	\$ 10,589	\$ 10,531	\$ 11,566	\$ 8,227	\$ 8,473	\$ 5,365	\$ 5,329

**BALANCE SHEET AMOUNTS (As of December 31):**

Assets	\$ 918,042	\$ 925,532	\$ 916,837	\$ 884,034	\$ 629,627	\$ 919,669	\$ 914,343
Investment Securities	177,293	191,208	217,044	195,930	151,912	172,218	184,886
Net Loans	616,580	624,811	608,605	597,670	435,873	634,801	632,032
Deposits	721,948	720,518	691,032	645,434	424,725	733,134	712,400
Long-Term Borrowings	45,397	58,220	68,835	68,094	72,720	35,633	51,792
Stockholders' Equity	\$ 132,446	\$ 127,333	\$ 120,466	\$ 116,024	\$ 72,361	\$ 132,885	\$ 130,367

**Table of Contents**

	2012	2011	2010	2009	2008	As of or for the 6 months ended June 30,	
						2013	2012
<b>PER SHARE AMOUNTS:</b>							
Earnings per Share Basic	\$ 3.23	\$ 3.21	\$ 3.53	\$ 2.75	\$ 3.94	\$ 1.64	\$ 1.63
Earnings per Share Diluted	\$ 3.23	\$ 3.21	\$ 3.53	\$ 2.75	\$ 3.94	\$ 1.64	\$ 1.63
Dividends per Share	\$ 1.68	\$ 1.68	\$ 1.68	\$ 1.68	\$ 1.66	\$ 0.84	\$ 0.84
Book Value per Share	\$ 40.43	\$ 38.87	\$ 36.77	\$ 38.75	\$ 33.69	\$ 40.56	\$ 39.79
Weighted Average Common Shares							
Outstanding Basic	3,276,079	3,276,079	3,276,079	2,994,059	2,148,000	3,276,079	3,276,079
Weighted Average Common Shares							
Outstanding Diluted	3,276,411	3,276,079	3,276,079	2,994,059	2,148,000	3,277,516	3,276,100
<b>FINANCIAL RATIOS:</b>							
Net Interest Margin (1)	4.05%	4.02%	4.39%	4.50%	4.34%	3.92%	4.09%
Return on Average Assets	1.14	1.13	1.30	1.02	1.37	1.16	1.15
Return on Average Equity	8.07	8.45	9.73	7.89	11.90	8.01	8.24
Average Equity to Average Assets	14.18	13.37	13.38	12.94	11.54	14.47	13.99
Dividend Payout Ratio	52.01%	52.34%	47.59%	61.09%	42.13%	51.22%	51.53%

(1) Net interest margin is presented on a tax equivalent basis.

**Table of Contents**

**Selected Unaudited *Pro Forma* Combined Financial Data for Peoples**

The following table shows information about the combined company's financial condition and results of operations, after giving effect to the merger. This information is called unaudited *pro forma* financial information in this document. The information under "Combined Income Statement" in the table below gives effect to the *pro forma* results for the six months ended June 30, 2013 and the year ended December 31, 2012. The information under "Combined Balance Sheet" in the table below assumes the merger was completed on June 30, 2013. This *pro forma* financial information assumes that the merger is accounted for as a reverse merger using the acquisition method of accounting and represents a current estimate of the financial information based on available financial information of Peoples and Pensco. See "Proposal: The Merger Accounting Treatment" on page 89.

The unaudited *pro forma* combined financial information includes adjustments to reflect the assets and liabilities of Peoples at their estimated fair values at or near June 30, 2013. The unaudited *pro forma* data, while helpful in illustrating the financial characteristics of the combined company under one set of assumptions, does not reflect the impact of factors that may result as a consequence of the merger or consider any potential impacts of current market conditions or the merger on revenues, expense efficiencies, asset dispositions and share repurchases, among other factors, nor the impact of possible business model changes. As a result, unaudited *pro forma* data is presented for illustrative purposes only and does not represent an attempt to predict or suggest future results.

The information presented below should be read together with the historical consolidated financial statements of Peoples and Pensco, including the related notes, and together with the consolidated historical financial data for Peoples and Pensco and the other *pro forma* financial information, including the related notes, appearing elsewhere in this document. See "Unaudited *Pro Forma* Combined Financial Information" beginning on page F-66 in the joint proxy statement/prospectus. In addition, as explained in more detail in the accompanying notes to the unaudited *pro forma* financial information found elsewhere in this joint proxy statement/prospectus, the allocation of the purchase price reflected in the Selected Unaudited *Pro Forma* Combined Financial Data is subject to adjustment and will vary from the actual purchase price allocation that will be recorded upon completion of the merger based upon changes in the balance sheet including fair value estimates.

**Table of Contents****Selected Unaudited Pro Forma Combined Financial Data**

(\$ In Thousands, Except Per Share Data)

	For the Year Ended December 31, 2012	For the Six Months Ended June 30, 2013
<b>Combined Income Statement (1)(2):</b>		
Interest income	\$ 65,150	\$ 31,628
Interest expense	9,316	3,563
Net interest income	55,834	28,065
Provision for loan losses	2,619	1,130
Net interest income after provision for loan losses	53,215	26,935
Noninterest income	16,287	8,231
Noninterest expenses	44,649	22,464
Income before income taxes	24,853	12,702
Provision for Income tax expense	5,078	2,706
Net income	\$ 19,775	\$ 9,996
<b>Combined Balance Sheets:</b>		
Investment securities		\$ 310,564
Net loans		1,121,001
Other assets		207,908
Total assets		\$ 1,639,473
Total deposits		\$ 1,333,144
Short-term borrowing		26,160
Long-term borrowing		38,350
Other liabilities		15,894
Stockholders' equity		225,925
Total liabilities and stockholders' equity		\$ 1,639,473

**Table of Contents****Comparative Pro Forma Per Share Data**

Presented below is the Penseco and Peoples historical per share financial data, the unaudited *pro forma* combined per share financial data, and the Penseco *pro forma* equivalent per share financial data for the six months ended June 30, 2013 and the year ended December 31, 2012. This information should be considered together with the financial statements and related notes of Penseco and Peoples and with the unaudited *pro forma* combined financial data included under *Unaudited Pro Forma Combined Financial Information* found elsewhere in this joint proxy statement/prospectus.

**Unaudited Pro Forma Per Share Data****For The Six Months Ended June 30, 2013**

(\$ In Thousands, Except Per Share Data)

	Accounting Acquirer Penseco Financial Services Corporation	Accounting Acquiree Peoples Financial Services Corp.	Pro Forma Peoples Combined (1)(2)(3)(4)	Pro Forma Equivalent Penseco Share (5)
<b>Earnings per share:</b>				
<b>For the six months ended June 30, 2013</b>				
Net income per share (Basic)	\$ 1.64	\$ 1.48	\$ 1.33	\$ 1.81
Net income per share (Diluted)	\$ 1.64	\$ 1.48	\$ 1.33	\$ 1.81
<b>Dividends Declared:</b>				
<b>For the six months ended June 30, 2013</b>				
	\$ 0.84	\$ 0.46	\$ 0.62	\$ 0.85
<b>Book Value:</b>				
<b>As of June 30, 2013</b>				
	\$ 40.56	\$ 21.89	\$ 29.96	\$ 40.85
<b>Tangible Book Value:</b>				
<b>As of June 30, 2013</b>				
	\$ 32.28	\$ 21.74	\$ 22.39	\$ 30.53

**Unaudited Pro Forma Per Share Data****For The Year Ended December 31, 2012**

(Amounts In Thousands, except per share data)

	Accounting Acquirer Penseco Financial Services Corporation	Accounting Acquiree Peoples Financial Services Corp.	Pro Forma Peoples Combined (1)(2)(3)(4)	Pro Forma Equivalent Penseco Share (5)
<b>Earnings per share:</b>				
<b>For the year ended December 31, 2012</b>				
Net income (loss) per share (Basic)	\$ 3.23	\$ 2.93	\$ 2.61	\$ 3.56
Net income (loss) per share (Diluted)	\$ 3.23	\$ 2.93	\$ 2.61	\$ 3.56
<b>Dividends Declared:</b>				
<b>For the year ended December 31, 2012</b>				
	\$ 1.68	\$ 0.86	\$ 1.24	\$ 1.69
<b>Book Value:</b>				
<b>As of December 31, 2012</b>				
	\$ 40.43	\$ 21.46	\$ 29.73	\$ 40.54
<b>Tangible Book Value:</b>				
<b>As of December 31, 2012</b>				
	\$ 32.11	\$ 21.29	\$ 22.13	\$ 30.18



**Table of Contents**

- (1) The pro forma combined basic earnings and diluted earnings per share of Peoples common stock is based on the pro forma combined net income for Peoples and Penseco divided by the pro forma common shares or diluted common shares of the combined entities. The pro forma information includes adjustments related to the fair value of assets and liabilities of Peoples and is subject to adjustment as additional information becomes available and as additional analysis are performed.
- (2) The pro forma earnings per share information does not include anticipated cost savings or revenue enhancements, nor does it include one-time merger and integration expenses which will be expensed against income. Peoples and Penseco currently anticipates potential annual pre-tax cost savings following the merger will be approximately \$7.1 million pre-tax, which are expectedly to largely be realized within one year after the merger, but there is no assurance that the anticipated cost savings will be realized on the anticipated time schedule or at all.
- (3) The pro forma combined balance sheet and book value per share data does include the impact of merger expenses on the balance sheet with Peoples after tax charges currently estimated at \$1.1 million, illustrated as a pro forma fair value liability accrual, and Penseco's after-tax estimated charges of \$0.9 million, illustrated as a pro forma adjustment to retained earnings. The pro forma combined book value and tangible book value per share of Peoples common stock is based on the pro forma combined common stockholders' equity of Peoples and Penseco divided by total pro forma common shares of the combined entities.
- (4) Pursuant to the merger agreement, Peoples and Penseco have agreed that for at least five years after the merger, Peoples will pay a quarterly cash dividend in an amount no less than \$0.31 per share, provided that sufficient funds are legally available for payment of dividends and that Peoples and the combined bank remains well-capitalized in accordance with applicable regulatory guidelines. The post-merger quarterly dividend may only be reduced below \$.31 per share upon the approval of 80% of the board of directors, accordingly the pro forma Peoples dividend is illustrated at \$0.31 per quarter.
- (5) Pro forma equivalent Penseco per share amount is calculated by multiplying the pro forma combined per share amount by the assumed exchange ratio of 1.3636.

## **Table of Contents**

### **Risk Factors**

In addition to the other information included and incorporated by reference into this joint proxy statement/prospectus, including the matters addressed in A Warning About Forward-Looking Information, on page 34, Peoples and Penseco shareholders should carefully consider the matters described below to determine whether to approve and adopt the merger agreement.

#### **Risks Relating to the Merger**

*Because the market price of Peoples common stock will fluctuate, Penseco shareholders cannot be sure of the trading price of the merger consideration they will receive.*

Upon completion of the merger, each share of Penseco common stock will be converted into the right to receive merger consideration consisting of shares of Peoples common stock. The exchange ratio in the merger agreement will not be adjusted in the event of any change in the stock prices of Peoples or Penseco prior to the merger. There also will be a period of time between the date when shareholders of each of Peoples and Penseco vote on the merger agreement and the date when the merger is completed. The relative prices of Peoples and Penseco common stock may vary between the date of this joint proxy statement/prospectus, the dates of the special meetings, and the date of completion of the merger. The market price of Peoples and Penseco common stock may change as a result of a variety of factors, including general market and economic conditions, changes in its business, operations and prospects, and regulatory considerations. Many of these factors are beyond the control of Peoples or Penseco and are not necessarily related to a change in the financial performance or condition of Peoples or Penseco. As Peoples and Penseco market share prices fluctuate, based on numerous factors, the value of the shares of Peoples common stock that a Penseco shareholder will receive will correspondingly fluctuate. In addition, Peoples is not listed and does not trade on a national exchange. It is impossible to predict accurately the market price of Peoples common stock after completion of the merger. Accordingly, the prices of Peoples and Penseco common stock on the dates of the special meetings may not be indicative of their prices immediately prior to completion of the merger and the price of Peoples common stock after the merger is completed.

See Summary Market Price and Dividend Information . We urge you to obtain current market quotations for Peoples common stock.

*The combined company will incur significant transaction and merger-related costs in connection with the merger.*

Peoples and Penseco expect to incur costs associated with combining the operations of the two companies. Peoples and Penseco have just recently begun collecting information in order to formulate detailed integration plans to deliver planned synergies. Additional unanticipated costs may be incurred in the integration of the businesses of Peoples and Penseco. Whether or not the merger is consummated, Peoples and Penseco will incur substantial expenses, such as legal, accounting, printing and financial advisory fees, in pursuing the merger. Although Peoples and Penseco expect that the elimination of duplicative costs, as well as the realization of other efficiencies related to the integration of the businesses, may offset incremental transaction and merger-related costs over time, this net benefit may not be achieved in the near term, or at all.

*Some of the conditions to closing of the merger may result in delay or prevent completion of the merger, which may adversely affect the value of our companies securities.*

Completion of the merger is conditioned upon the receipt of certain governmental consents and approvals, including consents and approvals required by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation (FDIC) and the Pennsylvania Department of Banking and Securities. Failure to obtain these consents would prevent consummation of the merger. Even if the approvals are obtained, the effort



## **Table of Contents**

involved may delay consummation of the merger. Governmental authorities may also impose conditions in connection with the merger that may adversely affect the combined company's operations after the merger. However, neither Peoples nor Penseco is required to take any action or agree to any condition or restriction in connection with obtaining any approvals that would reasonably be expected to have a material adverse effect on Penseco, Peoples or the combined company.

### ***The merger may distract our management from their other responsibilities.***

The merger could cause the management of the companies to focus their time and energies on matters related to the merger that otherwise would be directed to the companies' business and operations. Any such distraction on the part of management, if significant, could affect management's ability to service existing business and develop new business and adversely affect the combined company's business and earnings following the merger.

### ***Peoples and Penseco directors and executive officers may have interests in the merger that differ from your interests.***

Some of Peoples' and Penseco's directors and executive officers have interests in the transaction other than their interests as shareholders. For example, after the merger of Peoples and Penseco, six (6) current directors of Peoples and eight (8) current directors of Penseco will continue to serve on Peoples' combined board of directors. In addition:

William E. Aubrey II shall serve as the chairman of the board of Peoples and the board of directors has agreed to reappoint him until the Peoples 2017 Annual Meeting of Shareholders.

Alan W. Dakey, a director and the President and Chief Executive Officer of Peoples previously entered into an employment agreement with Peoples that would provide him with severance payments upon a termination after a change in control. The consummation of the merger will also afford him vested benefits and payments in certain benefit plans.

Alan Dakey is expected to enter into a consulting agreement wherein he will assist with the integration of Penn Security Bank and Trust Company into Peoples Neighborhood Bank for a six month period following the merger for which he will be paid \$95,000.

Peoples Neighborhood Bank and Penn Security Bank and Trust Company employees will be immediately eligible for participation in all benefit plans on the terms of such benefit plans.

Alan W. Dakey, Scott A. Seasock, and Joseph M. Ferretti will receive the actuarially equivalent of their retirement benefits under their respective supplemental executive retirement plan agreements.

Debra E. Dissinger will become vested in her supplemental executive retirement plan agreement.

Joseph M. Ferretti will be offered a new employment agreement providing for certain benefits and an increase in base salary.

The Peoples directors will become fully vested in the Peoples Directors' Retirement Plan.

Peoples and/or Penseco may award retention bonuses to certain employees, who have not yet been identified.

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Peoples has offered employment to Craig W. Best and Thomas P. Tulaney and other Pensco executive officers and will retain the employment of Scott A. Seasock, Joseph M. Ferretti and Debra E. Dissinger.

These and certain other additional interests of Peoples and Pensco's directors and executive officers are described in detail in Proposal The Merger Interests of Directors, Officers, and Others in the Merger, found elsewhere in this document. These circumstances may cause some of Peoples and Pensco's directors and executive officers to view the proposed merger differently than you view it.

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**Table of Contents**

***The fairness opinions obtained by Peoples and Penseco from their financial advisors will not reflect changes in circumstances after the date of the fairness opinions.***

Boenning & Scattergood, Inc., Peoples' financial advisor in connection with the merger, and Griffin Financial Group, LLC, Penseco's financial advisor in connection with the merger have delivered to the boards of directors of Peoples and Penseco, respectively, their opinions dated as of June 28, 2013. Both opinions state that as of the date of such opinions, and based upon and subject to the factors and assumptions set forth therein, the merger consideration to be paid to the holders of the outstanding shares of Penseco common stock pursuant to the merger agreement was fair from a financial point of view to the shareholders of Peoples and Penseco. As a result, Peoples and Penseco shareholders should be aware that the opinions do not address the fairness of the merger consideration at any time other than as of June 28, 2013. The opinions do not reflect changes that may occur or may have occurred after the date of such opinions, including changes to the operations and prospects of Peoples or Penseco, changes in general market and economic conditions or regulatory or other factors. Any such changes, or changes in other factors on which the opinions are based, may materially alter or affect the estimated valuation conclusions reached in such opinions for Peoples and Penseco shareholders.

***The unaudited pro forma financial data included in this joint proxy statement/prospectus are preliminary and our actual financial position and results of operations after the merger may differ materially from the unaudited pro forma financial data included in this joint proxy statement/prospectus.***

The unaudited *pro forma* financial data in this joint proxy statement/prospectus are presented for illustrative purposes only and are not necessarily indicative of what the combined company's actual financial position or results of operations would have been had the merger been completed on the dates indicated. The *pro forma* financial data reflect adjustments, which are based upon preliminary estimates, to record Peoples' identifiable assets acquired and liabilities assumed at fair value and the resulting goodwill recognized. The purchase price allocation reflected in this document is preliminary, and final allocation of the purchase price will be based upon the actual purchase price and the fair value of the assets and liabilities of Peoples as of the date of the completion of the merger. Accordingly, the final purchase accounting adjustments may differ materially from the *pro forma* adjustments reflected in this document.

***After the merger is complete, Penseco shareholders will become Peoples shareholders and will have different rights than their current rights.***

Upon completion of the merger, Penseco shareholders will become Peoples shareholders. Differences in Penseco's articles of incorporation and bylaws and Peoples' articles of incorporation and bylaws will result in changes to the rights of Penseco shareholders who become Peoples shareholders. For more information, see *Comparison of Shareholders' Rights*, beginning on page 171 of this document. Shareholders of Penseco may conclude that their current rights under Penseco's articles of incorporation and bylaws are more advantageous than the rights they may have as a Peoples shareholder under Peoples' articles of incorporation and bylaws.

***Upon completion of the merger, Peoples shareholders will have a reduced ownership and voting interest after the merger and will exercise less influence over management.***

Peoples shareholders currently have the right to vote in the election of the board of directors of Peoples and on other matters affecting Peoples. When the merger occurs, the shares of Peoples common stock held by the current Peoples shareholders will represent a percentage ownership of the combined company that is much smaller than the shareholder's current percentage ownership of Peoples. In fact, it is expected that the former shareholders of Peoples as a group will own only approximately 41% of the outstanding shares of Peoples immediately after the merger. Because of this, Peoples' shareholders will have less influence on the management and policies of the combined company than they now have on the management and policies of Peoples. In addition, the initial board of directors of the combined company will include 14 members, eight of whom are current members of the Penseco board of directors.

## **Table of Contents**

### ***If the merger is not completed, Peoples and Penseco will have incurred substantial expenses without realizing the expected benefits.***

Peoples and Penseco will incur substantial expenses in connection with the merger. The completion of the merger depends on the satisfaction of specified conditions and the receipt of regulatory approvals. Penseco and Peoples cannot guarantee that these conditions will be met. If the merger is not completed, these expenses could have a material adverse impact on the financial condition of Peoples and Penseco because they would not have realized the expected benefits.

### ***The merger agreement limits the ability of Peoples and Penseco to pursue alternatives to the merger.***

The merger agreement contains no shop provisions that, subject to specified exceptions, limit the ability of Peoples and Penseco to solicit, encourage, discuss, recommend or commit to alternative acquisition proposals, as well as a termination fee that is payable by Penseco under certain circumstances. These provisions might discourage potential competing transaction partners that might have an interest in acquiring all or a significant part of Peoples or Penseco from considering or proposing that acquisition even if it were prepared to pay consideration with a higher per share market price than that proposed in the merger, or might result in a potential competing transaction partner proposing to pay a lower per share price to acquire Peoples or Penseco than it might otherwise have proposed to pay.

### ***Failure to complete the merger in certain circumstances could require Peoples or Penseco to pay a termination fee.***

If the merger should fail to occur in certain circumstances that relate to a possible combination of Peoples or Penseco with another acquirer, Peoples or Penseco may be obligated to pay the other \$3,700,000 as a termination fee. See Proposal The Merger Terms of the Merger Termination Fee .

## **Risks Relating to Peoples and Its Business**

### ***The soundness of other financial services institutions may adversely affect our credit risk.***

We rely on other financial services institutions through trading, clearing, counterparty, and other relationships. We maintain limits and monitor concentration levels of our counterparties as specified in our internal policies. Our reliance on other financial services institutions exposes us to credit risk in the event of default by these institutions or counterparties. These losses could adversely affect our results of operations and financial condition.

### ***Peoples is subject to credit risk which may negatively affect our financial condition and results of operations.***

As of June 30, 2013, approximately 72.5% of Peoples' loan portfolio consisted of commercial and industrial, construction, and commercial real estate loans. These types of loans are generally viewed as having more risk of default than residential real estate loans or consumer loans. These types of loans are also typically larger than residential real estate loans and consumer loans. Because Peoples' loan portfolio contains a significant number of commercial and industrial, construction, and commercial real estate loans some of which have large balances, the deterioration of one or a few of these loans could cause a significant increase in non-performing loans. An increase in non-performing loans could result in a net loss of earnings from these loans, an increase in the provision for loan losses, and an increase in loan charge-offs, all of which could have a material adverse effect on Peoples' financial condition and results of operations.

### ***Peoples' ability to pay dividends is subject to limitations.***

The merger agreement contemplates that, unless 80% of the board of directors determines otherwise, the combined company will pay a quarterly cash dividend in an amount no less than \$0.31 per share for five years

## **Table of Contents**

after the effective time of the merger, provided that sufficient funds are legally available, and that Peoples and Peoples Security Bank and Trust Company remain well-capitalized in accordance with applicable regulatory guidelines.

After the merger, Peoples will continue to be a bank holding company and its operations will continue to be conducted by direct and indirect subsidiaries, each of which is a separate and distinct legal entity. Substantially all of Peoples' assets are and will be held by its direct and indirect subsidiaries.

Peoples' ability to pay dividends depends on its receipt of dividends from its direct and indirect subsidiaries. After the merger, its principal banking subsidiary, Peoples Security Bank and Trust Company, will be its primary source of dividends. As a state chartered bank, Peoples Security Bank and Trust Company will be subject to regulatory restrictions on the payment and amounts of dividends under the Pennsylvania Banking Code.

Further, the ability of banking subsidiaries to pay dividends is also subject to their profitability, financial condition, capital expenditures and other cash flow requirements. There is no assurance that Peoples' subsidiaries will be able to pay the dividends contemplated by the merger agreement or other dividends in the future or that Peoples will generate adequate cash flow to pay dividends in the future. Peoples' failure to pay dividends on its common stock could have a material adverse effect on the market price of its common stock.

### ***Changes in interest rates could adversely impact our financial condition and results of operations.***

Peoples' ability to make a profit, like that of most financial institutions, substantially depends upon its net interest income, which is the difference between the interest income earned on interest earning assets, such as loans and investment securities, and the interest expense paid on interest-bearing liabilities, such as deposits and borrowings. However, certain assets and liabilities may react differently to changes in market interest rates. Further, interest rates on some types of assets and liabilities may fluctuate prior to changes in broader market interest rates, while rates on other types of assets may lag behind. Additionally, some assets such as adjustable-rate mortgages have features, and rate caps, which restrict changes in their interest rates.

Factors such as inflation, recession, unemployment, money supply, global disorder such as that experienced as a result of the terrorist activity on September 11, 2001, instability in domestic and foreign financial markets, and other factors beyond our control, may affect interest rates. Changes in market interest rates will also affect the level of voluntary prepayments on loans and the receipt of payments on mortgage-backed securities, resulting in the receipt of proceeds that may have to be reinvested at a lower rate than the loan or mortgage-backed security being prepaid. Although Peoples pursues an asset-liability management strategy designed to control its risk from changes in market interest rates, changes in interest rates can still have a material adverse effect on our profitability.

### ***If we have higher loan losses than we have allowed for, our earnings could materially decrease.***

Our loan customers may not repay loans according to their terms, and the collateral securing the payment of loans may be insufficient to assure repayment. We may therefore experience significant credit losses which could have a material adverse effect on our operating results. We make various assumptions and judgments about the collectability of our loan portfolio, including the creditworthiness of borrowers and the value of the real estate and other assets serving as collateral for the repayment of loans. In determining the size of the allowance for loan losses, we rely on our experience and our evaluation of economic conditions. If our assumptions prove to be incorrect, our current allowance for loan losses may not be sufficient to cover losses inherent in our loan portfolio and adjustment may be necessary to allow for different economic conditions or adverse developments in our loan portfolio. Consequently, a problem with one or more loans could require us to significantly increase the level of our provision for loan losses. In addition, federal and state regulators periodically review our allowance for loan losses and may require us to increase our provision for loan losses or recognize further loan charge-offs. Material additions to the allowance would materially decrease our net income.

## **Table of Contents**

### ***Our results of operations may be materially and adversely affected by other-than-temporary impairment charges relating to our investment portfolio.***

Numerous factors, including the lack of liquidity for re-sales of certain investment securities, the absence of reliable pricing information for investment securities, adverse changes in the business climate, adverse regulatory actions or unanticipated changes in the competitive environment, could have a negative effect on our investment portfolio in future periods. Investments are evaluated periodically to determine whether a decline in their value is other than temporary. Management utilizes criteria such as the magnitude and duration of the decline, in addition to the reasons underlying the decline, to determine whether the loss in value is other than temporary. The term other than temporary indicates that the prospects for a near term recovery of value are not necessarily favorable, or that there is a lack of evidence to support fair values equal to, or greater than, the carrying value of the investment.

Once a decline in value is determined to be other than temporary, the value of the security is reduced and a corresponding charge to earnings is recognized. If an impairment charge is significant enough, it could affect our ability to pay dividends, which could materially adversely affect us and our ability to pay dividends to shareholders. Significant impairment charges could also negatively impact our regulatory capital ratios and result in us not being classified as well-capitalized for regulatory purposes.

### ***Post-merger integration and change of Peoples' historical business model may fail to achieve expected results.***

The success of the transaction depends heavily on a smooth integration and post-merger operations of the combined Peoples Security Bank and Trust Company. Benefits of the transaction to shareholders may not be realized if the post-merger integration is not well executed or well received by each company's historical customers. This risk is exacerbated by a material change in the business processes that have been historically operated by Pensco to those of Peoples.

### ***Peoples may fail to realize the cost savings it expects to achieve from the merger.***

The success of the merger will depend, in part, on Peoples' ability to realize the estimated cost savings from combining the businesses of Peoples and Pensco. While we believe that the cost savings estimates are achievable, it is possible that the potential cost savings could be more difficult to achieve than we anticipate. Peoples' cost savings estimates also depend on its ability to combine the businesses of Peoples and Pensco in a manner that permits those cost savings to be realized. If our estimates are incorrect or we are unable to combine the two companies successfully, the anticipated cost savings may not be realized fully or at all, or may take longer to realize than expected.

### ***Combining Peoples and Pensco into Peoples may be more difficult, costly or time-consuming than expected.***

Peoples and Pensco have operated, and, until the completion of the merger, will continue to operate, independently. The integration process could result in the loss of key employees, the disruption of each company's ongoing business, inconsistencies in standards, controls, procedures and policies that adversely affect either company's ability to maintain relationships with clients and employees or achieve the anticipated benefits of the merger. As with any merger of financial institutions, there also may be disruptions that cause Peoples and Pensco to lose customers or cause customers to withdraw their deposits from Peoples or Pensco, or other unintended consequences that could have a material adverse effect on Peoples' results of operations or financial condition.

## **Table of Contents**

### ***We may incur significant costs to ensure compliance with corporate governance and accounting requirements.***

We expect to incur significant costs associated with our public company reporting requirements, costs associated with applicable corporate governance requirements, including requirements under the Sarbanes-Oxley Act of 2002 and other rules implemented by the SEC. We expect all of these applicable rules and regulations to increase our legal and financial compliance costs and to make some activities more time-consuming and costly.

### ***We will be subject to more stringent capital and liquidity requirements in the future, which may adversely affect our net income and future growth.***

In July 2013, the federal banking agencies issued final rules to implement the Basel III regulatory capital reforms and changes required by the Dodd-Frank Act. U.S. implementation of Basel III would lead to significantly higher capital requirements and more restrictive leverage and liquidity ratios than those currently in place.

Future increases in minimum capital requirements could adversely affect our net income. Furthermore, our failure to comply with the minimum capital requirements could result in our regulators taking formal or informal actions against us which could restrict our future growth or operations.

### ***We may elect or need to seek additional capital in the future, but that capital may not be available when needed.***

We are required by federal and state regulatory authorities to maintain adequate levels of capital to support our operations. In the future, we may elect or need to raise additional capital. Our ability to raise additional capital, if needed, will depend on conditions in the capital markets at that time, which are outside our control, and on our financial performance. Accordingly, we cannot assure you of our ability to raise additional capital if needed on acceptable terms. If we cannot raise additional capital when needed, our ability to expand our operations through internal growth or acquisitions could be materially impaired.

### ***Peoples' success will depend upon the ability of management to adapt to the consolidated company structure.***

The business success of Peoples and Peoples Security Bank and Trust Company depends to a great extent upon the services of their directors and executive officers. Management's ability to operate Peoples profitably will require the acquisition of new knowledge and skills. In particular, if Peoples expands geographically or expands to provide non-banking services through the acquisition or formation of additional subsidiaries, current management may not have the necessary experience for successful operation in these new areas. There is no guarantee that management would be able to meet these new challenges or that Peoples would be able to retain new directors or personnel with the appropriate background and expertise.

### ***Our financial performance may suffer if our information technology is unable to keep pace with growth or industry developments.***

Effective and competitive delivery of our products and services is increasingly dependent upon information technology resources and processes, both those provided internally as well as those provided through third party vendors. In addition to better serving customers, the effective use of technology increases efficiency and enables us to reduce costs. Our future success will depend, in part, upon our ability to address the needs of our customers by using technology to provide products and services to enhance customer convenience, as well as to create additional efficiencies in our operations. Many of our competitors have greater resources to invest in technological improvements. Additionally, as technology in the financial services industry changes and evolves, keeping pace becomes increasingly complex and expensive for us. There can be no assurance that we will be able to effectively implement new technology-driven products and services, which could reduce our ability to compete effectively.

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**Table of Contents**

***A failure in or a breach of our information systems or infrastructure, including as a result of cyber attacks, could disrupt our business, damage our reputation, and could have a material adverse effect on our business, financial condition and results of operations.***

In the ordinary course of Peoples' business activities, including the ongoing maintenance of deposits, loan and other account relationships for Peoples' customers, receiving instructions and effecting transactions for those customers and other users of Peoples' products and services, we regularly collect, process, transmit and store significant amounts of confidential information regarding its customers, employees and others. In addition to confidential information regarding our customers, employees and others, Peoples and in some cases a third party, compile, process, transmit and store proprietary, non-public information concerning its own business, operations, plans and strategies.

Information security risks for Peoples and other financial institutions have significantly increased in recent years in part because of the proliferation of new technologies, the use of the Internet and telecommunications technologies to conduct financial transactions, and the increased sophistication and activities of organized crime, hackers, terrorists and other external parties. We rely on digital technologies, computer and email systems, software, and networks to conduct secure processing, transmission and storage of confidential information. In addition, to access our products and services, our customers may use personal smart phones, tablet PCs and other mobile devices that are beyond our control systems. Our technologies, systems, networks and our customers' devices have been subject to, and are likely to continue to be the target of, cyber attacks, computer viruses, malicious code, phishing attacks or information security breaches that could result in the unauthorized use, loss or destruction of our or our customers' confidential information, or otherwise disrupt our or our customers' or other third parties' business operations. We believe that it is more likely than not that such attempted attacks may continue.

Although Peoples uses a variety of physical, procedural and technological safeguards to protect confidential information from mishandling, misuse or loss, these safeguards do not provide absolute assurance that mishandling, misuse or loss of the information will not occur, and that if mishandling, misuse or loss of the information did occur, those events will be promptly detected and addressed. A failure in or breach of our operational or information security system, or those of a third-party service provider, as a result of cyber-attacks or information security breaches could have a material adverse affect on our business, damage our reputation, increase our costs and/or cause significant losses. Although Peoples believes that it currently has adequate information security procedures and other safeguards in place and it will continue to make it a priority to develop and enhance controls and processes designed to safeguard our information systems from attacks, damage or unauthorized access, as information security risks and cyber threats continue to evolve, Peoples may be required to expend substantial resources to further enhance its information security measures and/or to investigate and remediate any information security vulnerabilities.

***Peoples common stock may not be listed on a national securities exchange, and the market for Peoples common stock may not be more active than the market for either Peoples or Pensco common stock.***

Although we plan to apply to list Peoples common stock on The Nasdaq Stock Market, Inc. or the New York Stock Exchange (the "NYSE"), we cannot guarantee that our stock will be listed on Nasdaq, NYSE, or any other exchange. Accordingly, although the Peoples common stock offered in the merger will be freely transferable once you receive your Peoples stock certificate, Peoples common stock may not be listed on a national securities exchange. Instead, Peoples common stock may be traded in local over-the-counter markets and privately negotiated transactions. Although the common stock is quoted on the OTCQB marketplace, there is very limited trading in our shares. There is no assurance that an active public trading market for Peoples common stock will develop. Further, we cannot assure you that significant trading in Peoples common stock will take place for several years, if ever. Investors should consider their shares of Peoples common stock as a long-term investment because, among other things, they may not be able to promptly liquidate their investment at a reasonable price in the event of a personal financial emergency or otherwise.



## **Table of Contents**

### ***Future acquisitions by Peoples could dilute your ownership of Peoples and may cause Peoples to become more susceptible to adverse economic events.***

Peoples may issue shares of its common stock in connection with future acquisitions and other investments, which would dilute your ownership interest in Peoples. While there is no assurance that these transactions will occur, or that they will occur on terms favorable to Peoples, future business acquisitions could be material to Peoples, and the degree of success achieved in acquiring and integrating these businesses into Peoples could have a material effect on the value of Peoples common stock. In addition, these acquisitions could require Peoples to expend substantial cash or other liquid assets or to incur debt, which could cause Peoples to become more susceptible to economic downturns and competitive pressures.

### ***An economic downturn in northeastern Pennsylvania or southern New York or a general decline in economic conditions could adversely affect Peoples' financial results.***

After the merger, Peoples' operations will be concentrated in northeastern Pennsylvania and southern New York. As a result of this geographic concentration, Peoples' financial results may correlate to the economic conditions in these areas. Deterioration in economic conditions in this market area, particularly in the industries on which this geographic areas depend, or a general decline in economic conditions may adversely affect the quality of the loan portfolio (including the level of non-performing assets, charge offs and provision expense) and the demand for products and services, and, accordingly, Peoples' results of operations. Inflation has some impact on Peoples' and Peoples Security Bank and Trust Company's operating costs. Peoples' future acquisitions could dilute your ownership of Peoples and may cause Peoples to become more susceptible to adverse economic events.

### ***Strong competition within Peoples' market area may limit its growth and profitability.***

Competition in the banking and financial services industry is intense. Peoples will compete actively with other northeastern Pennsylvania and southern New York financial institutions, many larger than Peoples, as well as with financial and non-financial institutions headquartered elsewhere. Commercial banks, savings banks, savings and loan associations, credit unions, and money market funds actively compete for deposits and loans. Such institutions, as well as consumer finance, insurance companies and brokerage firms, may be considered competitors with respect to one or more services they render. Peoples will likely be generally competitive with all institutions in its service areas with respect to interest rates paid on time and savings deposits, service charges on deposit accounts, interest rates charged on loans and fees for trust and investment advisory services. Many of the institutions with which Peoples competes have substantially greater resources and lending limits and may offer certain services that Peoples does not or cannot provide. Peoples' profitability depends upon Peoples' ability to successfully compete in its market area.

### ***Peoples operates in a highly regulated environment and may be adversely affected by changes in laws and regulations.***

Peoples and Peoples Security Bank and Trust Company will be subject to extensive regulation, supervision and examination by certain state and federal agencies including the Federal Deposit Insurance Corporation, as insurer of Peoples Security Bank and Trust Company's deposits, the Board of Governors of the Federal Reserve System, as regulator of the holding company, and the Pennsylvania Department of Banking and Securities, as regulator of Pennsylvania chartered banks. Such regulation and supervision govern the activities in which an institution and its holding company may engage and are intended primarily to ensure the safety and soundness of financial institutions. Regulatory authorities have extensive discretion in their supervisory and enforcement activities, including the imposition of restrictions on operations, the classification of assets and determination of the level of the allowance for loan losses. Any change in such regulation and oversight, whether in the form of regulatory policy, regulations, legislation or supervisory action, may have a material impact on Peoples Security Bank and Trust Company's and Peoples' operations. There also are several federal and state statutes which

## **Table of Contents**

regulate the obligation and liabilities of financial institutions pertaining to environmental issues. In addition to the potential for attachment of liability resulting from its own actions, a bank may be held liable under certain circumstances for the actions of its borrowers, or third parties, when such actions result in environmental problems on properties that collateralize loans held by the bank. Further, the liability has the potential to far exceed the original amount of a loan issued by the bank.

### **A Warning About Forward-Looking Information**

This document, including information incorporated by reference in this document, contains forward-looking statements within the meaning of Section 27A of the Securities Act, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, with respect to the financial condition, results of operations, and business of each of Peoples, Peoples Neighborhood Bank, Penseco, and Penn Security Bank and Trust Company. These include statements relating to revenues, cost savings, and anticipated benefits resulting from the merger. You can find many of these statements by looking for words such as believes, expects, anticipates, estimates, projects or similar words or expressions.

These forward-looking statements involve substantial risks and uncertainties. There are many factors that may cause actual results to differ materially from those contemplated by these forward-looking statements. See *Risk Factors*, beginning on page 25 of this document.

Because forward-looking statements are subject to risks and uncertainties, actual results may differ materially from those expressed or implied by these statements. We caution Peoples and Penseco shareholders not to place undue reliance on these statements. These statements speak only as of the date of this document or, if made in any document incorporated by reference, as of the date of that document.

All written or oral forward-looking statements attributable to Peoples or Penseco or any person acting on their behalf made after the date of this document are expressly qualified in their entirety by the cautionary statements contained or referred to in this section. Neither Peoples nor Penseco undertakes any obligation to release publicly any revisions to forward-looking statements to reflect events or circumstances after the date of this document or to reflect the occurrence of unanticipated events.

### **The Peoples Special Meeting of Shareholders**

#### **General**

The Peoples special meeting of shareholders will be held at American Legion Post 357, 612 New York Avenue, Hallstead, Pennsylvania 18822, at 10:00 a.m., local time, on November 15, 2013.

#### **Record Date and Shares Outstanding and Entitled to Vote**

The record date for the Peoples special meeting of shareholders is September 27, 2013. On the record date, there were 3,087,406 shares issued and outstanding. Only shareholders of record at the close of business on the Peoples record date will be entitled to receive notice of and to vote at the special meeting.

#### **Matters to be Considered at the Special Meeting**

Holders of Peoples common stock will consider and vote upon:

Proposal 1 a proposal to approve and adopt the merger agreement which is attached as Annex A to this joint proxy statement/prospectus and incorporated herein by reference;

Proposal 2 a proposal to approve an amendment to Article 4 of Peoples Articles of Incorporation to increase the authorized number of common stock from 12,500,000 shares to 25,000,000 shares;

## **Table of Contents**

Proposal 3 an advisory (non-binding) proposal to approve the golden parachute compensation payable to the named executive officers of Peoples and Pensco in connection with the merger;

Proposal 4 a proposal to adjourn or postpone the Peoples special meeting of shareholders, if necessary, to permit further solicitation of proxies in the event there are not sufficient votes at the special meeting of shareholders to approve the merger agreement; and

any other matter that may properly come before the special meeting.

### **Quorum**

Peoples shareholders entitled to cast at least a majority of the votes which all shareholders are entitled to cast on the record date must be represented in person or by proxy at the Peoples special meeting of shareholders for a quorum to be present for purposes of voting on the merger agreement, the amendment to the articles of incorporation, the advisory (non-binding) golden parachute proposal, and the adjournment or postponement proposal, and any other matter to be considered at Peoples special meeting of shareholders.

### **Votes Required**

*Approve and Adopt the Merger Agreement.* The approval and adoption of the merger agreement requires the affirmative vote, in person or by proxy, of the holders of at least a majority of the outstanding shares of Peoples common stock on the record date because the Peoples board of directors has unanimously approved the merger agreement.

*Approval of the Amendment to the Articles of Incorporation.* The affirmative vote of a majority of the shares voted at the special meeting of shareholders is required to approve and adopt the amendment to Peoples articles of incorporation.

*Advisory (Non-binding) Vote Regarding Golden Parachute Compensation.* The affirmative vote of a majority of the votes cast by the holders of our common stock entitled to vote on that matter at a shareholders meeting at which a quorum is present is required to approve on an advisory (non-binding) basis, the golden parachute compensation payable to the named executive officers of Peoples and Pensco in connection with the merger.

*Discretionary Authority to Adjourn or Postpone the Special Meeting.* The affirmative vote of a majority of the shares voted at the Peoples special meeting of shareholders is required to approve the adjournment or postponement of the special meeting to solicit additional proxies.

Each shareholder of Peoples on the record date will be entitled to one vote for each share held of record at the Peoples special meeting of shareholders. The directors and executive officers of Peoples have agreed to vote all shares of Peoples common stock that they own on the record date in favor of the approval and adoption of the merger agreement. On the record date, directors and executive officers of Peoples owned approximately 222,791 shares of Peoples common stock, or approximately 7.21% of the then outstanding shares of Peoples common stock.

### **Voting**

The Peoples board of directors is soliciting proxies from the Peoples shareholders. This will give Peoples shareholders an opportunity to vote at the Peoples special meeting of shareholders. When you deliver a valid proxy, the shares represented by that proxy will be voted by a named agent in accordance with your instructions.

If a Peoples shareholder does not vote by proxy or by attending the Peoples special meeting of shareholders and voting in person, it will have the same effect as voting against the merger.

## **Table of Contents**

If a Peoples shareholder votes by proxy card but makes no specification on the proxy card regarding the proposals, the agent will vote all of the shareholder's shares FOR approval and adoption of the merger agreement and the merger and the adjournment or postponement proposal.

### **Revocation of Proxies**

Any Peoples shareholder may revoke a proxy at any time before or at the Peoples special meeting in one or more of the following ways:

1. Delivering a written notice of revocation bearing a later date than the proxy at any time prior to the vote at the special meeting of shareholders to the Secretary of Peoples;
  2. Submitting a later-dated proxy prior to the vote at the special meeting of shareholders; or
  3. Attending the special meeting of shareholders and voting in person after giving written notice to the Secretary of Peoples.
- A Peoples shareholder should send any written notice of revocation or subsequent proxy to:

Peoples Financial Services Corp.

Attention: Corporate Secretary

82 Franklin Avenue

Hallstead, PA 18822

You also may hand deliver the notice of revocation or subsequent proxy to the Corporate Secretary, before the taking of the vote at the special meeting of shareholders. Attendance at the special meeting of shareholders will not by itself constitute a revocation or proxy.

### **Dissenters' Rights**

Under Section 1930 and Chapter 15, Subchapter D, of the Pennsylvania Business Corporation Law of 1988, as amended, holders of Peoples common stock who properly file with Peoples a written notice of intention to dissent will have the right to obtain a cash payment for the statutorily determined fair value of their shares (excluding any element of value arising in anticipation of the merger) in the event that the merger is completed. In order to exercise those rights, Peoples shareholders must comply with the procedural requirements of Chapter 15, Subchapter D of the Pennsylvania Business Corporation Law. The statutorily determined fair value cannot be predicted and could be more or less than the value of the merger consideration. Failure to take any of the steps required under Chapter 15, Subchapter D of the Pennsylvania Business Corporation Law on a timely basis may result in the loss of dissenters' rights. The provisions relating to dissenters' rights under Pennsylvania Business Corporation Law are attached to this joint proxy statement/prospectus as Annex D. See Proposal The Merger Rights of Dissenting Shareholders .

### **Solicitation of Proxies**

Peoples will bear the cost of the solicitation of proxies from its own shareholders, but Peoples and Penseco will equally share the cost of printing and mailing this joint proxy statement/prospectus. In addition to solicitation by mail, the directors, officers and employees of Peoples and its subsidiaries may solicit proxies from Peoples shareholders by telephone, electronically, or in person without compensation other than reimbursement for their actual expenses. Peoples also will make arrangements with brokerage houses and other custodians, nominees, and fiduciaries for the forwarding of solicitation material to the beneficial owners of stock held of record by such persons. Peoples will reimburse those custodians, nominees, and fiduciaries for their reasonable out-of-pocket expenses in connection with forwarding solicitation materials. In addition, Peoples has also made arrangements with Regan & Associates, Inc., New York, New York, to assist in soliciting proxies and has agreed to pay them \$8,000 for these services.



## **Table of Contents**

### **The Penseco Special Meeting of Shareholders**

#### **General**

The Penseco special meeting of shareholders will be held at the Hilton Scranton and Conference Center, 100 Adams Avenue, Scranton, Pennsylvania 18503, at 2:00 p.m., local time, on November 21, 2013.

#### **Record Date and Shares Outstanding and Entitled to Vote**

The record date for the Penseco special meeting of shareholders is September 27, 2013. On the record date, there were 3,285,145 shares issued and outstanding. Only shareholders of record at the close of business on the Penseco record date will be entitled to receive notice of and to vote at their special meeting.

#### **Matters to be Considered at the Special Meeting**

Holders of Penseco common stock will consider and vote upon:

Proposal 1 a proposal to approve and adopt the merger agreement which is attached as Annex A to this joint proxy statement/prospectus and incorporated herein by reference;

Proposal 2 a proposal to approve, on an advisory basis, the compensation of Penseco's named executive officers that is based on or related to the proposed merger; and

Proposal 3 a proposal to adjourn the special meeting, if necessary, to solicit additional proxies in the event that there are not sufficient votes at the time of the special meeting to approve the proposal to approve and adopt the merger agreement.

#### **Quorum**

The holders of a majority of the shares of Penseco common stock outstanding and entitled to vote as of the record date must be present at the Penseco special meeting, either in person or by proxy, for a quorum to be present for purposes of voting on the merger agreement, the adjournment or postponement proposal, and any other matter to be considered at the Penseco special meeting.

#### **Votes Required**

*Approve and Adopt the Merger Agreement.* In accordance with Penseco's articles of incorporation, the approval and adoption of the merger agreement requires the affirmative vote of the holders of at least 75% of the shares Penseco common stock outstanding on the record date.

*Advisory (Non-binding) Vote Regarding Golden Parachute Compensation.* In accordance with Penseco's bylaws, the affirmative vote of a majority of Penseco shares represented, in person or by proxy, at the special meeting is required to approve, on an advisory basis, the compensation of Penseco's named executive officers that is based on or related to the proposed merger.

*Discretionary Authority to Adjourn or Postpone the Special Meeting.* In accordance with Penseco's bylaws, the affirmative vote of a majority of Penseco shares represented, in person or by proxy, at the special meeting is required to approve the proposal to adjourn the special meeting, if necessary, to solicit additional proxies.

Each holder of shares of Penseco common stock outstanding on the record date will be entitled to one vote for each share held of record at the Penseco special meeting of shareholders. The directors and executive officers of Penseco have agreed to vote all shares of Penseco common stock that they own on the record date in favor of the approval and adoption of the merger agreement. On the record date, directors and executive officers of Penseco beneficially owned approximately 413,701 shares of Penseco common stock, or approximately 12.6% of the outstanding shares of Penseco common stock.



## **Table of Contents**

### **Ownership of Shares; Attending the Meeting**

You may own shares of Pensco in one of the following ways:

Directly, in your name as the shareholder of record;

Indirectly, through a broker, bank or other holder of record in street name ; or

Indirectly, through the Penn Security Bank and Trust Company Employee Stock Ownership Plan, or ESOP.

If you hold your shares in certificate form and not through a bank, brokerage firm or other nominee, you may vote your shares in one of the following ways:

*By Mail.* If you choose to vote by mail, complete the enclosed proxy, date and sign it, and return it in the postage-paid envelope provided.

*In Person.* If you choose to vote in person, come to the annual meeting and cast your vote. If you attend the meeting, you may vote your shares in person even if you have previously submitted a proxy.

*Telephonic voting.* If you choose to vote by telephone, call toll-free (866) 702-2540 in the United States from any touch-tone telephone and follow the instructions. Have your proxy card available when you call, and use the company number and account number shown on your proxy card.

*Internet Voting.* If you choose internet voting, visit [www.rtcoproxy.com/pfns](http://www.rtcoproxy.com/pfns) and follow the on-screen instructions. Have your proxy card available when you access the web page, and use the company number and account number shown on your proxy card.

You may submit your proxy by telephone or via internet until 3:00 AM the day before the meeting.

If you hold your shares in street name, your broker, bank or other holder of record is sending these proxy materials to you. As the beneficial owner, you have the right to direct your broker, bank or other holder of record how to vote on your behalf by filling out a voting instruction form that accompanies your proxy materials. Your broker, bank or other holder of record may allow you to provide voting instructions by telephone or by the Internet. Please see the voting instruction form provided by your broker, bank or other holder of record that accompanies this proxy statement. If you hold your shares in street name, you will need proof of ownership to be admitted to the meeting. (For example, a recent brokerage statement or letter from your bank or broker.) If you want to vote your shares of Pensco common stock held in street name in person at the special meeting, you must obtain a written proxy in your name from the broker, bank or other holder of record of your shares.

If you hold your shares in an ESOP account, you will receive a single voting instruction card for the ESOP that reflects all shares you may vote under the ESOP. Under the terms of the ESOP, the ESOP trustee votes all shares held by the ESOP, but each ESOP participant may direct the trustee how to vote the shares of common stock allocated to his or her account. The ESOP trustee will not vote shares for which no voting instructions are received.

### **Voting**

The Pensco board of directors is soliciting proxies to request that you allow your shares of Pensco common stock to be represented at the special meeting by the persons named on the enclosed Pensco proxy card. All shares of Pensco common stock represented at the special meeting by properly executed and dated proxy cards will be voted according to the instructions indicated on the proxy card. If you sign, date and return a proxy card without giving voting instructions, your shares will be voted as recommended by our board of directors.





## **Table of Contents**

The Pensco board of directors recommends that you vote:

FOR the proposal to approve and adopt the merger agreement;

FOR the proposal to approve, on an advisory basis, the compensation of Pensco's named executive officers that is based on or related to the proposed merger; and

FOR the proposal to adjourn the special meeting, if necessary, to solicit additional proxies.

If any matters incident to the conduct of the meeting and not described in this proxy statement are properly presented at the special meeting, the persons named on the proxy card will use their judgment to determine how to vote your shares.

If you hold your shares in street name, it is critical that you instruct your bank or broker how to vote. If you hold your shares in street name and you do not instruct your bank or broker how to vote, your bank or broker will not be permitted to vote your shares on any matter related to the merger or executive compensation or on other non-discretionary matters, and may elect not to vote your shares on other matters. A broker non-vote occurs when a broker submits a proxy that does not indicate a vote for some of the proposals because the beneficial owners have not instructed the broker on how to vote on such proposals.

Broker non-votes are considered present, and as a result, will have the same effect as a vote against the merger proposal and each proposal for which the affirmative vote of a majority of shares represented at the special meeting is required.

If you return a valid proxy or attend the meeting in person, we will count your shares for purposes of determining whether there is a quorum, even if you abstain from voting. Broker non-votes, if any, also will be counted for purposes of determining the existence of a quorum.

Abstentions are considered to be present and, as a result, will have the same effect as a vote against the merger proposal and each proposal for which the affirmative vote of a majority of shares represented at the special meeting is required.

## **Revocation of Proxies**

Any Pensco shareholder may revoke a proxy at any time before or at the Pensco special meeting in one or more of the following ways:

1. Delivering a written notice of revocation bearing a later date than the proxy at any time prior to the vote at the special meeting of shareholders to the Secretary of Pensco;
2. Submitting a later-dated proxy prior to the vote at the special meeting of shareholders; or
3. Attending the special meeting of shareholders and voting in person after giving written notice to the Secretary of Pensco.

A Pensco shareholder should send any written notice of revocation or subsequent proxy to:

Pensco Financial Services Corporation

Attention: Corporate Secretary

150 North Washington Avenue

Scranton, PA 18503

You also may hand deliver the notice of revocation or subsequent proxy to the Secretary before the taking of the vote at the special meeting of shareholders. Attendance at the special meeting of shareholders will not by itself constitute a revocation or proxy.



**Table of Contents****Dissenters' Rights**

Under Section 1930 and Chapter 15, Subchapter D of the Pennsylvania Business Corporation Law of 1988, as amended, holders of Penseco common stock who properly file with Penseco a written notice of intention to dissent will have the right to obtain a cash payment for the statutorily determined fair value of their shares (excluding any element of value arising in anticipation of the merger) in the event that the merger is completed. In order to exercise those rights, Penseco shareholders must comply with the procedural requirements of Chapter 15, Subchapter D of the Pennsylvania Business Corporation Law. The statutorily determined fair value cannot be predicted and could be more or less than the value of the merger consideration. Failure to take any of the steps required under Chapter 15, Subchapter D of the Pennsylvania Business Corporation Law on a timely basis may result in the loss of dissenters' rights. The provisions relating to dissenters' rights under Pennsylvania Business Corporation Law are attached to this joint proxy statement/prospectus as Annex F. See Proposal The Merger Rights of Dissenting Shareholders .

**Solicitation of Proxies**

Penseco will bear the cost of the solicitation of proxies from its own shareholders, but Peoples and Penseco will equally share the cost of printing and mailing this joint proxy statement/prospectus. In addition to solicitation by mail, the directors, officers, and employees of Penseco and Peoples and their subsidiaries may solicit proxies from Penseco shareholders by telephone, electronically, or in person without compensation other than reimbursement for their actual expenses. Penseco also will make arrangements with brokerage houses and other custodians, nominees, and fiduciaries for the forwarding of solicitation material to the beneficial owners of stock held of record by such persons. Penseco will reimburse those custodians, nominees, and fiduciaries for their reasonable out-of-pocket expenses in connection with forwarding solicitation materials. In addition, Penseco has also made arrangements with Regan & Associates, Inc., New York, New York, to assist in soliciting proxies and has agreed to pay them \$27,500 for these services.

**Proposal:****The Merger**

The following information describes the material terms and provisions of the merger. This description is not complete. We qualify this discussion in its entirety by reference to the merger agreement which we incorporate by reference in this joint proxy statement/prospectus. A copy of the merger agreement is attached to this document as Annex A to provide information regarding the terms of the proposed merger. Except for its status as the contractual document between the parties with respect to the merger described in the merger agreement, it is not intended to provide factual information about the parties. The representations and warranties contained in the merger agreement were made only for purposes of the merger agreement and as of specific dates, were solely for the benefit of the parties to the merger agreement, and may be subject to limitations agreed to by the contracting parties, including being qualified by disclosures between the parties. These representations and warranties may have been made for the purposes of allocating contractual risk between the parties to the agreement instead of establishing these matters as facts and may be subject to standards of materiality applicable to the contracting parties that differ from those applicable to investors. Accordingly, they should not be relied on by investors as statements of factual information. We urge you to read the full text of the merger agreement carefully.

**General**

On June 28, 2013, Peoples and Penseco jointly announced the execution of the merger agreement. Pursuant to the merger agreement, Penseco will merge with and into Peoples. After the merger, but no earlier than the next business day, Penn Security Bank and Trust Company will merge with and into Peoples Neighborhood Bank under the name Peoples Security Bank and Trust Company . The mergers are expected to be completed during late 2013. On September 17, 2013, Peoples and Penseco entered into an Amendment No. 1 to the Agreement and Plan of Merger which would permit Peoples to pursue a listing of its common stock on either The Nasdaq Stock Market, Inc. or on the New York Stock Exchange following the merger.

## **Table of Contents**

In the merger, Penseco shareholders will receive 1.3636 shares of Peoples common stock for each share of Penseco common stock they hold on the effective time of the merger.

Peoples will not issue fractional shares of common stock to Penseco shareholders pursuant to this merger; consequently, Penseco shareholders will receive cash in lieu of any fractional shares they would have otherwise received according to the terms of the merger agreement.

The approval and adoption of the merger agreement requires the affirmative vote, in person or by proxy, of the holders of at least a majority of the outstanding shares entitled to vote at the Peoples special meeting of shareholders and requires the affirmative vote, in person or by proxy, of at least 75% of the outstanding shares entitled to vote at the Penseco special meeting of shareholders.

## **Background of the Merger**

The boards of directors of Peoples and Penseco evaluate their respective businesses and strategic opportunities on an ongoing basis. The executive committee of Penseco's board of directors monitors a group of approximately twenty potential transaction partners to evaluate potential business combinations from time to time. As part of these ongoing efforts, the executive committee of Penseco's board of directors met on February 27, 2013, to discuss various matters, including potential transactions with Peoples and one other party. Based on the interest at the meeting, the Penseco executive committee authorized Craig W. Best, President and Chief Executive Officer of Penseco, to engage Cedar Hill Advisors, LLC to provide financial advisory services to Penseco, including with respect to a potential transaction with Peoples.

On February 28, 2013, Mr. Best presented a financial model, prepared with the assistance of Cedar Hill, to the Penseco executive committee. On the basis of the financial model and, more particularly, on the potential strategic benefits of a business combination with Peoples, including the combined company's increased size and scale, the geographic complement of the Peoples and Penseco branch networks, including the ability of Penseco to accelerate expansion into the Marcellus Shale region, the relative ownership of the combined company, the ability of Penseco shareholders to continue to participate in the growth of the combined company, and the potential effects on its employees, customers and communities, the Penseco executive committee determined to pursue a business combination with Peoples. To that end, the Penseco executive committee authorized Mr. Best to approach William Aubrey II, Chairman of the board of directors of Peoples, regarding the potential business combination and, on February 28, 2013, Mr. Best met with Mr. Aubrey to discuss the potential transaction.

Following the meeting, through March 18, 2013, Mr. Best and Mr. Aubrey had a number of exploratory phone calls to discuss the potential transaction, Peoples' interest in the potential transaction, and future actions. On March 15, 2013, Penseco's executive committee met to discuss management's recommendations regarding certain terms of the potential transaction, including a proposed exchange ratio, and authorized Mr. Best to discuss the terms with Peoples.

On March 18, 2013, Mr. Best met with Mr. Aubrey, Alan W. Dakey, President and Chief Executive Officer of Peoples, and Scott A. Seasock, Senior Vice President and Chief Financial Officer of Peoples, to discuss the terms approved by the Penseco executive committee and other general parameters of a potential transaction. Mr. Best provided materials regarding the proposed transaction to be shared with Peoples board of directors. Mr. Best and Mr. Aubrey had a follow-up phone call on March 19, 2013.

Penseco's board of directors met on March 19, 2013, to discuss the potential transaction, management's recommendations, the board's fiduciary duties in connection with the potential transaction, and the proposed next steps. Management made a presentation to the board regarding financials and general terms of the transaction. At the meeting, Penseco's board of directors designated an independent committee of the board of directors, comprised of directors Cesare, Hume, Keisling and Naismith, to review, consider and evaluate any proposals that may be made with respect to a possible business combination involving Penseco, including the potential transaction with Peoples, and to make recommendations to the board of directors.

## **Table of Contents**

On March 20, 2013, Messrs. Best, Dakey and Seasock had a conference call to review the materials provided by Mr. Best at their March 18 meeting, including the assumptions used and other matters. Messrs. Best and Dakey had a subsequent phone call to discuss other transaction matters, including professional advisors.

On March 22, 2013, Penseco's independent committee met to discuss the potential transaction and heard Mr. Best's report of his meeting and discussions with Peoples management from March 18 to March 20.

On March 26, 2013, Mr. Aubrey made a presentation to the Peoples board of directors about the proposed transaction with Penseco, after which he had a telephone call with Mr. Best to discuss Peoples' level of interest in pursuing the transaction.

Mr. Best sent Mr. Aubrey a formal confidentiality agreement and proposed transaction timeline on March 27, 2013, and sent confidentiality agreements and requests for proposals (RFPs) to potential professional and financial advisors.

On March 28, 2013, Mr. Best and Mr. Aubrey met to discuss and review a draft non-binding indication of interest and the proposed timeline for the transaction and on March 29, 2013, Penseco's independent committee met with Mr. Best to discuss the same.

At Peoples' regular board meeting on March 29, 2013, the board discussed the proposed transaction with Penseco, including the draft non-binding indication of interest and proposed timeline. A merger committee was formed to evaluate the potential transaction composed of Earle Wootton, Chairman of the committee, directors Kukuchka, Stover, and Dakey and Mr. Seasock as management's representative. At the reorganizational meeting of the board of directors on April 3, 2013, the merger committee became a standing committee of the board and was renamed the Strategic Planning Committee. The committee members remained the same members as selected at the March 29 meeting.

Earle Wootton, Chairman of Peoples' strategic planning committee, met with Mr. Best on April 4, 2013, to discuss a planned presentation to the committee. Mr. Best made the presentation to the committee, comprised of directors Wootton, Kukuchka, Stover and Dakey, on April 5, 2013. The presentation included, among other things, a review of the preliminary *pro forma* financials, the proposed exchange ratio of 1.3636, and proposed timeline.

Also on April 5, 2013, the Penseco independent committee met to discuss the potential transaction. Mr. Best reported to the committee on his earlier meeting with Peoples' strategic planning committee, as well as the responses received from advisors with respect to the RFPs sent out on March 27.

On April 10, 2013, Mr. Best met with Joseph T. Wright, a director of Peoples, to review the presentation made to Peoples' strategic planning committee on April 5.

Penseco's board of directors held its regular meeting on April 16, 2013 and discussed, among other matters, the financial metrics of the transaction and compared them to criteria previously identified by the board. The expected benefits for Penseco's shareholders, customers, employees and communities as well as the potential strategic benefits of the transaction were also discussed.

April 30, 2013, Mr. Best and Mr. Seasock met to discuss potential strategic benefits of the transaction.

Penseco's independent committee met May 2, 2013, to discuss the potential transaction, including the timeline, projected advisory costs and estimated cost saves that would result from the potential merger.

On April 12, 2013, Peoples engaged Boenning & Scattergood as its financial advisor. On May 3, 2013, Boenning & Scattergood made a presentation to the strategic planning committee which included an overview of

## **Table of Contents**

Penseco, summary of the proposed terms, a contribution analysis, transaction considerations and observations. Later that day, Mr. Aubrey contacted Mr. Best to discuss the outcome of the strategic planning committee meeting. Mr. Aubrey indicated that Peoples would be interested in further pursuing the transaction if Penseco would be able to validate Penseco's estimated cost saves and address certain governance matters.

Also, at the May 3, 2013 Peoples board of directors' meeting, the board of directors reviewed the community banking industry, community bank capital markets, and strategic alternatives. These strategic alternatives included remaining independent, selective acquisitions of smaller banks or banks in existing or adjacent markets, mergers of equals with a bank of similar size that has compatible markets and a similar culture and operating philosophy (thereby taking a "best of breed" approach to personnel and operations to enhance growth, cost savings and other synergies amongst companies), or to sell to a larger competitor in the market or a bank looking to expand into Peoples' market. A standalone analysis was undertaken and reviewed including, among other things, growth, profitability, portfolio composition, asset quality, market performance, opportunities going forward, financial projections, discounted dividend analysis and standalone opportunities and challenges. Selective acquisition opportunities were also reviewed, including acquisition candidates and potential acquisition branch locations. Preliminary analysis of various prospective target acquisition candidates was reviewed including information in connection with branch acquisitions. The opportunities and challenges both historical/current and prospective of this alternative were reviewed.

A merger of equals analysis and review was also undertaken, including the business rationale for such an approach including enhanced growth opportunities, improved profitability, revenue enhancements, expanded and enhanced management team, greater liquidity for shareholders, and preservation of local identity. The challenges associated with a merger of equals were also discussed. Structuring of merger of equals was discussed. Various potential prospective merger of equals candidates were discussed. Various contribution analyses of merger of equals candidates were undertaken and reviewed. The opportunities and challenges of various potential merger of equals combinations were reviewed and discussed.

The potential strategic alternative of a sale of the company was analyzed, reviewed and discussed including current valuations, current activity, shareholder liquidity, potential returns, and business opportunity issues. Various comparables were reviewed and analyzed. The opportunities and challenges associated with a sale of the company were reviewed and discussed.

The board of directors discussed and reviewed quantification of each of these opportunities and alternatives and Peoples' prior history, current and future prospects in connection with each alternative, and the probability of successfully implementing such alternatives. The board of directors concluded unanimously that pursuing a strategy of prudently growing the company, enhancing shareholder value, improving liquidity, improving future business prospects, broadening and strengthening management, maintaining cultural, philosophical and community identity were in the best interests of Peoples and its constituencies, including the shareholders. The board of directors believed that when comparing these alternatives that the potential transaction with Penseco may meet these objectives and goals subject to continued investigation, analysis, due diligence, development of terms agreement negotiation, validation of estimated cost saves and the successful resolution of certain governance matters.

On May 6, 2013, Mr. Best provided an update to Penseco's independent committee, including with respect to Penseco's management efforts to validate the estimated cost saves. Committee members discussed governance matters with Mr. Best.

Penseco held its annual meeting of shareholders and board reorganization meeting on May 7, 2013. At the board meeting, Mr. Best updated the Board on the progress of the transaction with Peoples and a proposal, previously discussed with the independent committee, regarding the size and composition of the board of directors of the combined company, the classification of directors, Peoples mandatory retirement bylaw applicable to directors, and a proposed bylaw amendment.

**Table of Contents**

On May 10, 2013, the Penseco independent committee approved a proposal with respect to the composition of the board of directors of the combined company and authorized and directed Mr. Best to present the proposal to Peoples. Mr. Best then presented the proposal to Mr. Aubrey.

On May 15 and 16, 2013, Mr. Best spoke with Messrs. Wootton and Aubrey to discuss various aspects of the potential transaction. On May 17, 2013, Peoples received a draft cost-savings analysis from Cedar Hill Advisors, which had been prepared by Cedar Hill Advisors in collaboration with Boenning & Scattergood.

Penseco's independent committee met on May 17, 2013 to discuss the potential transaction's progress, proposed board structure, the identified cost saves, a communication plan proposal and an updated timeline.

On May 20, 2013, Mr. Best met with Mr. Hull of Boenning & Scattergood regarding potential cost savings as a result of a transaction between Peoples and Penseco.

Peoples engaged Bybel Rutledge on May 20, 2013, to serve as special legal counsel regarding the potential transaction with Penseco.

Peoples' management and Boenning & Scattergood met with Penseco's management and Cedar Hill Advisors to discuss certain financial and cost-savings considerations relating to a potential transaction with Penseco on May 24, 2013.

Penseco's independent committee met on May 25, 2013 to review the information discussed at the May 24th meeting between Peoples management and Penseco's management and financial advisors.

On May 28, 2013, Mr. Hull presented the cost-savings analysis to Peoples' board of directors. The board of directors reviewed, discussed, and considered the analysis.

Penseco's board of directors met on May 28, 2013. At the meeting, members of Penseco's management reviewed the progress of the potential transaction with Peoples. Among other matters, the board discussed potential risks associated with the transaction, particularly the risk that the combined company may not achieve potential revenue enhancements, cost savings or earnings, the risk that the per share market price of Peoples common stock may decline, and the risk that the liquidity of the Peoples common stock following the proposed transaction may not be significantly better than the current liquidity of the Penseco common stock. The board also discussed potential strategies to address those risks, the validated cost savings, the financial metrics of the transaction, the proposed timeline, a draft of a non-binding letter of interest and a due diligence plan and schedule.

On May 28, 2013, Messrs. Dakey and Best met to discuss various matters relating to the proposed transaction, including personnel and operations.

Peoples' strategic planning committee met with Peoples' management to discuss cost-savings and current status of negotiations with Penseco on May 30, 2013.

On May 31, 2013, Peoples board of directors met to discuss the strategic opportunity presented by the Penseco discussions and the non-binding indication of interest received from Penseco. Mr. Hull from Boenning & Scattergood and Mr. Bybel from Bybel Rutledge were present. The chairman of the strategic planning committee presented the timeline and status of discussions with Penseco. Mr. Hull presented the potential terms and issues regarding a transaction with Penseco including pricing, comparable transactions and present value calculations. Mr. Bybel discussed the fiduciary duties of the board of directors under Pennsylvania law. The board authorized the chairman of the strategic planning committee to enter into the non-binding indication of interest with Penseco. The board of directors also reviewed, discussed and revisited their prior conversations, considerations and analysis regarding strategic alternatives previously reviewed in detail on



## **Table of Contents**

May 3, 2013, and concluded that the proposed transaction with Penseco could be in the best interests of its shareholders and constituents as of this time and warranted moving to the next step of due diligence.

The board of directors of Penseco met at a special meeting held May 31, 2013, to discuss the proposed transaction with Peoples and authorized the execution of a non-binding indication of interest with Peoples. The parties executed the non-binding indication of interest later that day.

Between May 31, 2013 and June 28, 2013, each of the parties and its respective advisors engaged in various due diligence investigations of the other party, both in person and through a secure website.

On June 3, 2013, Penseco engaged Pepper Hamilton LLP as legal counsel with respect to the proposed transaction and, on June 6, 2013, engaged Griffin Financial Group, LLC to provide financial advisory services in connection with the proposed transaction. On June 7, 2013, Penseco's independent committee met to discuss the potential transaction, including the plans for a definitive merger agreement, transaction expenses and next steps.

On June 12, 2013, Bybel Rutledge sent the initial draft of the merger agreement reflecting the terms of the executed non-binding indication of interest for all parties to review. On June 19, 2013, Pepper Hamilton responded with comments and proposed revisions on behalf of its client, Penseco, to the June 12, 2013 draft of the merger agreement. The Pepper Hamilton draft proposed changes to the definition of Acquisition Proposal and Material Adverse Effect; the addition of a Superior Acquisition Proposal as a mechanism to terminate the merger agreement; removal of the mechanism for continuing service on the board of directors by the initial Penseco and Peoples board of directors; placing the current directors into agreed upon respective classes; changes to the exchange procedure for Penseco shareholders to exchange their shares of Penseco common stock for Peoples common stock; changes to the representations and warranties; changes to the no shop provision where the board of directors of Penseco agreed not to accept any other bids except in certain circumstances to fulfill their fiduciary duties; removal of the post-closing covenant to continue the payment of \$.31 per share dividend to Peoples shareholders after the effective time of the transaction; a reduction in the maximum percentage of Penseco dissenting shares that would serve as a condition to closing from ten percent to one percent; and other less significant edits.

After consultation with Peoples, Bybel Rutledge circulated a revised draft on June 25, 2013. This draft included certain changes to the definition of Material Adverse Effect, revisions to the composition of the board of directors as well as the mechanism for continuing service after closing. The revisions included changes in order to comply with corporate governance listing standards for nominating committees. Select changes were made to the representations and warranties, specifically the representations regarding tax, ERISA, and compliance with law. The covenants were also revised to allow for regularly scheduled bonus payments for employees. Select revisions were made to the no shop provision as requested by Penseco to ensure compliance with the Penseco board of director's fiduciary duties. In addition, changes to the termination section were revised regarding certain situations when expenses would be reimbursed by the terminating party to the non-terminating party primarily the elimination of a termination fee if the Penseco shareholders failed to approve the transaction by the requisite percentage. A section was also added to the termination provision to allow the parties to terminate the merger agreement based upon a decrease in the stock price of the other party and a decrease in the stock price of a peer group of financial institutions.

Pepper Hamilton, after consultation with Penseco, circulated comments on the June 25, 2013 draft on June 26, 2013 requesting revisions to the representations regarding financial statements and regulatory reports and to the timing of the bank merger following the merger of the holding company, as well as other edits.

After consultation with Peoples, Bybel Rutledge circulated a revised draft on June 26, 2013 adding the ability for the parties to issue annual and retention bonuses and reducing the amount of dissenting shares of Penseco that could dissent as a condition to close. In addition, the requested change regarding the timing of the bank merger was made.

**Table of Contents**

Pepper Hamilton responded on behalf of Penseco on June 27, 2013, requesting an increase in the percentage of a company that would be purchased that would constitute an Acquisition Proposal and other edits. In addition, conference calls were held to discuss the corporate governance listing rules regarding the nominating committees for selecting directors.

After consultation with Peoples, Bybel Rutledge circulated a revised draft on June 27, 2013 making the requested changes to the definition of Acquisition Proposal, revising the mechanism for selecting directors after closing to comply with the corporate governance listing rules regarding nominating committees for selecting directors. In addition, revisions were made the termination provision that only Penseco could terminate the agreement for a reduction in stock price of Peoples and a reduction in the stock price of a peer group of financial institutions.

Bybel Rutledge circulated a revised merger agreement with non-material changes on June 27, 2013 which would be the version of the merger agreement that was executed. Penseco's independent committee continued to meet regularly and direct the efforts of management and Penseco's advisors throughout this period.

Penseco's board of directors held a special meeting on June 18, 2013, and received reports from Penseco's management and legal and financial advisors with respect to the proposed transaction, results of due diligence investigations, a preliminary analysis relating to Griffin's fairness opinion, duties and responsibilities of the board and the draft merger agreement.

On June 19, 2013, Messrs. Best and Dakey met to discuss management structure and integration. Later, Messrs. Best, Wootton and Hull met to discuss the status, due diligence results, employee matters and issues relating to the draft merger agreement.

Peoples' strategic planning committee met with other members of the Peoples board on June 25, 2013 to consider and review the current status of the negotiations with Penseco and due diligence findings. Mr. Hull reviewed the Boenning and Scattergood presentation with the board of directors. Mr. Bybel reviewed with the board of directors the draft merger agreement and all schedules, exhibits, and annexes thereto and their duties under law.

On June 28, 2013, Peoples' board of directors met to consider the merger agreement and the schedules, exhibits, and annexes thereto. Mr. Hull reviewed the Boenning and Scattergood presentation with the board of directors. Mr. Bybel reviewed with the board of directors the merger agreement and all schedules, exhibits, and annexes thereto and their duties under law. After presentations by management and Boenning & Scattergood and receipt of a written fairness opinion from Boenning & Scattergood, the board of directors discussed, considered, approved and adopted the terms of the transaction and the merger agreement.

That same day, at a special meeting of the Penseco board of directors, the board heard the reports of Penseco's management regarding the proposed transaction, Griffin with respect to its fairness opinion, Pepper Hamilton with respect to the terms of the merger agreement, and the independent committee with respect to its recommendation regarding the proposed transaction. After extensive discussion among the members of the board, the Penseco board of directors approved and adopted the terms of the transaction and the merger agreement.

Following the Peoples and Penseco board meetings, the parties executed the merger agreement and announced the transaction on June 28, 2013.

## **Table of Contents**

### **Certain Non-Public, Unaudited, Forward-Looking Information Exchanged by Peoples and Penseco**

In the course of their due diligence examinations, Peoples and Penseco each provided copies of certain internal financial projections for future periods prepared by senior management to the other and to Boenning & Scattergood, Inc. and Griffin Financial Group, LLC, respectively to assist them in preparing their analyses of the transaction.

Peoples, Boenning, and Griffin obtained from Penseco a copy of Penseco's internal 2013 operating budget, which included forecasted operating results for 2013. Penseco and Boenning obtained from Peoples a copy of Peoples' internal 2013 operating budget, dated December 2012, which included forecasted operating results for 2013, Peoples' strategic plan, dated October 2012, and risk assessment and capital plan, dated September 2012. Further, Griffin obtained additional projections for Peoples and Penseco prepared by the Penseco senior management team in conjunction with Cedar Hill Advisors.

Penseco's internal 2013 operating budget provided to Peoples, which had been prepared in January 2013 and updated to reflect 2013 actual results through April 30, 2013, included the following projections for the year ending December 31, 2013: net interest income of approximately \$30.6 million, net income of approximately \$10.4 million and earnings per share of approximately \$3.18.

Peoples' internal 2013 operating budget provided to Penseco included the following projections for the year ending December 31, 2013: net interest income of approximately \$24.4 million, net income of approximately \$9.3 million and earnings per share of approximately \$3.00.

The foregoing projections are provided for the sole purpose of describing certain projections that were exchanged between the parties. Actual results for Peoples, Penseco or the combined company could vary significantly from the projections.

The referenced budgets and projections involve significant assumptions regarding, among other things, interest rates, projected loan, deposit and asset growth, dividends, asset quality and allowance for loan losses, loan-to-deposit ratios and return on assets which were based on historical data, trends and interim results along with any known information that would potentially cause future results to differ from prior results. Additional significant assumptions underlying the projections included amounts necessary to estimate the impact of acquisition accounting, as well as anticipated costs savings. Because the projections were based on numerous variables and assumptions, including factors related to general economic and competitive conditions, which are inherently uncertain; accordingly, actual results could vary significantly from those set forth in the projections.

The senior management of both companies developed their 2013 operating budgets prior to and without regard for the proposed merger, and Penseco and Peoples do not publicly disclose internal management projections of the type used by Boenning and Griffin in connection with their review of the merger, or any other earnings guidance or financial projections. As a result, such projections were not prepared with a view towards public disclosure.

Further, such projections are not intended to comply with the guidelines for financial forecasts established by the American Institute of Certified Public Accountants or any other established guidelines regarding projections or forecasts.

In addition, they were not reviewed or compiled by any accounting firm or the financial advisors of Peoples or Penseco, either in connection with their preparation or for the purpose of providing any opinion with respect thereto. The reports of the independent registered public accounting firms of Peoples and Penseco included in or incorporated by reference into this document relate solely to the historical financial information of the respective companies as referred to therein. Such reports do not extend to the above discussion of the Peoples and Penseco projections and should not be read as doing so.

## Table of Contents

### **Peoples Reasons for the Merger**

Peoples board of directors considered the terms of the merger agreement, the long-term and short-term strategic and economic benefits of the proposed merger, the short and long-term *pro forma* financial impact and the *pro forma* ownership percentages of the and potential effects on the outstanding common stock of the combined company which would be held by the present holders of Peoples and Penseco common stock and determined that it is advisable and in the best interests of Peoples for Peoples to enter into the merger agreement with Penseco. Accordingly, Peoples board of directors recommends that Peoples shareholders vote FOR approval and adoption of the merger agreement.

In the course of making its decision to approve the transaction with Penseco, Peoples board of directors consulted with Peoples independent merger and acquisitions committee, executive management and Peoples financial and legal advisors. Peoples board of directors considered, among other things, the following factors:

Peoples board of directors reviewed its own strategic opportunities, business, operations, financial condition, earnings, and prospects and also reviewed Penseco's business, operations, financial condition, earnings, and prospects, including both Peoples and Penseco's geographic positions in Northeastern Pennsylvania and Southern New York. After concluding its review, Peoples concluded that the merger would enhance its competitive strategic position, potential prospective business opportunities, operations, management, prospective financial condition, future earnings and business prospects. Specifically, Peoples believes that the merger will enhance its business opportunities due to the combined company having a greater market share, market presence and the ability to offer more diverse (i.e. Trust Services and merchant services) and more profitable products, as well as a broader based and geographically diversified branch system to enhance deposit collection and funding costs, and a higher legal and business lending limit to originate larger and potentially more profitable commercial loans. The greater market share, market diversity and enhanced products and services should lead to prospects of enhancing customer relationships, lower operating costs, increased earnings, and enhanced profitability from better and more diversified sources. The board of directors of Peoples viewed these items as favorable factors, supporting the decision to proceed with the merger;

Its understanding of the current and prospective environment in which Peoples and Penseco operate, including regional and local economic conditions, the competitive environment for financial institutions generally, and continuing prospects for mergers in the financial services industry, and the likely effect of these factors on Peoples and Penseco, in light of, and in absence of, the proposed business combination. Specifically, the board of directors of Peoples believes that the future business environment for financial institutions will become more competitive and concentrated. The board of directors of Peoples believes that the merger will help the resulting bank be more competitive with the institutions remaining in the market place because the combined company will have numerous and greater resources than either company had individually. The board of directors of Peoples viewed these items as favorable factors, supporting the decision to proceed with the merger;

The effort of Peoples management to identify potential counterparties to potential transactions; the Peoples Board of Directors weighed the opportunities that they had during the last two years to grow the company and the future prospects of such opportunities. The Board of Directors believes that the ability to grow through potential acquisitions and mergers is meaningful to the long term prospects of Peoples and is enhanced through the combination with Penseco which may result in the ability of the company to grow assets and earnings in the long run for the Peoples shareholders. The Board of Directors viewed this as a favorable feature supporting the decision to proceed with the merger;

The board's review with its legal and financial advisors of the structure of the merger, the financial and other terms of the merger and related documents including the board's assessment of the Peoples exchange ratio to the Peoples shareholders relative to the terms of and benefits to be derived from the merger;

The combination could result in potential annualized cost savings aggregating nearly \$7.1 million, as well as the potential for incremental revenue opportunities enabling a potential significant increase in



## Table of Contents

long-term future earnings accretion, improving long-term investor value, and creating a stronger franchise. The potential cost savings are expected to be derived from the reconfiguration of duplicate internal operations and administrative functions and the elimination of redundant external contractual services and from the convergence and standardization of various retirement, bonus, and incentive programs. The board of directors of Peoples viewed these items as favorable factors, supporting the decision to proceed with the merger;

The proposed board and management structure which would position the combined company with strong leadership and strategic vision while improving its ability to attract and retain competitive management. Specifically, the board of directors of Peoples viewed the resulting management structure and team as addressing a management concern that Peoples had with respect to the future and leadership. The resulting management team of the combined company, its experience and abilities was viewed as a favorable factor by the Peoples board of directors in supporting this transaction;

The review by the Peoples board of directors of the structure and terms of the merger, including the exchange ratio and the expectation that the merger would qualify as a type of transaction that is generally tax-free to shareholders for United States federal income tax purposes. The board of directors of Peoples reviewed the tax-free treatment for federal income tax purposes as favorable because the board believes that it would provide the shareholders of Penseco with more value than a taxable transaction on similar terms and the resulting company with clarity of tax status. The board viewed the exchange ratio relative to the other terms as favorable because of the future prospects for combined growth (both organic and inorganic) and profitability and the potential for price appreciation and liquidity, which factors the Peoples board of directors viewed as favorably supporting the decision to proceed with the merger;

The ability to offer more diverse and progressive business services and products of Penseco to Peoples customers could result in opportunities to obtain synergies and compete with larger financial institutions as products are cross-marketed and distributed over a broader customer base. Specifically, the board of directors of Peoples believes that this will enhance the ability to generate profits. This was viewed favorably by the Peoples board of directors in supporting the transaction;

The prospects to increase long-term shareholder value by increasing the potential of share liquidity (the potential quotation of share transactions on a national exchange), increasing common stock dividends to \$1.24 per share through cost savings and enhanced and accelerated earnings, and enhanced consolidated earnings, provided sufficient funds are legally available and that Peoples and its subsidiary bank remains well-capitalized in accordance with applicable regulatory guidelines;

The fact that certain provisions of the merger agreement prohibit or limit Penseco from soliciting or responding to proposals for alternative transactions, Penseco's obligation to pay a termination fee of \$3.7 million if the merger agreement is terminated due to Penseco accepting another offer, and Penseco's obligation to pay \$600,000 in liquidated damages in the event that the merger agreement is terminated due to Penseco's breach;

The fact that, pursuant to the merger agreement, Penseco must generally conduct its business in the ordinary course and Penseco is subject to a variety of other restrictions on the conduct of its business prior to the completion of the merger or termination of the merger agreement;

The financial information and analyses presented by Boenning & Scattergood, Inc. to the board of directors, and the opinion of Boenning & Scattergood, Inc. to the effect that, as of the date of such opinion, based upon and subject to the factors and assumptions set forth in such opinion, the exchange ratio in the proposed merger was fair to the shareholders of Peoples from a financial point of view;

The likelihood that the regulatory approvals necessary to complete the merger would be obtained;

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The historical illiquidity of Peoples common stock was reviewed. However, this short-term negative was offset by the belief by the Peoples board of directors that the overall company structure, resulting management, synergies, cost savings and potential revenue enhancements would create and enhance long-term shareholder value and liquidity and these were deemed to outweigh any short-term negatives; and

## Table of Contents

The merger will not result in any immediate branch closures by either Peoples or Penseco because the market areas are tangential and not overlapping. This was viewed as a positive factor by the Peoples board of directors.

The board of directors of Peoples also considered the fact that the combined institution would result in a financial institution with more than \$1.6 billion in assets. The addition of the other market area is expected to provide sustained business development opportunities by enabling Peoples and Penseco to capitalize on the other s banking franchise to compete in the Northeastern Pennsylvania market.

Peoples board of directors reviewed the totality of the future prospects opportunities of Peoples its needs, the environment relative to the terms of the merger and its anticipated effects and concluded that the merger and its terms with the prospects of enhanced earnings, dividends, liquidity, with stronger, broader and deeper management while retaining operational focus were in the best long-term interests of Peoples and its shareholders.

Peoples board of directors also considered the following:

The fact that Peoples shares to be issued to holders of Penseco stock to complete the merger will result in reduced ownership and voting interest to existing Peoples shareholders. While ownership reduction is expected to occur in the short term, the board of directors believes that the long-term benefits to be derived from the merger (increased long-term earnings, cost savings, enhanced management, increased dividends, among other things) more than offset this;

The proposed board and management arrangements, including Peoples commitment to (i) appoint eight (8) Penseco directors and six (6) Peoples directors to the combined fourteen (14) member Peoples board of directors and to Peoples Neighborhood Bank board of directors, (ii), consider employing certain senior officers of Penseco as employees of Peoples after the merger;

The risk that integration of Peoples and Penseco will not occur as desired and the potential impact of integration if not successful on the expected benefits of the merger;

The potential challenges associated with obtaining regulatory approvals required to complete the transaction in a timely manner;

The fact that, pursuant to the merger agreement, Peoples must generally conduct its business in the ordinary course and Peoples is subject to a variety of other restrictions on the conduct of its business prior to the completion of the merger or termination of the merger agreement, which may delay or prevent Peoples undertaking business opportunities which may arise pending completion of the merger;

The risk that potential benefits (strategic, operational, financial), cost benefits and other synergies sought in the merger may not be realized or may not be realized within the expected time period and the risks associated with the integration of Peoples and Penseco;

The risk that certain tax attributes of Peoples and Penseco may be affected by the transaction; and

The potential for diversion of management and employee attention and for employee attrition during the period prior to the completion of the merger and the potential effect on Peoples business and relations with customers, service providers and other stakeholders whether or not the merger is consummated.

The foregoing discussion of the factors considered by the Peoples board of directors in evaluating the merger agreement is not intended to be exhaustive, but, rather, includes all material factors considered by the Peoples board of directors. Peoples board of directors evaluated the factors described above, including asking questions of Peoples legal and financial advisors. In reaching its decision to approve the agreement and the merger, the Peoples board of directors did not quantify or assign relative values to the factors considered, and individual directors may have given different weights to different factors. The Peoples board of directors relied





## **Table of Contents**

on the experience and expertise of its legal advisors regarding the structure of the merger and the terms of the merger agreement and on the experience and expertise of its financial advisors for quantitative analysis of the financial terms of the merger.

Peoples board of directors realizes that there can be no assurance about future results, including results expected or considered in the factors listed above. The Peoples board of directors considered all of the above factors as a whole, and on an overall basis considered them to be favorable to, and support, its determination to enter into the merger agreement.

### **Recommendation of the Peoples Board of Directors**

The Peoples board of directors has approved the merger agreement and the merger and believes that the proposed merger is in the best interests of Peoples and its shareholders. Accordingly, the Peoples board of directors recommends that Peoples shareholders vote FOR approval and adoption of the merger agreement, the merger and the transactions in connection therewith.

### **Opinion of Peoples Financial Advisor**

By letter dated April 12, 2013, Peoples retained Boenning & Scattergood, Inc., or Boenning, to act as its exclusive financial advisor in connection with a possible sale, merger, or other business combination. Boenning & Scattergood, Inc. is an investment banking firm headquartered in West Conshohocken, Pennsylvania with an expertise in merger and acquisitions involving banks and other financial institutions. Boenning & Scattergood, Inc. is regularly engaged in the valuation of financial institutions and their securities in connection with mergers and acquisitions and other corporate transactions.

Boenning & Scattergood, Inc. acted as financial advisor to Peoples in connection with the proposed transaction and participated in certain of the negotiations leading to the execution of the merger agreement, dated as of June 28, 2013. At a meeting of the Peoples board of directors on June 28, 2013, the Peoples board of directors reviewed the merger agreement and Boenning & Scattergood, Inc. delivered to the board of directors its oral and written opinion, that as of such date and based upon and subject to the various considerations set therein, the exchange ratio was fair to the holders of Peoples common stock from a financial point of view. The Peoples board of directors approved the merger agreement at this meeting. We will refer to the opinion of June 28, 2013 as the Opinion

The full text of Boenning & Scattergood, Inc.'s written opinion dated June 28, 2013, which is referred to herein as the Opinion, is attached as Annex B and is incorporated in this joint proxy statement/prospectus by reference. The Opinion outlines the procedures followed, assumptions made, matters considered and qualifications and limitations on the review undertaken by Boenning & Scattergood, Inc. in rendering the Opinion. The description of the Opinion set forth below is qualified in its entirety by reference to the Opinion. Peoples shareholders are urged to read the entire Opinion carefully in connection with their consideration of the proposed merger.

The Opinion speaks only as of its date. The Opinion was directed to the Peoples board of directors and is directed only to the fairness, from a financial point of view, of the exchange ratio to be paid to the holders of Peoples common stock. It does not address the underlying business decision of Peoples to engage in the merger or any other aspect of the merger and is not a recommendation to any Peoples shareholder as to how such shareholder should vote at the special meeting with respect to the merger or any other matter.

In connection with rendering the Opinion, Boenning & Scattergood, Inc. reviewed and considered, among other things:

the merger agreement;

audited financial statements for the three years ended December 31, 2012 and other historical financial information of Peoples;

certain publicly available financial statements and other historical financial information of Penseco;

**Table of Contents**

certain internal financial projections for Peoples and Penseco and for the year ending December 31, 2012, as provided by senior management of Peoples and Penseco;

the *pro forma* financial impact of the proposed merger between Penseco and Peoples based on assumptions as determined by the senior managements of Peoples and Penseco, relating to transaction expenses, purchase accounting adjustments, the application of reverse merger accounting treatment to the merger and cost savings;

the terms and structures of other comparable recent mergers and acquisition transactions in the commercial banking sector;

the current market environment generally and in the commercial banking sector in particular; and

such other information, financial studies, analyses and investigations and financial, economic and market criteria as Boenning & Scattergood, Inc. considered relevant.

the current market environment generally and in the commercial banking sector in particular; and

such other information, financial studies, analyses and investigations and financial, economic and market criteria as Boenning & Scattergood, Inc. considered relevant.

Boenning & Scattergood, Inc. also discussed with certain members of senior management of Peoples the business, financial condition, results of operations and prospects of Peoples and held similar discussions with senior management of Penseco concerning the business, financial condition, results of operations and prospects of Penseco.

In performing its review, Boenning & Scattergood, Inc. relied upon the accuracy and completeness of all of the financial and other information that was available to Boenning & Scattergood, Inc. from public sources, that was provided to Boenning & Scattergood, Inc. by Peoples and Penseco, or their respective representatives, or that was otherwise reviewed by Boenning & Scattergood, Inc., and Boenning & Scattergood, Inc. has assumed such accuracy and completeness for purposes of rendering the Opinion. Boenning & Scattergood, Inc. has further relied on the assurances of the respective managements of Peoples and Penseco that they are not aware of any facts or circumstances that would make any of such information inaccurate or misleading. Boenning & Scattergood, Inc. has not been asked to and has not undertaken an independent verification of any of such information and does not assume any responsibility or liability for the accuracy or completeness thereof. Boenning & Scattergood, Inc. did not make an independent evaluation or appraisal of the specific assets, the collateral securing assets or the liabilities (contingent or otherwise) of Peoples and Penseco or any of their respective subsidiaries. Boenning & Scattergood, Inc. renders no opinion or evaluation on the collectability of any assets or the future performance of any loans of Peoples and Penseco. Boenning & Scattergood, Inc. did not make an independent evaluation of the adequacy of the allowance for loan losses of Peoples and Penseco, or the combined entity after the merger, and it has not reviewed any individual credit files relating to Peoples and Penseco. Boenning & Scattergood, Inc. has assumed, with Peoples' consent, that the respective allowances for loan losses for both Peoples and Penseco are adequate to cover such losses and will be adequate on a *pro forma* basis for the combined entity.

In preparing its analyses, Boenning & Scattergood, Inc. used internal financial projections for Peoples and Penseco as provided by the senior management of Peoples and Penseco. Boenning & Scattergood, Inc. also received and used in its analyses certain projections of transaction costs, purchase accounting adjustments, expected cost savings and other synergies which were prepared by and/or reviewed with the senior management of Peoples and Penseco. With respect to those projections, estimates and judgments, the management of Peoples and Penseco confirmed to Boenning & Scattergood, Inc. that those projections, estimates and judgments reflected the best currently available estimates and judgments of Peoples management of the future financial performance of Peoples and Boenning & Scattergood, Inc. assumed that such performance would be achieved. The projections furnished to Boenning & Scattergood, Inc. and used by it in certain of its analyses were prepared by Peoples' and Penseco's senior management team. Peoples and Penseco does not publicly disclose internal management projections of the type provided to Boenning & Scattergood, Inc. in connection with its review of the merger. As



## **Table of Contents**

a result, such projections were not prepared with a view towards public disclosure. The projections were based on numerous variables and assumptions, which are inherently uncertain, including factors related to general economic and competitive conditions. Accordingly, actual results could vary significantly from those set forth in the projections. Boenning & Scattergood, Inc. expresses no opinion as to such financial projections or estimates or the assumptions on which they are based. Boenning & Scattergood, Inc. has also assumed that there has been no material change in Peoples and Pensco's assets, financial condition, results of operations, business or prospects since the date of the most recent financial statements made available to Boenning & Scattergood, Inc. Boenning & Scattergood, Inc. has assumed in all respects material to its analysis that Peoples and Pensco will remain as going concerns for all periods relevant to its analyses, that all of the representations and warranties contained in the merger agreement and all related agreements are true and correct, that each party to the merger agreement will perform all of the covenants required to be performed by such party under the merger agreement and that the conditions precedent in the merger agreement are not waived. Finally, with the consent of Peoples, Boenning & Scattergood, Inc. has relied upon the advice that Peoples has received from its legal, accounting and tax advisors as to all legal, accounting and tax matters relating to the merger and the other transactions contemplated by the merger agreement.

The Opinion is necessarily based on financial, economic, market and other conditions as in effect on, and the information made available to us as of, the date hereof. Events occurring after the date hereof could materially affect the Opinion. Boenning & Scattergood, Inc. has not undertaken to update, revise, reaffirm or withdraw the Opinion or otherwise comment upon events occurring after the date thereof.

The Opinion was directed to the Peoples board of directors in connection with its consideration of the merger and does not constitute a recommendation to any shareholder of Peoples as to how any such shareholder should vote at the Peoples special meeting. The Opinion is directed only to the fairness, from a financial point of view, of the exchange ratio to the holders of Peoples common stock and does not address the underlying business decision of Peoples to engage in the merger, the relative merits of the merger as compared to any other alternative business strategies that might exist for Peoples or the effect of any other transaction in which Peoples might engage. The Opinion shall not be reproduced or used for any other purposes, without Boenning & Scattergood, Inc.'s prior written consent. The Opinion has been approved by Boenning & Scattergood, Inc.'s fairness opinion committee. Boenning & Scattergood, Inc. has consented to inclusion of the Opinion and a summary thereof in this joint proxy statement/prospectus and in the registration statement on Form S-4 which includes this joint proxy statement/prospectus. Boenning & Scattergood, Inc. does not express any opinion as to the fairness of the amount or nature of the compensation to be received in the merger by any officer, director, or employee, or class of such persons, relative to the compensation to be received in the merger by any other shareholder.

In rendering its Opinion, Boenning & Scattergood, Inc. performed a variety of financial analyses. The following is a summary of the material analyses performed by Boenning & Scattergood, Inc., but is not a complete description of all the analyses underlying Boenning & Scattergood, Inc.'s opinion. The summary includes information presented in tabular format. In order to fully understand the financial analyses, these tables must be read together with the accompanying text. The tables alone do not constitute a complete description of the financial analyses. The preparation of a fairness opinion is a complex process involving subjective judgments as to the most appropriate and relevant methods of financial analysis and the application of those methods to the particular circumstances. In arriving at its opinion, Boenning & Scattergood, Inc. did not attribute any particular weight to any analysis or factor that it considered. Rather, Boenning & Scattergood, Inc. made qualitative judgments as to the significance and relevance of each analysis and factor. Boenning & Scattergood, Inc. did not form an opinion as to whether any individual analysis or factor (positive or negative) considered in isolation supported or failed to support the Opinion; rather Boenning & Scattergood, Inc. made its determination as to the fairness of the exchange ratio on the basis of its experience and professional judgment after considering the results of all its analyses taken as a whole. The process, therefore, is not necessarily susceptible to a partial analysis or summary description. Boenning & Scattergood, Inc. believes that its analyses must be considered as a whole and that selecting portions of the factors and analyses to be considered without considering all factors and

## Table of Contents

analyses, or attempting to ascribe relative weights to some or all such factors and analyses, could create an incomplete view of the evaluation process underlying its opinion. Also, no company included in Boenning & Scattergood, Inc.'s comparative analyses described below is identical to Peoples or Penseco and no transaction is identical to the merger. Accordingly, an analysis of comparable companies or transactions involves complex considerations and judgments concerning differences in financial and operating characteristics of the companies and other factors that could affect the public trading values or merger transaction values, as the case may be, of Peoples or Penseco and the companies to which they are being compared.

In performing its analyses, Boenning & Scattergood, Inc. also made numerous assumptions with respect to industry performance, business and economic conditions and various other matters, many of which cannot be predicted and are beyond the control of Peoples, Penseco and Boenning & Scattergood, Inc. The analysis performed by Boenning & Scattergood, Inc. is not necessarily indicative of actual values or future results, both of which may be significantly more or less favorable than suggested by such analyses. Boenning & Scattergood, Inc. prepared its analyses solely for purposes of rendering the Opinion and provided such analyses to the Peoples board of directors at the June 28, 2013 meeting. Estimates on the values of companies do not purport to be appraisals or necessarily reflect the prices at which companies or their securities may actually be sold. Such estimates are inherently subject to uncertainty and actual values may be materially different. Accordingly, Boenning & Scattergood, Inc.'s analyses do not necessarily reflect the value of Peoples' common stock or the prices at which Peoples' common stock may be sold at any time. The analysis and the Opinion of Boenning & Scattergood, Inc. was among a number of factors taken into consideration by the board of directors of Peoples in making its determination to approve of Peoples' entry into the merger agreement and the analyses described below should not be viewed as determinative of the decision the board of directors of Peoples or management with respect to the fairness of the merger.

At the June 28, 2013 meeting of the Peoples board of directors, Boenning & Scattergood, Inc. presented certain financial analyses of the merger. The summary below is not a complete description of the analyses underlying the opinions of Boenning & Scattergood, Inc. or the presentation made by Boenning & Scattergood, Inc. to the Peoples board of directors, but is instead a summary of the material analyses performed and presented in connection with the Opinion.

*Summary of Transaction.* The merger, while considered a merger of equals, will be accounted for as a reverse acquisition by Penseco of Peoples using the purchase method of accounting and, accordingly, the assets and liabilities of Peoples will be recorded at their respective fair values on the date the merger is completed. The Merger will be effected by the issuance of shares of Peoples stock to Penseco shareholders. In accordance with ASC Topic 805: Business Combinations, the final accounting purchase price assigned to record the shares issued in the merger will be based on the closing price of Penseco's common stock on the effective date of the merger.

While Penseco's stock price be used to determine the final accounting purchase price, for purposes of its opinion, Boenning & Scattergood calculated an offer-based purchase price, implied pricing and valuation multiples based upon Peoples' 10-day average stock price as of June 27, 2013, of \$36.07. Each share of Penseco common stock will be exchanged for 1.3636 shares of Peoples common stock. The implied offer price in stock paid to Penseco was derived by multiplying the negotiated exchange ratio of 1.3636 by Peoples' 10-day average stock price of \$36.07 stock price resulting in a per share value to Penseco's shareholders of \$49.19.

**Table of Contents**

Based on Peoples price per common share of \$36.07 (the 10-day average price per common share price of Peoples as of June 27, 2013, the day prior to the announcement of the transaction) and the negotiated exchange ratio of 1.3636, the key transaction statistics were as follows:

Aggregate Implied Consideration Offered to Penseco	\$ 161.1Million
Implied Consideration Offered Per Penseco Common Share	\$ 49.19
Premium / (Discount) to Penseco s Average Reported Stock Price (1)	29.7%
Aggregate Implied Consideration Offered to Penseco s:	
Book Value per Share	121%
Tangible Book Value per Share	152%
Last Twelve Months (LTM) Earnings per Share	15.5x
<i>Pro Forma</i> Peoples Ownership	40.8%
<i>Pro Forma</i> Penseco Ownership	59.2%

(1) Based on \$37.92 per share which represented the price of Penseco s 10-day average stock price as of June 27, 2013. *Comparable Companies Analysis.* Boenning & Scattergood compared selected publicly available financial, operating and stock market data for both Peoples and Penseco with those of a peer group in order to compare their historical financial and operating performance with the peers and examine the financial considerations relative to the market valuations of the peers. The financial and operating data is as of March 31, 2013 (unless otherwise noted), and the stock market data is as of June 27, 2013. Peoples peers consisted of companies with an asset size between \$400 million and \$700 million and are located in Pennsylvania. Penseco s peers have asset sizes between \$750 million and \$1.25 billion and are located in Pennsylvania. Their respective peers are summarized below:

Peoples Financial Services Corporation		Penseco Financial Services Corporation	
Norwood Financial Corporation	American Bank Incorporated	Citizens & Northern Corporation	QNB Corporation
Embassy Bancorp, Inc.	Emclair Financial Corporation	Orrstown Financial Services, Inc.	Citizens Financial Services, Inc.
DNB Financial Corporation	Northumberland Bancorp*	Codus Valley Bancorp, Inc.	Penns Woods Bancorp, Inc.
CCFNB Bancorp, Inc.	Juniata valley Financial Corporation	Penseco Corporation	First Keystone Corporation
Dimeco, Inc.	Hamlin Bank and Trust Company*	Republic First Bancorp, Inc.	FNB Bancorp, Inc.
Fidelity D&D Bancorp, Inc.	First Community Financial Corporation*	Franklin Financial Services Corporation	ENB Financial Corporation
Honat Bancorp, Inc.	CBT Financial Corporation	AmeriServ Financial, Inc.	Somerset Trust Holding Company
Kish Bancorp, Inc.	Allegheny Valley Bancorp, Inc.	First National Community Bancorp, Inc.	Royal Bancshares of Pennsylvania, Inc.
CB Financial Services, Inc.*			

\* Financial data as of December 31, 2012.

**Table of Contents**

Boenning & Scattergood, Inc. compared selected operating, financial data for Peoples with those of its peers. The financial and operating data for Peoples peer group is as of March 31, 2013 (unless otherwise noted) and all market data is as of June 27, 2013.

	<b>Peoples</b>	<b>Peer Median</b>
	(\$ in Thousands)	
Total Assets	\$ 677,782	\$ 534,056
Tang. Equity / Tang. Assets	9.9%	9.1%
Loans / Deposits	82.3%	76.2%
Nonperforming Assets(1) / Assets	1.86%	1.37%
LTM(3) Return on Average Assets	1.38%	0.90%
LTM(3) Return on Average Common Equity	14.30%	9.23%
LTM(3) Non-Interest Income / Average Assets	0.78%	0.74%
LTM(3) Non-Interest Expense / Average Assets	2.41%	2.54%
LTM(3) Efficiency Ratio(2)	52.1%	64.1%
LTM(3) Net Interest Margin	3.92%	3.49%
Price / 52 Week High Price	87.5%	91.1%
Price to:		
Book Value Per Common Share	158.8%	104.5%
Tangible Book Value Per Common Share	160.0%	115.6%
LTM(3) Earnings Per Common Share	12.1x	11.5x
Dividend Yield	2.64%	3.63%
Avg. Weekly Volume / Common Shares Outstanding	0.12%	0.09%

(1) Defined as total nonaccrual loans plus other real estate owned plus accruing loans that are 90 days past due.

(2) Defined as non-interest expense less intangible amortization divided by the sum of net interest income plus non-interest income.

(3) LTM stands for the latest twelve months.

Boenning & Scattergood, Inc. compared selected operating, financial data for Pensco with those of its peers. The financial and operating data for Pensco's peer group is as of March 31, 2013 (unless otherwise noted) and all market data is as of June 27, 2013.

	<b>Pensco</b>	<b>Peer Median</b>
	(\$ in Thousands)	
Total Assets	\$ 929,788	\$ 922,432
Tang. Equity / Tang. Assets	11.7%	9.2%
Loans / Deposits	85.8%	68.6%
Nonperforming Assets(1) / Assets	0.50%	1.86%
LTM(3) Return on Average Assets	1.13%	0.90%
LTM(3) Return on Average Common Equity	7.86%	8.75%
LTM(3) Non-Interest Income / Average Assets	1.20%	0.81%
LTM(3) Non-Interest Expense / Average Assets	3.14%	2.88%
LTM(3) Efficiency Ratio(2)	63.4%	65.2%
LTM(3) Net Interest Margin	4.05%	3.57%
Price / 52 Week High Price	96.8%	91.6%
Price to:		
Book Value Per Common Share	92.8%	110.9%
Tangible Book Value Per Common Share	116.6%	111.4%
LTM(3) Earnings Per Common Share	11.9x	11.5x
Dividend Yield	4.45%	2.53%
Avg. Weekly Volume / Common Shares Outstanding	0.12%	0.25%





**Table of Contents**

- (1) Defined as total nonaccrual loans plus other real estate owned plus accruing loans that are 90 days past due.
- (2) Defined as non-interest expense less intangible amortization divided by the sum of net interest income plus non-interest income.
- (3) LTM stands for the latest twelve months.

*Contribution Analysis.* Boenning & Scattergood analyzed the contribution that Peoples would have made to various assets, liabilities, revenue and income of the combined company's latest twelve month earnings as of March 31, 2013 (except where noted). Boenning & Scattergood also reviewed the ownership percentage that Penseco's shareholders would receive in the transaction relative to its financial contribution to the combined company. Existing Peoples' shareholders will own approximately 40.8% of the combined company's common stock value of the combined company. Boenning & Scattergood has not expressed any opinion as to the actual value of Peoples common stock when issued in the merger or the price at which Peoples common stock will trade after the merger.

The analysis indicated the following information as of and for the twelve months ended March 31, 2013 (except where noted) for both Peoples and Penseco:

	<b>Peoples</b>	<b>Penseco</b>
Total Assets	42%	58%
Gross Loans	43%	57%
Deposits	44%	56%
Total Equity	34%	66%
Tangible Equity	39%	61%
Tangible Common Equity	39%	61%
LTM(1) Net Income	46%	54%
2013 Estimated Net Income	47%	53%
Non-Performing Assets(2)	25%	75%
LTM(1) Net Interest Income	42%	58%
LTM(1) Non-Interest Expense	35%	65%
LTM(1) Non-Interest Income	32%	68%
<i>Pro Forma</i> Ownership	41%	59%

- (1) LTM stands for the latest twelve months.
- (2) Defined as total nonaccrual loans plus other real estate owned plus accruing loans that are 90 days past due. Ratios are actually reversed as a higher amount would support a lower respective contribution percentage.

*Contribution Analysis Comparison.* Boenning & Scattergood analyzed the contribution that Peoples would have made to various assets, liabilities, revenue and income of the combined company's latest twelve month earnings as of March 31, 2013 against comparable publicly available metrics of certain companies that had undertaken a merger of equal transaction according to SNL Securities, LLC. This analysis was conducted in order to compare the level of contribution that Peoples was making to the combined entity relative to the amount of *pro forma* ownership its shareholders would retain relative to the peer group. Boenning & Scattergood has not expressed any opinion as to the actual value of Peoples common stock when issued in the merger or the price at which Peoples common stock will trade after the merger.

**Table of Contents**

The analysis indicated the following information as of and for the twelve months ended March 31, 2013 for both Peoples and Penseco and the last publicly reported data prior to the transaction involving the peer medians:

	Peoples / Penseco	Merger of Equal Peer Medians
<b>Contribution of:</b>		
Assets	42% / 58%	52% / 48%
Non-Performing Assets(1)	25% / 75%	55% / 45%
Tangible Common Equity	39% / 61%	57% / 43%
Net Income	46% / 54%	50% / 50%
Market Capitalization	50% / 50%	58% / 42%
<i>Pro Forma</i> Board Representation	43% / 57%	50% / 50%
<i>Pro Forma</i> Ownership	41% / 59%	52% / 48%

(1) Defined as total nonaccrual loans plus other real estate owned plus accruing loans that are 90 days past due. Ratios are actually reversed as a higher amount would support a lower respective contribution percentage.

No company, however, used in this analysis is identical to Peoples, Penseco or the transaction. Accordingly, an analysis of the result of the foregoing is not mathematical; rather, it involves complex considerations and judgments concerning differences in financial and operating characteristics of the companies and other factors that would affect the public trading values of the companies or company to which they are being compared.

*Discounted Dividend Analysis.* Using a discounted dividend analysis, Boenning & Scattergood, Inc. estimated the present value of the future cash flows that would accrue to a holder of a share of Peoples' common stock over a five-year period. This analysis was performed in order to compare the financial consideration in the transaction to an estimated implied value for Peoples' common stock based on projected future cash flows. This stand-alone analysis was based on several assumptions, including a price to earnings multiple range of 10.0x to 14.0x of Peoples' terminal year common earnings per share, EPS growth rates based upon Peoples' management's five-year projected earnings per share, and Peoples' current common cash dividend payout ratio of 30.0%. On June 27, Peoples' price to earnings multiple was 12.1x while the median value of its peers was 11.5x. The multiple applied to Peoples' estimated five-year earnings per share value is Peoples' current price to earnings multiple. The terminal value and projected annual cash dividends were then discounted to present value using a discount rate of 14.3%. This discount rate was used in order to reflect an expected rate of return required by holders or prospective buyers of Peoples' common stock. The analysis indicated that, based upon the aforementioned assumptions, the per common share present value of Peoples' common stock, on a stand-alone basis, ranged from \$19.73 to \$42.53. Based on Peoples' then current price to earnings multiple of 12.1x, the midpoint value was approximately \$29.54.

Boenning & Scattergood, Inc. performed a similar analysis on the five-year financial projections of Peoples' tangible book value per share. This analysis was based on a tangible book multiple range of 1.16x (Peoples' median peers multiple as of June 27, 2013) and 1.60x (Peoples' June 27, 2013, price to tangible book) to the terminal year tangible book value based upon Peoples' management's five-year projected earnings per share, EPS growth rates based upon Peoples' management's five-year projected earnings per share, and Peoples' current common cash dividend payout ratio of 30.0%. The terminal value was then discounted to present value using a discount rate of 14.3%. The analysis indicated that, based upon the aforementioned assumptions, the per share present value of Peoples' common stock, on a stand-alone basis, ranged from \$22.36 to \$34.07. Based on Peoples' then current price to tangible book value multiple of 1.60x, the midpoint value was approximately \$31.77.

In connection with the discounted dividend analysis performed, Boenning & Scattergood considered and discussed with Peoples' board how the present value analysis would be affected by changes in the underlying assumptions, including variations with respect to the growth rate of assets, net interest spread, non-interest income, non-interest expenses and dividend payout ratio. Boenning & Scattergood noted that the discounted dividend stream and terminal value analysis is a widely used valuation methodology, but the assumptions that must be made, and the results of this analysis, are not necessarily indicative of actual values or future results.

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## **Table of Contents**

*Pro Forma Merger Analysis.* Boenning analyzed certain potential *pro forma* effects of the merger, assuming the following: (i) the merger had been completed as of March 31, 2013; (ii) the implied price to be paid by Peoples for each share of Penseco common stock at the time of the announcement was \$49.19 based on the fixed stock-for-stock exchange ratio of 1.3636 shares of Peoples common stock for each share of Penseco common stock; (iii) estimated one-time transaction related costs expensed prior to closing; (iv) Peoples performance was calculated in accordance with Peoples management's prepared earnings projections; (v) Penseco performance was calculated in accordance with Penseco management's prepared earnings projections; (vi) certain other assumptions pertaining to costs and expenses associated with the transaction, intangible amortization, opportunity cost of cash and other items. The analyses indicated that, for the full years 2013 and 2014, the merger (excluding transaction expenses) would be accretive to Peoples projected earnings per share and, on a *pro forma* basis as of March 31, 2013, would be slightly dilutive to Peoples tangible book value per share. In addition, the *pro forma* quarterly cash dividend of \$.31 per share for the combined company would be accretive to Peoples current quarterly cash dividend of \$.23 per share. The actual results achieved by the combined company may vary from projected results and the variations may be material.

*Boenning's Compensation and Other Relationships with Peoples.* Boenning has acted as financial advisor to Peoples in connection with the merger and received a fee totaling \$25,000 prior to the execution of the definitive agreement. In addition, Peoples agreed to pay Boenning a transaction fee of approximately \$805,000 of which \$275,000, which included, among other things, delivery of Boenning's opinion, was paid upon the signing of a definitive agreement with the remainder to be paid upon the closing of the merger. Peoples has also agreed to reimburse Boenning for its reasonable out-of-pocket expenses and to indemnify Boenning against certain liabilities arising out of its engagement. Boenning's Opinion was approved by Boenning's fairness opinion committee.

In the ordinary course of their respective broker and dealer businesses, Boenning may purchase securities from and sell securities to Peoples and Penseco and their affiliates. Boenning may also actively trade the equity securities of Peoples and Penseco or their affiliates for its own accounts and for the accounts of its customers and, accordingly, may at any time hold a long or short position in such securities.

### **Penseco's Reasons for the Merger**

The Penseco board of directors and its independent committee consulted with Penseco's management, as well as legal and financial advisors and determined that the merger is in the best interests of Penseco and Penseco's shareholders. In reaching its conclusions to approve the merger agreement, the Penseco board considered the terms and conditions of the merger agreement, as well as a number of factors, including the following material factors:

#### ***Strategic Considerations***

The merger of Penseco and Peoples would create a financial institution with \$1.6 billion in assets. The combined company's increased size and scale would be better able to absorb increasing regulatory and compliance expenses than Penseco would on its own;

The geographic expansion into a region of the Marcellus Shale which has experienced significant natural gas drilling activity and the economic benefits associated with such activity;

The significant increase in assets, capital, earnings and management depth; along with the potential listing on a national exchange, would create opportunities for future strategic acquisitions, asset growth, earnings growth and increased shareholder value;

The ability to offer fiduciary wealth management, estate and trust services to existing customers of Peoples and residents of the Marcellus Shale region;

The current environment in the banking and financial services industry, including national and regional economic conditions, continued consolidation, evolving trends and competition, and the likely effect of these factors on Penseco in light of, and in the absence of, the merger;



**Table of Contents**

Penseco's business, operations, financial condition, earnings and prospects and Peoples' business, operations, financial condition, earnings and prospects, taking into account the results of the due diligence review of Peoples by Penseco and its financial, legal and other advisors;

The potential alternatives available to Penseco, including other potential extraordinary transactions and the alternative of remaining independent, and the risks and challenges inherent in successfully implementing Penseco's business plans, the value to the shareholders of these alternatives, the timing and likelihood of achieving value from these alternatives; and

The ability to complete the merger, including, in particular, the likelihood of obtaining regulatory approval and the provisions of the merger agreement regarding the parties' obligations to pursue the regulatory approvals.

***Financial Impact on Shareholders***

The merger would result in potential annualized cost savings of \$7.1 million, as well as the potential for increased revenue opportunities which would provide significant increases in earnings per share over what Penseco would have earned per share had it remained independent. The potential cost savings are expected to come from the reduction of duplicate resources and administrative functions as well as the elimination of redundant external contractual services and the standardization of various retirement benefits;

The potential for the combined company to generate greater earnings per share and tangible book value per share for Penseco shareholders, on an as-converted basis, than Penseco would have the ability to achieve should it remain independent;

Peoples' consenting to increase the dividend per share enabling Penseco shareholders to continue to earn, on an as converted basis, the same level of dividend;

The exchange ratio of 1.3636 shares of Peoples shares for each share of Penseco. The closing market price per share of Peoples common stock of \$34.90 on June 27, 2013, the last trading day prior to the approval of the merger agreement by the Penseco board of directors, which, when multiplied by the exchange ratio would suggest a market value of the merger consideration to be received by Penseco shareholders of \$47.59;

The ability to increase scale and accelerate the achievement of certain of Penseco's strategic goals, including listing on a national exchange, expanding geographically and into a significant Marcellus shale region, and gaining access to personnel, expertise and other resources;

The expected revenue enhancement and diversification, as well as cost savings and efficiencies; and

The ability of the combined company to continue to grow, through both its operations and potential future acquisitions.

***Effect on Common Stock***

The greater liquidity of the combined company's common stock relative to Penseco's common stock;

The increased market capitalization of the combined company relative to Penseco's current market capitalization; and

The parties' commitment to pay a minimum dividend of \$0.31 per share of the surviving corporation for 5 years after the merger, subject to availability of sufficient funds and retention of the combined bank's well capitalized status.

**Table of Contents**

***Form of Merger Consideration***

1.3636 shares of Peoples common stock for each share of Penseco common stock;

The expectation that the receipt of Peoples common stock by Penseco shareholders would generally be tax-free for U.S. federal income tax purposes; and

Penseco shareholders would have the ability to continue to participate in the growth of the combined company.

***Value of Merger Consideration***

The premium to the market value of Penseco common stock represented by the value of the merger consideration;

The historical and current market prices of Penseco common stock and Peoples common stock;

The prices, multiples of earnings per share and premiums on core deposits in other recent acquisitions of financial institutions, as compared to the price, multiples and premiums in the merger;

The *pro forma* financial effects of the merger, including the potential cost savings (resulting from back office efficiencies, consolidations and other cost savings) and enhanced revenue anticipated from the merger and the effects of the merger on the risk-based and leverage capital ratios of the combined company and the prospects of enhanced earnings per share growth attained by a merger with Peoples; and

The financial analysis conducted by Griffin Financial Group, LLC and its opinion to the board of directors that, as of the date of the merger agreement, the exchange ratio is fair, from a financial point of view, to Penseco shareholders.

***No Shop, Termination and Break-Up Fee***

The restrictions imposed on Penseco and Peoples from soliciting alternative transactions;

The fact that parties respective board of directors may withdraw or modify its recommendation that its shareholders approve the merger only if the board concludes in good faith, after consultation with outside counsel, that failure to do so may constitute a breach of its fiduciary duties;

The provisions permitting the Penseco board of directors to terminate the merger agreement if the value of Peoples common stock were to decline by more than 25% from its price after the announcement of the merger agreement; and underperform the NASDAQ Bank Index by more than 25% during such time period;



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The break-up fee of \$3.7 million that Penseco or Peoples would be required to pay to the other if the merger agreement is terminated under certain circumstances and Penseco or Peoples subsequently merges, is acquired or liquidates;

The fact that the break-up fee provision of the merger agreement could have the effect of discouraging superior proposals for a business combination between Penseco or Peoples and a third party; and

The fact that Peoples or Penseco may terminate the merger agreement upon a material breach by the other party and receive reimbursement of actual out-of-pocket costs and expenses, not to exceed \$600,000.

### *Directors and Officers*

The agreement that 8 of the 14 members of the combined company's board of directors would be alumni of the Penseco board of directors and that Craig W. Best would be appointed to serve as the combined company's chief executive officer;

The existence and nature of the voting agreements to be obtained from the directors of Penseco and Peoples in support of the merger; and

## **Table of Contents**

The fact that the interests of certain of Pensco's and Peoples' officers and directors may be said to be different from, or in addition to, the interests of shareholders generally.

### ***Other Constituencies***

The possible effects of the merger on Pensco's employees, customers, suppliers and creditors and on the communities in which Pensco's facilities are located;

A common culture of commitment to the communities the companies serve;

The combined company, headquartered in Scranton, will continue to be community based and will be a major force for economic development in Northeastern Pennsylvania, as evidenced by the following information:

In 2012, the two companies collectively spent approximately \$8.5 million with 965 local businesses.

The new company is expected to employ approximately 380 banking professionals.

In 2012, the two companies combined contributed approximately \$763,000 to local charities and nonprofit organizations.

In 2012, the two companies extended over \$380 million in credit to local residents and businesses.

With increased earnings and capital, the new bank should have the ability to spend more in the community, bring jobs to the area, contribute more to local charities and be able to meet the credit needs of larger local companies that, because of their size, have had to secure financing from larger, out of area banks;

Management's belief that Pensco's customers would benefit from a combination with Peoples due to the combined company's enhanced ability to serve its customers more broadly and effectively because of the combined company's greater scale, lending capabilities and range of financial products and services; and

The complexity and risks involved in successfully integrating Pensco and Peoples in a timely manner, and the potential impact of integration on various constituencies

The foregoing discussion of the factors considered by the Pensco board of directors in evaluating the transaction is not intended to be exhaustive, but, rather, includes all material factors considered by the Pensco board of directors. In reaching its decision to approve the transaction, the Pensco board of directors did not quantify or assign relative weights to the factors considered, and individual directors may have given different weights to different factors. The Pensco board of directors evaluated the factors described above, including asking questions of Pensco's management and legal and financial advisors, and determined that the transaction was in the best interests of Pensco.

### **Recommendation of the Pensco Board of Directors**

The Pensco board of directors has unanimously determined that the merger agreement and the merger are fair to and in the best interests of Pensco and that the merger consideration is fair to and in the best interests of the shareholders of Pensco, approved the merger agreement and the merger, and unanimously recommends that Pensco shareholders vote FOR approval of the merger agreement and the merger.

**Opinion of Penseco's Financial Advisor**

On June 17, 2013, Penseco engaged Griffin Financial Group, LLC ( Griffin ), to provide financial advisory and investment banking services to Penseco. Griffin agreed to assist Penseco in assessing the fairness to the shareholders of Penseco, from a financial point of view, of the exchange ratio required in the proposed merger of Penseco with Peoples. Griffin is a FINRA licensed, nationally recognized investment banking firm with substantial experience in transactions similar to the merger. As part of its investment banking business, Griffin is engaged in the representation and valuation of financial services companies in connection with mergers and acquisitions.

## **Table of Contents**

As part of its engagement, representatives of Griffin attended the meeting of the Penseco board of directors held on June 28, 2013, at which the Penseco board of directors evaluated the proposed merger with Peoples. At this meeting, Griffin reviewed the financial aspects of the proposed merger and provided its opinion that, as of such date, the exchange ratio in connection with the proposed merger was fair, from a financial point of view, to the shareholders of Penseco. The Penseco board of directors approved the merger agreement at this meeting.

The full text of Griffin's written opinion is attached as Annex C to this document and is incorporated herein by reference. Penseco shareholders are urged to read the opinion in its entirety for a description of the assumptions made, matters considered, procedures followed and qualifications and limitations on the review undertaken by Griffin. The description of the opinion set forth herein is qualified in its entirety by reference to the full text of such opinion.

***Griffin's opinion speaks only as of the date of the opinion. The opinion is directed to the Penseco board of directors and is limited to the fairness, from a financial point of view, to the shareholders of Penseco with regards to the Exchange Ratio in the transaction. Griffin does not express an opinion as to the fairness of the transaction to creditors or other stakeholders of Penseco or as to the underlying decision by Penseco to engage in the transaction or the relative merits of the transaction compared to other strategic alternatives which may be available to Penseco.***

In providing its opinion, Griffin:

- (i) reviewed a draft of the Agreement;
- (ii) reviewed and discussed with Penseco certain publicly available business and financial information concerning Penseco, and the economic and regulatory environments in which it operates;
- (iii) reviewed and discussed with Penseco and Peoples their respective financial information as of December 31, 2012, March 31, 2013 and May 31, 2013 and for the year and year to date periods then ended;
- (iv) discussed with the management of Penseco and Peoples matters relating to their respective financial condition, liquidity, net income, asset quality, reserve levels and capital adequacy and market valuation and related matters as of such dates and for the periods then ended;
- (v) compared the proposed financial terms of the transaction with the publicly available financial terms of certain transactions involving whole bank sales and acquisitions during such time frames as deemed relevant by Griffin;
- (vi) compared the financial condition of Penseco to the financial condition and valuation of certain institutions deemed relevant by Griffin;
- (vii) evaluated, from publicly available sources and discussions with the management of Penseco and Peoples, the capacity of Penseco and Peoples to complete the transaction on a timely basis;
- (viii) discussed with management of Penseco and Peoples the anticipated benefits of and identified risks in the transaction; and
- (ix) performed such other financial studies and analyses and considered such other information as deemed appropriate for the purpose of this opinion

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In addition, Griffin held discussions with certain members of managements of Pensco and Peoples with respect to certain aspects of the transaction, including past and current business operations, regulatory relations, financial condition, dividend and capital policies, market opportunities within each of their core operating markets, and other matters that it deemed appropriate for the purpose of its opinion.

In conducting its review and arriving at its opinion, Griffin relied upon the accuracy and completeness of all of the financial and other information provided to them or otherwise publicly available. Griffin did not

## Table of Contents

independently verify the accuracy or completeness of any such information or assume any responsibility for such verification or accuracy. Griffin relied upon the management of Pensco and Peoples as to the reasonableness and achievability of the financial and operating forecasts and projections (and the assumptions and bases therefore) provided to Griffin and assumed that such forecasts and projections reflected the best currently available estimates and judgments of such managements and that such forecasts and projections will be realized in the amounts and in the time periods estimated by such managements. Griffin assumed, without independent verification, that the aggregate allowances for loan and lease losses for Pensco and Peoples were adequate to cover such losses. Griffin did not make or obtain any evaluations or appraisals of the property, assets or liabilities of Pensco or Peoples, nor did it examine any individual credit files.

The projections and associated assumptions used by Griffin in certain of its analyses were sourced from Pensco and Peoples' senior management teams. Pensco and Peoples do not publicly disclose internal management projections of the type provided to Griffin in connection with its review of the merger. As a result, such projections were not prepared with a view towards public disclosure. The projections were based on numerous variables and assumptions, which are inherently uncertain, including factors related to general economic and competitive conditions. Accordingly, actual results could vary significantly from those set forth in the projections.

For purposes of providing its opinion, Griffin assumed that, in all respects material to its analysis:

the merger will be completed substantially in accordance with the terms set forth in the merger agreement with no additional payments or adjustments to the Exchange Ratio;

the representations and warranties of each party in the merger agreement and in all related documents and instruments referred to in the merger agreement are true and correct in all respects material to Griffin's analysis;

each party to the merger agreement and all related documents will perform all of the covenants and agreements required to be performed by such party under such documents;

all conditions to the completion of the merger will be satisfied without any waivers or modifications to the merger agreement; and

in the course of obtaining the necessary regulatory, contractual, or other consents or approvals for the merger, no restrictions, including any termination, divestiture requirements, termination or other payments or amendments or modifications, will be imposed that will have a material adverse effect on the future results of operations or financial condition of the combined entity or the contemplated benefits of the merger, including the cost savings, revenue enhancements and related expenses expected to result from the merger.

Griffin further assumed that the merger will be accounted for using the acquisition method under generally accepted accounting principles, and that the merger will qualify as a tax-free reorganization for United States federal income tax purposes.

Griffin's opinion is not an expression of an opinion as to the prices at which shares of Pensco common stock or shares of Peoples common stock will trade following the announcement of the merger or the actual value of the shares of common stock of the combined company when issued pursuant to the merger, or the prices at which the shares of common stock of the combined company will trade following the completion of the merger.

In performing its analyses, Griffin made various assumptions with respect to economic, general business, industry performance, market and financial conditions and other matters, which are beyond the control of Griffin, Pensco and Peoples. Any estimates contained in the analyses performed by Griffin are not necessarily indicative of actual values or future results, which may be significantly more or less favorable than suggested by these analyses. Additionally, estimates of the possible value of businesses or securities do not purport to be appraisals or to reflect the prices at which such businesses or securities might actually be sold. Accordingly, these analyses

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## **Table of Contents**

and estimates are judgmental and are inherently subject to substantial uncertainty. In addition, the Griffin opinion was among several factors taken into consideration by the Penseco board in making its determination to approve the merger agreement and the merger. Consequently, the analyses described below should not be viewed as determinative of the decision of the Penseco board with respect to the fairness of the consideration.

The following is a summary of the material analyses presented by Griffin to the Penseco board of directors on June 28, 2013, in connection with Griffin's fairness opinion. The summary is not a complete description of the analyses underlying Griffin's opinion or the presentation made by Griffin to the Penseco board, but summarizes the material analyses performed and presented in connection with such opinion.

The preparation of the fairness opinion is a comprehensive and complex, analytical process, involving various determinations as to the most appropriate and relevant methods of financial analysis and the application of those methods to the particular circumstances. Therefore, a fairness opinion is not readily susceptible to partial analysis or summary description. In arriving at its opinion, Griffin did not attribute any particular weight to any analysis or factor that it considered, but rather made qualitative judgments as to the significance and relevance of each analysis and factor. The financial analyses summarized within include information presented in tabular format. Accordingly, Griffin believes that its analyses and the summary of its analyses must be considered as a whole and that selecting portions of its analyses and factors or focusing on the information presented below in tabular format, without considering all analyses and factors or the full narrative description of the financial analyses, including the methodologies and assumptions underlying the analyses, could create a misleading or incomplete view of the process underlying its analyses and opinion. The tables alone do not constitute a complete description of the financial analyses.

### *Summary of Proposal*

Pursuant to the Agreement and Plan of Merger, dated as of June 28, 2013 (the Agreement), by and between Penseco and Peoples, Penseco will be merged with and into Peoples, and each outstanding share of Company Common Stock, other than shares of Company Common Stock held in treasury or owned by Peoples and its affiliates, will be converted into the right to receive 1.3636 shares of Peoples (the Exchange Ratio).

### *Accounting*

As a result of the transaction, former shareholders of Peoples will own approximately 40.8% of the combined institution's outstanding common stock. While Peoples is the legal acquirer in the transaction, Penseco is acquiring control of Peoples, and Penseco is expected to be deemed to be the acquirer for financial reporting purposes (a reverse merger). In accordance with ASC Topic 805: Business Combinations, the final accounting purchase price will be computed using the number of shares Penseco would have had to issue to give Peoples shareholders 40.8% ownership of the combined entity, multiplied by the Penseco stock price on the effective date of the merger. At July 25, 2013 and under ASC Topic 805, Penseco would have needed to issue 2.3 million new shares to give Peoples shareholders 40.8% ownership of the combined entity, and based upon Penseco's stock price on June 25, 2013 of \$37.75, the price paid by Penseco to purchase Peoples would have been \$85.4 million in the aggregate.

### *Trading Prices*

The merger agreement and the exchange ratio will result in Penseco shareholders receiving 1.3636 shares of Peoples common stock for each share of Penseco common stock held. Based on the June 25, 2013 trading price of Peoples common stock of \$34.75, this results in a value to Penseco shareholders of \$47.39 per share, which is greater than the June 25, 2013 trading price of Penseco common stock of \$37.75. However, both companies trade over the counter without significant trading volume, and trading pricing may not be reliable indications of the value of the each company as a whole. As such, Griffin's evaluation of the fairness of the Exchange Ratio to the shareholders of Penseco considered other factors, including a relative contribution analysis and assessments of the value of the consideration given by Penseco (40.8% of Penseco) versus the value being received (59.2% of Peoples), as well as other traditional valuation methodologies.

**Table of Contents***Contribution Analysis*

Griffin reviewed financial information relating to Penseco and Peoples to understand the relative contribution of each company to the combined entity, compared to the *pro forma* ownership resulting from the transaction. A summary of the analysis performed using financial data as of March 31, 2013 and market data as of June 25, 2013 is as follows:

	Penseco	Peoples
Exchange Ratio	59.2%	40.8%
Market Capitalization	54%	46%
Total Assets	58%	42%
Total Net Loans	57%	43%
Total Deposits	56%	44%
Tangible Common Equity	61%	39%
Net Income to Common Shareholders (LTM)	54%	46%
Net Income to Common Shareholders (YTD)	53%	47%

Evaluation of each of the relative contribution metrics involves complex considerations and judgments concerning differences in financial and operating characteristics, other factors and other risks that could affect the actual relative contribution of each company to the combined company. Accordingly, an evaluation of the results of this analysis is subjective.

In evaluating the exchange ratio, Griffin considered the value given by Penseco to acquire Peoples based on the Penseco trading price (\$85.4 million), as well as the value of the consideration computed based on the Peoples trading price (\$107.2 million).

In connection with Griffin's evaluation of the fairness of the exchange ratio, Griffin also performed a comparable company analysis and a discounted cash flow analysis with respect to each of Penseco and Peoples, and a comparable transaction analysis with respect to Peoples.

**Valuation of Peoples***Comparable Companies Analysis*

Using publicly available information, Griffin compared the financial performance and condition of Peoples to the following publicly traded banks with assets between \$500 million and \$900 million headquartered in Pennsylvania, New Jersey, and New York, excluding Long Island and the five boroughs of New York City, with returns on average assets greater than 0.50% and non-performing assets (including loans 90 days past due) less than 3.50%. Companies included in this group were:

Citizens Financial Services, Inc.	Somerset Trust Holding Company
Penns Woods Bancorp, Inc.	Mid Penn Bancorp, Inc.
Evans Bancorp, Inc.	Lyons Bancorp, Inc.
First Keystone Corporation	Norwood Financial Corp.
1 <sup>st</sup> Constitution Bancorp	Orange County Bancorp, Inc.
FNB Bancorp, Inc.	Solvay Bank Corporation
ENB Financial Corp.	DNB Financial Corporation
Embassy Bancorp, Inc.	Bancorp of New Jersey, Inc.
CCFNB Bancorp, Inc.	CB Financial Services, Inc.
Fidelity D & D Bancorp, Inc.	American Bank Incorporated
Kish Bancorp, Inc.	Emclaire Financial Corp.
Honat Bancorp, Inc.	Elmira Savings Bank



**Table of Contents**

To perform this analysis, Griffin used financial information as of the most recently available quarter end and market price information was as of June 25, 2013. Griffin's analysis showed the following concerning Peoples and its peers' financial condition, risk profile, valuation, and liquidity:

Performance and Risk Profiles	Peoples Peers				
	Peoples	Minimum	Mean	Median	Maximum
Total Assets (\$000)	677,782	510,915	680,778	658,757	882,950
NPA + 90 Days PD/ Assets (%)	1.86	0.00	1.41	1.39	3.08
Reserves/ NPA + 90 Days PD (%)	52.74	18.17	93.39	70.72	444.53
LTM Loan Growth (%)	1.34	(5.36)	5.18	3.13	20.71
ROAA (%)	1.38	0.62	0.99	0.95	1.65
Efficiency Ratio (%)	52.13	48.08	62.68	62.56	82.98
Net Interest Margin (%)	3.92	2.55	3.56	3.39	4.38
TCE/ TA (%)	9.93	6.18	9.13	9.06	13.40
Leverage Ratio (%)	9.42	7.10	9.64	9.44	12.97

Valuation and Liquidity	Peoples Peers				
	Peoples	Minimum	Mean	Median	Maximum
Market Cap. (\$ millions)	107.2	37.35	76.4	66.8	158.55
Price/ TBV (%)	159.31	80.41	120.60	117.92	184.91
Avg. Daily Trading Volume (1 yr.)	733	21	1,178	610	6,357

*Selected Transactions Analysis*

Griffin reviewed publicly available information related to selected acquisitions of banks and bank holding companies as well as thrifts and thrift holding companies nationwide with total assets between \$300 million and \$1.5 billion, having a NPA + 90 Days PD / Total Assets ratio of less than 3.5% and return on average assets for the last 12 months greater than 0.50%, that were announced between January 1, 2012 and June 25, 2013. The transactions included in the group were:

**Acquirer**

Heartland Financial USA, Inc.  
 Merchants Bancorp  
 Triumph Consolidated Cos., LLC  
 Glacier Bancorp, Inc.  
 CBFH, Inc.  
 CNB Financial Corporation  
 Lakeland Bancorp, Inc.  
 Strategic Growth Bank Incorporated  
 First Financial Bankshares, Inc.  
 Old Florida Bancshares, Inc.  
 F.N.B. Corporation  
 NBT Bancorp Inc.  
 Prosperity Bancshares, Inc.  
 Pacific Premier Bancorp, Inc.  
 Umpqua Holdings Corporation  
 MidSouth Bancorp, Inc.  
 American National Corporation  
 Penns Woods Bancorp, Inc.  
 Investors Bancorp, Inc. (MHC)  
 United Financial Bancorp, Inc.  
 Carlisle Bancshares, Inc.  
 Provident New York Bancorp

**Acquiree**

Morrill Bancshares, Inc.  
 CITBA Financial Corporation  
 National Bancshares, Inc.  
 North Cascades Bancshares, Inc.  
 VB Texas, Inc.  
 FC Banc Corp.  
 Somerset Hills Bancorp  
 New Mexico Banquest Corporation  
 Orange Savings Bank, SSB  
 New Traditions National Bank  
 Annapolis Bancorp, Inc.  
 Alliance Financial Corporation  
 Coppermark Bancshares, Inc.  
 First Associations Bank  
 Circle Bancorp  
 PSB Financial Corporation  
 Western Bank  
 Luzerne National Bank Corporation  
 Marathon Banking Corporation  
 New England Bancshares, Inc.  
 Northstar Financial Corporation  
 Gotham Bank of New York

**Table of Contents**

Transaction multiples for the transaction were derived from an assumed purchase price of \$85.4 million, or \$27.68 per Peoples share. For each transaction referred to above, Griffin derived and compared, among other things, the following implied ratios:

price per common share paid for the acquired company to tangible book value per share of the acquired company based on the latest publicly available financial statements of the company available prior to the announcement of the acquisition;

transaction premium as a percent of core deposits (core deposits exclude all deposit accounts with balances over \$100,000 and foreign deposits)

price per common share paid for the acquired company to last twelve months earnings per share of the acquired company;

The results of the analysis are set forth in the following table:

(Based on Exchange Ratio)	Peoples/ Penseco Merger	Precedent Transactions Minimum	Precedent Transactions Mean	Precedent Transactions Median	Precedent Transactions Maximum
<i>Aggregate Transaction Value to:</i>					
Tangible Book Value (%)	126.9	100.0	141.1	139.6	212.2
Franchise Premium/ Core Deposits (%)	3.9	0.1	4.9	4.1	12.4
Price/ LTM EPS (x)	9.6	11.0	16.4	17.4	23.8

No company or transaction used as a comparison in the above analysis is identical to Peoples or the transaction. Accordingly, an analysis of these results is not purely mathematical. Rather, it involves complex considerations and judgments concerning differences in financial and operating characteristics of the companies and of the banking environment at the time of the opinion.

*Discounted Cash Flow Analysis*

Griffin performed a discounted cash flow analysis to estimate a range of the present values of after-tax cash flows that Peoples could provide to equity holders through 2018 on a stand-alone basis. In performing this analysis, Griffin used Peoples earnings and growth estimates provided by Peoples, and assumed discount rates ranging from 8.0% to 12.0%. The range of values was determined by adding (1) the present value of projected cash flows to Peoples shareholders from 2014 to 2018 and (2) the present value of the terminal value of Peoples tangible book value. In calculating the terminal value of Peoples, Griffin applied multiples ranging from 120% of tangible common equity to 190% of tangible common equity. This resulted in a range of values of Peoples from \$77.9 million to \$117.8 million. The discounted cash flow present value analysis is a widely used valuation methodology that relies on numerous assumptions, including asset and earnings growth rates, terminal values and discount rates. The analysis did not purport to be indicative of the actual values or expected values of Peoples.

*Valuation of Penseco**Comparable Companies Analysis*

Using publicly available information, Griffin compared the financial performance and condition of Penseco to the following publicly traded banks with assets between \$800 million and \$1.5 billion headquartered in Pennsylvania, New Jersey, and New York, excluding Long Island and the five boroughs of New York City, with returns on average assets greater than 0.25% and non-performing assets (including loans 90 days past due) less than 3.00%. Companies included in this group were:

Chemung Financial Corporation  
Citizens & Northern Corporation  
Codorus Valley Bancorp, Inc.

Bank of Utica  
Citizens Financial Services, Inc.  
Penns Woods Bancorp, Inc.

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ACNB Corporation  
Adirondack Trust Company  
ConnectOne Bancorp, Inc.  
AmeriServ Financial, Inc.  
QNB Corp.

Evans Bancorp, Inc.  
First Keystone Corporation  
1<sup>st</sup> Constitution Bancorp  
FNB Bancorp, Inc.

**Table of Contents**

To perform this analysis, Griffin used financial information as of the most recently available quarter and market price information was as of June 25, 2013. Griffin's analysis showed the following concerning Penseco's and its peers' financial condition, risk profile, valuation, and liquidity:

Performance and Risk Profiles	Penseco's Peers				
	Penseco	Minimum	Mean	Median	Maximum
Total Assets (\$000)	929,788	810,333	966,439	918,780	1,279,972
NPA + 90 Days PD/ Assets (%)	0.50	0.44	1.44	1.36	2.75
Reserves/ NPA + 90 Days PD (%)	152.22	27.09	77.06	62.35	249.83
LTM Loan Growth (%)	(0.16)	(6.71)	4.50	1.90	30.54
ROAA (%)	1.13	0.46	1.09	0.97	1.75
Efficiency Ratio (%)	63.43	25.74	60.58	59.84	87.15
Net Interest Margin (%)	4.05	2.60	3.70	3.81	4.38
TCE/ TA (%)	11.75	7.35	9.85	9.12	15.78
Leverage Ratio (%)	11.78	8.28	10.34	9.87	14.28

Valuation and Liquidity	Penseco's Peers				
	Penseco	Minimum	Mean	Median	Maximum
Market Cap. (\$ millions)	123.7	55.9	118.1	110.3	237.5
Price/ TBV (%)	116.61	70.98	124.20	122.43	184.91
Avg. Daily Trading Volume (1 yr.)	812	3	4,909	2,725	17,858

*Selected Transactions Analysis*

Griffin did not perform a selected transaction analysis in its evaluation of the value of Penseco, as there is not a change of control with respect to Penseco in the transaction. Therefore, recent acquisition transactions which contain a change of control premium in their pricing would not, in Griffin's judgment, be a relevant indicator of value for Penseco.

*Discounted Cash Flow Analysis*

Griffin performed a discounted cash flow analysis to estimate a range of the present values of after-tax cash flows that Penseco could provide to equity holders through 2018 on a stand-alone basis. In performing this analysis, Griffin used Penseco earnings estimates provided by Penseco and assumed discount rates ranging from 8.0% to 12.0%. The range of values was determined by adding (1) the present value of projected cash flows to Penseco shareholders from 2014 to 2018 and (2) the present value of the terminal value of Penseco's tangible book value. In calculating the terminal value of Penseco, Griffin applied multiples ranging from 115% of tangible common equity to 165% of tangible common equity. This resulted in a range of values of Penseco from \$97.6 million to \$141.4 million. The discounted cash flow present value analysis is a widely used valuation methodology that relies on numerous assumptions, including asset and earnings growth rates, terminal values and discount rates. The analysis did not purport to be indicative of the actual values or expected values of Penseco.

The Penseco board of directors retained Griffin as the financial adviser to Penseco regarding the merger. As part of its investment banking business, Griffin is, from time to time, engaged in the valuation of bank and bank holding company securities in connection with mergers and acquisitions, public and private placement of listed and unlisted securities, rights offerings and other forms of valuations for various purposes. As specialists in the securities of banking companies, Griffin has experience in, and knowledge of, the valuation of banking enterprises. In the ordinary course of its business as a broker-dealer, Griffin may, from time to time, purchase securities from, and sell securities to, Penseco and Peoples. As a market maker in securities Griffin may from time to time have a long or short position in, and buy or sell, debt or equity securities of institutions like and possibly including, Penseco and Peoples, for Griffin's own account and for the accounts of its customers. To the extent Griffin held any such positions, it was disclosed to Penseco and Peoples.

Pursuant to the Griffin engagement agreement, Penseco agreed to pay Griffin a non-refundable retainer fee of \$25,000 payable upon execution of the engagement letter, a \$100,000 fee payable upon the delivery of Griffin's fairness opinion, and an additional \$75,000 fee contingent on the completion of a transaction. Penseco requested the

**Table of Contents**

contingent portion of the fee in light of the regulatory and stockholder approvals required to complete the transaction, in particular the requirement that the transaction be approved by the affirmative vote of holders of 75 percent of the outstanding shares of Penseco common stock. In light of Griffin's qualifications and the amount of the contingent portion of the fee, the Penseco board did not believe that the contingency impacted the significance or reliability of Griffin's fairness opinion. In addition, while Cedar Hill did not issue a formal fairness opinion, the financial advice it did provide assisted the Penseco board in assessing the significance and reliability of Griffin's fairness opinion. In addition, Penseco also agreed to reimburse Griffin for reasonable out-of-pocket expenses and disbursements incurred in connection with its retention and to indemnify Griffin against certain liabilities, including liabilities under the federal securities laws. During the two years preceding the date of its opinion to Penseco, Griffin has not received compensation for investment banking services from Penseco, and Griffin has not received compensation for investment banking services from Peoples.

**Terms of the Merger*****Effect of the Merger***

Upon completion of the merger, Penseco will merge with and into Peoples. No sooner than one business day after the merger, Peoples and Penseco will use their best efforts to cause Penn Security Bank and Trust Company to merge with and into Peoples Neighborhood Bank. The articles of incorporation and the bylaws of Peoples, as amended pursuant to the merger agreement, will govern the combined company subject to the approval and adoption of certain amendments by Peoples shareholders. Peoples' resulting amended and restated articles of incorporation and bylaws are attached to this joint proxy statement/prospectus as Exhibits 4 and 5 to Annex A.

***Merger Consideration*****Penseco Common Stock**

Shareholders of Penseco will receive 1.3636 fully paid and non-assessable shares of Peoples common stock for each share of Penseco common stock they own immediately prior to the effective time of the merger, subject to adjustment according to the terms of the merger agreement. Peoples will not issue fractional shares of common stock, and any former shareholder of Penseco that would otherwise be entitled to receive a fractional share of Peoples common stock will receive cash in an amount equal to that fraction multiplied by Peoples market share price as defined in the merger agreement. See Proposal: The Merger Terms of the Merger Exchange Procedures .

The exchange ratio will be appropriately adjusted if there is a stock dividend, stock split, reverse stock split, common stock reclassification, or other similar event regarding Peoples common stock before completion of the merger. By way of illustration, if Peoples declares and pays a stock dividend of 5% on or prior to the effective time of the merger, the exchange ratio will be adjusted upward by 5%. Under this hypothetical, Penseco shareholders entitled to receive Peoples common stock pursuant to the merger agreement would receive 1.4318 shares of Peoples common stock, adjusted up from 1.3636 shares, for each share of Penseco common stock they owned immediately prior to the effective time of the merger.

Peoples will not issue fractional shares of its common stock in connection with the merger. Each holder of Penseco common stock who otherwise would have been entitled to a fraction of a share of Peoples common stock will receive cash in lieu of the fractional share of Peoples common stock (without interest) in an amount calculated pursuant to the merger agreement. The merger agreement calculates the cash amount by multiplying the fractional share to which the holder would otherwise be entitled (after taking into account all shares of Penseco common stock owned by the holder at the effective time of the merger) by the numeric average of the daily high bid and low ask quotations for a share of Peoples common stock as reported on the OTCQB market place maintained by OTC Markets Group Inc. for each of the consecutive 20 trading days ending on and including the tenth day prior to the effective time of the merger. If no bid or ask quotations are available for any date, then the average closing price of a share of Peoples common stock will be the price of the last reported trade.

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## **Table of Contents**

### **Peoples Common Stock and Stock Options**

Each share of Peoples common stock and each option to purchase a share of Peoples common stock outstanding immediately prior to completion of the merger will remain outstanding after the merger.

### ***Exchange Procedures***

Peoples and Penseco expect to designate Registrar and Transfer Company, Cranford, New Jersey, to act as their exchange agent in connection with the exchange procedures for converting shares of Penseco common stock into the merger consideration. At or prior to the effective time of the merger, Peoples will deposit the merger consideration with the exchange agent for delivery to the Penseco shareholders in accordance with the merger agreement.

As soon as reasonably practicable after the effective time of the merger, the exchange agent will mail to each Penseco shareholder a letter of transmittal with instructions for submitting his or her Penseco stock certificates (or evidence of book-entry shares) in exchange for Peoples common stock and any cash in lieu of fractional shares. At that time, those Penseco shareholders will need to carefully review the instructions, complete the materials enclosed with the instructions, and return the materials along with their Penseco stock certificates (or evidence of book-entry shares). After receipt of the properly completed letter of transmittal and Penseco stock certificates (or evidence of book-entry shares), a holder of Penseco common stock will be entitled to receive the whole number of shares of Peoples common stock and a check representing cash payment in lieu of any fractional shares.

Shares of Peoples common stock will be issued after the effective time of the merger and will entitle the holders to dividends and any other distributions to which all holders of Peoples common stock are entitled. Until the letter of transmittal is submitted and the Penseco common stock is surrendered for exchange after completion of the merger, holders will not receive any stock consideration, dividends, or distributions on any Peoples common stock into which shares of their Penseco common stock have been converted. When the letter of transmittal is submitted and the Penseco common stock is surrendered, Peoples will pay any accrued or unpaid dividends or other distributions on such Peoples common stock without interest.

Following the effective time of the merger and until surrendered, all outstanding Penseco common stock is evidence solely of the right to receive the merger consideration. In no event will Peoples, Penseco or the exchange agent be liable to any former Penseco shareholder for any amount paid in good faith to a public official pursuant to any applicable abandoned property, escheat, or similar law.

Penseco shareholders are urged to carefully read the information set forth under the caption *Proposal: The Merger* *Material U.S. Federal Income Tax Consequences* and to consult their tax advisors for a full understanding of the merger's tax consequences to them.

### ***Effective time***

Subject to the provisions of the merger agreement, the articles of merger shall be duly prepared, executed and delivered for filing with the Pennsylvania Department of State on the closing date of the merger. The merger shall become effective at such time, on such date, as the articles of merger are filed with the Pennsylvania Department of State, or at such date and time as may be specified in the articles of merger. See *Proposal: The Merger* *Terms of the Merger* *Conditions to the Merger* and *Proposal: The Merger* *Terms of the Merger* *Regulatory Approvals* .

### ***Representations and Warranties***

The merger agreement contains customary representations and warranties relating to, among other things, the following:

Organization of Peoples and Penseco and their respective subsidiaries;

Capital structures of Peoples and Penseco;

**Table of Contents**

Due authorization, execution, delivery, performance, and enforceability of the merger agreement;

Receipt of consents or approvals of governmental entities or third parties necessary to complete the merger;

Preparation of regulatory reports and financial statements consistent with generally accepted accounting principles;

Filing of tax returns and payment of taxes;

Absence of a material adverse effect (as defined in the merger agreement) since December 31, 2012, for either Peoples or Penseco;

Material contracts;

Quality of title to assets and properties;

Maintenance of adequate insurance;

Absence of undisclosed material pending or threatened litigation

Compliance with applicable laws and regulations;

Employee and employee benefit plans;

Brokers, finders and financial advisors;

Environmental matters;

Allowance for loan losses;

Absence of certain related party transactions;

Validity and binding nature of loans reflected as assets in the financial statements of Peoples and Penseco;

Accuracy and compliance of information contained in documents filed with the SEC and other federal or state regulatory authorities and the timeliness of the filings;

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Peoples, Peoples Neighborhood Bank, Penseco, and Penn Security Bank and Trust Company being well capitalized within the meaning of the Federal Reserve Board, FDIC, and Pennsylvania Department of Banking and Securities regulations, as applicable;

Quality of investment securities;

Absence of certain equity plans and agreements granting equity securities in Penseco and Peoples or their subsidiaries or granting options or warrants for Penseco and Peoples or their subsidiaries;

Fiduciary accounts;

Receipt of a fairness opinion from Peoples and Penseco's financial advisors;

Intellectual property;

State anti-takeover laws; and

Quality of representations.

### ***Conduct of Business Pending Merger***

In the merger agreement, Peoples and Penseco each agreed to use their best efforts to preserve their business organizations intact, to maintain good relationships with employees, and to preserve the goodwill of customers and others with whom they do business. In addition, they agreed to conduct their business and to engage in transactions only in the ordinary course of business consistent with past practice and policies, except as otherwise required by the merger agreement.



**Table of Contents**

Peoples and Penseco also agreed in the merger agreement that they will not do any of the following and will not permit any of their subsidiaries to do any of the following, except as contemplated by the merger agreement or as consented to by the other party:

Amend or change any provision of its articles of incorporation or bylaws;

Change the number of authorized or issued shares of Peoples and Penseco capital stock or issue any shares except that Peoples may issue shares of Peoples common stock upon the valid exercise of presently outstanding options to acquire Peoples common stock;

Issue or grant any option (except in accordance with past practice under their benefit plans), warrant, call, commitment, subscription, right or agreement of any character relating to their authorized or issued capital stock or any securities convertible into shares of such stock, or split, combine or reclassify any shares of capital stock, or declare, set aside or pay any dividend or other distribution in respect of capital stock, or redeem or otherwise acquire any shares of capital stock, except in accordance with past practice. Provided however, Peoples and Penseco in accordance with applicable law may continue to pay regular quarterly cash dividends of \$0.23 per share and \$0.42 per share, respectively in accordance and consistent with past practice;

Grant any severance or termination pay to, or, enter into any new or amend any existing employment agreement with any employee, officer, or director, except in accordance with applicable law;

Increase the compensation of, any employee, officer or director except that (A) Peoples and Penseco may pay salary increases consistent with past practice in such amounts not in excess of five percent (5%) in the aggregate for all employees, officers and directors, (B) Peoples and Penseco may pay retention bonuses in an aggregate amount not to exceed \$250,000 to such employees whose services are desired in connection with transition activities, and (C) Peoples and Penseco may pay their annual bonuses prior to closing in accordance with their customary and normal practices, but in no event to exceed the aggregate and individual amounts paid for the year 2012 by seven percent (7%);

Merge or consolidate any subsidiary with any other corporation; sell or lease all or any substantial portion of its assets or business;

Make any acquisition of all or any substantial portion of the business or assets of any other person, firm, association, corporation or business organization other than in connection with the collection of any loan or credit arrangement;

Enter into a purchase and assumption transaction with respect to deposits and liabilities;

Permit the revocation or surrender by any subsidiary of its certificate of authority to maintain, or file an application for the relocation of, any existing branch office;

Sell or otherwise dispose of any capital stock;

Make any sale, assignment, transfer, pledge, hypothecation or other disposition of, or incurrence of any lien with respect to, any assets having a book or market value, in excess of \$100,000, other than pledges of assets to secure Federal Home Loan Bank advances, customer repurchase agreements, or government deposits, sales of assets received in satisfaction of debts previously contracted in the normal course of business, or sale of any security for its investment portfolio, in each case, in the ordinary course of

business and consistent with past practice;

Take any action which would result in any of its representations and warranties set forth in the merger agreement becoming untrue, or in any of the conditions to close not being satisfied, except in each case as may be required by applicable law;

Change any method, practice or principle of accounting or tax accounting, except as may be required from time to time by GAAP or any governmental entity;

Waive, release, grant or transfer any rights of value or modify or change in any material respect any existing material agreement to which it or any subsidiary is a party, other than in the ordinary course of business consistent with past practice;

**Table of Contents**

Implement any new pension, retirement, profit sharing, bonus, welfare benefit or similar plan or arrangement, or, materially amend any existing plan or arrangement, except in accordance with applicable law;

Purchase any security for its investment portfolio other than in the ordinary course of business and consistent with past practice;

Amend or otherwise modify the underwriting and other lending guidelines and policies or otherwise fail to conduct its lending activities in the ordinary course of business consistent with past practice;

Enter into, renew, extend or modify any other transaction with any affiliate, except in the ordinary course of business and which are in compliance with the requirements of applicable laws and regulations;

Change deposit or loan rates other than in the ordinary course of business consistent with past practice;

Enter into any interest rate swap, floor or cap or similar commitment, agreement or arrangement, except in the ordinary course of business consistent with past practice;

Take any action that would give rise to a right of a continuing payment to any individual under any agreement;

Take any action or knowingly fail to take any action, which action or failure to act could reasonably be expected to preclude the merger from qualifying as a reorganization within the meaning of Section 368(a) of the Internal Revenue Code; or

Make, change or revoke any material tax election or enter into any material agreement or arrangement with respect to taxes. Peoples and Pensco each also agree to:

Provide the other with reasonable access to its properties, assets, books, and records, personnel subject to certain confidentiality provisions and limitations;

Prepare and provide accurate information for this proxy statement/prospectus and various regulatory filings, including the registration statement filed with the Securities and Exchange Commission by Peoples covering the securities to be issued in this merger;

Cooperate with each other and use their reasonable best efforts to promptly obtain and comply with all governmental approvals required for the merger, provided that such efforts do not require it to take any action that would reasonably be expected to have a material adverse effect, as defined in the merger agreement;

Use their reasonable best efforts to take all action necessary or desirable to permit completion of the merger as soon as practicable;

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Not to take, or cause, or to the best of its ability permit to be taken, any action that would substantially impair the prospects of completing the merger;

Advise the other of any change or event having a material adverse effect on it (as defined in the merger agreement) or which it believes would or would be reasonably likely to cause or constitute a material breach of any of its representations, warranties, or covenants set forth in the merger agreement;

Cause one or more of its designated representatives to confer on a weekly or such other basis as mutually determined, regarding their financial condition, operations and business and matters relating to the completion of the transactions contemplated by the merger agreement;

Provide each other a copy of the minutes of any meeting of the board of directors or any subsidiary or committee;

Provide to the other a consolidated balance sheet and statement of operations for the each month, quarter, and for fiscal year;

Provide to the other party, investment, loan, deposit and borrowing information, in account and deposit level detail;

## **Table of Contents**

Provide to the other party a written list of (i) all loans classified by it or any regulatory authority as Other Loans Specially Mentioned, Special Mention, Substandard, Doubtful, Loss, Classified, Criticized, Watch List, or any other classification import (ii) all commercial and mortgage loans classified as non-accrual, and (iii) all commercial loans classified as in substance foreclosed;

Permit the other, at its own expense, to cause a Phase I Environmental Audit to be performed at any physical location owned or occupied by the other party or any of its subsidiaries;

Take all action necessary to properly call, convene and hold a special meeting of its shareholders to consider and vote upon a proposal to approve and adopt the merger agreement and the transactions contemplated thereby, and in the case of Peoples, approve and adopt the amended and restated articles of incorporation;

Recommend that its shareholders approve and adopt the merger agreement and the transactions contemplated thereby and in the case of Peoples the amendment and restatement of the articles of incorporation and not withdraw, modify or change in any manner adverse to the other party hereto such favorable recommendation. However, either Pensco or Peoples may withdraw, modify or qualify such recommendation if it determines, in good faith after consultation with its legal and financial advisers, that the failure to do so may constitute a breach of its fiduciary duties;

Cooperate in the preparation and distribution of any press release related to the merger agreement and the transactions contemplated thereby, and any other public disclosures. However, nothing shall prohibit either party from making any disclosure which its counsel deems necessary under applicable law, or either party from making any disclosure necessary to fulfill its obligations under the Securities Exchange Act of 1934, as amended;

Maintain, and cause its subsidiaries to maintain, insurance in such amounts as are reasonable to cover such risks as are customary in relation to the character and location of its properties and the nature of its business;

Maintain, and cause its subsidiaries to maintain, books of account and records in accordance with GAAP applied on a basis consistent with those principles used in preparing the financial statements heretofore delivered in accordance with the merger agreement; and

Timely file all federal, state, and local tax returns required to be filed by it or its respective subsidiaries and timely pay all taxes due, and terminate all tax sharing agreements or arrangements among it and its subsidiaries as of the effective time of the merger.

### ***Indemnification and Insurance***

Peoples and Pensco agree to cooperate and use their best efforts to indemnify certain individuals to the extent permitted by Pennsylvania law and their respective articles of incorporation and bylaws. Whether asserted or arising before or after the effective time of the merger, Peoples and Pensco will indemnify former and current directors and officers of Peoples and Pensco and their respective subsidiaries as well as those who become directors and officers of Peoples or Pensco or their respective subsidiaries prior to the effective time of the merger. Indemnification rights will be triggered if an eligible officer or director is made part of any threatened or actual claim, action, suit, proceeding or investigation, whether civil, criminal or administrative, based in whole or in part on, or arising in whole or in part out of, or pertaining to:

- (1) The fact that the person is or was a director, officer, or employee of Peoples or Pensco, any of their respective subsidiaries, or any of their respective predecessors; or

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(2) The merger agreement or any of the transactions contemplated thereby.

On or after the effective time of the merger, Peoples will indemnify, defend, and hold harmless all prior and then-existing directors, officers and employees of Peoples, Pensco and their respective subsidiaries against:

(1) All losses, claims, damages, costs, expenses, liabilities or judgments or amounts that are paid in settlement (with the prior approval of Peoples) of or in connection with any claim, action, suit,

## **Table of Contents**

proceeding or investigation based in whole or in part on, or arising in whole or in part out of, the fact that the person is or was a director, officer, or employee of Peoples, Penseco or their respective subsidiaries, whether pertaining to any matter existing or occurring at or prior to the effective time of the merger and whether asserted or claimed prior to, or at or after, the effective time of the merger; and

- (2) All of the indemnified liabilities identified in paragraph (1) immediately above based in whole or in part on, or arising in whole or in part out of, or pertaining to the merger agreement or the transactions contemplated thereby, to the same extent as an officer, director, or employee may be indemnified by Peoples or its subsidiaries, as the case may be, as of June 28, 2013.

The above indemnification rights include the right to advancement of expenses; however, no officer, director, or employee may be indemnified by Peoples if indemnification is prohibited by applicable law.

For six (6) years after the effective time of the merger, subject to certain limitations, Peoples will maintain a directors and officers liability insurance policy providing coverage amounts not less than the coverage amounts provided under the Penseco directors and officers liability insurance policy, on terms generally no less favorable and covering persons who are currently covered by the Penseco insurance policies.

### ***No Solicitations of Other Transactions***

So long as the merger agreement remains in effect, Penseco and Peoples shall not and shall not authorize or permit any of their directors, officers, employees or agents, to directly or indirectly:

- (1) solicit, initiate or encourage any inquiries relating to, or the making of any proposal which relates to, an acquisition proposal (as defined in the merger agreement);
- (2) recommend or endorse an acquisition proposal;
- (3) participate in any discussions or negotiations regarding an acquisition proposal;
- (4) provide any third party with any nonpublic information in connection with any acquisition proposal; or
- (5) enter into an agreement with any other party with respect to an acquisition proposal.

Penseco and Peoples will notify each other if any inquiries or proposals relating to an acquisition proposal are received or any such negotiations or discussions are sought to be initiated or continued.

Notwithstanding the foregoing, the board of directors of Penseco or Peoples may respond to, in a manner it deems appropriate, recommend or endorse, participate in any discussions, provide any third party with nonpublic information, or enter into an agreement regarding, unsolicited inquiries relating to an acquisition proposal, in each case, if the respective board of directors shall have determined, in good faith after consultation with its legal and financial advisors, that the failure to do so may constitute a breach of their fiduciary duties. Nothing contained in the merger agreement shall prevent Penseco and Peoples, and their respective boards of directors, from complying with Rule 14d-9 and Rule 14e-2 under the Securities Exchange Act of 1934, as amended, with respect to an acquisition proposal; provided, that such rules will in no way eliminate or modify the effect that any action pursuant to such rules would otherwise have under the merger agreement.

### ***Dividends and Authorization to Pay Dividends***

Prior to the effective time of the merger, Penseco and Peoples will coordinate the declaration, payment and record dates of any regular quarterly dividends so that holders of Penseco common stock do not receive two dividends, or fail to receive one dividend, for any quarter.

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For five (5) years after the effective time of the merger, Peoples will continue to pay a quarterly cash dividend in an amount no less than \$0.31 per share, provided sufficient funds are legally available and that Peoples and Peoples Security Bank and Trust Company remain well-capitalized in accordance with applicable regulatory guidelines, unless the board of directors of Peoples determines otherwise in accordance with its fiduciary duties upon the approval of at least 80% of the directors.



## **Table of Contents**

### ***Corporate and Bank Name Following Merger***

For three years after the merger, Peoples will not change the corporate name from Peoples Financial Services Corp. unless the board of directors of Peoples shall determine otherwise upon approval of at least 80% of the directors.

For three (3) years after the effective time of the merger, the surviving bank will be named Peoples Security Bank and Trust Company and will not change its name unless the board of directors of Peoples and the bank determine otherwise upon approval of at least 80% of the directors of each entity.

### ***Nasdaq or NYSE Listing***

Peoples and Pensco will use their commercially reasonable best efforts to list Peoples common stock on the Nasdaq Global Market or New York Stock Exchange at or as soon as reasonably practical after the effective time of the merger, unless the board of directors of Peoples determines otherwise upon the approval of at least 80% of the directors.

### ***Headquarters and Operations Locations***

For three (3) years after the effective time of the merger:

- (1) the headquarters of Peoples and Peoples Security Bank and Trust Company will be located in Scranton, Pennsylvania;
- (2) the deposit operations and data processing of Peoples and Peoples Security Bank and Trust Company will be located in Hallstead, Pennsylvania; and
- (3) the loan operations of Peoples and Peoples Security Bank and Trust Company will be located in Scranton, Pennsylvania; unless the board of directors of Peoples and Peoples Security Bank and Trust Company determine otherwise upon the approval of at least 80% of the directors of each entity.

### ***Dividend Reinvestment Plan***

Prior to the effective time of the merger, Pensco will suspend the acceptance of dividends and other contributions of participants in its dividend reinvestment plan, terminate the dividend reinvestment plan and distribute all shares of Pensco common stock and the value of all cash held in participant's plan accounts in accordance with the terms of the dividend reinvestment plan. Prior to the effective time of the merger, Peoples will suspend the acceptance of dividends and other contributions of participants in its dividend reinvestment plan until the effective time of the merger.

### ***Conditions to Merger***

Peoples and Pensco's obligations to complete the merger are subject to the satisfaction of various conditions at or prior to the closing date of the merger, including the following:

Peoples and Pensco's shareholders must approve and adopt the merger agreement and Peoples' shareholders must approve the amendment and restatement of the articles of incorporation;

The representations and warranties of each party to the merger agreement must be true and correct as of June 28, 2013, and as of the closing date of the merger except as to any representation or warranty where the breach would not constitute a material adverse effect (as defined in the merger agreement) on Peoples or Pensco;

All obligations required to be performed by each party under the merger agreement have been performed in all material respects at or prior to the closing date of the merger;

**Table of Contents**

All requisite approvals and consents must be obtained and any related regulatory waiting periods must have expired;

There must be no order, decree, or injunction in effect preventing the completion of the transactions contemplated by the merger agreement, and no statute, rule, regulation, order, injunction or decree which prohibits or makes illegal the completion the merger;

The registration statement must be effective and any required approvals of state securities agencies must have been obtained;

Opinions from Peoples and Pensco's respective special legal counsels that the merger will be treated as a reorganization within the meaning of section 368(a) of the Internal Revenue Code have been received. See Terms of the Merger Material U.S. Federal Income Tax Consequences ;

All consents and authorizations of landlords and other third parties that are necessary to permit the merger to be consummated without the violation of any lease or other material agreement must have been received;

The holders of no more than 7% of Peoples or Pensco's respective issued and outstanding shares seek to perfect dissenters' appraisal rights; and

No change in the business, property, assets (including loan portfolios), liabilities (whether absolute, contingent, or otherwise), operations, business prospects, liquidity, income or financial condition of Peoples and Pensco or either's subsidiaries, which has had or would reasonably be likely to have, individually or in the aggregate, a material adverse effect (as defined in the merger agreement) must have occurred.

Under the terms of the merger agreement, a material adverse effect means any state of facts, change, circumstance, event, condition, occurrence, action, or omission that:

- (1) has or would be reasonably expected to have a material adverse effect on the business, financial condition, results of operations, or business prospects of Pensco or Peoples including but not limited to the entry by Pensco or Peoples, into a regulatory agreement, or
- (2) materially impairs the ability of such party or its subsidiary to consummate the transactions contemplated by the merger agreement on a timely basis, other than, in each case, any change, circumstance, event or effect relating to:
  - (a) changes in general economic or political conditions affecting banking institutions generally, including, but not limited to, changes in interest rates, but not if such changes disproportionately affect Pensco or Peoples when compared to other banking institutions;
  - (b) any change in GAAP or applicable law that does not disproportionately affect such party and its subsidiaries taken as a whole relative to other participants (including the other party hereto) in the industry;
  - (c) any action or omission of a party (or any of its subsidiaries) taken pursuant to the terms of the merger agreement or taken or omitted to be taken with the express written permission of the other party;

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- (d) any effect with respect to a party hereto caused, in whole or in substantial part, by the other party;
- (e) reasonable expenses, including expenses associated with the retention of legal, financial, or other advisors, incurred by Pensco or Peoples in connection with the negotiation, execution and delivery of the merger agreement and the consummation of the transactions contemplated hereby; and
- (f) any act of terrorism, war (whether or not declared), national disaster or any national or international calamity affecting the United States that does not disproportionately affect such party and its subsidiaries, taken as a whole, relative to other participants in the industry, in the United States (including the other party hereto).

## **Table of Contents**

Except for the requirements of Peoples and Penseco shareholder approval; regulatory approvals; and the absence of any order, decree, or injunction preventing the transactions contemplated by the merger agreement, Peoples and Penseco each may waive each of the conditions described above in the manner and to the extent described in Proposal: The Merger Terms of the Merger Amendment; Waiver .

### ***Amendment; Waiver***

Subject to applicable law, at any time prior to the consummation of the transactions contemplated by the merger agreement, Peoples and Penseco may:

- (1) amend the merger agreement;
- (2) extend the time for the performance of any of the obligations or other acts of either Peoples or Penseco;
- (3) waive any inaccuracies in the representations and warranties contained in the merger agreement or in any document delivered pursuant to the merger agreement; or
- (4) waive compliance with any of the agreements or conditions contained in the provisions of the merger agreement relating to the covenants of Peoples and Penseco between June 28, 2013, and the closing date of the merger and relating to the conditions to closing.

However, any amendment, extension or waiver granted or executed after shareholders of Penseco or Peoples have approved the merger agreement cannot modify either the amount or the form of the consideration to be provided to holders of Penseco common stock upon consummation of the merger or otherwise materially adversely affect the shareholders of Penseco or Peoples without the approval of the shareholders who would be so affected.

### ***Termination***

The merger agreement may be terminated on or at any time prior to the closing date of the merger:

- (1) by the mutual written consent of Peoples and Penseco;
- (2) by Peoples or Penseco:
  - (a) if the merger has not occurred on or before March 31, 2014, unless the failure of the merger to occur is due to the failure of the party seeking to terminate the merger agreement to perform its covenants and agreements required by the merger agreement;
  - (b) if any governmental agency issues a final unappealable administrative order which would not permit satisfaction of the conditions to the merger under the merger agreement, unless it is due to the failure of the party seeking to terminate the merger agreement to perform its covenants and agreements required by the merger agreement;
- (3) by Penseco if Peoples has, or by Peoples if Penseco has, in any material respect, breached (i) any material covenant contained in the merger agreement or (ii) any representation or warranty contained in the merger agreement, which would have a material adverse

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effect (as defined in the merger agreement) on the nonbreaching party, and such breach has not been substantially cured by the earlier of 30 days after the written notice of the breach is given to the breaching party or the effective time of the merger unless the breach no longer causes a material adverse effect;

- (4) by either party if its shareholders did not approved the merger agreement at its special meeting unless prior to such shareholder vote, the board of directors of the party whose shareholders failed to approve the merger agreement withdrew, modified or changed in a manner adverse to the other party its approval or recommendation of the merger agreement; or
- (5) by either party, subject to certain conditions, if its board of directors shall have determined in good faith after consultation with its legal and financial advisers, taking into account, all relevant factors, that failure to agree to or endorse another acquisition proposal and terminate the merger agreement

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**Table of Contents**

may constitute a breach of their fiduciary duties. However, the merger agreement may only be terminated after giving notice to the other party and negotiating with the other party in good faith to make adjustments to the merger agreement;

- (6) By Penseco, if at any time during the five (5) business day period commencing with the determination date (the later date of either the date the last regulatory approval is obtained or the date of the Peoples special meeting of shareholders), if both of the following conditions are satisfied:
- (a) the average daily high bid and low ask quotations for Peoples common stock as reported on the OTCQB market place for 20 consecutive trading days ending on and including the 10<sup>th</sup> day prior to the determination date shall be less than \$26.175; and
  - (b) (A) the number obtained by dividing the average daily high bid and low ask quotations for Peoples common stock as reported on the OTCQB market place for 20 consecutive trading days ending on and including the 10<sup>th</sup> day prior to the determination date is less than (B) the number obtained by dividing closing price of the Nasdaq Bank Index as of the determination date by the closing price of the Nasdaq Bank Index as of June 28, 2013, minus 0.25.

If the merger is terminated pursuant the merger agreement, the merger agreement will be void except for provisions relating to the confidentiality of information furnished to either Peoples or Penseco during the course of the merger and provisions relating to the expenses associated with the merger. There will be no further liability on the part of Peoples or Penseco to the other, except for any liability arising out of any uncured willful material breach of any covenant or other agreement contained in the merger agreement or any fraudulent breach of a representation or warranty.

***Expenses***

Except as described below, each party will bear and pay all costs and expenses incurred by it in connection with the transactions contemplated by the merger agreement, including fees and expenses of its own financial consultants, accountants and counsel.

However, if the merger agreement is terminated as a result of any breach of a representation, warranty, covenant, or other agreement of Peoples or Penseco, the non-terminating party will be liable to the other for actual out-of-pocket costs and expenses, including the reasonable fees and expenses of financial consultants, accountants, and legal counsel, incurred by the other party up to a maximum amount of \$600,000. The payment of expenses will be the exclusive remedy and upon delivery of such payment, the non-terminating party will have no further obligations to the terminating party pursuant to the merger agreement.

***Termination Fee***

If either party fails to complete the merger after the occurrence of one of the following events, and the other party is not in material breach of the merger agreement, the party failing to complete the merger will pay the other party a fee of \$3,700,000:

- (1) a party concludes in good faith, after consultation with its legal and financial advisers, that it must agree to or endorse an acquisition proposal (as defined in the merger agreement) and terminate the merger agreement in order to comply with its fiduciary responsibilities;
- (2) another person enters into an agreement, letter of intent, or memorandum of understanding with a party which relates to an acquisition proposal;
- (3) a party authorizes, recommends or publicly proposes, or publicly announces an intention to authorize, recommend, or propose an agreement to enter into an acquisition proposal;

- (4) a party's shareholders fail to approve the merger agreement, or the special meeting of shareholders is cancelled, if prior to the shareholder vote or cancellation:



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**Table of Contents**

- (a) a party recommends that its shareholders approve or accept an acquisition proposal with any other person; or
  
- (b) a party fails to call, give notice of, convene and hold a special meeting of shareholders; or
  
- (5) a party's shareholders fail to approve the merger agreement or the special meeting of shareholders is cancelled, if prior to the shareholder vote or cancellation any person, publicly announces its intention to make an acquisition proposal of that party and has not publicly withdrawn the announcement at least thirty (30) days prior to the meeting of shareholders and within twelve (12) months after such event the party enters into any term sheet, letter of intent, agreement or similar type agreement with such person which relates to an acquisition proposal; or

***Regulatory Approvals***

Completion of the transaction is subject to the prior receipt of all consents or approvals of federal and state regulatory authorities required to complete the merger of Peoples and Penseco. As of the date of this joint proxy statement/prospectus, appropriate applications for approval have been filed with the appropriate regulatory authorities. Peoples and Penseco have agreed to use their reasonable best efforts to obtain all regulatory approvals required to complete the transaction. Approvals must be obtained from the Board of Governors of the Federal Reserve System; the Federal Deposit Insurance Corporation, the primary federal regulator of state-chartered banks that are not members of the Federal Reserve System; and from the Pennsylvania Department of Banking and Securities, the primary regulator of Pennsylvania-chartered deposit-taking institutions. The merger cannot proceed in the absence of the required regulatory approvals. On October 7, 2013, Peoples received approval from the Federal Reserve Bank of Philadelphia, acting on delegated authority of the Federal Reserve Board, of its application to merge with Penseco.

***Management After the Merger***

At the effective time of the merger, the total number of persons serving on the board of directors of Peoples and Peoples Security Bank and Trust Company shall be increased to fourteen (14). Six (6) of the fourteen (14) persons to serve initially on the board of directors of Peoples at the effective time of the merger will be appointed by the Peoples board of directors and eight (8) of the fourteen (14) persons will be appointed by the Penseco board of directors from among the current directors of Peoples and Penseco, respectively, who, except for executive officers, are independent directors as determined in accordance with Nasdaq Stock Market Marketplace Rules or the New York Stock Exchange Listed Company Manual, as applicable, and who meet the eligibility requirements under the Peoples bylaws, as amended. The directors from each of Peoples and Penseco shall be evenly distributed as close as possible among the three (3) classes of Peoples with two (2) classes having five (5) directors and one (1) class having four (4) directors each to serve until their successors are duly elected and qualified in accordance with applicable law, the articles of incorporation, and the bylaws of Peoples, as amended.

For each of the 2014, 2015 and 2016 annual meetings of shareholders of Peoples, director nominees shall be selected, or recommended for the board of directors selection, by a nominating committee comprised solely of independent directors. During this three year period, director nominees will be selected and nominated as follows: With respect to each directorship held by an incumbent director formerly affiliated with Penseco, as sub-committee of the nominating committee composed entirely of former Penseco directors will select a director nominee who, except for executive officers, will be an independent director (as determined in accordance with Nasdaq rules) and will satisfy the eligibility requirements set forth in Peoples bylaws. With respect to each directorship held by an incumbent director formerly affiliated with Peoples prior to the merger, as sub-committee of the nominating committee composed entirely of former directors who serve on the Peoples board of directors prior to the merger will select a director nominee who, except for executive officers, will be an independent director (as determined in accordance with Nasdaq or NYSE rules) and will satisfy the eligibility requirements set forth in Peoples bylaws. This procedure for director nominations may be modified by a vote of at least 80% of the Peoples board of directors following the merger.

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**Table of Contents**

For three (3) years immediately following the effective time of the merger, directors formerly of Peoples and Pensco will have pro rata representation on all committees of Peoples and its subsidiaries based upon the representative number of directors of each party on the board of directors as described above, unless the board of directors of Peoples, will determine otherwise upon the approval of at least 80% of the board of directors of Peoples.

William E. Aubrey, II will be the Chairman of the Board of Peoples and, provided Mr. Aubrey remains a member of the board of directors of Peoples, Peoples board of directors will continue to elect Mr. Aubrey at each organizational meeting of directors as Chairman until the 2017 Annual Meeting of Shareholders of Peoples unless the board of directors of Peoples shall determine otherwise upon the approval of at least 80% of the board of directors. On the effective time of the merger, the following shall be among the executive officers of Peoples:

(A) Craig W. Best President and Chief Executive Officer

(B) Scott A. Seasock Chief Financial Officer

(C) Debra E. Dissinger Chief Operating Officer

For more information, see Proposal: The Merger Interests of Directors, Officers, and Others in the Merger .

***Employment; Severance***

Peoples will use its best efforts to continue the employment of all current employees in positions that will contribute to the successful performance of the combined organization. Subject to execution of a customary form of release, Peoples agrees to provide severance pay to any full-time, active employee of Peoples Security Bank and Trust Company whose employment is terminated within one (1) year after the effective time as a result of the merger.

The severance pay will be made if (1) the employee's position is eliminated or (2) the employee is not offered comparable employment (i.e., a position of generally similar job description, responsibilities, and pay and where the employee is not required to commute more than thirty (30) miles more than the employee's present commute). Peoples will not pay severance pay to any employee (1) who is being paid under an existing employment or change in control agreement, (2) whose employment is terminated for cause, or (3) who voluntarily leaves employment prior to the effective time of the merger.

The severance pay will be equal two (2) weeks' pay for each full year of continuous service with a minimum severance benefit of four (4) weeks' pay and a maximum severance benefit of twenty-six (26) weeks' pay. Terminated employees will have the right to continue coverage under COBRA. During the severance payment term or until the employee is enrolled in another health plan, whichever occurs first, Peoples Security Bank and Trust Company will continue to pay the employer's share of medical benefits, provided that COBRA coverage shall run concurrently with the period that Peoples or its subsidiaries pay the employer's share of health coverage. Employees are not third party beneficiaries of these commitments.

***Employee Benefits***

Peoples and Pensco shall, before or promptly after the effective time of the merger, review all benefit plans of Penn Security Bank and Trust Company and Peoples Neighborhood Bank in order to establish the benefit plans to be made available to employees after the effective time of the merger. Peoples will:

- (1) provide its employees credit for all years of service with Peoples or Pensco or any of their subsidiaries and predecessors for the purpose of eligibility and vesting and provide employees credit for all years of service for benefit accrual for the Pensco or Peoples benefit plans;

- (2) cause any and all pre-existing condition limitations and eligibility waiting periods under group health plans to be waived with respect to their employees who remain as employees of Peoples or its subsidiaries (and their eligible dependents); and

## **Table of Contents**

- (3) cause to be credited any deductibles incurred by employees and their beneficiaries and dependents during the portion of the calendar year prior to their participation in the new benefit plans.

Peoples and Penseco and their subsidiaries agree to honor all vested or accrued benefit obligations to, and contractual rights of their current and former employees, including any benefits or rights arising as a result of the transactions contemplated by the merger agreement (either alone or in combination with any other event). In order to accomplish the foregoing, Peoples or its subsidiary and Penseco or its subsidiary may amend, freeze, merge or terminate any benefit plan of Peoples Neighborhood Bank, Peoples, Penseco, or Penn Security Bank and Trust Company, respectively.

### **Interests of Directors, Officers, and Others in the Merger**

Certain members of Peoples and Penseco's management and board of directors may have interests in the transaction in addition to their interests as Peoples or Penseco shareholders, respectively. The Peoples and Penseco boards of directors were aware of these factors and considered them, among other matters in approving the merger agreement.

### ***Share Ownership***

As of September 27, 2013, the record date for the special meetings of Peoples and Penseco shareholders:

1. The directors and executive officers of Peoples may be deemed to be the beneficial owners of 222,791 shares, representing 7.21% of the outstanding shares of Peoples common stock.
2. The directors and executive officers of Penseco may be deemed to be the beneficial owners of 413,701 shares, representing 12.6% of the outstanding shares of Penseco common stock.
3. Peoples and the directors and executive officers of Peoples may be deemed to be the beneficial owners of 10,513 shares, representing 0.32% of the outstanding shares of Penseco common stock.

Shares of Penseco common stock held by Peoples will be cancelled as of the effective time of the merger.

### ***Board Positions and Compensation***

Upon completion of the merger, six (6) of the fourteen (14) persons to serve initially on the board of directors of Peoples at the effective time shall be appointed by the Peoples board of directors and eight (8) of the fourteen (14) persons shall be appointed by the Penseco board of directors. Each person who serves as a director of Peoples will be compensated in accordance with the policies of Peoples.

The following directors of Peoples are expected to continue as directors of Peoples on the effective time of the transaction: William E. Aubrey II, Ronald G. Kukuchka, Richard S. Lochen, Jr., George H. Stover, Jr., Earle A. Wootton, and Joseph T. Wright, Jr. The following directors of Penseco are expected to become directors of Peoples on the effective time of the transaction: Craig W. Best, Joseph G. Cesare, James G. Keisling, P. Frank Kozik, Robert W. Naismith, James B. Nicholas, Emily S. Perry, and Steven L. Weinberger.

For more information, see Proposal The Merger Terms of the Merger Management After the Merger.

### ***Management Positions***

On the effective time of the merger, the following persons are expected to be the executive officers of Peoples:

Craig W. Best President and Chief Executive Officer

Scott A. Seasock Chief Financial Officer



**Table of Contents**

Debra E. Dissinger Chief Operating Officer

Michael L. Jake Chief Risk Officer

Thomas P. Tulaney Chief Lending Officer

Greg D. Misterman Chief Credit Officer

Lynn M. Peters Thiel Chief Retail Officer South

Joseph M. Ferretti Co-Chief Lending Officer North

Each executive officer of Peoples shall hold office until his or her successor is appointed and qualified or otherwise in accordance with applicable law, the articles of incorporation, and the bylaws of Peoples, and such person's respective employment agreement.

***Severance Agreements/Payments***

Messrs. Dakey, Seasock, and Ferretti are parties to respective supplemental executive retirement plans pursuant to which Peoples Neighborhood Bank shall pay each the actuarially equivalent to his retirement benefit under the plan within ten days of a change in control. Mr. Joseph M. Ferretti will be offered a new employment agreement which will provide for a retention bonus. Mr. Dakey's whose employment will be terminated and, in connection therewith, he will receive a lump sum amount equal to 2.99 times his base amount as defined by Internal Revenue Code Section 280G(b)(3) pursuant to his employment agreement.

The Peoples directors will become fully vested, if not already, in the Peoples Director Retirement Plan.

***Consulting Agreement***

Alan Dakey is expected to enter into a consulting agreement wherein he will assist with the integration of Penn Security Bank and Trust Company into Peoples Neighborhood Bank for a six month period following the merger for which he will be paid \$95,000.

***Summary of Peoples Golden Parachute Arrangements***

The following table sets forth the aggregate dollar value of the various elements of compensation that each named executive officer of Peoples and Pensco would receive that is based on or otherwise relates to the merger, assuming the following:

the merger closed on June 30, 2013, the last practicable date prior to the date of these materials, and

Messrs. Scott A. Seasock, Debra E. Dissinger, and Joseph M. Ferretti remain in the employ of Peoples post closing. Any changes in these assumptions or estimates would affect the amounts shown in the following table.

**Golden Parachute Compensation for the Named Executive Officers of Peoples Financial Services Corp.**

Name	Tax Reimbursements
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	Cash (\$ (1))	Equity (\$)	Pension/ NQDC (\$ (2))	Perquisites/ Benefits (\$ (3))	( \$)	Other (\$ (4))	Total (\$)
Alan W.Dakey	425,367		227,915	15,138			668,420
Scott A. Seasock			151,943				151,943
Debra E. Dissinger			213,174				213,174
Joseph M. Ferretti			227,915			153,622	381,537

- (1) The amounts listed in this column represent the double trigger change in control severance payments which may be made under the named executive officer's respective employment agreements. The payments

**Table of Contents**

will only be made to each respective named executive officer (i) should the named executive officer terminate employment after a change in control for good reason (as defined in the employment agreement) provided that within one hundred twenty days of the good reason occurrence the executive provides Peoples with thirty (30) days notice to cure and Peoples fails to cure the occurrence or (ii) the named executive officer is terminated without cause (as defined in the employment agreement). The employment agreements contain gross-down provisions.

- (2) The named executive officers' benefits under their supplemental executive retirement plans will fully vest upon a change in control. This is considered a single-trigger arrangement. The amount listed in this column sets forth the amount which Messrs. Dakey, Seasock, and Ferretti will receive within ten days of the change in control. Of the \$227,915, Mr. Dakey will receive \$50,198 was previously vested; of the \$151,943, Mr. Seasock will receive \$5,880 was previously vested; of the \$227,915, Mr. Ferretti will receive \$7,483 was previously vested. The amount listed in this column for Ms. Dissinger represents the present value of Ms. Dissinger's benefit of \$20,000 per year for 15 years beginning after she reaches age 65. Of the \$213,174, \$91,206 was previously vested.
- (3) The amounts listed in this column represent the approximate costs of providing health care benefits to the named executive officer under the respective employment agreement assuming that that named executive officer was involuntarily terminated without cause or the executive terminated employment for good reason. The amounts listed were determined using the assumptions used for financial reporting purposes under generally accepted accounting principles. The payments under this column are considered double-trigger payments.
- (4) Under the agreement which will be provided to Mr. Ferretti, he will be offered a retention bonus equal to \$153,622 payable over three years.

**Employment Agreements**

Pursuant to Mr. Dakey's employment agreement, in the event that after a change in control he is terminated without cause or terminates his employment for good reason as hereinafter defined, he will be entitled to a lump sum amount equal to 2.99 times his base amount as defined by Internal Revenue Code Section 280G(b)(3). Good reason is defined as a reduction in title or a reduction in responsibilities or authority or assignment of duties inconsistent with his position; a reassignment which requires the named executive officer to move his principal residence; any removal of the named executive officer from office or any adverse change in the terms and conditions of his employment except for a termination for cause as defined in the employment agreement; any reduction in his annual base salary; any failure of Peoples to provide him with benefits at least as favorable as those enjoyed under the pension, life insurance, medical, health, accident, disability or Peoples other employee benefit plans unless such reduction is part of a reduction for all employees; material change in the legal relationship between Peoples and Peoples Neighborhood Bank; or any material breach of the employment agreement by Peoples or Peoples Neighborhood Bank. Mr. Dakey would also be entitled to a continuation of group health insurance benefits for one year following the termination of his employment.

Pursuant to Mr. Seasock's employment agreement, in the event that after a change in control he is terminated without cause or terminates his employment for good reason as hereinafter defined, he will be entitled to a lump sum amount equal to 2.0 times his Annual Base Salary. Good reason is defined as a reduction in title or a reduction in responsibilities or authority or assignment of duties inconsistent with his position; a reassignment which requires the named executive officer to move his principal residence; any removal of the named executive officer from office or any adverse change in the terms and conditions of his employment except for a termination for cause as defined in the employment agreement; any reduction in his annual base salary; any failure of Peoples to provide him with benefits at least as favorable as those enjoyed under the pension, life insurance, medical, health, accident, disability or Peoples other employee benefit plans unless such reduction is part of a reduction for all employees; material change in the legal relationship between Peoples and Peoples Neighborhood Bank; or any material breach of the employment agreement by Peoples or Peoples Neighborhood Bank. Mr. Seasock would also be entitled to a continuation of group health insurance benefits for two years following the termination of his employment.



**Table of Contents**

Pursuant to Mr. Ferretti's employment agreement, in the event that after a change in control he is terminated without cause or terminates his employment for good reason as hereinafter defined, he will be entitled to a lump sum amount equal to 2.0 times his Annual Base Salary. Good reason is defined as a reduction in title or a reduction in responsibilities or authority or assignment of duties inconsistent with his position; a reassignment which requires the named executive officer to move his principal residence; any removal of the named executive officer from office or any adverse change in the terms and conditions of his employment except for a termination for cause as defined in the employment agreement; any reduction in his annual base salary; any failure of Peoples to provide him with benefits at least as favorable as those enjoyed under the pension, life insurance, medical, health, accident, disability or Peoples other employee benefit plans unless such reduction is part of a reduction for all employees; material change in the legal relationship between Peoples and Peoples Neighborhood Bank; or any material breach of the employment agreement by Peoples or Peoples Neighborhood Bank. Mr. Ferretti would also be entitled to a continuation of group health insurance benefits for one year following the termination of his employment.

Mr. Ferretti will be offered a new employment agreement which will provide for a base salary of \$175,000, a maximum bonus of twenty (20%) percent of his salary, and a supplemental executive retirement plan providing for a benefit of \$40,000 for 10 years.

**Supplemental Executive Retirement Plans**

Messrs. Dakey, Seasock, and Ferretti are parties to respective supplemental executive retirement plan agreements pursuant to which the bank shall pay each the actuarially equivalent of his retirement benefit under the plan within ten days of a change in control. The actuarially equivalent is defined as the equivalent value to the normal form of benefit determined under generally accepted actuarial principles. The actuarially equivalent lump sum shall be calculated using the rate used by the plan administrator for determining the accrual balance. Mr. Dakey's retirement benefit, at age 65, is \$30,000 per year payable in monthly installments for 120 months. Mr. Seasock's retirement benefit, at age 65, is \$20,000 per year payable in monthly installments for 120 months. Mr. Ferretti's retirement benefit, at age 65 is twenty percent (20%) of the average of his base salary over the three previous years.

Ms. Dissinger is a party to a supplemental executive retirement plan whereupon a change in control she shall become fully vested in her retirement benefit. She will receive \$20,000 per year for 15 years after she turns 65 years old.

**Summary of Pensco Golden Parachute Arrangements**

The following table sets forth the aggregate dollar value of the various elements of compensation that each of Pensco's named executive officers, as identified in the definitive proxy statement for Pensco's 2013 annual meeting of shareholders, would receive based on or otherwise related to the merger, assuming the merger closed on July 31, 2013, the last practicable date prior to the date of these materials.

Any changes in these assumptions could affect the amounts shown in the following table.

**Golden Parachute Compensation for****Named Executive Officers of Pensco Financial Services Corporation**

Name	Cash (\$)	Equity (\$)	Pension/ NQDC (\$)(1)	Perquisites/ Benefits (\$)	Tax Reimbursements (\$)	Other (\$)	Total (\$)
Craig W. Best							
Patrick M. Scanlon			38,191				38,191
Thomas P. Tulaney							
Greg D. Misterman							
Lynn M. Peters Thiel							

## **Table of Contents**

- (1) Represents the value of Mr. Scanlon's vested account balance under Penseco's executive deferred compensation plan, which will be paid to Mr. Scanlon in a single lump sum within 45 days following the merger.

### ***Cash Severance***

Messrs. Best and Tulaney, each of whom is party to an employment agreement, have provisions in their agreements that provide for certain cash severance benefits in the event of voluntary or involuntary termination following a change in control. The employment agreements will be assumed by the surviving corporation by virtue of the merger and the surviving corporation will succeed to the rights of Penseco under the employment agreements. Because immediately following the merger, a majority of the common stock of the surviving corporation will be owned by current Penseco shareholders and a majority of the board of directors of the surviving corporation will consist of current Penseco directors, the merger will not constitute a change in control under the terms of the employment agreements.

The named executive officers other than Messrs. Best and Tulaney are covered by the severance policy applicable to our employees generally. That policy provides for certain severance benefits which are based on, among other things, length of service. This severance policy does not provide any different or additional benefits based on or related to the merger.

### ***Acceleration of Vesting or Cancellation of Equity Awards***

Messrs. Best and Tulaney have received restricted stock awards under Penseco's equity incentive plan (the 2008 Long-Term Incentive Plan), which awards have not yet vested. Under the terms of the Penseco equity incentive plan, the merger will not constitute a change in control, again, because immediately following the merger current Penseco directors will constitute a majority of the board of directors of the surviving corporation and the shares of Peoples common stock into which the Penseco common stock will be converted will represent at least fifty percent of the common stock of the surviving corporation. Accordingly, the vesting of the restricted stock awards will not be accelerated. In accordance with the terms of the merger agreement, no payment in cancellation of the restricted stock awards will be made and the restricted stock awards will remain outstanding, subject to conversion of the underlying stock. Penseco has no outstanding options or other unvested equity awards.

### ***Pension and Nonqualified Deferred Compensation Benefits***

Messrs. Best and Scanlon are participants in Penseco's Executive Deferred Compensation Plan. Under the terms of that plan, account balances become payable within 45 days after a change of control, which is broadly defined to include a change in ownership, change in effective control, or change in the ownership of a substantial portion of the company's assets, as each term is defined under Section 409A of the Internal Revenue Code and related regulations and guidance. Mr. Best has waived his benefit under the plan. Mr. Scanlon is already fully vested in all Penseco balances under the plan. Mr. Scanlon's vested account balance is comprised of Penseco contributions in the amount of \$27,011, plus earnings on those contributions. The merger will constitute a change of control under the Executive Deferred Compensation Plan and Mr. Scanlon will receive payment of his account balance under such plan.

### ***Perquisites, Benefits, Tax Reimbursements and Other Compensation***

Except as describe above, none of Penseco's named executive officers will receive any perquisites, benefits, tax reimbursements or other compensation which are based on or otherwise related to the merger.

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## **Table of Contents**

### ***Indemnification and Insurance***

On or after the effective time of the merger, Peoples will indemnify, defend, and hold harmless all prior and then-existing directors, officers and employees of Peoples, Penseco and their respective subsidiaries against:

- (1) All losses, claims, damages, costs, expenses, liabilities or judgments or amounts that are paid in settlement (with the prior approval of Peoples) of or in connection with any claim, action, suit, proceeding or investigation based in whole or in part on, or arising in whole or in part out of, the fact that the person is or was a director, officer, or employee of Peoples, Penseco or their respective subsidiaries, whether pertaining to any matter existing or occurring at or prior to the effective time of the merger and whether asserted or claimed prior to, or at or after, the effective time of the merger; and
- (2) All of the indemnified liabilities identified in paragraph (1) immediately above based in whole or in part on, or arising in whole or in part out of, or pertaining to the merger agreement or the transactions contemplated thereby, to the same extent as an officer, director, or employee may be indemnified by Peoples or its subsidiaries, as the case may be, as of June 28, 2013.

The above indemnification rights include the right to advancement of expenses; however, no officer, director, or employee may be indemnified by Peoples if indemnification is prohibited by applicable law.

After the effective time of the merger, Peoples will maintain a directors' and officers' liability insurance policy providing coverage amounts not less than the coverage amounts provided under the Penseco directors' and officers' liability insurance policy and on terms generally no less favorable. The policy will cover persons who are currently covered by the Penseco insurance policies for a period of six years after the effective time of the merger. However, Peoples is not obligated to make annual premium payments for the six-year period which exceed 200% of the annual premium payment as of December 31, 2012, under Penseco's current policy in effect as of June 28, 2013. If the amount of the premiums necessary to procure insurance coverage exceeds this maximum amount, Peoples will use its reasonable best efforts to maintain the most advantageous policies of directors' and officers' liability insurance obtainable for a premium equal to the maximum amount.

### ***Voting Agreements***

As a condition to entering into the merger agreement, each of the directors and certain executive officers of Peoples and Penseco entered into an agreement pursuant to which each such director or executive officer agreed to vote all of his or her shares of Peoples or Penseco common stock, as applicable, in favor of the merger agreement. The forms of voting agreement, which are substantially the same, are attached as Exhibits 1 and 2 to Annex A of this document. The voting agreements may have the effect of discouraging persons from making a proposal for an acquisition transaction involving Penseco or Peoples. The following is a brief summary of the material provisions of the voting agreements:

The directors and executive officers agreed, among other things, to vote, or cause to be voted, (a) for approval and adoption of the merger agreement and the transactions contemplated thereby, and (b) against any action that is intended, or could reasonably be expected to impede, interfere with, delay, postpone, or adversely affect the transaction contemplated in the merger agreement, all shares over which they exercise sole voting power, and to use reasonable efforts to cause all other shares over which they share voting power, including those held in a voting trust jointly with other persons, to be voted in the same manner;

The directors and executive officers agreed not to sell, transfer, or otherwise dispose of their Peoples or Penseco common stock, as applicable, subject to certain exceptions; and

Those directors of Peoples or Penseco who continue as directors of Peoples agreed, for three years after the effective time of the merger, to vote or cause to be voted their shares for the director nominees whom the board of directors of Peoples recommends for election to the board of directors of Peoples.

## **Table of Contents**

### **Accounting Treatment**

The merger will be accounted for as a reverse merger using the acquisition method of accounting, in accordance with the provisions of FASB ASC Topic 805-10 Business Combinations which provides guidance to determine the accounting acquiring entity in this transaction, which included, but were not limited to, the following factors:

The relative voting interests in Peoples after the merger is completed;

The composition of the governing body of Peoples after the merger is completed;

The composition of the senior management of Peoples after the merger is completed;

The terms of the exchange of equity securities in the merger; and

The relative size of the Penseco and Peoples at the time of merger.

Based on consideration of all the relevant facts and circumstances of the merger, including the above factors, for accounting purposes, Penseco is considered to be acquiring Peoples in this transaction. As a result, the historical financial statements of the combined company will be the historical financial statements of Penseco following the completion of the merger. The merger will be effected by the issuance of shares of Peoples stock to Penseco shareholders. The assets and liabilities of Peoples as of the effective date of the merger will be recorded at their respective estimated fair values and added to those of Penseco. Any excess of purchase price over the net estimated fair values of the acquired assets and liabilities of Peoples will be allocated to all identifiable intangible assets. Any remaining excess will then be allocated to goodwill, the goodwill resulting from the merger will not be amortized to expense, but instead will be reviewed for impairment at least annually. To the extent goodwill is impaired, its carrying value would be written down to its implied fair value and a charge would be made to earnings. Customer related intangibles and other intangibles with definite useful lives will be amortized to expense over their estimated useful lives.

In periods following the completion of the merger, the comparative historical financial statements of Peoples will be those of Penseco prior to the merger. These financial statements will reflect the results attributable to the acquired operations of Peoples, as the acquired company for accounting purposes, beginning on the date the merger is completed. The unaudited *pro forma* financial information contained in this document has been prepared using the acquisition method of accounting. See *Unaudited Pro Forma Combined Financial Data* beginning on page F-66 of this document.

### **Material U.S. Federal Income Tax Consequences**

Subject to the limitations, assumptions, and qualifications as discussed herein, in the opinion of each of Bybel Rutledge LLP and Pepper Hamilton LLP, the following discussion addresses the material U.S. federal income tax consequences of the merger to U.S. holders (as defined below) of Penseco common stock. This discussion is based on the Internal Revenue Code of 1986, as amended (the Code), Treasury regulations promulgated under the Code, judicial authorities, published positions of the Internal Revenue Service (the IRS), and other applicable authorities, all as in effect on the date of this document and all of which are subject to change (possibly with retroactive effect) and to differing interpretations which could affect the accuracy of this discussion.

This discussion assumes that U.S. holders of Penseco common stock hold their shares as capital assets within the meaning of Section 1221 of the Code. This discussion does not address all aspects of U.S. federal income taxation that may be relevant to U.S. holders in light of their particular circumstances and does not address aspects of U.S. federal income taxation that may be applicable to U.S. holders subject to special treatment under the federal income tax laws (including banks; financial institutions; tax-exempt organizations; insurance companies; dealers or brokers in securities; traders in securities that elect to use a mark-to-market method of accounting; investors or owners of pass-through entities; mutual funds; holders subject to the alternative minimum tax provisions of the Code; regulated investment companies, real estate investment trusts, controlled foreign corporations; passive foreign investment companies; persons who hold their respective shares



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**Table of Contents**

of Penseco common stock as part of a hedge, straddle, constructive sale, conversion or other integrated securities transaction; expatriates; or persons who acquired their Penseco common stock as compensation or through a tax qualified retirement plan, or who held or acquired their Penseco common stock through an employee stock ownership plan or dividend reinvestment plan). In addition, this discussion does not address the tax consequences to holders of Penseco common stock who exercise appraisal and/or dissenter's rights. Further, this discussion does not consider any aspect of state, local, or foreign taxation or any aspects of U.S. federal tax law (such as the unearned income Medicare contribution tax pursuant to the Health Care and Education Reconciliation Act of 2010) other than federal income tax law.

**This discussion is not intended to be tax advice to any particular holder of Penseco common stock. Tax matters regarding the merger are complicated, and the tax consequences of the merger to you will depend on your particular situation. Penseco shareholders are urged to consult their tax advisors with respect to the particular U.S. federal, state, local, and foreign tax consequences to them of the merger.**

For purposes of this discussion, you are a U.S. holder if you beneficially own Penseco common stock and you are:

a citizen or resident of the United States for federal income tax purposes;

a corporation, or other entity taxable as a corporation for U.S. federal income tax purposes, created or organized under the laws of the United States or any of its political subdivisions;

a trust, if (i) a U.S. court is able to exercise primary supervision over the administration of the trust and one or more U.S. persons have the authority to control all substantial decisions of the trust or (ii) the trust has a valid election in effect under applicable Treasury regulations to be treated as a U.S. person; or

an estate that is subject to U.S. federal income tax on its income regardless of its source.

If an entity classified as a partnership for U.S. federal income tax purposes holds Penseco common stock, the tax treatment of a partner generally will depend upon the status of the partner and the activities of the partnership. Partners of partnerships holding Penseco common stock should consult their own tax advisors.

It is a condition to the closing of the merger that Peoples receive the opinion of its special counsel, Bybel Rutledge LLP, and that Penseco receive the opinion of its counsel, Pepper Hamilton LLP, substantially to the effect that, on the basis of facts, representations, and assumptions set forth or referred to in that opinion (including factual representations contained in certificates of officers of Peoples and Penseco), the merger will be treated as a reorganization within the meaning of Section 368(a) of the Code. The tax opinions are not binding on the IRS or the courts, and neither Peoples nor Penseco intends to request a ruling from the IRS with respect to the U.S. federal income tax consequences of the merger. Consequently, no assurance can be given that the IRS will not assert, or that a court would not sustain, a position contrary to any of those set forth below.

The discussion below addresses the material U.S. federal income tax consequences to a U.S. holder of Penseco common stock resulting from the qualification of the merger as a reorganization within the meaning of Section 368(a) of the Code.

***Exchange of Penseco common stock for Peoples common stock***

A U.S. holder that exchanges shares of Penseco common stock for shares of Peoples common stock in the merger generally will not recognize any gain or loss except in respect of cash received in lieu of any fractional share of Peoples common stock (as discussed below). The aggregate adjusted tax basis of the shares of Peoples common stock received by the U.S. holder in the merger will be equal to the aggregate adjusted tax basis of the shares of Penseco common stock surrendered in exchange therefor, reduced by the tax basis allocable to any fractional share of Peoples common stock for which cash is received. The holding period of the Peoples common stock received by a U.S. holder will include the holding period of the shares of Penseco common stock



## **Table of Contents**

surrendered in exchange therefor. If a U.S. holder acquired different blocks of Penseco common stock at different times or at different prices, the holder should consult his or her tax advisor with regard to identifying the bases or holding periods of the particular shares of Peoples common stock received in the exchange.

### ***Cash received in lieu of a fractional share***

Cash received by a U.S. holder in lieu of a fractional share of Peoples common stock generally will be treated as received in redemption of the fractional share, and gain or loss generally will be recognized based on the difference between the amount of cash received in lieu of the fractional share and the portion of the holder's aggregate adjusted tax basis of the shares of Penseco common stock surrendered that is allocable to the fractional share. The gain or loss generally will be long-term capital gain or loss if the holding period for the fractional share (including the holding period of the shares of Penseco common stock surrendered therefor) is more than one year. Long-term capital gains of individuals generally are eligible for reduced rates of taxation. The deductibility of capital losses is subject to limitations.

### ***Information Reporting and Backup Withholding***

If a U.S. holder receives cash in the merger (including cash received in lieu of a fractional share), the holder may be subject to information reporting and backup withholding at a rate of 28%. You generally will not be subject to backup withholding if you (1) provide an accurate taxpayer identification number, certify that you are not subject to backup withholding and otherwise comply with the backup withholding rules; or (2) provide proof that you are exempt from backup withholding. Amounts withheld under the backup withholding rules will be allowed as a refund or credit against a U.S. holder's federal income tax liability provided that the holder furnishes the required information to the IRS.

**The foregoing discussion is not intended to be a complete analysis or description of all potential U.S. federal income tax consequences of the merger and is not intended to be, and should not be construed as, tax advice. Penseco shareholders are strongly urged to consult with their tax advisors to determine the particular U.S. federal, state, local, and foreign tax consequences to them of the merger.**

### **Resales of Peoples Common Stock**

The shares of Peoples stock to be issued to shareholders of Penseco under the merger agreement have been registered under the Securities Act of 1933 and may be freely traded without restriction by holders who will not be affiliates of Peoples after the merger.

Certain directors and executive officers of Penseco will be considered affiliates of Peoples after the merger. They may resell shares of Peoples common stock received in the merger only if the shares are registered for resale under the Securities Act or an exemption is available. They may resell under the safe harbor provisions of Rule 145 under the Securities Act or as otherwise permitted under the Securities Act. Each person deemed to be an affiliate will enter into an agreement with Peoples providing that the person will not transfer any shares of Peoples stock received in the merger, except in compliance with the Securities Act. Peoples encourages any such person to obtain advice of securities counsel before reselling any Peoples stock.

### **Application to be Listed on The Nasdaq Stock Market, Inc. or the New York Stock Exchange**

Peoples plans to apply to list Peoples common stock on The Nasdaq Stock Market, Inc. or the New York Stock Exchange. We hope that this will make the stock more liquid. However, we cannot guarantee that our application will be accepted. Accordingly, although, the Peoples common stock offered in the merger will be freely transferable once you receive your Peoples stock certificate, Peoples' common stock may not be listed on a national securities exchange. Instead, Peoples common stock may be traded in local over-the-counter markets and privately negotiated transactions. Moreover, even if Peoples' common stock is listed on a securities



**Table of Contents**

exchange, there is no assurance that an active public trading market for Peoples common stock will develop. The development and maintenance of a public market, having the desirable characteristics of depth, liquidity and orderliness depends on the existence of willing buyers and sellers, the presence of which is not within our control. The number of active buyers and sellers of Peoples common stock at any particular time may be limited which may have an adverse effect on the price at which shares of our common stock can be sold. Further, we cannot assure you that significant trading in Peoples common stock will take place for several years, if ever. Investors should consider their shares of Peoples common stock as a long-term investment because, among other things, they may not be able to promptly liquidate their investment at a reasonable price in the event of a personal financial emergency or otherwise.

**Rights of Dissenting Shareholders**

Pursuant to the Pennsylvania Business Corporation Law, shareholders of Peoples and Penseco have the right to dissent from the merger and to obtain payment of the fair value of their Peoples or Penseco common stock, as the case may be, if the merger is consummated. The term fair value means the value of Peoples or Penseco common stock immediately before completion of the merger, taking into account all relevant factors, but excluding any appreciation or depreciation in anticipation of the merger.

The following summary of the steps necessary to exercise the right to dissent is qualified in its entirety by the full text of Section 1930 and Subchapter D of Chapter 15 of the Pennsylvania Business Corporation Law, which are attached as Annex D to this joint proxy statement/prospectus. Each step must be taken in the indicated order and in strict compliance with the applicable provisions of the statute in order to perfect dissenters rights. The failure of any shareholder to comply with these steps will result in the shareholder receiving the consideration contemplated by the merger agreement. See Proposal The Merger Terms of the Merger . Any shareholder of Peoples or Penseco who contemplates exercising the right to dissent is urged to read carefully the provisions of Section 1930 and Subchapter D of Chapter 15 of the Pennsylvania Business Corporation Law.

Any written notice or demand which is required in connection with the exercise of dissenters rights, whether before or after the effective time of the merger, must be sent to the following locations:

**In the case of a Peoples shareholder:**

Peoples Financial Services Corp.  
82 Franklin Avenue  
Hallstead, PA 18822  
Attn: Corporate Secretary  
Shareholders who wish to dissent must:

**In the case of a Penseco shareholder:**

Penseco Financial Services Corporation  
150 North Washington Avenue  
Scranton, PA 18503  
Attn: Investor Relations Officer

1. File with Peoples or Penseco, as the case may be, a written notice of intention to demand that they be paid the fair value for their shares of Peoples or Penseco common stock prior to the vote of shareholders on the merger at the Peoples special meeting to be held on November 15, 2013 or Penseco special meeting to be held on November 21, 2013.
2. If the merger is effected, the dissenters must effect no change in the beneficial ownership of their Peoples or Penseco common stock from the date of the filing of the intention to demand payment through the effective time of the merger.
3. And the dissenters must vote against the merger, abstain from voting for the merger, or not vote their Peoples or Penseco common stock to approve the merger.

Neither submitting a proxy against nor a vote in person against adoption and approval of the merger agreement will constitute the necessary written notice of intention to dissent described above. Beneficial owners of Peoples or Penseco common stock whose shares are held of record in street name by a brokerage firm or other nominee must obtain the written consent of the record holder to the beneficial owners exercise of

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**Table of Contents**

dissenters' rights and must submit the consent to Peoples or Penseco, as the case may be, no later than the time of the filing of their notice of intention to dissent.

If the merger is adopted and approved by the required vote of Peoples' and Penseco's shareholders at their respective special meetings, Peoples and Penseco will mail a notice to all dissenters who gave due notice of intention to demand payment and who refrained from voting in favor of the merger. The notice will state where and when a demand for payment must be sent and where certificates for Peoples and Penseco common stock must be deposited in order to obtain payment. It also will include a form for demanding payment and a copy of Subchapter D of Chapter 15 of the Pennsylvania Business Corporation Law. The time set for receipt of the demand for payment and deposit of stock certificates will not be less than 30 days from the date of mailing of the notice.

Shareholders who fail to timely demand payment or fail to timely deposit stock certificates, as required by Peoples' or Penseco's notice, will not have any right to receive payment of the fair value of their Peoples or Penseco common stock.

Promptly after the merger is complete, or upon timely receipt of demand for payment if the merger already has been completed, Peoples will either remit to dissenters who have made demand and have deposited their stock certificates the amount that Peoples, as successor to Penseco, estimates to be the fair value of the Peoples and Penseco common stock or give written notice that no such remittance is being made. The remittance or notice will be accompanied by:

1. A closing balance sheet and an income statement of Peoples or Penseco, as the case may be, for a fiscal year ending not more than 16 months before the date of remittance, together with the latest available interim financial statements;
2. A statement of Peoples' estimate of the fair value of the Peoples or Penseco common stock, as the case may be; and
3. Notice of the right of the dissenter to demand payment or supplemental payment under Pennsylvania Business Corporation Law accompanied by a copy of Subchapter D of Chapter 15 of Pennsylvania Business Corporation Law.

If Peoples does not remit the estimated fair value for shares with respect to which demand for payment has been made and stock certificates have been deposited, then Peoples will return any certificates that have been deposited. Peoples will mark returned certificates and any certificates subsequently issued in exchange therefor to record the fact that demand for payment has been made. Transferees of shares so marked will not acquire any rights in Peoples or Penseco other than those rights held by the original dissenter after such dissenter demanded payment of fair value.

If a dissenter believes that the amount stated or remitted by Peoples is less than the fair value of the Peoples or Penseco common stock, the dissenter may send Peoples his or her own estimate of the fair value of the Peoples or Penseco common stock, as the case may be, which will constitute a demand for payment of the amount of the deficiency. If Peoples remits payment of its estimated value of a dissenter's Peoples or Penseco common stock, as the case may be, and the dissenter does not file his own estimate within 30 days after the mailing by Peoples of its remittance, the dissenter will be entitled to no more than the amount remitted to him or her by Peoples.

Within 60 days after the latest to occur of (1) the completion of the merger, (2) the timely receipt by Peoples or Penseco, as the case may be, of any demands for payment, or (3) timely receipt by Peoples or Penseco, as the case may be, of any estimates by dissenters of fair value, if any demands for payment remain unsettled, Peoples or Penseco, may file, in the case of Peoples, in the Court of Common Pleas of Susquehanna County or, in the case of Penseco, in the Court of Common Pleas of Lackawanna County, an application requesting that the fair value of the Peoples or Penseco common stock be determined by the Court. In such case, all dissenters, wherever

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**Table of Contents**

residing, whose demands have not been settled must be made parties to the proceeding as in an action against their shares, and a copy of the application must be served on each dissenter.

If Peoples or Penseco were to fail to file an application, then any dissenter, on behalf of all dissenters who have made a demand and who have not settled their claim against Peoples or Penseco, may file an application in the name of Peoples or Penseco at any time within the 30-day period after the expiration of the 60-day period and request that the fair value be determined by the Court. The fair value determined by the Court may, but need not, equal the dissenters' estimates of fair value. If no dissenter files such an application, then each dissenter entitled to do so shall be paid Peoples' or Penseco's estimate of the fair value of the Peoples or Penseco common stock, as the case may be, and no more, and may bring an action to recover any amount not previously remitted, plus interest at a rate the Court finds fair and equitable.

Peoples and Penseco intend to negotiate in good faith with any dissenting shareholder. If after negotiation, a claim cannot be settled, then Penseco and/or Peoples, as successor, intends to file an application requesting that the fair value of the Peoples or Penseco common stock be determined by the Court. The fair value that would be determined by the Court cannot be predicted and could be more or less than the value of the merger consideration.

**Description of Peoples**

**General**

Peoples, a bank holding company incorporated in 1986 under the laws of Pennsylvania, provides a full range of financial services through its wholly-owned subsidiary, Peoples Neighborhood Bank, including its subsidiaries, Peoples Advisors, LLC, Peoples Financial Leasing, LLC and Peoples Neighborhood Abstract, LLC. The Company services its retail and commercial customers through twelve full-service community banking offices located within the Lackawanna, Susquehanna and Wyoming counties of Northern Pennsylvania and Broome county of Southern New York.

Peoples Neighborhood Bank is a state non-member bank under the jurisdiction of the Pennsylvania Department of Banking and the Federal Deposit Insurance Corporation. Peoples Neighborhood Bank's primary product is loans to small- and medium-sized businesses. Other lending products include one-to-four family residential mortgages and consumer loans. Peoples Neighborhood Bank primarily funds its loans by offering open time deposits to commercial enterprises and individuals. Other deposit product offerings include certificates of deposits and various demand deposit accounts.

Peoples Advisors, LLC, a member managed limited liability company, provides investment advisory services to individuals and small businesses. Peoples Financial Leasing, LLC, provides employee leasing services to Peoples Neighborhood Bank.

Peoples Neighborhood Abstract, LLC, a limited liability company, offers title insurance and abstract services to residential and commercial mortgage loan customers.

Peoples Advisors, LLC; Peoples Financial Leasing, LLC and Peoples Neighborhood Abstract, LLC did not meet the quantitative thresholds for required segment disclosure in conformity with accounting principles generally accepted in the United States of America ( GAAP ). Peoples Neighborhood Bank's twelve community banking offices, all similar with respect to economic characteristics, share a majority of the following aggregation criteria: (i) products and services; (ii) operating processes; (iii) customer bases; (iv) delivery systems; and (v) regulatory oversight. Accordingly, they were aggregated into a single operating segment.

As of June 30, 2013, Peoples had 152 full-time equivalent employees. Peoples and Peoples Neighborhood Bank are not parties to any collective bargaining agreement and employee relations are considered to be good.

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## **Table of Contents**

### **Description of Business**

#### ***Market Areas***

Peoples Neighborhood Bank's principal market area consists of Susquehanna, Wyoming and Lackawanna Counties of northeastern Pennsylvania and Broome County in the southern tier of New York. In addition, parts of Wayne and Bradford Counties in Pennsylvania that border Susquehanna and Wyoming Counties are also considered part of the market area.

Specifically, Peoples Neighborhood Bank's market area is situated between:

the city of Binghamton, Broome County, New York, located to the north;

the city of Scranton, Lackawanna County, Pennsylvania, to the south; and

Wilkes-Barre, Luzerne County, Pennsylvania, to the southwest.

Susquehanna County could best be described as a bedroom county with a high percentage of its residents commuting to work in Broome County, New York, or Lackawanna County, Pennsylvania. The southern part of Susquehanna County tends to gravitate south for both employment and shopping, while the northern part of the county goes north to Broome County, New York. The western part of Susquehanna County gravitates south and west to and through Wyoming County. The majority of Peoples Neighborhood Bank's offices are located in counties that would be considered sparsely populated, as they are made up of many small towns and villages.

Most recently, the production of natural gas from the Marcellus Shale formation located in the heart of Peoples Neighborhood Bank's market area has begun to provide economic benefits to the communities served and as a result to Peoples Neighborhood Bank itself. Natural gas producers have already invested billions of dollars in Pennsylvania in lease and land acquisition, new well drilling, infrastructure development and community partnerships, with an even greater investment expected in the future. The growth of Peoples Neighborhood Bank's deposits, and to a lesser extent, loan portfolio, has been influenced by natural gas drilling activities.

#### ***Products and Services***

##### **Lending Activities**

Peoples Neighborhood Bank provides a full range of retail and commercial lending products designed to meet the borrowing needs of consumers and small and medium sized businesses in its market areas. A significant amount of Peoples Neighborhood Bank's loans are to customers located within the defined market area. Peoples Neighborhood Bank has no foreign loans or highly leveraged transaction loans, as defined by the Federal Reserve Board. Although Peoples Neighborhood Bank participates in loans originated by other banks, the majority of loans in the portfolio have been originated by itself.

Retail lending products include the following types of loans, among others: (i) residential real estate; (ii) automobiles; (iii) manufactured housing; (iv) personal; (v) student; (vi) home equity and (vii) credit card. Commercial lending products include the following types of loans, among others: (i) commercial real estate; (ii) working capital; (iii) equipment and other commercial needs; (iv) construction; (v) Small Business Administration and (vi) agricultural and mineral rights. The terms offered on a loan vary depending primarily on the type of loan and credit-worthiness of the borrower.

Payment risk is a function of the economic climate in which Peoples Neighborhood Bank's lending activities are conducted. Economic downturns in the economy generally or in a particular sector could cause cash flow problems for customers and make loan payments more difficult. Peoples Neighborhood Bank attempts to minimize this risk by not being exposed to loan concentrations of a single customer or a group of customers, the loss of any one or more of whom would have a materially adverse effect on its financial condition. Interest rate

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## Table of Contents

risk ( IRR ) would occur if Peoples Neighborhood Bank were to make loans at fixed rates in an environment in which rates were subject to rise thereby preventing it from making loans at higher prevailing rates. Peoples Neighborhood Bank attempts to mitigate this risk by making adjustable rate commercial loans and by limiting repricing terms to five years or less for customers requiring fixed rate loans. Finally, collateral risk can occur if Peoples Neighborhood Bank's position in collateral taken as security for loan repayment is not adequate. Peoples Neighborhood Bank minimizes collateral risk by avoiding loan concentrations to particular borrowers, by perfecting liens on collateral and by obtaining appraisals on property prior to extending loans. Peoples Neighborhood Bank attempts to mitigate its exposure to these and other types of risks by stratifying authorization requirements by loan size and complexity.

### Deposit Activities

Peoples Neighborhood Bank's primary source of funds is the cash flow provided by its financing activities, mainly deposit gathering. Other sources of funds are provided by investing activities, including principal and interest payments on loans and investment securities, and operating activities, primarily net income. Peoples Neighborhood Bank offers a variety of deposit accounts with a range of interest rates and terms, including, among others: (i) money market accounts; (ii) NOW accounts; (iii) savings accounts; (iv) certificates of deposit; (v) individual retirement accounts and (vi) demand deposit accounts. These deposits are primarily obtained from areas surrounding Peoples Neighborhood Bank's branch offices. Peoples Neighborhood Bank relies primarily on marketing, product innovation, technology, service and long-standing relationships with customers to attract and retain these deposits. Other deposit related services include: (i) remote deposit capture; (ii) automatic clearing house transactions; (iii) cash management services; (iv) automated teller machines; (v) point of sale transactions; (vi) safe deposit boxes; (vii) night depository services; (viii) direct deposit and (ix) official check services.

### Wealth Management Services

Peoples Wealth Management, a division of Peoples Advisors, LLC, provides a comprehensive array of wealth management products and services to individuals, small businesses and nonprofit entities. These products and services include the following, among others: (i) investment portfolio management; (ii) estate planning; (iii) annuities; (iv) business succession planning; (v) insurances; (vi) education funding strategies and (vii) tax planning.

### *Competition*

Peoples Neighborhood Bank competes primarily with commercial banks, thrift institutions and credit unions, many of which are substantially larger in terms of assets and available resources. Certain of these institutions have significantly higher lending limits than Peoples Neighborhood Bank and may provide various services for their customers that are not presently available at Peoples Neighborhood Bank. In addition, Peoples Neighborhood Bank experiences competition for deposits from mutual funds and security brokers, while consumer discount, mortgage and insurance companies compete for various types of loans. Credit unions, finance companies and mortgage companies enjoy certain competitive advantages over Peoples Neighborhood Bank as they are not subject to the same regulatory restrictions and taxations as commercial banks. Principal methods of competing for bank products, permitted nonbanking services and financial activities include price, nature of product, quality of service and convenience of location.

Peoples Neighborhood Bank's most significant competitive advantage originates from its business philosophy which includes offering direct access to senior management and other officers and providing friendly, informed and courteous service, local and timely decision making, flexible and reasonable operating procedures and consistently applied credit policies. In addition, Peoples Neighborhood Bank's success has been, and will continue to be, a result of its emphasis on community involvement and customer relationships. With consolidation continuing in the financial industry, and particularly in Peoples Neighborhood Bank's market area,

## **Table of Contents**

smaller community banks such as Peoples Neighborhood Bank are gaining opportunities and market share as larger institutions reduce their emphasis on or exit the markets.

### ***Seasonality***

Generally, the operations of Peoples Neighborhood Bank are not seasonal in nature. However, Peoples Neighborhood Bank's business activities have been somewhat influenced by the recent increase in activities related to natural gas drilling in its market area.

### ***Supervision and Regulation***

Peoples and its subsidiaries are extensively regulated under federal and state laws. Generally, these laws and regulations are intended to protect consumers, not shareholders. The following is a summary description of certain provisions of law that affect the regulation of bank holding companies and banks. This discussion is qualified in its entirety by reference to applicable laws and regulations. Changes in law and regulation may have a material effect on the business and prospects of Peoples.

Peoples is a bank holding company within the meaning of the Bank Holding Company Act of 1956, as amended, and is subject to regulation, supervision, and examination by the Federal Reserve Board (FRB). Peoples is required to file annual and quarterly reports with the FRB and to provide the FRB with such additional information as the FRB may require. The FRB also conducts examinations of Peoples.

With certain limited exceptions, Peoples is required to obtain prior approval from the FRB before acquiring direct or indirect ownership or control of more than 5% of any voting securities or substantially all of the assets of a bank or bank holding company, or before merging or consolidating with another bank holding company. Additionally, with certain exceptions, any person or entity proposing to acquire control through direct or indirect ownership of 25% or more of any voting securities of Peoples is required to give 60 days' written notice of the acquisition to the FRB, which may prohibit the transaction, and to publish notice to the public.

Peoples' banking subsidiary is regulated by the Pennsylvania Department of Banking and Securities (the Department of Banking) and the FDIC. The Department of Banking may prohibit an institution over which it has supervisory authority from engaging in activities or investments that the agency believes constitute unsafe or unsound banking practices. Federal banking regulators have extensive enforcement authority over the institutions they regulate to prohibit or correct activities that violate law, regulation or a regulatory agreement or which are deemed to constitute unsafe or unsound practices.

Enforcement actions may include:

the appointment of a conservator or receiver;

the issuance of a cease and desist order;

the termination of deposit insurance, the imposition of civil money penalties on the institution, its directors, officers, employees and institution affiliated parties;

the issuance of directives to increase capital;

the issuance of formal and informal agreements;

the removal of or restrictions on directors, officers, employees and institution-affiliated parties; and

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the enforcement of any such mechanisms through restraining orders or any other court actions.

Peoples Neighborhood Bank is subject to certain restrictions on extensions of credit to executive officers, directors, principal shareholders or any related interests of such persons which generally require that such credit

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## Table of Contents

extensions be made on substantially the same terms as are available to third persons dealing with Peoples Neighborhood Bank and not involving more than the normal risk of repayment. Other laws tie the maximum amount that may be loaned to any one customer and its related interests to capital levels of Peoples Neighborhood Bank.

### Limitations on Dividends and Other Payments

Peoples' current ability to pay dividends is largely dependent upon the receipt of dividends from Peoples Neighborhood Bank. Both federal and state laws impose restrictions on the ability of Peoples and Peoples Neighborhood Bank to pay dividends. Under such restrictions, Peoples Neighborhood Bank may not, without prior approval, declare dividends in excess of the sum of its net profit for that year combined with its retained net profits of the preceding two calendar years. In addition to these specific restrictions, bank regulatory agencies, in general, also have the ability to prohibit proposed dividends by a financial institution that would otherwise be permitted under applicable regulations if the regulatory body determines that such distribution would constitute an unsafe or unsound practice.

### Permitted Non-Banking Activities

Generally, a bank holding company may not engage in any activities other than banking, managing, or controlling its bank and other authorized subsidiaries, and providing service to those subsidiaries. With prior approval of the FRB, Peoples may acquire more than 5% of the assets or outstanding shares of a company engaging in non-bank activities determined by the FRB to be closely related to the business of banking or of managing or controlling banks. The FRB provides expedited procedures for expansion into approved categories of non-bank activities.

Subsidiary banks of a bank holding company are subject to certain quantitative and qualitative restrictions: (i) on extensions of credit to the bank holding company or its subsidiaries; and (ii) on the use of their securities as collateral for loans to any borrower. These regulations and restrictions may limit Peoples' ability to obtain funds from Peoples Neighborhood Bank for its cash needs, including funds for the payment of dividends, interest and operating expenses. Further, subject to certain exceptions, a bank holding company and its subsidiaries are prohibited from engaging in certain tie-in arrangements in connection with any extension of credit, lease or sale of property or furnishing of services.

Under FRB policy, a bank holding company is expected to act as a source of financial strength to its subsidiary banks and to make capital injections into a troubled subsidiary bank, and the FRB may charge the bank holding company with engaging in unsafe and unsound practices for failure to commit resources to a subsidiary bank when required. A required capital injection may be called for at a time when the holding company does not have the resources to provide it. In addition, depository institutions insured by the FDIC can be held liable for any losses incurred by, or reasonably anticipated to be incurred by, the FDIC in connection with the default of or assistance provided to, a commonly controlled FDIC-insured depository institution. Accordingly, in the event that any insured subsidiary of a bank holding company causes a loss to the FDIC, other insured subsidiaries of a bank holding company could be required to compensate the FDIC by reimbursing it for the estimated amount of such loss. Such cross guarantee liabilities generally are superior in priority to the obligation of the depository institutions to its shareholders due solely to their status as shareholders and obligations to other affiliates.

### Pennsylvania Law

As a Pennsylvania bank holding company, Peoples is subject to various restrictions on its activities as set forth in Pennsylvania law. This is in addition to those restrictions set forth in federal law. Under Pennsylvania law, a bank holding company that desires to acquire a bank or bank holding company that has its principal place of business in Pennsylvania must obtain permission from the Department of Banking.



## **Table of Contents**

### **Interstate Banking Legislation**

The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 provides that, among other things, substantially all state law barriers to the acquisition of banks by out-of-state bank holding companies were eliminated. The law also permits interstate branching by banks, subject to the ability of states to opt-out completely or to set an earlier effective time.

### **Financial Institution Reform, Recovery, and Enforcement Act ( FIRREA )**

FIRREA was enacted into law in order to address the financial condition of the Federal Savings and Loan Insurance Corporation, to restructure the regulation of the thrift industry, and to enhance the supervisory and enforcement powers of the federal bank and thrift regulatory agencies. As the primary federal regulator of Peoples Neighborhood Bank, the FDIC, in conjunction with the Department of Banking is responsible for its supervision. When dealing with capital requirements, those regulatory bodies have the flexibility to impose supervisory agreements on institutions that fail to comply with regulatory requirements. The imposition of a capital plan, termination of deposit insurance, and removal or temporary suspension of an officer, director or other institution-affiliated person may cause enforcement actions.

There are three levels of civil penalties under FIRREA.

The first tier provides for civil penalties of up to \$5,000 per day for any violation of law or regulation.

The second tier provides for civil penalties of up to \$25,000 per day if more than a minimal loss or a pattern is involved.

Finally, civil penalties of up to \$1 million per day may be assessed for knowingly or recklessly causing a substantial loss to an institution or taking action that results in a substantial pecuniary gain or other benefit.

Criminal penalties are increased to \$1 million per violation and may be up to \$5 million for continuing violations or for the actual amount of gain or loss. These penalties may be combined with prison sentences of up to five years.

### **Federal Deposit Insurance Corporation Improvement Act of 1991 ( FDICIA )**

FDICIA provides for, among other things:

publicly available annual financial condition and management reports for financial institutions, including audits by independent accountants;

the establishment of uniform accounting standards by federal banking agencies;

the establishment of a prompt corrective action system of regulatory supervision and intervention, based on capitalization levels, with more scrutiny and restrictions placed on depository institutions with lower levels of capital;

additional grounds for the appointment of a conservator or receiver; and

restrictions or prohibitions on accepting brokered deposits, except for institutions which significantly exceed minimum capital requirements.

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A central feature of FDICIA is the requirement that the federal banking agencies take prompt corrective action with respect to depository institutions that do not meet minimum capital requirements. Pursuant to FDICIA, the federal bank regulatory authorities have adopted regulations setting forth a five-tiered system for measuring the capital adequacy of the depository institutions that they supervise. Under these regulations, a depository institution is classified in one of the following capital categories:

well capitalized ;

adequately capitalized ;

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**Table of Contents**

under capitalized ;

significantly undercapitalized ; and

critically undercapitalized .

Peoples Neighborhood Bank was categorized as well capitalized under the regulatory framework for prompt corrective action at December 31, 2012, based on the most recent notification from the FDIC. An institution may be deemed by the regulators to be in a capitalization category that is lower than is indicated by its actual capital position if, among other things, it receives an unsatisfactory examination rating with respect to asset quality, management, earnings or liquidity.

FDICIA generally prohibits a depository institution from making any capital distribution including payment of a cash dividend or paying any management fees to its holding company, if the depository institution would thereafter be undercapitalized. Undercapitalized depository institutions are subject to growth limitations and are required to submit capital restoration plans. If a depository fails to submit an acceptable plan, it is treated as if it is significantly undercapitalized . Significantly undercapitalized depository institutions may be subject to a number of other requirements and restrictions, including orders to sell sufficient voting stock to become adequately capitalized, requirements to reduce total assets and stop accepting deposits from correspondent banks. Critically undercapitalized institutions are subject to the appointment of a receiver or conservator; generally within 90 days of the date such institution is determined to be critically undercapitalized.

FDICIA provides the federal banking agencies with significantly expanded powers to take enforcement action against institutions that fail to comply with capital or other standards. Such actions may include the termination of deposit insurance by the FDIC or the appointment of a receiver or conservator for the institution. FDICIA also limits the circumstances under which the FDIC is permitted to provide financial assistance to an insured institution before appointment of a conservator or receiver.

Under FDICIA, each federal banking agency is required to prescribe, by regulation, non-capital safety and soundness standards for institutions under its authority. The federal banking agencies, including the FDIC, have adopted standards covering:

internal controls;

information systems and internal audit systems;

loan documentation;

credit underwriting;

interest rate exposure;

asset growth; and

compensation fees and benefits.

Any institution that fails to meet these standards may be required to develop an acceptable plan, specifying the steps that the institutions will take to meet the standards. Failure to submit or implement such a plan may subject the institution to regulatory sanctions. Peoples believes that it meets substantially all the standards that have been adopted. FDICIA also imposed new capital standards on insured depository institutions. Before establishing new branch offices, Peoples Neighborhood Bank must meet certain minimum capital stock and surplus requirements and must obtain State approval.

Risk-Based Capital Requirements

The federal banking regulators have adopted certain risk-based capital guidelines to assist in the assessing capital adequacy of a banking organization's operations for both transactions reported on the balance sheet as

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## Table of Contents

assets and transactions, such as letters of credit, and recourse agreements, which are recorded as off-balance sheet items. Under these guidelines, nominal dollar amounts of assets and credit-equivalent amounts of off-balance sheet items are multiplied by one of several risk adjustment percentages, which range from 0% for assets with low credit risk, such as certain US Treasury securities, to 100% for assets with relatively high credit risk, such as business loans.

A banking organization's risk-based capital ratios are obtained by dividing its qualifying capital by its total risk adjusted assets. The regulators measure risk-adjusted assets, which include off-balance-sheet items, against both total qualifying capital, the sum of Tier 1 capital and limited amounts of Tier 2 capital, and Tier 1 capital.

Tier 1, or core capital, includes common equity, perpetual preferred stock and minority interest in equity accounts of consolidated subsidiaries, less goodwill and other intangibles, subject to certain exceptions.

Tier 2, or supplementary capital, includes, among other things, limited life preferred stock, hybrid capital instruments, mandatory convertible securities, qualifying subordinated debt, and the allowance for loan and lease losses, subject to certain limitations and less restricted deductions. The inclusion of elements of Tier 2 capital is subject to certain other requirements and limitations of the federal banking agencies.

Banks and bank holding companies subject to the risk-based capital guidelines are required to maintain a ratio of Tier 1 capital to risk-weighted assets of at least 4% and a ratio of total capital to risk-weighted assets of at least 8%. The appropriate regulatory authority may set higher capital requirements when particular circumstances warrant. At December 31, 2012, Peoples met both requirements with Tier 1 and Total capital ratios of 12.11% and 13.36%. In addition to risk-based capital, banks and bank holding companies are required to maintain a minimum amount of Tier 1 capital to total assets, referred to as the leverage capital ratio, of at least 4.00%. At December 31, 2012, Peoples' leverage ratio was 9.17%.

Failure to meet applicable capital guidelines could subject a banking organization to a variety of enforcement actions including:

limitations on its ability to pay dividends;

the issuance by the applicable regulatory authority of a capital directive to increase capital, and in the case of depository institutions, the termination of deposit insurance by the FDIC, as well as to the measures described under FDICIA as applicable to undercapitalized institutions.

In addition, future changes in regulations or practices could further reduce the amount of capital recognized for purposes of capital adequacy. Such a change could affect the ability of Peoples Neighborhood Bank to grow and could restrict the amount of profits, if any, available for the payment of dividends to Peoples.

### Regulatory Capital Changes

In July 2013, the federal banking agencies issued final rules to implement the Basel III regulatory capital reforms and changes required by the Dodd-Frank Act. The phase-in period for community banking organizations begins January 1, 2015, while larger institutions (generally those with assets of \$250 billion or more) must begin compliance on January 1, 2014. The final rules call for the following capital requirements:

A minimum ratio of common equity tier 1 capital to risk-weighted assets of 4.5%.

A minimum ratio of tier 1 capital to risk-weighted assets of 6%.

A minimum ratio of total capital to risk-weighted assets of 8% (no change from the current rule).

A minimum leverage ratio of 4%.

In addition, the final rules establish a common equity tier 1 capital conservation buffer of 2.5% of risk-weighted assets applicable to all banking organizations. If a banking organization fails to hold capital above the

## Table of Contents

minimum capital ratios and the capital conservation buffer, it will be subject to certain restrictions on capital distributions and discretionary bonus payments. The phase-in period for the capital conservation and countercyclical capital buffers for all banking organizations will begin on January 1, 2016.

Under the proposed rules, accumulated other comprehensive income (AOCI) would have been included in a banking organization's common equity tier 1 capital. The final rules allow community banks to make a one-time election not to include these additional components of AOCI in regulatory capital and instead use the existing treatment under the general risk-based capital rules that excludes most AOCI components from regulatory capital. The opt-out election must be made in the first call report or FR Y-9 series report that is filed after the financial institution becomes subject to the final rule.

The final rules permanently grandfather non-qualifying capital instruments (such as trust preferred securities and cumulative perpetual preferred stock) issued before May 19, 2010 for inclusion in the tier 1 capital of banking organizations with total consolidated assets less than \$15 billion as of December 31, 2009 and banking organizations that were mutual holding companies as of May 19, 2010.

The proposed rules would have modified the risk-weight framework applicable to residential mortgage exposures to require banking organizations to divide residential mortgage exposures into two categories in order to determine the applicable risk weight. In response to commenter concerns about the burden of calculating the risk weights and the potential negative effect on credit availability, the final rules do not adopt the proposed risk weights but retain the current risk weights for mortgage exposures under the general risk-based capital rules.

Consistent with the Dodd-Frank Act, the new rules replace the ratings-based approach to securitization exposures, which is based on external credit ratings, with the simplified supervisory formula approach in order to determine the appropriate risk weights for these exposures. Alternatively, banking organizations may use the existing gross-up approach to assign securitization exposures to a risk weight category or choose to assign such exposures a 1,250 percent risk weight.

Under the new rules, mortgage servicing assets (MSAs) and certain deferred tax assets (DTAs) are subject to stricter limitations than those applicable under the current general risk-based capital rule. The new rules also increase the risk weights for past-due loans, certain commercial real estate loans, and some equity exposures, and makes selected other changes in risk weights and credit conversion factors.

Peoples is in the process of assessing the impact of these changes on the regulatory ratios of Peoples and Peoples Neighborhood Bank on the capital, operations, liquidity and earnings of Peoples and Peoples Neighborhood Bank.

## Interest Rate Risk

Regulatory agencies include, in their evaluations of a bank's capital adequacy, an assessment of the bank's Interest Rate Risk (IRR) exposure. The standards for measuring the adequacy and effectiveness of a banking organization's IRR management includes a measurement of board of directors and senior management oversight, and a determination of whether a banking organization's procedures for comprehensive risk management are appropriate to the circumstances of the specific banking organization. Peoples Neighborhood Bank utilizes internal IRR models to measure and monitor IRR. In addition, Peoples Neighborhood Bank employs an independent consultant to provide a quarterly assessment of its IRR. Finally, regulatory agencies, as part of the scope of their periodic examinations, evaluate Peoples Neighborhood Bank's IRR management. For these reasons, Peoples does not expect the IRR evaluation in the agencies' capital guidelines to result in significant changes in its capital requirements.

## Community Reinvestment Act

The Community Reinvestment Act of 1977, (CRA) is designed to create a system for bank regulatory agencies to evaluate a depository institution's record in meeting the credit needs of its community. The CRA

## Table of Contents

regulations were completely revised as of July 1, 1995, to establish performance-based standards for use in examining for compliance. Peoples Neighborhood Bank had its last CRA compliance examination in 2012 and received a satisfactory rating.

### USA Patriot Act of 2001

The Patriot Act contains anti-money laundering and financial transparency laws and imposes various regulations, including standards for verifying client identification at account opening, and rules to promote cooperation among financial institutions, regulators and law enforcement entities in identifying parties that may be involved in terrorism or money laundering.

### Regulation W

Certain transactions, including loans and credit extensions, between Peoples and its affiliates and subsidiaries are subject to quantitative and qualitative limitations, collateral requirements, and other restrictions imposed by statute and FRB regulation. Transactions subject to these restrictions are generally required to be made on an arms-length basis. These restrictions generally do not apply to transactions between Peoples and its direct wholly-owned subsidiaries.

### Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank)

In 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act was signed into law. Dodd-Frank is intended to effect a fundamental restructuring of federal banking regulation. Among other things, Dodd-Frank created the Financial Stability Oversight Council to identify systemic risks in the financial system and gives federal regulators authority to take control of and liquidate financial firms. Dodd-Frank additionally created an independent federal regulator to administer federal consumer protection laws. Dodd-Frank has and is expected to continue to have a significant impact on Peoples' business operations as its provisions take effect. It is expected that, as various implementing rules and regulations are released, they will increase Peoples' operating and compliance costs and could increase the Peoples Neighborhood Bank's interest expense. Among the provisions that are likely to affect Peoples' are the following:

#### *Holding Company Capital Requirements*

Dodd-Frank requires the FRB to apply consolidated capital requirements to bank holding companies that are no less stringent than those currently applied to depository institutions. Under these standards, trust preferred securities will be excluded from Tier 1 capital unless such securities were issued prior to May 19, 2010, by a bank holding company with less than \$15 billion in assets. Dodd-Frank additionally requires that bank regulators issue countercyclical capital requirements so that the required amount of capital increases in times of economic expansion, consistent with safety and soundness.

#### *Deposit Insurance*

Dodd-Frank permanently increases the maximum deposit insurance amount for banks, savings institutions and credit unions to \$250,000 per depositor. Dodd-Frank also broadens the base for FDIC insurance assessments. Assessments are now based on the average consolidated total assets less tangible equity capital of a financial institution. Dodd-Frank requires the FDIC to increase the reserve ratio of the Deposit Insurance Fund from 1.15% to 1.35% of insured deposits by 2020 and eliminates the requirement that the FDIC pay dividends to insured depository institutions when the reserve ratio exceeds certain thresholds. Further, Dodd-Frank eliminated the federal statutory prohibition against the payment of interest on business checking accounts.

#### *Corporate Governance*

Dodd-Frank requires publicly-traded companies to give stockholders a non-binding vote on executive compensation at least every three years, a non-binding vote regarding the frequency of the vote on executive



## **Table of Contents**

compensation at least every six years, and a non-binding vote on golden parachute payments in connection with approvals of mergers and acquisitions unless previously voted on by stockholders. Additionally, Dodd-Frank directs the federal banking regulators to promulgate rules prohibiting excessive compensation paid to executives of depository institutions and their holding companies with assets in excess of \$1.0 billion, regardless of whether the company is publicly traded. Dodd-Frank also gives the SEC authority to prohibit broker discretionary voting on elections of directors and executive compensation matters.

### *Prohibition Against Charter Conversions of Troubled Institutions*

Dodd-Frank prohibits a depository institution from converting from a state to a federal charter, or vice versa, while it is the subject of a cease and desist order or other formal enforcement action or a memorandum of understanding with respect to a significant supervisory matter unless the appropriate federal banking agency gives notice of the conversion to the federal or state authority that issued the enforcement action and that agency does not object within 30 days. The notice must include a plan to address the significant supervisory matter. The converting institution must also file a copy of the conversion application with its current federal regulator, which must notify the resulting federal regulator of any ongoing supervisory or investigative proceedings that are likely to result in an enforcement action and provide access to all supervisory and investigative information relating thereto.

### *Interstate Branching*

Dodd-Frank authorizes national and state banks to establish branches in other states to the same extent as a bank chartered by that state would be permitted. Previously, banks could only establish branches in other states if the host state expressly permitted out-of-state banks to establish branches in that state. Accordingly, banks are able to enter new markets more freely.

### *Limits on Interstate Acquisitions and Mergers*

Dodd-Frank precludes a bank holding company from engaging in an interstate acquisition the acquisition of a bank outside its home state unless the bank holding company is both well capitalized and well managed. Furthermore, a bank may not engage in an interstate merger with another bank headquartered in another state unless the surviving institution will be well capitalized and well managed. The previous standard in both cases was adequately capitalized and adequately managed.

### *Limits on Interchange Fees*

Dodd-Frank amended the Electronic Fund Transfer Act to, among other things, give the Federal Reserve the authority to establish rules regarding interchange fees charged for electronic debit transactions by payment card issuers having assets over \$10 billion and to enforce a statutory requirement that such fees be reasonable and proportional to the actual cost of a transaction to the issuer.

### *Consumer Financial Protection Bureau*

Dodd-Frank created the Consumer Financial Protection Bureau (CFPB), which is granted broad rulemaking, supervisory and enforcement powers under various federal consumer financial protection laws, including the Equal Credit Opportunity Act, Truth in Lending Act, Real Estate Settlement Procedures Act, Fair Credit Reporting Act, Fair Debt Collection Act, Consumer Financial Privacy provisions of the Gramm-Leach-Bliley Act, and certain other statutes. The CFPB has examination and primary enforcement authority with respect to depository institutions with \$10 billion or more in assets. Smaller institutions are subject to rules promulgated by the CFPB, but continue to be examined and supervised by federal banking regulators for consumer compliance purposes. The CFPB has authority to prevent unfair, deceptive or abusive practices in connection with the offering of consumer financial products. Dodd-Frank authorizes the CFPB to establish certain minimum

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## Table of Contents

standards for the origination of residential mortgages including a determination of the borrower's ability to repay. In addition, Dodd-Frank will allow borrowers to raise certain defenses to foreclosure if they receive any loan other than a qualified mortgage as defined by the CFPB. Dodd-Frank permits states to adopt consumer protection laws and standards that are more stringent than those adopted at the federal level and, in certain circumstances, permits state attorneys general to enforce compliance with both the state and federal laws and regulations.

### Ability to Repay and Qualified Mortgage Rule

Pursuant to the Dodd Frank Act, the Consumer Financial Protection Bureau issued a final rule on January 10, 2013 (effective on January 10, 2014), amending Regulation Z as implemented by the Truth in Lending Act, requiring mortgage lenders to make a reasonable and good faith determination based on verified and documented information that a consumer applying for a mortgage loan has a reasonable ability to repay the loan according to its terms. Mortgage lenders are required to determine consumers' ability to repay in one of two ways. The first alternative requires the mortgage lender to consider the following eight underwriting factors when making the credit decision: (1) current or reasonably expected income or assets; (2) current employment status; (3) the monthly payment on the covered transaction; (4) the monthly payment on any simultaneous loan; (5) the monthly payment for mortgage-related obligations; (6) current debt obligations, alimony, and child support; (7) the monthly debt-to-income ratio or residual income; and (8) credit history. Alternatively, the mortgage lender can originate qualified mortgages, which are entitled to a presumption that the creditor making the loan satisfied the ability-to-repay requirements. In general, a qualified mortgage is a mortgage loan without negative amortization, interest-only payments, balloon payments, or terms exceeding 30 years. In addition, to be a qualified mortgage, the points and fees paid by a consumer cannot exceed 3% of the total loan amount. Loans which meet these criteria will be considered qualified mortgages, and as a result generally protect lenders from fines or litigation in the event of foreclosure. Qualified mortgages that are higher-priced (e.g. subprime loans) garner a rebuttable presumption of compliance with the ability-to-repay rules, while qualified mortgages that are not higher-priced (e.g. prime loans) are given a safe harbor of compliance. The final rule, as issued, is not expected to have a material impact on Peoples Neighborhood Bank's lending activities and on Peoples statements of income or condition.

### Jumpstart Our Business Startups (JOBS) Act

In April 2012, the JOBS Act became law. The JOBS Act is aimed at facilitating capital raising by smaller companies and banks and bank holding companies by implementing the following changes:

Raising the threshold requiring registration under the Securities Exchange Act of 1934 (Exchange Act) for banks and bank holding companies from 500 to 2,000 holders of record;

Raising the threshold for triggering deregistration under the Exchange Act for banks and bank holding companies from 300 to 1,200 holders of record;

Raising the limit for Regulation A offerings from \$5 million to \$50 million per year and exempting some Regulation A offerings from state blue sky laws;

Permitting advertising and general solicitation in Rule 506 and Rule 144A offerings;

Allowing private companies to use crowd funding to raise up to \$1 million in any 12-month period, subject to certain conditions; and,

Creating a new category of issuer, called an Emerging Growth Company, for companies with less than \$1 billion in annual gross revenue, which will benefit from certain changes that reduce the cost and burden of carrying out an equity initial public offering (IPO) and complying with public company reporting obligations for up to five years.

## **Table of Contents**

### *Future Legislation*

Proposed legislation is introduced in almost every legislative session that would dramatically affect the regulation of the banking industry. We cannot predict if any such legislation will be adopted nor if adopted how it would affect the business of Peoples or Peoples Neighborhood Bank. Past history has demonstrated that new legislation or changes to existing laws or regulations usually results in greater compliance burden and therefore generally increases the cost of doing business.

### **Property**

Peoples corporate headquarters is located at 82 Franklin Avenue, Hallstead, Susquehanna County, Pennsylvania. Peoples owns the facility which has approximately 9,800 square feet.

In addition to the above location, at December 31, 2012, Peoples owned 10 and leased two retail community banking offices. Peoples also owns an office building located at 241 Main Street, Hallstead, Susquehanna County, Pennsylvania, which serves as its Bank Secrecy Act facility and leases an office building located in Scranton, Lackawanna County, Pennsylvania, which serves as a loan production office. Peoples considers its properties to be suitable and adequate for its current and immediate future purposes.

### **Legal Proceedings**

Peoples, Peoples Neighborhood Bank and its subsidiaries are not parties to any legal proceedings that could have a material effect on the financial condition or operating results of the Peoples. In addition, Peoples, Peoples Neighborhood Bank and its subsidiaries are not parties to any legal proceedings under federal and state environmental laws.

### **Information about Peoples Directors**

The following provides information, as of December 31, 2012, about each director. The information presented includes information each director has given us about his age, all positions he holds, and his principal occupation for the past five years. The following also includes certain individual qualifications and skills that contribute to the board's effectiveness as a whole. We believe that all of our directors have a reputation for integrity, honesty and adherence to high ethical standards. They each have demonstrated business insight and an ability to exercise sound judgment, as well as a commitment to service.

**William E. Aubrey II**, age 50, has been a director of Peoples Financial Services Corp. and Peoples Neighborhood Bank since 2006 and Chairman of the board since 2008. His current term expires in 2016. He has been President and Chief Executive Officer of Gertrude Hawk Chocolates since 2003. The board has determined that Mr. Aubrey is qualified to be on the board due to his executive management experience gained by being President of two companies. He also brings knowledge gained by serving on several community boards and an education background in the finance area - MBA and CPA.

**Alan W. Dakey**, age 61, has been a director of Peoples Financial Services Corp. and Peoples Neighborhood Bank since 2009. His current term expires in 2015. He has been President/Chief Executive Officer of Peoples and Peoples Neighborhood Bank since 2009. The board has determined that Mr. Dakey is qualified to be on the board due to his 38 years of banking experience including titles as Chief Executive Officer, President, and Chairman of the board. He also holds a MBA in Finance from The University of Scranton and a BS in Accounting from Bloomsburg University.

**Ronald G. Kukuchka**, age 59, has been a director of Peoples Financial Services Corp. and Peoples Neighborhood Bank since 2007. His current term expires in 2014. He has been President of Ace Robbins, Inc. since 1982. The board has determined that Mr. Kukuchka is qualified to be on the board due to his leaderships

## **Table of Contents**

skills gained from owning a successful petroleum company in our market area for over 25 years. He also brings experience gained by serving as director for the Pennsylvania Marketers & Convenience Store Association, director of the Tunkhannock Fireman's Relief Association, and from being trustee of the Roy Piper Charitable Trust.

**Richard S. Lochen, Jr.**, age 49, has been a director of Peoples Financial Services Corp. and Peoples Neighborhood Bank since 2003. His current term expires in 2014. He has been a Certified Public Accountant with the firm of Lochen & Chase PC since 1995. He was the former President/Chief Executive Officer of Peoples and Peoples Neighborhood Bank and Former Chief Administrative Officer of Peoples and Peoples Neighborhood Bank. The board has determined that Mr. Lochen is qualified to be on the board due to his knowledge of auditing publically-traded financial institutions that he gained during his career as a CPA, which included assisting in preparation of annual and quarterly filings with the SEC. He also brings executive leadership experience and understanding of the operations of Peoples gained from his serving as Chief Executive Officer of Peoples and Peoples Neighborhood Bank for four years.

**George H. Stover, Jr.**, age 66, has been a director of Peoples Financial Services Corp. and Peoples Neighborhood Bank since 1992. His current term expires in 2014. He has been a Real Estate Appraiser since 1972. The board has determined that Mr. Stover is qualified to be on the board due to his leadership skills obtained from successfully operating his own insurance and real estate business for 40 years. In addition, Mr. Stover has expertise of real estate values due to being an experienced real estate appraiser.

**Earle A. Wootton**, age 68, has been a director of Peoples Financial Services Corp. and Peoples Neighborhood Bank since 2010. His current term expires in 2015. He is a director of the Community Foundation of Susquehanna and Wyoming Counties and the former President of a group of commercial printing and publishing companies. The board has determined that Mr. Wootton is qualified to be on the board due to his executive management skills acquired through being Chief Executive Officer of a printing company for 30 years. He also brings experience gained through being a previous director of a national bank for 18 years, and being the founder and chairman of a community foundation.

**Joseph T. Wright, Jr.**, age 57, has been a director of Peoples Financial Services Corp. and Peoples Neighborhood Bank since 2009. His current term expires in 2016. He has been an attorney at law with Wright Reihner PC since 1980. The board has determined that Mr. Wright is qualified to be on the board due to his experience and knowledge gained while being a practicing attorney for over thirty years with involvement in numerous financially complex matters related to disputes involving shareholders, employment matters, contracts, valuation issues, real estate matters, and general business issues related to risk assessment.

### ***Director Compensation***

Each member of the board of directors receives \$750 for each Peoples Neighborhood Bank board meeting, with the exception of the Chief Executive Officer. All Peoples Neighborhood Bank board members receive \$500 for each committee meeting they attend and \$300 for each branch meeting they attend, with the exception of the Chief Executive Officer. All directors receive a retainer of \$14,000 per year, with the exception of the Chief Executive Officer. The Chairman receives an additional \$800 per month. The Audit Committee Chairman receives an additional \$250 per audit committee meeting.

### **Directors Supplemental Life Insurance Plan**

Effective June 24, 2011, Peoples Neighborhood Bank established a director supplemental life insurance plan. All directors are eligible for the life insurance benefit, subject to medical underwriting acceptance. The plan currently insures seven (7) directors. The director life insurance benefit of \$100,000 per participating director will be provided through a single premium BOLI program because BOLI is a more cost-effective way of providing the benefits. The eligible participating directors are not required to pay any premiums on the life insurance policy, but have the imputed value of the insurance coverage included in their taxable income.

**Table of Contents****Directors Deferred Compensation Plan**

On March 26, 2011, Peoples Neighborhood Bank adopted the director Deferred Compensation Plan effective April 15, 2011. All current directors are eligible to participate in the director Deferred Compensation Plan. The plan allows for deferrals by participants of up to 100% of their director's fees and bonuses. There is no maximum dollar limit on the amount that may be deferred by a participant each year. Participants are permitted to change their percentage of deferral annually. The participants are always 100% vested in the amount they defer and the earnings credited to their accounts. Participants are entitled to receive a distribution from their account upon: a termination of service, a change in control, or a specified date as allowed within the plan.

**Directors Retirement**

Peoples provides a retirement benefit to its non-employee directors. The plan requires a minimum of ten years of service unless a change of control occurs, in which case the directors become fully vested in the benefit. After the tenth year, the director is granted an annual retirement distribution of \$150 times the director's number of years of service on the board. This benefit is payable to the director or beneficiary for a ten-year period following retirement. Peoples has a mandatory retirement age of 70.

**Directors Compensation Table**

Name	Fees Earned or Paid in Cash	Change in Pension Value and Non-Qualified Deferred Compensation Earnings	All Other Compensation (1)	Total
William E. Aubrey II	\$ 42,600	\$ 0	\$ 213	\$ 42,813
Ronald G. Kukuchka	\$ 29,500	\$ 415	\$ 566	\$ 30,481
Richard S. Lochen, Jr.	\$ 32,500	\$ 131	\$ 213	\$ 32,844
George H. Stover, Jr.	\$ 30,500	\$ 0	\$ 1,190	\$ 31,690
Earle A. Wootton	\$ 31,800	\$ 0	\$ 1,692	\$ 33,492
Joseph T. Wright, Jr.	\$ 32,700	\$ 0	\$ 520	\$ 33,220

(1) Amount reflects the Imputed Income on the directors Split Dollar Insurance Plan for 2012.

***Executive Officers***

The following table identifies each of the executive officers of Peoples and Peoples Neighborhood Bank, their age as of December 31, 2012, the position they currently hold and their professional experience during the prior five years.

Name	Age	Position and Prior Experience
Alan W. Dakey	61	President and Chief Executive Officer of Peoples and Peoples Neighborhood Bank since 2009. Former President/CEO/director of Mid Penn Bancorp, Inc.
Debra E. Dissinger	58	Secretary of Peoples and Executive Vice President/Chief Operations Officer/Chief Risk Officer of Peoples Neighborhood Bank
Joseph M. Ferretti	43	Executive Vice President/Chief Lending Officer of Peoples Neighborhood Bank; Senior Vice President/Chief Credit Officer of Peoples Neighborhood Bank.
Scott A. Seasock	55	Senior Vice President/Chief Financial Officer of Peoples Neighborhood Bank since 2011. Former Chief Financial Officer of Community Bank and Trust

## **Table of Contents**

Executive Officers of Peoples are elected by the board of directors on an annual basis and serve at the discretion of the board of directors. There are no family relationships among any of the Executive Officers or directors of Peoples.

### ***Executive Compensation***

#### **Compensation Discussion and Analysis**

##### ***Overview of Objectives***

The executive compensation program of Peoples is designed to provide a competitive based salary as well as provide incentives to our executive officers to effectively lead and manage our company and its growth strategy. Decisions regarding executive compensation are determined by Peoples compensation committee with the approval of the board of directors.

The program is designed to support annual and long-term company goals that create consistent profitable growth while providing long-term value to our shareholders. The objectives of Peoples executive compensation plan are to: (1) attract, motivate and retain highly qualified executives; (2) link total compensation to both individual performance and the performance of the bank and holding company; (3) appropriately balance short-term and long-term financial objectives, build shareholder value and reward individual, team and company performances, and (4) align executive and shareholder interests by including equity as part of total compensation.

In this compensation discussion and analysis, Peoples Chief Executive Officer, Chief Operating Officer/Chief Risk Officer, Chief Financial Officer, and Chief Lending Officer are referred to collectively as the named executive officers.

During the year ended December 31, 2012, Peoples compensated the named executive officers with a combination of base salary, cash bonus, equity compensation-through the Employee Stock Ownership Plan ( ESOP ), and benefit plans and perquisites which the compensation committee believed were comparable to other financial institutions of similar size in our region.

##### ***Components of the Compensation Program***

Peoples executive compensation includes three key elements: base salary, annual cash incentives and benefit plans.

##### **Base Salary**

Base salary is the basic element of the executive compensation program and the foundation for setting incentive compensation target awards. The Committee determines the range of base salary to offer to a new executive by evaluating (1) the duties, complexities and responsibilities of the position; (2) the level of experience required, and (3) compensation for positions having similar scope and accountability as Peoples Neighborhood Bank s peers. The Committee uses a peer group of banks with asset sizes of \$500 million to \$1 billion in total assets and located in the Northeast Pennsylvania region and sets initial compensation between 83 and 106 percent of the median salary for comparable positions within the peer group.

Each year, the Peoples compensation committee reviews each named executive officer s individual performance, length and nature of experience and competency, and the potential for advancement in determining the amount of pay adjustments to recommend to the board of directors. The Chief Executive Officer s and Chief Financial Officer s salary increased at the percentage required by their employment agreements.

**Table of Contents**Annual Cash Incentives

In January 2008, the compensation committee recommended to the board of directors an Incentive Compensation Plan (the Peoples Neighborhood Bank's Executive Cash Bonus Plan) which was adopted by Peoples' directors. Incentive Compensation represents the at risk portion of an executive's pay. The compensation committee sets corporate goals for the named executive officers to achieve in order to qualify for a cash bonus. Measurements and weighting for 2012 contained both Economic Profit Targets and Individual Strategic Targets.

Economic Profit Targets based on achieving budgeted goals included: Net Income weighted at 50%, Total Average Assets at 5%, Return on Average Assets at 5%, Return on Average Equity at 5%, and Efficiency Ratio at 5%. The net income factor is determined on a sliding scale allowing for the bonus calculation to be less than 50% for a graduated variance of under budget performance, and to be more than 50% on a graduated scale for being over budget. Peoples believes financial goals create a strong and objective link between executive compensation and shareholder value creation. Peoples uses economic profit as the measurement for financial goal achievement because it promotes the simultaneous optimization of growth, earnings and capital efficiency. Peoples believes economic profit is the best indicator of long-term shareholder value creation and correlates well with long-term stock price appreciation.

The economic targets and results for the year 2012 for each executive were as follows:

**Bank wide financial component 70%**

	Goal	Results	Component %
Budget	9,125	9,120	50%
Total Average Assets	642	641	5%
ROAA	1.42	1.42	5%
ROAE	15.08	14.92	5%
Efficiency Ratio	<60	53	5%
<b>Total Bank Wide %</b>			<b>70%</b>

The non-economic component for the cash bonus, which was weighted at 30%, was based on Individual Strategic Goals. Strategic plans were outlined for each officer and attainment of the target was based on the execution of the related department's strategic goals. The board sets separate goals to align executives' interests with the financial performance of either Peoples or their individual area of responsibility. The non-economic goals for each respective executive were as follows:

Mr. Alan Dakey**Individual strategic goals component- 30%**

	Component %	% Achieved	% Factor
1. Accomplish strategic objectives as identified in the tracking report	7.5%	100%	7.50%
2. Support the Peoples Wealth Mgt program in order to earn net income of 40% of gross income before amortization	7.5%	0%	0.00%
2012 results 27% earned			
3. Execute the growth strategy portion of the strategic plan that addresses the Lackawanna County market.	7.5%	100%	7.50%
Loans at \$118 million and deposits at \$48 million			
4. Execute the growth strategy portion of the strategic plan that addresses the Broome County market.	7.5%	67%	5.00%

**Table of Contents**Mr. Scott Seasock**Individual strategic goals component- 30%**

		Component %	% Achieved	% Factor
1.	Investment Portfolio Management: Overall Total Performance of the Investment Portfolio with respect to total return and risk ranking in the top 20% of all financial institutions in the US as reported in the Investment Performance Digest as of 9/30/11	10%	100%	10.00%
2.	Financial Reporting: Degree to which the executive has improved financial reporting processes in order to attain timeliness and adequacy of financial disclosures and compliance with applicable laws and regulations. Degree to which the executive has improved profitability through decision making with respect to net interest income, noninterest income and other expenses.	10%	100%	10.00%
3.	ALCO Management: Overall management of the interest sensitivity, liquidity, and capital adequacy of the financial institution in terms of maintaining specified policy limits while maximizing profitability.	10%	100%	10.00%

Ms. Debra E. Dissinger**Individual strategic goals component- 30%**

		Component %	% Achieved	% Factor
1.	Complete technology plan projects on time and on budget.	7.5%	100%	7.50%
2.	Successful implementation and utilization of Synapsys to include all technical support, profitability implementation by 6-1-12 and integration with all non-core data sources.	7.5%	75%	5.63%
3.	Achieve regulatory exam goals.	7.5%	100%	7.50%
4.	Risk Goals	1.875%	100%	1.88%
	Monitor and guide Electronic Banking Committee activities to improve controls on operational risks on wires, ACH, and RDC.	1.875%	100%	1.88%
	Complete a numerical assessment on compliance risk by regulation	1.875%	100%	1.88%
	Monitor and report on exam exceptions quarterly	1.875%	100%	1.88%
	Complete a Liquidity Risk Management Assessment	30%		28.13%

Mr. Joseph M. Ferretti**Individual strategic goals component- 30%**

1.	Reach loan growth goal per budget. Budget for 2012 was 10.6%; actual for 2012 was 4.0%	6%	0%	0.00%
2.	Manage 4 CML officers to reach their individual goals including Peoples Wealth Management referrals, COI calls, and deposit goals	6%	100.00%	6.00%
3.	Past due loans to average 1.25% or better; Average for 2012 was .97%	6%	100%	6.00%
4.	Loan charge offs of .0050% or less. Losses for 2012 at .08%	6%	0%	0.00%
5.	Accomplish assigned objectives in the growth strategy portion of the strategic plan tracking report	6%	100%	6.00%

If the executive did not meet the established goals, the compensation committee had the discretion to award the bonus based upon their best judgment and other considerations. For the year 2012, the Compensation





**Table of Contents**

Committee using their discretionary authority approved a 100% payment of management's eligible bonus for the named executive officers. Although some of the named executive officers and Peoples Neighborhood Bank did not meet 100% of the goals, the Compensation Committee acknowledged the very positive financial results for the year 2012 and the named executive officers' contribution to such.

The table below shows the values of the incentive awards for the year 2012 granted in 2013:

NEO	Awarded
Alan Dakey	\$ 50,562
Debbie Dissinger	\$ 21,012
Joseph Ferretti	\$ 20,085
Scott Seasock	\$ 22,838

In order to ensure that the risks associated with the cash incentive plan are minimized, each named executive officer can only earn up to a percentage of base salary, as determined by the compensation committee, based upon the specific position held by the named executive officer and the responsibilities associated with such position. Additionally, in order to minimize any risk associated with the Incentive Compensation Plan, the named executive officers, effective with the 2010 bonuses, are required to sign a clawback agreement, as discussed in detail below.

**Clawback Agreement**

In order to participate in the Cash Incentive Plan, all executives are required to sign a clawback agreement. The clawback agreement allows Peoples to recover any overpayment of the cash incentive in the event that Peoples is required to restate its financial statements because of a material financial reporting violation or an executive's misconduct or fraudulent activity. The policy applies to any current or former executive officer who received a bonus under the plan during the three-year period preceding the date on which the restatement is required. Nevertheless, the three-year period does not extend before the year 2010.

**Benefits**

**ESOP.** Peoples designed an ESOP as a long-term incentive to focus executives on long-term value creation and to provide balance to the annual incentives. The ESOP covers substantially all employees who meet the eligibility requirements and was intended to reward all employees, including the named executive officers, based upon Peoples' long-term success as measured by shareholder return.

**401(k) and Profit Sharing Plan.** Peoples Neighborhood Bank also maintains a profit sharing plan under the provisions of Section 401(k) of the Internal Revenue Code in an effort to provide all employees with a means by which they can save for retirement and also to provide tax-deferred compensation, not to exceed the amount allowed under the Internal Revenue Code, as a reward for saving for retirement.

**Health Insurance.** Named executive officers participate in Peoples' other benefit plans on the same terms as other employees. These plans include medical, life insurance and flex spending account benefits and are standard in the industry.

**Supplemental Employee Retirement Plan.** In 2004, Peoples provided a supplemental employee retirement plan (SERP) to Ms. Dissinger as appreciation for her years of service and to incent her to continue to serve Peoples Neighborhood Bank. Peoples also provided SERPs to Messrs. Dakey, Ferretti, and Seasock, to incent them to continue to serve Peoples Neighborhood Bank and to assure the overall competitiveness of Peoples' executive compensation program. The SERP benefits vest over time, unless a change of control occurs.

**Split Dollar Insurance Agreement.** In 2004, Peoples provided a split dollar insurance agreement to Ms. Dissinger as an inducement to continue to utilize her best efforts on behalf of Peoples Neighborhood Bank.

## **Table of Contents**

Under the agreement, Ms. Dissinger would be entitled to a death benefit while employed of either two times her salary to a maximum of \$400,000 or 100% of the Net Death Proceeds.

### **Perquisites**

The compensation committee regularly reviews Peoples' perquisites and believes they are appropriate and modest when compared to peer companies and are necessary to attract and retain high-caliber talent. Peoples Neighborhood Bank provides a vehicle allowance to its Chief Executive Officer, Chief Financial Officer, and Chief Lending Officer as they are required to entertain business clients. The Committee also believes that country clubs can serve as appropriate forums for building client relationships and for community interaction. Peoples Neighborhood Bank reimburses monthly membership expenses for Messrs. Dakey and Ferretti based on demonstrable business requirements, which are approved monthly and reviewed annually.

### **Impact of Prior Compensation in Setting Elements of Compensation**

Prior compensation of the named executive officers does not impact how Peoples sets elements of current compensation. The compensation committee believes that current total compensation must be sufficient to attract, motivate and retain top management. The compensation committee analyzes outstanding option grants, outstanding plan awards and overall stock ownership for each of the named executive officers to ensure that future change-in-control agreements and other benefits provide appropriate and relevant incentives to the executives.

### **The Role of Management in Determining Compensation**

The Chief Executive Officer sets performance goals for the other named executive officers. The board of directors sets performance goals for the Chief Executive Officer. The Chief Executive Officer reviews each of the other named executive officer's yearly performance and discusses the performance review with and makes a recommendation on increases to base salary to the compensation committee. The compensation committee then presents its recommendations for increases in base salary to the board of directors for all named executive officers. No named executive officer is present when the compensation committee or the board of directors discusses his/her respective compensation levels.

### **The Role of the Compensation Committee**

The compensation committee is responsible for recommending compensation policies to the board for approval, as well as developing and implementing the compensation programs for the named executive officers and other key members. Key items pertaining to executive compensation such as base salary increases, Incentive Compensation Plan, and the offering of SERP agreements are submitted to the board for approval following the review and recommendation of the compensation committee. The Chief Executive Officer consults with the compensation committee in determining the specific individual Strategic Goals outlined in the Incentive Compensation Plan, but does not participate in discussions on his own compensation.

Operating within the framework of duties and responsibilities established by the board, the compensation committee's role is to assure Peoples (1) compensation strategy is aligned with the long-term interests of the shareholders and members; (2) compensation structure is fair and reasonable; and (3) compensation reflects both corporate and individual performance.

### **Compensation Committee Consultants**

The compensation committee's charter provides that any outside compensation consultants who offer advice on compensation levels and benefits for the Chief Executive Officer or other senior executives will be retained by the compensation committee, report to the chair of the compensation committee and submit fee statements for approval to the chair of the compensation committee. The consultant's findings are reported directly to the

## **Table of Contents**

compensation committee. Any other consulting services by such compensation consultants for Peoples must be approved in advance by the compensation committee chair. A consultant was not used by the Committee in 2012.

### **Accounting and Tax Treatments**

All elements of compensation, including salaries, generate charges to earnings under generally accepted accounting principles (GAAP). Generally, no adjustment is made to compensation based on accounting factors, but the tax effect of various types of compensation are considered. Code Section 409A implemented tax rules applicable to nonqualified deferred compensation arrangements, and steps to comply with such rules have been taken to the extent applicable.

### **Material Difference in Compensation**

The material difference in compensation between the named executive officers is the amount of base salary paid to each. As base salary is determined by reference to the position of the individual, the amount of experience of the individual, and the performance of the individual, the compensation committee believes the differences are warranted.

### **Benchmarking**

Periodically, the compensation committee compares Peoples' senior management compensation levels with comparable levels in industry benchmark studies and peer group data to gain a general knowledge of compensation in the industry. To do so, the bank participates in a survey provided by L.R. Webber Associates that benchmarks salary and benefits from Pennsylvania financial institutions who participated in the survey. The survey includes general compensation information and ranges for executives. The results are reported by bank asset size and geographic region. We use the survey data to compare the base salaries of our executive positions to the range reported for those positions at other banking institutions with total asset size and geography similar to ours to determine whether Peoples is compensating its executives within the industry standard range. For the year, 2012, Peoples' base compensation fell within the range reported in the survey and no adjustments were made to Peoples' base salaries as a result of the survey. The banks included in the 2012 survey for Peoples' asset size included

1st Summit Bank (Johnstown, PA)

Community Bank (Carmichaels, PA)

Dime Bank (Honesdale, PA)

Ephrata National Bank (Ephrata, PA)

Farmers National Bank (Emlenton, PA)

First Citizens National Bank (Mansfield, PA)

First Columbia Bank & Trust Co. (Bloomsburg, PA)

First Keystone National Bank (Berwick, PA)

Honesdale National Bank (Honesdale, PA)

Jersey Shore State Bank (Williamsport, PA)

Mid Penn Bank (Millersburg, PA)

Penn Security Bank & Trust Company (Scranton, PA)

Peoples Neighborhood Bank (Hallstead, PA)

Somerset Trust Company (Somerset, PA)

Washington Financial Bank (Washington, PA)

The board of directors also considers salary levels for comparable positions in industries other than the financial services industry.

## **Table of Contents**

### **Company Stock Ownership**

While we believe that it is important that the Peoples named executive officers and directors own shares of Peoples common stock, we do not have equity or security ownership requirements for executive officers or directors.

### **Executive Agreements**

In 2012, Peoples was a party to employment agreements with the Chief Executive Officer, Chief Lending Officer and Chief Financial Officer. The officers employment agreements provide payment upon a termination without cause or a termination for good reason in consideration for a noncompetition provision which restricts their ability to compete with Peoples in certain events. Termination without cause and termination for good reason provisions are standard in the industry for executives to give the executive some security that in the event he is terminated without cause or he suffers an adverse employment action, that he will receive some compensation during the transition phase.

The Chief Operations Officer/Chief Risk Officer has a Change in Control Agreement. All of these agreements are designed to be part of a competitive compensation package, thereby aiding in attracting and retaining top quality executives. The agreements are designed to (1) assure the continuity of executive management and (2) ensure executive management is able to objectively evaluate any change in control proposal and act in the best interests of shareholders during a possible acquisition, merger or combination.

### **Compensation**

The compensation committee makes its recommendations on compensation policies and practices after thoughtful deliberation of the effects such practices may have on employees as they relate to risk management and risk-taking incentives and if such policies and practices could create risks that are reasonably likely to have a material adverse effect on Peoples. The risk-reward structure of Peoples is based primarily on Peoples goals rather than individual goals for the purpose of aligning individual rewards with the interest of the shareholders and encouraging teamwork and as such, Peoples has determined that all of its compensation policies and practices, including those for employees other than the named executive officers, are not reasonably likely to have a material adverse effect on Peoples.

**Table of Contents****Summary Compensation Table**

The table below sets forth information with respect to annual compensation awarded to, earned by, or paid to each of the Chief Executive Officer, the Chief Financial Officer, and to the other named executive officers to the extent such person's total compensation exceeded \$100,000 for the years ended December 31, 2012, 2011 and 2010.

Name and Principal Position	Year	Salary (\$)	Non-Equity Incentive Plan Compensation	Change in Pension	All Other Compensation (\$)	Total (\$)
				Value and Nonqualified Deferred Compensation Earnings (\$)		
Alan W. Dakey	2012	202,248	50,562	30,873	42,956 (1)	326,639
	2011	190,800	64,099	19,700	37,390 (1)	311,989
President and Chief Executive Officer	2010	180,000	49,500	0	28,206 (1)	257,706
Scott A. Seasock	2012	152,250	22,838	5,782	22,275 (2)	203,145
Senior VP/ Chief Financial Officer	2011	136,077	28,928	0	8,625 (2)	173,630
Debra E. Dissinger	2012	140,080	21,012	11,065	13,429 (3)	185,586
	2011	136,000	27,795	10,538	12,677 (3)	187,010
Chief Operating Officer/Chief Risk Officer	2010	128,000	22,464	10,036	10,357 (3)	170,857
Joseph M. Ferretti	2012	133,900	20,085	3,499	25,574 (4)	183,058
	2011	130,000	25,838	3,325	23,321 (4)	182,484
Executive VP/Chief Lending Officer	2010	122,000	20,385	0	10,006 (4)	152,391

- (1) Includes director's fees of \$0, \$4,500 and \$6,000; deferred compensation of \$7,500, \$0 and \$0; automobile allowance of \$12,000 for each year; ESOP contributions of \$12,500, \$12,015 and \$9,609; 401(k) plan contributions of \$8,004, \$5,927 and \$415; health and wellness program incentives of \$500, \$500 and \$182; and country club dues of \$2,452, \$2,448 and \$0 in 2012, 2011 and 2010, respectively.
- (2) Includes automobile allowance of \$9,000 and \$8,625; ESOP contributions of \$9,059 and \$0; 401(k) plan contributions of \$4,216 and \$0 in 2012 and 2011, respectively.
- (3) Includes ESOP contributions of \$8,393, \$7,923 and \$6,406; 401(k) plan contributions of \$5,036, \$4,754 and \$3,840; and health and wellness program incentives of \$0, \$0 and \$111 in 2012, 2011 and 2010, respectively.
- (4) Includes automobile allowance of \$9,000, \$7,500 and \$0; ESOP contributions of \$7,987, \$7,519 and \$6,257; 401(k) plan contributions of \$4,792, \$4,512 and \$3,749; health and wellness program incentives of \$189, \$183 and \$0; and country club dues of \$3,606, \$3,607 and \$0 in 2012, 2011 and 2010, respectively.

**Non-equity Incentive Compensation Plan** In January 2008, the compensation committee recommended to the board of directors an Incentive Compensation Plan which was approved by Peoples' directors. The compensation committee sets corporate goals for the named executive officers to achieve in order to qualify for a cash bonus. Cash bonus awards to the named executive officers for 2012 are structured as follows: President/Chief Executive Officer 25% of base salary; CRO/COO 15% of base salary; CFO 15% of base salary, and CCO 15% of base salary. Measurements for 2012 were as follows: a minimum of 70% of the targets were tied to economic profit targets with the remaining 30% based on execution of the related department strategic goals. Net income was weighted on a graduated scale with a 50% weight if the budget target was reached and then calculated on a sliding scale of additional bonus credits for additional revenue or a decrease of bonus credits for under-goal revenue on the same sliding scale. The four other economic targets were compared to budget- total average assets, if at goal or above, was valued at 5% maximum of base salary, return on average assets (ROAA) also at 5%, return on average equity (ROAE) also at 5%, and the efficiency ratio also at 5%. The non-economic component for the cash bonus, which made up the last 30%, was based on strategic goals. Strategic plans outlined for each officer were payable based on the execution of the related department's strategic goals. The results for 2012 were that each executive officer received 90% in bonus credits for exceeding the budgeted net income goal, another 20% for reaching each of the other four economic profit targets valued at 5% each, and the

**Table of Contents**

last component, which was based on completion of each officer's personal strategic goals, ranged between 22% and 30% for the named executive officers. This resulted in bonus payments of: Chief Executive Officer, Alan Dakey, received 100% of 25% of his base pay or \$50,562; Chief Operations Officer/Chief Risk Officer, Debra Dissinger, received 100% of 15% of her base pay or \$21,012; Chief Lending Officer, Joseph Ferretti, received 100% of 15% of his base pay or \$20,085 and Chief Financial Officer, Scott Seasock, received 100% of 15% of his base pay or \$22,838.

**ESOP** Contributions to the ESOP are at the discretion of the board of directors. Employer contributions are allocated to participant accounts based on their percentage of total base and short-term incentive compensation for the plan year. The amounts contributed to the plan are the same percentage of compensation for the named executive officers as for all employees. During 2012, total contributions to the plan charged as an expense to operations were \$262,000. Under the terms of the ESOP, the trustee must invest assets primarily in common stock of Peoples. Under the ESOP, employee participants are entitled to voting rights attributable to stock allocated to their accounts.

**401(k)** The plan covers substantially all employees who have completed one year of service. Contributions to the plan by Peoples Neighborhood Bank equal 50% of the employee contribution up to a maximum of 6% of annual salary. During 2012, total employer contributions to the plan charged as an expense to operations were \$137,000.

**Outstanding Equity Awards at Fiscal Year End December 31, 2012****Option Awards**

Name	Number of Securities Underlying Unexercised Options (#) Exercisable	Number of Securities Underlying Unexercised Options (#) Unexercisable	Equity Incentive Plan Awards: Number of Securities Underlying Unexercised Options (#)	Option Exercise Price	Option Expiration Date
Debra E. Dissinger	150	0	0	\$ 27.50	6/1/2013
	150	0	0	\$ 34.10	11/12/2014
	150	0	0	\$ 30.75	10/3/2015
Joseph M. Ferretti	150	0	0	\$ 27.50	6/1/2013
	150	0	0	\$ 34.10	11/12/2014
	150	0	0	\$ 30.75	10/3/2015

**Option Exercises**

There were no option exercises in 2012.

**Pension Benefits**

Name	Plan Name	Number of Years Credited Service (#)	Present Value of Accumulated Benefit (\$)	Payments During Last Fiscal Year (\$)
Alan W. Dakey	Executive Supplemental Retirement Plan	2	\$ 19,700	\$ 0
Debra E. Dissinger	Executive Supplemental Retirement Plan	37	\$ 78,074	\$ 0
Joseph M. Ferretti	Executive Supplemental Retirement Plan	15	\$ 8,810	\$ 0



**Table of Contents**Payments Upon Termination of Employment

The following chart outlines the benefits payable to the named executive officers upon a termination of employment and assumes that the termination of employment occurred on December 31, 2012:

Name	Termination Without Cause	Termination for Good Reason	Termination after a Change in Control
Alan W. Dakey	\$ 469,194 (1)	\$ 469,194 (1)	\$ 668,420 (2)
Debra E. Dissinger	91,206 (7)	91,206 (7)	493,334 (3)
Joseph M. Ferretti	304,785 (4)	304,785 (4)	381,537 (5)
Scott A. Seasock	339,882 (6)	339,882 (6)	339,882 (6)

- (1) Mr. Dakey would receive \$404,248 under his Employment Agreement, \$50,195 under his SERP, and \$14,751 in health benefits.
- (2) Mr. Dakey would be eligible for \$423,367 under his Employment Agreement, a lump sum payment of \$229,915 under his SERP, and \$14,751 in health benefits.
- (3) Ms. Dissinger would receive \$280,160 under her Change in Control Agreement and \$213,174 under her SERP. Under the SERP agreement Ms. Dissinger would be eligible for the stated retirement benefit which is \$20,000 per year for 15 years.
- (4) Mr. Ferretti would receive \$267,800 under his Employment Agreement, \$7,483 under his SERP, and \$29,502 in health benefits.
- (5) Mr. Ferretti would be eligible for \$153,622 under his Employment Agreement and a lump sum payment of \$227,915 under his SERP.
- (6) Mr. Seasock would receive \$304,500 under his Employment Agreement, a lump sum of \$5,880 under his SERP, and \$29,502 in health benefits.
- (7) Ms. Dissinger would receive \$91,206 under her SERP.

Supplemental Employee Retirement Plans In 2004, Peoples entered into a Supplemental Executive Retirement Plan with Debra Dissinger, Chief Operations Officers/Chief Risk Officer. The amount of the normal retirement benefit is \$20,000 per annum, paid to the executive for 15 years. Upon a change in control, Ms Dissinger will become vested in her benefit. On May 9, 2011, Peoples entered into Supplemental Executive Retirement Plan agreements with Alan Dakey, Chief Executive Officer and Joseph Ferretti, Chief Lending Officer. The amount of the normal retirement benefit for Mr. Dakey is \$30,000 per annum paid to the executive for 10 years. Mr. Ferretti's benefit is based on his benefit percentage and his final pay. On May 8, 2012, Peoples entered into a Supplemental Executive Retirement Plan Agreement with Scott Seasock. Mr. Seasock would receive \$20,000 for ten years upon retirement. In the event of a change of control, Messrs. Dakey, Ferretti and Seasock will receive the actuarially equivalent to their retirement benefit within ten (10) days of closing.

Employment Agreements On November 30, 2009, Peoples entered into an employment agreement with Alan W. Dakey as President & Chief Executive Officer. In the event that Mr. Dakey's employment is involuntarily terminated by Peoples without cause or the executive resigns from employment for good reason and no change in control shall have occurred at the date of such termination or resignation, Peoples shall pay (or cause to be paid) to the executive in cash within twenty days following termination or resignation, an amount equal to 2.0 times the highest sum of the following: (1) his taxable federal compensation reported on Form W-2 during each of the immediately preceding three calendar years; and (2) all amounts excluded from such compensation during the relevant calendar year by reason of Section 4(d) Code Section 125, and Code Section 401(k). If Mr. Dakey is terminated after a change in control, he will be entitled to 2.99 times his base amount as determined under Section 280G. In addition, executive shall be entitled to continuation of group health insurance benefits, at the same level enjoyed by executive immediately preceding the event, for one year following termination of the executive's employment. In exchange for receipt of the severance payment where no change in control has occurred, the Chief Executive Officer is prohibited for a period of one year from the date of termination, from entering into any relationship with any enterprise which is engaged in a business which competes with Peoples. The Chief Executive Officer's employment agreement is automatically renewed, on an annual basis, for a period of three years.

**Table of Contents**

On January 18, 2011, Peoples entered into an employment agreement with Scott Seasock as Senior Vice President & Chief Financial Officer. In the event that Mr. Seasock's employment is involuntarily terminated by Peoples without cause or the executive resigns from employment for good reason and no change in control shall have occurred at the date of such termination or resignation, Peoples shall pay (or cause to be paid) to the executive in cash within twenty days following termination or resignation, an amount equal to 2.0 times his Annual Base Salary. In addition, Mr. Seasock will be entitled to continuation of group insurance benefits, at the same level enjoyed by the executive immediately preceding the termination for the earlier of two (2) years following termination of employment or until he secures benefits from another employer. If Mr. Seasock is terminated after a change in control, he will be entitled to 2.0 times his Annual Base Salary. In addition, executive shall be entitled to continuation of group health insurance benefits, at the same level enjoyed by executive immediately preceding the event, for two years following termination of the executive's employment. In exchange for receipt of the severance payment where no change in control has occurred, the Chief Financial Officer is prohibited for a period of one year from the date of termination, from entering into any relationship with any enterprise which is engaged in a business which competes with Peoples. The Chief Financial Officer's employment agreement is automatically renewed, on an annual basis, for a period of three years. Notwithstanding the preceding provisions, in the event the lump sum payment described, when added to all other amounts or benefits would result in the imposition of an excise tax under Code Section 4999, such lump sum shall be reduced to the extent necessary to avoid such imposition.

On May 9, 2011, Peoples entered into an employment agreement with Joseph Ferretti as Senior Vice President & Chief Credit Officer. In the event that Mr. Ferretti's employment is involuntarily terminated by Peoples without cause or the executive resigns from employment for good reason and no change in control shall have occurred at the date of such termination or resignation, Peoples shall pay (or cause to be paid) to the executive in cash within twenty days following termination or resignation, an amount equal to 2.0 times his Annual Base Salary. In addition, Mr. Ferretti will be entitled to continuation of group insurance benefits, at the same level enjoyed by the executive immediately preceding the termination for the earlier of two (2) years following termination of employment or until he secures benefits from another employer. If Mr. Ferretti is terminated after a change in control, he will be entitled to 2.0 times his Annual Base Salary. In addition, executive shall be entitled to continuation of group health insurance benefits, at the same level enjoyed by executive immediately preceding the event, for two years following termination of the executive's employment. In exchange for receipt of the severance payment where no change in control has occurred, the Chief Credit Officer is prohibited for a period of one year from the date of termination, from entering into any relationship with any enterprise which is engaged in a business which competes with Peoples. The Chief Credit Officer's employment agreement is automatically renewed, on an annual basis, for a period of three years. Notwithstanding the preceding provisions, in the event the lump sum payment described, when added to all other amounts or benefits would result in the imposition of an excise tax under Code Section 4999, such lump sum shall be reduced to the extent necessary to avoid such imposition.

**Change in Control Agreements** Peoples also has entered into a change-in-control agreement with Ms. Dissinger. The agreement defines a change in control as having occurred (1) when any one person or a group acquires ownership of fifty percent or more of the total fair market value or total voting power of Peoples; (2) any one person or a group acquires thirty-five percent or more of the total voting power of Peoples; (3) a majority of Peoples' board is replaced during any 12-month period by directors whose appointment was not endorsed by a majority of the current board; or (4) any person or a group acquires assets from Peoples or Peoples Neighborhood Bank that have a total gross fair market value equal to or more than forty percent of the total gross fair market value of all assets of Peoples.

The executive is entitled to certain benefits if, at any time within two years after the change in control, any of the following triggering events occurs: (1) employment is terminated by Peoples for any reason other than cause or disability of the executive; or (2) employment is terminated by the executive for good reason. Good reason is defined as (1) assignment to the executive of duties substantially inconsistent with the executive's position, authority or responsibilities, or any other substantial adverse changes in the executive's

## **Table of Contents**

position, including title, authority or responsibilities; (2) Peoples' failure to comply with any of the provisions of the agreement; (3) a required change of more than 50 miles in the executive's principal place of work, except for travel reasonably required in performing the executive's responsibilities; (4) a purported termination of the executive's employment by Peoples which is not permitted by the agreement; (5) Peoples' failure to require a successor company to assume the agreement; or (6) the executive's good faith determination that the change in control resulted in the executive being substantially unable to carry out authorities or responsibilities attached to his or her position due to the change in control.

When a triggering event occurs following a change in control, the executive is entitled to two times the sum of the executive's annual base salary. This change in control agreement is automatically renewed, on an annual basis, for a period of two years.

The Chief Executive Officer and other named executive officers are entitled to receive reimbursement for any legal fees and expenses, plus interest thereon that may be incurred in enforcing or defending his or her agreement.

### ***Peoples' Compensation Policies and Practices as they Relate to Risk Management.***

The board of directors of Peoples has reviewed its compensation policies and practices and has determined that the policies and practices do not motivate imprudent risk taking and are not reasonably likely to have a material adverse effect on Peoples.

### ***Compensation Committee Interlocks and Insider Participation***

During Fiscal 2012, the compensation committee was comprised of at least three members, two of which are independent directors. An independent director is a director who is independent, as determined by the board, within the meaning of applicable stock exchange listing standards. Additionally, at least two members of the Committee must qualify as non-employee directors for purposes of Rule 16b-3 under the Securities Exchange Act of 1934, as amended, and as outside directors for purposes of Section 162(m) of the Internal Revenue Code. There are no interlocking board memberships between officers of Peoples and any member of the compensation committee.

### ***Director Independence***

The provisions of Peoples' Corporate Governance Guidelines regarding director independence meet the independence standards of the Nasdaq.

Pursuant to the Guidelines, the board undertook its annual review of director independence in December 2012. During this review, the board considered transactions and relationships between each director or any member of his immediate family and the Company and its subsidiaries and affiliates. The board also considered whether there were any transactions or relationships between directors or any member of their immediate family (or any entity of which a director or an immediate family member is an executive officer, general partner or significant equity holder) and members of Peoples' senior management or their affiliates. As provided in the Guidelines, the purpose of this review was to determine whether any such relationships or transactions existed that were inconsistent with a determination that the director is independent.

As a result of this review, the board affirmatively determined that William E. Aubrey II, Ronald G. Kukuchka, George H. Stover, Jr., Joseph T. Wright, Jr., and Earle A. Wootton are independent of Peoples and its management under the standards set forth in the Corporate Governance Guidelines.

In determining the independence of each director, the board considered the following relationships, which it determined were immaterial to the directors' independence. The board considered that Peoples and its subsidiaries in the ordinary course of business have, during the last three years, purchased products and services

**Table of Contents**

from companies at which some of our directors or their immediate family members were officers or employees during 2012. In each case, the amount paid to or received from these companies in each of the last three years did not approach the 2% of total revenue threshold in the Guidelines. The board also considered employment relationships with immediate family members of directors that involved compensation of less than the threshold of \$120,000 in Peoples Guidelines. The board determined that none of the relationships it considered impaired the independence of the directors.

**Beneficial Ownership****Principal Holders**

The following table sets forth, to the best of our knowledge, those persons or entities who owned of record or beneficially more than 5% of the outstanding shares of Peoples common stock as of September 30, 2013.

Beneficial ownership of Peoples common stock was determined by referring to Securities and Exchange Commission Rule 13d-3, which provides that a person should be credited with the ownership of any stock held, directly or indirectly, through any contract, arrangement, understanding, relationship, or otherwise has or shares:

Voting power which includes the power to vote, or to direct the voting of, the stock;

Investment power which includes the power to dispose, or to direct the disposition of, the stock; or

The right to acquire beneficial ownership within 60 days after September 30, 2013.

Name and Address of Beneficial Owner	Amount and Nature of Beneficial Ownership	Percent of Common Class
CEDE & CO <sup>(1)</sup> New York, NY Employee Stock Ownership	827,148	26.79%
Plan of Peoples Neighborhood Bank <sup>(2)</sup> Hallstead, PA	158,595	5.14%

<sup>(1)</sup> Holds shares of various brokerage firms, banks or other nominees, on behalf of individual shareholders, commonly referred to as shares held in street name.

<sup>(2)</sup> Shares held by various employees and former employees of Peoples Neighborhood Bank.

**Directors and Executive Officers**

The following table sets forth information concerning the beneficial ownership of the Peoples common stock as of September 30, 2013 for: (a) each incumbent director; (b) each named executive officer of Peoples identified in the Summary Compensation Table; and (c) the directors and executive officers as a group. Except as otherwise noted, the named individuals or family members had sole voting and investment power with respect to such securities.

Beneficial ownership of Peoples common stock was determined by referring to Securities and Exchange Commission Rule 13d-3, which provides that a person should be credited with the ownership of any stock held, directly or indirectly, through any contract, arrangement, understanding, relationship, or otherwise has or shares:

Voting power which includes the power to vote, or to direct the voting of, the stock;

Investment power which includes the power to dispose, or to direct the disposition of, the stock; or

The right to acquire beneficial ownership within 60 days after September 30, 2013.

**Table of Contents**

Directors and Executive Officers	Amount and Nature of Beneficial Ownership*	Percent of Common Class
William E. Aubrey II	31,900	1.03%
Alan W. Dakey	5,071	0.16% <sup>(1)</sup>
Debra E. Dissinger	14,942	0.48% <sup>(2)</sup>
Joseph M. Ferretti	2,963	0.10% <sup>(3)</sup>
Ronald G. Kukuchka	24,522	0.79% <sup>(4)</sup>
Richard S. Lochen, Jr.	9,423	0.31% <sup>(5)</sup>
Scott A. Seasock	7,814	0.25% <sup>(6)</sup>
George H. Stover, Jr.	77,499	2.51% <sup>(7)</sup>
Earle A. Wootton	21,000	0.68%
Joseph T. Wright, Jr.	27,657	0.90% <sup>(8)</sup>
All Directors and Executive Officers as a Group	222,791	7.21%

\* The securities beneficially owned by an individual may include securities owned by or for the individual's spouse, minor children and any other relative who has the same home, as well as securities that the individual has or shares voting or investment power, or has the right to acquire beneficial ownership within sixty (60) days after September 30, 2013. Beneficial ownership may be disclaimed as to certain of the securities. All numbers have been rounded to the nearest whole number.

(1) Includes 1,202 shares under Peoples' Employee Stock Ownership Plan ( ESOP ) which have been allocated to Mr. Dakey's account.

(2) Includes 13,415 shares under Peoples' ESOP which have been allocated to Ms. Dissinger's account and option grants of 300 shares. All other shares are held jointly with spouse.

(3) Includes 2,663 shares under Peoples' ESOP which have been allocated to Mr. Ferretti's account and option grants of 300 shares.

(4) Includes 18,144 shares held jointly with spouse and option grants of 200 shares.

(5) Includes 1,076 shares under Peoples' ESOP which have been allocated to Mr. Lochen's account, option grants of 500 shares, 228 shares held by minor children, and 4,753 shares held jointly with spouse.

(6) Includes 271 shares under Peoples' ESOP which have been allocated to Mr. Seasock's account.

(7) Includes option grants of 500 shares. All other shares are held jointly with spouse.

(8) Includes 1,445 shares held by minor child.

**Related Party Transactions**

Several of the Peoples' directors, officers, their immediate family members and companies with which they are associated, are customers of Peoples Neighborhood Bank. During 2012, many of them had banking transactions with Peoples Neighborhood Bank, in the ordinary course of Peoples Neighborhood Bank's business, and intend to do so in the future. Peoples Neighborhood Bank has a formal process with respect to the review and approval of loans extended by Peoples Neighborhood Bank to related persons. In 2006, Peoples Neighborhood Bank adopted written procedures to review and approve transactions with related persons. In accordance with these procedures all transactions with related persons must be approved or ratified by disinterested members of board of directors. All loans and commitments to loan included in such transactions were made under substantially the same terms, including interest rates, collateral, and repayment terms, as those prevailing at the time for comparable transactions with other persons not related to the lender and do not involve more than the normal risk of collection or present other unfavorable features.

**Changes in and Disagreements with Accountants on Accounting and Financial Disclosure**

On June 28, 2013, Peoples' board of directors approved the dismissal of ParenteBeard LLC as Peoples' independent registered public accounting firm and approved the engagement of BDO USA LLP as Peoples' new independent registered public accounting firm.

**Table of Contents**

The reports of ParenteBeard LLC on Peoples financial statements as of and for the years ended December 31, 2012 and December 31, 2011 did not contain an adverse opinion or a disclaimer of opinion, and were not qualified or modified as to uncertainty, audit scope, or accounting principles.

During Peoples two most recent fiscal years and subsequent interim period preceding ParenteBeard LLC's dismissal, there were: (i) no disagreements with ParenteBeard LLC on any matter of accounting principles or practices, financial statement disclosure or auditing scope or procedure, which disagreement, if not resolved to the satisfaction of ParenteBeard LLC would have caused ParenteBeard LLC to make reference to the subject matter of the disagreements in its reports on the consolidated financial statements of Peoples; and (ii) no reportable events (as such term is defined in Item 304(a)(1)(v) of Regulation S-K).

Pursuant to Item 304(a)(3) of Regulation S-K, Peoples has provided a copy of the above disclosures and requested that ParenteBeard LLC furnish it with a letter addressed to the Commission stating whether or not ParenteBeard LLC agrees with the above statements.

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**Table of Contents**

**Management's Discussion and Analysis of Financial Condition and Results of Operations**

**of Peoples Financial Services Corp.**

**Six Months Ended June 30, 2013 and 2012**

Management's Discussion and Analysis appearing on the following pages should be read in conjunction with the Consolidated Financial Statements contained in this Registration Statement.

**Forward-Looking Discussion:**

In addition to the historical information contained in this document, the discussion presented may contain and, from time to time, may make, certain statements that constitute forward-looking statements. Words such as expects, anticipates, believes, estimates and other similar expressions or future or conditional verbs such as will, should, would and could are intended to identify such forward-looking statements. These statements are not historical facts, but instead represent the current expectations, plans or forecasts of Peoples Financial Services Corp. and its subsidiaries (collectively, Peoples) regarding its future operating results, financial position, asset quality, credit reserves, credit losses, capital levels, dividends, liquidity, service charges, cost savings, effective tax rate, impact of changes in fair value of financial assets and liabilities, impact of new accounting and regulatory guidance, legal proceedings and other matters relating to Peoples and the securities that Peoples may offer from time to time. These statements are not guarantees of future results or performance and involve certain risks, uncertainties and assumptions that are difficult to predict, change over time and are often beyond Peoples control. Actual outcomes and results may differ materially from those expressed in, or implied by, forward-looking statements.

You should not place undue reliance on any forward-looking statement and should consider the uncertainties and risks discussed in the section entitled Risk Factors, in this Registration Statement, among others, and in any of Peoples subsequent Securities and Exchange Commission (SEC) filings. Forward-looking statements speak only as of the date they are made, and Peoples undertakes no obligation to update any forward-looking statement to reflect the impact of circumstances or events that arise after the date the forward-looking statement was made. Notes to the Consolidated Financial Statements referred to in the Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A) are incorporated by reference into the MD&A. Certain prior period amounts have been reclassified to conform with the current year's presentation.

**Critical Accounting Policies:**

Peoples financial statements are prepared in accordance with accounting principles generally accepted in the United States of America (GAAP). The preparation of financial statements in conformity with GAAP requires Peoples to establish critical accounting policies and make accounting estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements, as well as the reported amounts of revenues and expenses during those reporting periods.

For a further discussion of Peoples critical accounting policies, refer to Note 1 entitled, Summary of significant accounting policies, in the Notes to Consolidated Financial Statements for the year ended December 31, 2012, included in this Registration Statement. This note lists the significant accounting policies used by Peoples in the development and presentation of the financial statements. This MD&A, the Notes to Consolidated Financial Statements and other financial statement disclosures identify and address key variables and other qualitative and quantitative factors that are necessary for the understanding and evaluation of Peoples financial position, results of operations and cash flows.

**Operating Environment:**

The United States economy has shown modest signs of improvement in 2013. The Gross Domestic Product (GDP), the value of all goods and services produced in the United States, grew at an annualized pace of 2.5



**Table of Contents**

percent in the second quarter of 2013, following an annualized rate of 1.1 percent in the first quarter of 2013. Despite signs of expansion in this economic metric, the continuation of mixed signals in employment and housing caused the Federal Open Market Committee ( FOMC ) to maintain its federal funds target range at 0 to 25 basis points throughout the first half of 2013 with no anticipated change in sight. Moreover, the FOMC reiterated its pledge that the fed funds rate target will remain at the current level until the unemployment rate is down to 6.5 percent or inflation exceeds 2.5 percent. However with respect to another monetary policy initiative, there has been recent consideration among voting members of the FOMC to end, or at least taper the participation of the Federal Reserve in Quantitative Easing, a policy aimed at increasing the money supply through the purchase of mortgage backed securities from financial institutions. This FOMC initiative attempts to increase the money supply by flooding financial institutions with capital, in an effort to promote increased lending and liquidity. The threat of scaling back the asset purchases by the Federal Reserve have been recently reduced by inflationary concerns. The Consumer Price Index ( CPI ) came in with a month over month increase of 0.5 percent for June, 2013. Annualized, this would equate to an increase of 6.0 percent, which is well above the FOMC s target inflation rate. Contributing to the increase in CPI, was an increase in energy prices of 3.4 percent. In contrast to energy, food prices were up slightly at 0.2 percent for that same period.

National, Pennsylvania, New York and our market area s non-seasonally-adjusted unemployment rates at June 30, 2013 and 2012, are summarized as follows:

<b>June 30</b>	<b>2013</b>	<b>2012</b>
United States	7.6%	8.2%
Pennsylvania	7.9%	8.3%
New York	7.6%	8.7%
Lackawanna County	9.3%	9.2%
Susquehanna County	7.1%	7.2%
Wyoming County	9.4%	9.4%
Broome County	7.8%	9.0%

Employment conditions improved for the Commonwealth of Pennsylvania, as the unemployment rate fell to 7.9 percent for June of 2013 from 8.3 percent for the same point in 2012. The unemployment rate for New York State dropped to 7.6 percent at June 30, 2013, from 8.7 percent at June 30, 2012. With respect to the markets we serve, the unemployment rate decreased in two of the four counties. Broome County in the southern tier of New York decreased most significantly to 7.8 percent at June 30, 2013, from 9.0 percent at the comparable period in 2012. Susquehanna County in Pennsylvania decreased slightly from June 30, 2012 to June 30, 2013 and remains below the national average. Jobs related to natural gas drilling and exploration in Susquehanna County has contributed to the strength in the employment situation in those two counties. The unemployment rate in Wyoming County was unchanged at 9.4 percent comparing June 30, 2013 and 2012 while Lackawanna County increased slightly over that same period.

Earnings for all Federal Deposit Insurance Corporation-insured commercial banks increased \$13.3 billion or 19.2 percent comparing the first six months of 2013 and 2012. Reduced loan loss provisions and higher non-interest income were the primary sources of the record earnings posted by these financial institutions. Partially offsetting the improvement was a decrease in net interest income as a result of a reduction in net interest margins. With respect to bank balance sheets, total loans grew 2.7 percent and total deposits increased 4.9 percent comparing June 30, 2013 and 2012.

The United States economy is expected to continue a slow rate of improvement in the second half of 2013. The FOMC has predicted the economy will grow at a pace between 2.3 percent and 2.6 percent for the remainder of 2013. This slow rate of growth should not materially change interest rates which may adversely impact bank earnings as net interest margins compress from the inability of management to further reduce fund costs. Continuous expense control, sound balance sheet management and lower loan loss provisions could offset some of the negative impact of the reduction in net interest margins.

**Table of Contents****Review of Financial Position:**

Total assets grew \$17,451 or at an annualized rate of 5.2% to \$688,974 at June 30, 2013, from \$671,523 at December 31, 2012. For the six months ended June 30, 2013, total assets averaged \$671,775, an increase of \$45,713 or 7.3%, from \$626,062 for the same period of 2012. The 2013 balance sheet growth was driven by increases in total deposits of \$22,624, an annualized growth rate of 7.9%. Interest-bearing deposits increased \$12,883, while noninterest-bearing deposits grew \$9,741. Loans, net, increased \$26,440 or at an annualized rate of 11.4% to \$492,213 at June 30, 2013, compared to \$465,773 at December 31, 2012. Total stockholders' equity increased \$1,394 or at an annualized rate of 4.2%, to \$67,590 at June 30, 2013 from \$66,196 at year-end 2012.

**Investment Portfolio:**

The entire securities portfolio is held as available for sale, which allows for greater flexibility in using the investment portfolio for liquidity purposes by allowing securities to be sold when market opportunities occur. Investment securities totaled \$138,758 at June 30, 2013, a decrease of \$9,022 or 12.3% annualized from \$147,780 at December 31, 2012. The decrease resulted from contractual maturities and payments received from mortgage backed securities which were not reinvested into the portfolio. The mortgage backed sector totaled \$36,989, or 26.7% of the portfolio at June 30, 2013, as compared to \$44,422, or 30.1% at December 31, 2012.

For the six months ended June 30, 2013, the investment portfolio averaged \$146,290, an increase of \$10,657 or 7.9% compared to \$135,633 for the same period last year. The tax-equivalent yield on the investment portfolio decreased 33 basis points to 3.08% for the six months ended June 30, 2013, from 3.41% for the comparable period of 2012.

Securities available for sale are accounted for at fair value, with unrealized gains or losses net of deferred income taxes reported in the accumulated other comprehensive income component of stockholders' equity. The carrying value of securities at June 30, 2013, included a net unrealized gain of \$4,603 reported as accumulated other comprehensive income of \$3,038 in stockholders' equity, net of deferred income taxes of \$1,565. This compares to a net unrealized gain of \$7,388 at December 31, 2012, reported as an accumulated other comprehensive income of \$4,876, net of deferred income taxes of \$2,512.

**Loan Portfolio:**

Loans, net increased \$26,440, or 11.4% annualized, to \$492,213 at June 30, 2013 from \$465,773 at December 31, 2012. The growth reflected increases in commercial loans and commercial real estate loans partially offset by decreases in residential real estate and consumer loans. Commercial loans increased \$13,888, or 16.4% annualized, to \$184,267 at June 30, 2013 compared to \$170,379 at December 31, 2012. Commercial real estate loans increased \$13,823, or 17.6% annualized, to \$172,621 at June 30, 2013 compared to \$158,798 at December 31, 2012.

Residential real estate mortgages decreased \$296, or 0.5% annualized, to \$117,231 at June 30, 2013 compared to \$117,527 at December 31, 2012. Consumer loans decreased 10.3% annualized, or \$975, to \$18,094 at June 30, 2013 compared to \$19,069 at December 31, 2012.

For the six months ended June 30, 2013, loans averaged \$479,702, an increase of \$20,825 or 4.5% compared to \$458,877 for the same period of 2012. The tax-equivalent yield on the loan portfolio was 5.27% for the six months ended June 30, 2013, a decrease of 19 basis points from 5.46% for the same period last year.

In addition to the risks inherent in the loan portfolio, in the normal course of business, Peoples is also a party to financial instruments with off-balance sheet risk to meet the financing needs of customers. These instruments include legally binding commitments to extend credit, unused portions of lines of credit and commercial letters of credit made under the same underwriting standards as on-balance sheet instruments, and may involve, to varying degrees, elements of credit risk and interest rate risk ( IRR ) in excess of the amount recognized in the financial statements.

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**Table of Contents**

Unused commitments on June 30, 2013, totaled \$122,214, consisting of \$108,166 in unfunded commitments of existing loan facilities and \$14,048 in standby letters of credit. Due to fixed maturity dates, specified conditions within these instruments, and the ultimate needs of Peoples customers, many will expire without being drawn upon. Management believes that amounts actually drawn upon can be funded in the normal course of operations and therefore, do not represent a significant liquidity risk to Peoples. In comparison, unused commitments, at December 31, 2012, totaled \$77,342, consisting of \$65,696 in unfunded commitments of existing loans and \$11,646 in standby letters of credit.

Peoples records an allowance for off-balance sheet credit losses, if deemed necessary, separately as a liability. No allowance was deemed necessary at June 30, 2013 and December 31, 2012. Management does not anticipate that losses, if any, that may occur as a result of funding off-balance sheet commitments, would have a material adverse effect on Peoples operating results or financial position.

**Asset Quality:**

Nonperforming assets decreased \$646 or 5.2% to \$11,793 at June 30, 2013, from \$12,439 at December 31, 2012. Peoples experienced decreases in all major categories of nonperforming assets. As a percentage of loans, net and foreclosed assets, nonperforming assets equaled 2.39% at June 30, 2013 compared to 2.66% at December 31, 2012.

Loans on nonaccrual status decreased \$145 to \$7,789 at June 30, 2013 from \$7,934 at December 31, 2012. The reduction from year end was due primarily to a net decrease of \$237 in commercial and commercial real estate loans partially offset by an increase of \$92 in residential real estate loans.

The allowance for loan losses increased \$154 to \$6,735 at June 30, 2013, from \$6,581 at the end of 2012. The unallocated element of the allowance for loan losses was \$131 at June 30, 2013, and \$1,016 at December 31, 2012. The reduction in the unallocated element was directionally consistent with improvements in credit quality ratios and the level of net charge-offs. Nonperforming assets as a percentage of loans, net and foreclosed assets declined from 2.66% at December 31, 2012, to 2.39% at June 30, 2013. In addition, loans charged-off, net of recoveries, for the six months ended June 30, equaled \$176 or 0.7% of average loans outstanding in 2013 compared to \$468 or 0.21% of average loans outstanding in 2012. As is inherent with all estimates, the allowance for loan losses methodology is subject to a certain level of imprecision as it provides reasonable, but not absolute, assurance that the allowance will be able to absorb probable losses, in their entirety, as of the financial statement date. Factors, among others, including judgments made in identifying those loans considered impaired, appraisals of collateral values and measurements of certain qualitative factors, all cause this imprecision and support the establishment of the unallocated element. Management believes the unallocated element is sufficient to cover any inherent losses in the loan portfolio that have not been identified as part of the allocated element at June 30, 2013.

**Deposits:**

Deposits are attracted within Peoples primary market area through the offering of various deposit instruments including demand deposit accounts, NOW accounts, money market deposit accounts, savings accounts, and time deposits, including certificates of deposit and IRAs. During the six months ended June 30, 2013, total deposits increased \$22,624, or 7.9% annualized, to \$596,935 from \$574,311 at December 31, 2012. Time deposits increased \$659, or 1.1% annualized, to \$118,092 at June 30, 2013, compared to \$117,433 at December 31, 2012. Demand deposits, increased \$9,741, or 19.2% annualized, to \$112,063 at June 30, 2013, compared to \$102,322 at December 31, 2012. Interest-bearing transaction accounts, including NOW, money market and savings accounts, increased \$12,224, or 7.0% annualized, to \$366,780 at June 30, 2013, compared to \$354,556 at December 31, 2012.

For the six months ended June 30, 2013, average total deposits increased \$75,396 to \$578,973 compared to \$503,577 for the same period of 2012. Noninterest-bearing deposits grew \$11,392, while interest-bearing accounts increased \$64,004. The cost of interest-bearing deposits decreased 20 basis points to 0.84% for the six months ended June 30, 2013, from 1.04% for the same six months of 2012.

**Table of Contents**

Interest rates have been at historic lows for an extended period. Short term and core deposit rates have remained flat. As such, deposits have been attracted by offering rates on longer term time deposit products which are higher than other investment alternatives available to customers elsewhere in the market place. The added benefit of expanded FDIC insurance up to \$250 has also made bank deposits an attractive investment vehicle for customers.

In addition to deposit gathering, Peoples has in place various secondary sources of liquidity to fund operations through exercising existing credit arrangements with the Federal Home Loan Bank ( FHLB ). Short-term borrowings at June 30, 2013, totaled \$17,972 compared to \$12,764 at December 31, 2012. Long-term debt was \$2,717 at June 30, 2013, compared to \$13,130 at year end 2012 due to the maturity of two \$5,000 FHLB advances in the first quarter of 2013.

**Market Risk Sensitivity:**

The cumulative one-year rate sensitive assets ( RSA )/rate sensitive liabilities ( RLS ) ratio equaled 0.67 at June 30, 2013 and 0.66 at December 31, 2012. Given the length of time that market rates have been at historical lows and the potential for rates to rise in the future, the focus of ALCO has been to create a positive static gap position in the near term. With regard to RSA, Peoples predominantly offered medium- term, fixed-rate loans as well as adjustable rate loans. Management continues to offer a promotional certificate of deposit with an 84-month term in order to lengthen the duration of Peoples RSL. This current position indicates that the amount of RSA repricing within one year would be less than that of RSL, thereby causing a reduction in net interest income with market rate increases. However, these forward-looking statements are qualified in the aforementioned section entitled Forward-Looking Discussion in this Management s Discussion and Analysis.

As the static gap report fails to address the dynamic changes in the balance sheet composition or prevailing interest rates, management utilizes a simulation model to enhance asset/liability management. This model is used to create pro forma net interest income scenarios under various interest rate shocks. Model results at June 30, 2013, produced results similar to those indicated by the one-year static gap position. In addition, parallel and instantaneous shifts in interest rates under various interest rate shocks resulted in changes in net interest income that were well within policy limits. Management will continue to monitor IRR for the remainder of 2013 and employ deposit and loan pricing strategies and direct the reinvestment of loan and investment repayments in order to maintain a favorable IRR position.

**Liquidity:**

Peoples employs a number of analytical techniques in assessing the adequacy of Peoples liquidity position. One such technique is the use of ratio analysis related to the reliance on noncore funds to fund investments and loans maturing after June 30, 2013. Noncore funds at June 30, 2013, were comprised of time deposits in denominations of \$100 or more, repurchase agreements and other borrowings. These funds are not considered to be a strong source of liquidity since they are very interest rate sensitive and are considered to be highly volatile. At June 30, 2013, the net noncore funding dependence ratio, the difference between noncore funds and short-term investments to long-term assets, was 2.0%, while the net short-term noncore funding dependence ratio, noncore funds maturing within one-year, less short-term investments to long-term assets equaled -3.0%. These ratios indicated that Peoples had very little or no reliance on noncore funds at June 30, 2013. Comparatively, these ratios strengthened from year-end 2012 at 3.7% and -1.7%, respectively, indicating the reliance on noncore funds has decreased slightly. The decrease in noncore funding reliance resulted primarily from an increase in fed funds sold and the decrease in long-term debt.

The Consolidated Statements of Cash Flows present the changes in cash and cash equivalents from operating, investing and financing activities. Cash and cash equivalents, consisting of cash on hand, cash items in the process of collection, deposit balances with other banks and federal funds sold, increased \$1,274 during the six months ended June 30, 2013. Cash and cash equivalents increased \$11,830 for the same period last year. For

**Table of Contents**

the six months ended June 30, 2013, net cash inflows of \$16,089 from financing activities and \$7,388 from operating activities were partially offset by a \$22,203 net cash outflow from investing activities. For the same period of 2012, net cash inflows of \$11,521 from financing activities and \$3,890 from operating activities were partially offset by a \$3,581 net cash outflow from investing activities.

Financing activities provided net cash of \$16,089 for the six months ended June 30, 2013, and \$11,521 for the same six months of 2012. Deposit gathering is Peoples predominant financing activity. During the first six months of 2013 deposit gathering increased, which resulted in a \$22,624 increase in net cash. Similarly, deposit gathering provided net cash of \$43,828 for the same period of 2012.

Operating activities provided net cash of \$7,388 for the six months ended June 30, 2013, and \$3,890 for the same period of 2012. Net income, adjusted for the effects of gains and losses along with noncash transactions such as depreciation and the provision for loan losses, is the primary source of funds from operations.

Investing activities primarily include transactions related to Peoples lending activities and investment portfolio. Investing activities used net cash of \$22,203 for the six months ended June 30, 2013, compared to \$3,581 for the same period of 2012. In both 2013 and 2012, a net increase in lending activities was the primary factor causing the net cash outflow from investing activities.

**Capital:**

Stockholders' equity totaled \$67,590 or \$21.89 per share at June 30, 2013, compared to \$66,196 or \$21.46 per share at December 31, 2012. Net income of \$4,562 for the six months ended June 30, 2013 was the primary factor leading to the improved capital position. Stockholders' equity was also affected by cash dividends declared of \$1,420, common stock issuances of \$90 and other comprehensive losses resulting from market value fluctuations in the investment portfolio of \$1,838 net of income taxes.

Year-to-date dividends declared equaled \$0.46 per share in 2013, an increase of 9.5% compared to \$0.42 in 2012. The dividend payout ratio was 31.1% for the six months ended June 30, 2013, compared to 27.8% for the same period in 2012. It is the intention of the Board of Directors to continue to pay cash dividends in the future. However, these decisions are affected by operating results, financial and economic decisions, capital and growth objectives, appropriate dividend restrictions and other relevant factors.

The adequacy of capital is reviewed on an ongoing basis with reference to the size, composition and quality of resources and regulatory guidelines. Management seeks to maintain a level of capital sufficient to support existing assets and anticipated asset growth, maintain favorable access to capital markets, and preserve high quality credit ratings. As of June 30, 2013, Peoples Neighborhood Bank's Tier I capital to total average assets was 9.01%. The Tier I capital to risk weighted asset ratio was 11.59% and the total capital to risk weighted asset ratio was 12.84% at June 30, 2013. Peoples Neighborhood Bank was deemed to be well-capitalized under regulatory standards at June 30, 2013.

**Review of Financial Performance:**

For the six months ended June 30, 2013, net income equaled \$4,562 or \$1.48 per share, a decrease of \$142 or 3.0% compared to \$4,704 or \$1.51 per share for the same period of 2012. Peoples return on average assets ( ROA ) and return on average equity ( ROE ) were 1.37% and 14.02% for the first half of 2013 compared to 1.51% and 16.02% for the same period of 2012.

**Net Interest Income:**

For the six months ended June 30, 2013, tax-equivalent net interest income increased \$471 or 3.9% to \$12,625 in 2013 from \$12,154 in 2012. The net interest spread decreased to 3.80% for the six months ended June 30, 2013 from 3.86% for the six months ended June 30, 2012. The net interest margin decreased to 3.99% for the six month period ended June 30, 2013 from 4.10% for the same period in 2012.

**Table of Contents**

For the six months ended June 30, 2013, tax equivalent interest revenue increased \$46, or 0.3%, to \$14,773 as compared to \$14,727 for the six months ended June 30, 2012. The increase was primarily due to the growth in average earning assets which increased \$40,963 to \$637,517 for the first half of 2013 from \$596,554 for the same period in 2012. The overall yield on earning assets, on a fully tax equivalent basis, decreased 29 basis points for the six months ended June 30, 2013 at 4.67% as compared to 4.96% for the six months ended June 30, 2012. This was a result of the continuation of the low interest rate environment along with increased market competition. The yield earned on loans decreased 19 basis points for the first half of 2013 to 5.27% from 5.46% for the same period of 2012. Average loans increased to \$479,702 for the six months ended June 30, 2013 compared to \$458,877 for the comparable period of 2012. Tax equivalent interest earned on loans was \$12,525 for the six-month period ended June 30, 2013 compared to \$12,427 for the same period in 2012, an increase of \$98 or 0.8%.

Total interest expense decreased by \$425 or 16.5%, to \$2,148 for the six months ended June 30, 2013 from \$2,573 for the six months ended June 30, 2012. This decrease was the result of a favorable rate variance as the cost of funds decreased to 0.87% for the six months ended June 30, 2013 as compared to 1.10% for the same period in 2012. Offsetting the favorable rate variance was an increase in the average volume of interest bearing liabilities comparing the six months ended June 30, 2013 and 2012. Average interest bearing liabilities increased to \$495,479 for the six months ended June 30, 2013 as compared to \$469,124 for the six months ended June 30, 2012. This increase was driven primarily by the increase in average interest bearing transaction accounts. Average savings, money market and NOW accounts increased \$12,667, \$7,173 and \$36,886 comparing the six months ended June 30, 2013 to the same period in 2012.

**Table of Contents**

The average balances of assets and liabilities, corresponding interest income and expense and resulting average yields or rates paid are summarized as follows. Averages for earning assets include nonaccrual loans. Investment averages include available-for-sale securities at amortized cost. Income on investment securities and loans is adjusted to a tax equivalent basis using the prevailing federal statutory tax rate of 34.0%.

	Six months ended					
	June 2013			June 2012		
	Average Balance	Interest	Yield/ Rate	Average Balance	Interest	Yield/ Rate
<b>Assets:</b>						
<b>Earning assets:</b>						
<b>Loans</b>						
Taxable	\$ 446,743	\$ 11,633	5.25%	\$ 416,255	\$ 11,197	5.41%
Tax exempt	32,959	892	5.46	42,622	1,230	5.80
<b>Investments</b>						
Taxable	99,159	1,177	2.39	100,517	1,254	2.51
Tax exempt	47,131	1,055	4.51	35,116	1,041	5.96
Interest bearing deposits	562	2	0.72	1,076	5	0.93
Federal funds sold	10,963	14	0.26	968		
<b>Total earning assets</b>	<b>637,517</b>	<b>14,773</b>	<b>4.67%</b>	<b>596,554</b>	<b>14,727</b>	<b>4.96%</b>
Less: allowance for loan losses	6,627			5,549		
<b>Other assets</b>	<b>40,885</b>			<b>35,057</b>		
<b>Total assets</b>	<b>\$ 671,775</b>			<b>\$ 626,062</b>		
<b>Liabilities and Stockholders Equity:</b>						
<b>Interest bearing liabilities:</b>						
Money market accounts	\$ 43,321	100	0.47%	\$ 36,148	104	0.58%
NOW accounts	95,603	246	0.52	58,717	175	0.60
Savings accounts	218,040	478	0.44	205,373	659	0.65
Time deposits less than \$100	81,832	782	1.93	78,623	853	2.18
Time deposits \$100 or more	35,079	366	2.10	31,010	328	2.13
Short-term borrowings	16,270	64	0.79	40,514	111	0.55
Long-term debt	5,334	112	4.23	18,739	343	3.68
<b>Total interest bearing liabilities</b>	<b>495,479</b>	<b>2,148</b>	<b>0.87%</b>	<b>469,124</b>	<b>2,573</b>	<b>1.10%</b>
Non-interest bearing demand deposits	105,098			93,706		
Other liabilities	5,565			4,199		
Stockholders equity	65,633			59,033		
<b>Total liabilities and stockholders equity</b>	<b>\$ 671,775</b>			<b>\$ 626,062</b>		
<b>Net interest income/spread</b>		<b>\$ 12,625</b>	<b>3.80%</b>		<b>\$ 12,154</b>	<b>3.86%</b>
<b>Net interest margin</b>			<b>3.99%</b>			<b>4.10%</b>
<b>Tax equivalent adjustments:</b>						
Loans		\$ 303			\$ 418	
Investments		359			354	
<b>Total adjustments</b>		<b>\$ 662</b>			<b>\$ 772</b>	

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Note: Average balances were calculated using average daily balances. Interest income on loans includes fees of \$148 in 2013 and \$131 in 2012. Available-for-sale securities, included in investment securities, are stated at amortized cost with the related average unrealized holding gains of \$7,343 and \$5,429 for the six months ended June 30, 2013 and 2012 included in other assets. Tax-equivalent adjustments were calculated using the prevailing statutory tax rate of 34.0 percent



## **Table of Contents**

### **Provision for Loan Losses:**

For the six months ended June 30, 2013, the provision for loan losses totaled \$330. The provision for loan losses was \$1,035 for the same period in 2012. The provision for loan losses was larger in 2012 to address concerns with respect to the level of the allowance in relation to a greater degree of uncertainty in local and national economic conditions at that time. Based on our most recent evaluation at June 30, 2013, management believes that the allowance was adequate to absorb any known or potential losses in our portfolio.

### **Noninterest Income:**

For the six months ended June 30, 2013, noninterest income totaled \$2,348, a decrease of \$225 or 8.7% from \$2,573 for the comparable period of 2012. Revenue received from the Wealth Management Division increased \$113 year-to-date as a result of a pickup in appetite for investment type products and services as the economy slowly improves. Service charges, fees and commissions increased \$92 to \$1,632 for the six months ended June 30, 2013 from \$1,540 for the first half of 2012. Mortgage banking income increased \$37 to \$413 for the six months ended June 30, 2013 from \$376 for the same period last year as a result of an increase in the amount of loans sold in the six months ended June 30, 2013. Offsetting the increases in noninterest income for the six months ended June 30, 2013 was a \$384 decrease in gains (loss) from sales of investment securities available-for-sale and a \$90 loss resulting from the sale of other real estate owned compared to a \$7 loss in the prior period.

### **Noninterest Expenses:**

For the six months ended June 30, 2013, noninterest expense increased \$897 or 12.4% to \$8,109 in 2013 from \$7,212 in 2012.

For the six months ended June 30, 2013, salaries and benefit related expenses totaled \$3,958 or 48.8% of total noninterest expense, an increase of \$479 from \$3,479 or 48.2% of total noninterest expense for the same six months of 2012. Contributing to this increase was the additional staff at the new Westside office in Binghamton, New York which opened on December 28, 2012 in addition to normal merit increases.

For the six months ended June 30, 2013, net occupancy and equipment expense totaled \$1,669, an increase of \$126 or 8.2% from \$1,543 for the same six months of 2012. Increased depreciation expense and other costs related to the Westside office caused the increase between comparable periods.

For the six months ended June 30, 2013, other expenses totaled \$2,482, an increase of \$292 or 13.3% compared to \$2,190 for the same period of 2012. Insurance proceeds of \$353 were received in 2012 for flood damages incurred in 2011 and offset other expenses on a comparative basis. There were no such payments received in 2013.

### **Income Taxes:**

Peoples recorded income tax expense of \$1,310 and \$1,004 for the six-months ended June 30, 2013 and 2012. The effective tax rate increased to 22.3% in 2013 from 17.6% in 2012. Peoples recognized \$170 in investment tax credits in 2013 compared to \$370 in 2012. The credits are related to Peoples limited partnership investment in an elderly housing project.

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**Table of Contents**

**Management's Discussion and Analysis of Financial Condition and Results of Operations**

**of Peoples Financial Services Corp.**

**Years Ended December 31, 2012 and 2011**

Management's Discussion and Analysis appearing on the following pages should be read in conjunction with the Consolidated Financial Statements of Peoples Financial Services Corp. found elsewhere in this joint proxy statement/prospectus.

**Forward-Looking Statements**

In addition to the historical information contained in this document, the discussion presented may contain and, from time to time, may make, certain statements that constitute forward-looking statements. Words such as expects, anticipates, believes, estimates and other similar expressions or future or conditional verbs such as will, should, would and could are intended to identify such forward-looking statements. These statements are not historical facts, but instead represent the current expectations, plans or forecasts of Peoples and its subsidiaries regarding its future operating results, financial position, asset quality, credit reserves, credit losses, capital levels, dividends, liquidity, service charges, cost savings, effective tax rate, impact of changes in fair value of financial assets and liabilities, impact of new accounting and regulatory guidance, legal proceedings and other matters relating to Peoples and the securities that Peoples may offer from time to time. These statements are not guarantees of future results or performance and involve certain risks, uncertainties and assumptions that are difficult to predict, change over time and are often beyond its control. Actual outcomes and results may differ materially from those expressed in, or implied by, forward-looking statements.

You should not place undue reliance on any forward-looking statement and should consider the uncertainties and risks discussed in the section entitled Risk Factors, in this joint proxy statement/prospectus, among others, and in any of Peoples subsequent Securities and Exchange Commission (SEC) filings. Forward-looking statements speak only as of the date they are made, and Peoples undertakes no obligation to update any forward-looking statement to reflect the impact of circumstances or events that arise after the date the forward-looking statement was made. Notes to the Consolidated Financial Statements of Peoples Financial Services Corp. referred to in the Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A) are incorporated by reference into the MD&A. Certain prior period amounts have been reclassified to conform with the current year's presentation.

**Critical Accounting Policies**

Peoples financial statements are prepared in accordance with accounting principles generally accepted in the United States of America (GAAP). The preparation of financial statements in conformity with GAAP requires Peoples to establish critical accounting policies and make accounting estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements, as well as the reported amounts of revenues and expenses during those reporting periods.

For a discussion of the recent Accounting Standards Updates (ASU) issued by the Financial Accounting Standards Board (FASB) refer to Note 1 entitled Summary of significant accounting policies Recent accounting standards, in the Notes to Consolidated Financial Statements of Peoples Financial Services Corp. found elsewhere in this joint proxy statement/prospectus.

An accounting estimate requires assumptions about uncertain matters that could have a material effect on the financial statements if a different amount within a range of estimates were used or if estimates changed from period to period. Readers of this report should understand that estimates are made considering facts and circumstances at a point in time, and changes in those facts and circumstances could produce results that differ from when those estimates were made. Significant estimates that are particularly susceptible to material change within the near term relate to the determination of allowance for loan losses, determination of other-than-

## **Table of Contents**

temporary impairment, fair value of financial instruments, the valuations of real estate acquired in connection with foreclosures or satisfaction of loans and the valuation of loans deferred tax assets and liabilities. Actual amounts could differ from those estimates.

Peoples maintains the allowance for loan losses at a level it believes adequate to absorb probable credit losses related to individually evaluated loans, as well as probable incurred losses inherent in the remainder of the loan portfolio as of the balance sheet date. The balance in the allowance for loan losses account is based on past events and current economic conditions.

The allowance for loan losses account consists of an allocated element and an unallocated element. The allocated element consists of a specific portion for the impairment of loans individually evaluated and a formula portion for loss contingencies on those loans collectively evaluated. The unallocated element, if any, is used to cover inherent losses that exist as of the evaluation date, but which have not been identified as part of the allocated allowance using its impairment evaluation methodology due to limitations in the process.

Peoples' management monitors the adequacy of the allocated portion of the allowance quarterly and adjusts the allowance for any deficiencies through normal operations. This ongoing evaluation reduces potential differences between estimates and actual observed losses. The determination of the level of the allowance for loan losses is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available. Accordingly, management cannot ensure that charge-offs in future periods will not exceed the allowance for loan losses or that additional increases in the allowance for loan losses will not be required, resulting in an adverse impact on operating results.

In determining the requirement to record an other-than-temporary impairment on securities owned by Peoples, four main characteristics are considered including: (i) the length of time and the extent to which the fair value has been less than amortized cost; (ii) the financial condition and near-term prospects of the issuer; (iii) whether the market decline was affected by macroeconomic conditions and (iv) whether the entity has the intent to sell the debt security or more likely than not will be required to sell the debt security before its anticipated recovery. The assessment of whether an other-than-temporary impairment exists involves a high degree of subjectivity and judgment and is based on information available to management at a point in time.

Fair values of financial instruments, in cases where quoted market prices are not available, are based on estimates using present value or other valuation techniques which are subject to change.

Real estate acquired in connection with foreclosures or in satisfaction of loans is adjusted to fair value based upon current estimates derived through independent appraisals less cost to sell. However, proceeds realized from sales may ultimately be higher or lower than those estimates.

Deferred tax assets and liabilities are recognized for the estimated future tax effects of temporary differences by applying enacted statutory tax rates to differences between the financial statement carrying amounts and the tax bases of existing assets and liabilities. The amount of deferred tax assets is reduced, if necessary, to the amount that, based on available evidence, will more likely than not be realized. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes.

For a further discussion of Peoples' critical accounting policies, refer to Note 1 entitled, "Summary of significant accounting policies," in the Notes to Consolidated Financial Statements of Peoples Financial Services Corp. found elsewhere in this joint proxy statement/prospectus. This note lists the significant accounting policies used by Peoples in the development and presentation of the financial statements. This MD&A, the Notes to Consolidated Financial Statements of Peoples Financial Services Corp. and other financial statement disclosures identify and address key variables and other qualitative and quantitative factors that are necessary for the understanding and evaluation of Peoples' financial position, results of operations and cash flows.

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## **Table of Contents**

### **Review of Financial Position**

Peoples is headquartered in Northeastern Pennsylvania and offer traditional bank products and services, including loans, deposits and wealth management services, through its wholly-owned subsidiary, Peoples Neighborhood Bank. Peoples Neighborhood Bank operates twelve full-service community banking offices located within the contiguous four-county market area of Lackawanna, Wyoming and Susquehanna Counties in Pennsylvania and Broome County in New York. Each office, interdependent with the community, offers a comprehensive array of financial products and services to individuals, small- and medium-sized businesses and government entities. Peoples Neighborhood Bank has three subsidiaries, Peoples Advisors LLC, Peoples Financial Leasing LLC and Peoples Neighborhood Abstract LLC. Peoples Wealth Management, a division of Peoples Advisors LLC, engages in selling insurance products and provides investment advisory services to the general public. Peoples Financial Leasing LLC provides employee leasing services to Peoples Neighborhood Bank. Peoples Neighborhood Abstract LLC, a limited liability company, offers title insurance and abstract services to residential and commercial mortgage loan customers.

The continued weakness in economic conditions did not affect Peoples operations in 2012. Demand for loans was robust in its market area, while deposit gathering strengthened. Contrary to many financial institutions, its asset quality improved as the ratio of problem assets declined.

Recent events surrounding certain of its competitors experiencing asset quality and regulatory issues favorably impacted its loan demand. These financial institutions were forced to focus their efforts on improving their asset quality which curtailed their emphasis on meeting the needs of their existing commercial customer base. In addition, at the close of 2010, a major competitor and the only other community bank located in its market area was acquired by a large regional bank. Small- and medium-sized commercial customers used to having direct access to senior management and other primary officers, being able to receive prompt locally made decisions and offered flexible and reasonable terms chose to abandon their relationships and transferred accounts to Peoples. As a result of these events, its loan origination efforts prospered in 2012.

In addition to the favorable impact caused by the loss of a major competitor in its market area, one of the other major influences causing the strength of deposit gathering in 2012 was the effect of natural gas drilling. Many customers who own land in rural sections of Northeastern Pennsylvania were offered significant sums of money, including a flat land lease fee per acre and royalties for any gas extracted, by natural gas companies for drilling rights to their properties. In order to respond to the needs of these customers, Peoples began offering investment products and services specifically tailored to meet these needs through its retail community offices and wealth management division. The favorable deposit growth was also a function of the increase in commercial deposits as Peoples was successful in acquiring accounts of local school districts and municipalities.

Total assets increased \$50.1 million or 8.1 percent to \$671.5 million at December 31, 2012, from \$621.4 million at December 31, 2011. Total assets averaged \$640.8 million in 2012, an increase of \$53.2 million or 9.1 percent from \$587.6 million in 2011. Earning assets averaged \$607.4 million and equaled 94.8 percent of total average assets in 2012, compared to \$557.2 million or 94.8 percent of total average assets in 2011.

The balance sheet growth was driven by an increase in total deposits of \$80.0 million or 16.2 percent to \$574.3 million at the end of 2012, from \$494.3 million at year-end 2011. The increase included a reclassification of approximately \$30.0 million of deposits previously classified as borrowings in 2012. Total interest-bearing deposits increased \$70.7 million or 17.6 percent, while noninterest-bearing deposits rose \$9.3 million or 10.0 percent. Now account growth of \$43.0 million and time deposit increases of \$8.8 million were primarily responsible for the change in interest-bearing deposits in 2012. Short-term interest rates remained at historically low levels in 2012. As a result, Peoples experienced an 18 basis point reduction in its cost of funds to 1.07 percent in 2012 from 1.25 percent in 2011.

Loans, net increased \$20.7 million or 4.7 percent to \$465.8 million at December 31, 2012, from \$445.1 million at December 31, 2011. Loans averaged \$462.1 million and represented 76.1 percent of average

**Table of Contents**

earning assets in 2012, compared to \$420.6 million or 75.5 percent in 2011. Corresponding with the reductions in short-term interest rates, the prime rate remained at 3.25 percent over the course of 2012. The tax-equivalent yield on the loan portfolio decreased 28 basis points to 5.36 percent in 2012 from 5.64 percent in 2011. Excess deposits not used to fund loans were directed into the investment portfolio. Investment securities available-for-sale increased \$7.9 million to \$147.8 million at the end of 2012 from \$139.9 million at December 31, 2011. Similar to loan yields, the tax-equivalent yield on the investment portfolio declined 97 basis points in 2012. Overall, Peoples experienced a 38 basis point reduction in the tax-equivalent yield on earning assets to 4.81 percent in 2012 from 5.19 percent in 2011.

Stockholders' equity equaled \$66.2 million or \$21.46 per share at December 31, 2012, and \$59.6 million or \$19.11 per share at December 31, 2011. Peoples leverage ratio was 9.17 percent at the end of 2012, compared to 9.42 percent at December 31, 2011. The leverage ratio, as well as all of its capital ratios, exceeded regulatory standards for well capitalized institutions. Accumulated other comprehensive income increased \$1.2 million from year-end 2011, which resulted directly from an increase in the fair value of investment securities available-for-sale.

**Investment Portfolio**

Primarily, Peoples' investment portfolio provides a source of liquidity needed to meet expected loan demand and generates a reasonable return in order to increase its profitability. Additionally, Peoples utilizes the investment portfolio to meet pledging requirements and reduce income taxes. At December 31, 2012, its portfolio consisted primarily of short-term U.S. Government mortgage-backed securities, which provide a source of liquidity and intermediate-term, tax-exempt state and municipal obligations, which mitigate its tax burden.

Its investment portfolio is subject to various risk elements that may negatively impact its liquidity and profitability. The greatest risk element affecting its portfolio is market risk or interest rate risk ( IRR ). Understanding IRR, along with other inherent risks and their potential effects, is essential in effectively managing the investment portfolio.

Market risk or IRR relates to the inverse relationship between bond prices and market yields. It is defined as the risk that increases in general market interest rates will result in market value depreciation. A marked reduction in the value of the investment portfolio could subject Peoples to liquidity strains and reduced earnings if it is unable or unwilling to sell these investments at a loss. Moreover, the inability to liquidate these assets could require it to seek alternative funding, which may further reduce profitability and expose it to greater risk in the future. In addition, since the entire investment portfolio is designated as available-for-sale and carried at estimated fair value, with net unrealized gains and losses reported as a separate component of stockholders' equity, market value depreciation could negatively impact its capital position.

During 2012, the Federal Open Market Committee ( FOMC ) indicated that economic conditions warrant maintaining exceptionally low levels for the federal funds rate for an extended period. Yields on short-term U.S. Treasury securities hovered around the target range for the federal funds rate of 0 to 25 basis points in 2012, as economic data suggested weak employment conditions and relatively low inflation. Although many indicators pointed to an improving economy, albeit at moderate to slow rates, investors sought the relative safety offered by the U.S. Treasury which caused intermediate-and long-term rates to decline throughout 2012. Peoples' investment portfolio consists primarily of fixed-rate bonds. As a result, changes in general market interest rates have a significant influence on the fair value of its portfolio. Specifically, the parts of the yield curve most closely related to its investments include the 2-year and 10-year U.S. Treasury securities. The yield on the 2-year U.S. Treasury note affects the values of its mortgage-backed securities, whereas the 10-year U.S. Treasury note influences the value of tax-exempt state and municipal obligations. The yield on the 2-year U.S. Treasury was unchanged throughout 2012 and closed the year at 0.25 percent. However, the yield on the 10-year U.S. Treasury declined 11 basis points from 1.89 percent at December 31, 2011, to 1.78 percent at December 31, 2012. Since bond prices move inversely to yields, Peoples experienced an increase in the aggregate fair value of its

**Table of Contents**

investment portfolio. Peoples reported net unrealized holding gains, included as a separate component of stockholders' equity of \$4.9 million, net of income taxes of \$2.5 million, at December 31, 2012, and \$3.6 million, net of income taxes of \$1.9 million, at December 31, 2011.

The carrying values of the major classifications of available-for-sale securities as they relate to the total investment portfolio for the past three years are summarized as follows:

**Distribution of investment securities available-for-sale**

December 31	2012		2011		2010	
	Amount	%	Amount	%	Amount	%
U.S. Government-sponsored enterprises	\$ 32,931	22.28%	\$ 32,776	23.43%	\$ 38,785	31.85%
State and municipals:						
Taxable	18,694	12.65	19,728	14.10	18,374	15.09
Tax-exempt	47,388	32.07	39,686	28.37	50,309	41.31
Corporate debt securities	3,871	2.62	3,850	2.75	4,020	3.30
Mortgage-backed securities:						
U.S. Government agencies	21,554	14.59	16,912	12.09	4,476	3.68
U.S. Government-sponsored enterprises	22,868	15.47	26,263	18.77	4,527	3.72
Equity securities:						
Preferred			117	0.08	54	0.04
Common	474	0.32	567	0.41	1,227	1.01
Total	\$ 147,780	100.00%	\$ 139,899	100.00%	\$ 121,772	100.00%

Investment securities available-for-sale increased \$7.9 million to \$147.8 million at December 31, 2012, from \$139.9 million at December 31, 2011. Deposit gathering was strong in 2012, as stock market volatility caused investors to seek safer alternatives and landowners in its market area continue to receive proceeds from leasing their properties to natural gas drilling companies. Excess deposited funds not used to fund loans were directed into the investment portfolio. Security purchases totaled \$35.1 million in 2012, with the majority of the purchases consisted of U.S. Government agency and U.S. Government-sponsored enterprise mortgage-backed securities and tax-exempt state and municipal obligations.

Repayments of investment securities totaled \$22.5 million in 2012. Peoples received proceeds of \$4.8 million from the sale of investment securities in 2012. Net gains recognized on the sale of investment securities available-for-sale totaled \$383 in 2012.

Peoples recognized other-than-temporary impairments ( OTTI ) of \$87 in 2011 and \$164 in 2010 as a result of writing down certain common equity securities. There were no OTTI recognized for the year ended December 31, 2012. For additional information related to OTTI refer to Note 3 entitled "Investment securities available-for-sale," in the Notes to Consolidated Financial Statements of Peoples Financial Services Corp. found elsewhere in this joint proxy statement/prospectus.

Investment securities averaged \$134.1 million and equaled 22.1 percent of average earning assets in 2012, compared to \$121.6 million and 21.8 percent in 2011. The tax-equivalent yield on the investment portfolio decreased 97 basis points to 3.27 percent in 2012 from 4.24 percent in 2011.

At December 31, 2012 and 2011, there were no securities of any individual issuer, except for U.S. Government agency mortgage-backed securities, that exceeded 10.0 percent of stockholders' equity.

The maturity distribution of the amortized cost, fair value and weighted-average, tax-equivalent yield of the available-for-sale portfolio at December 31, 2012, is summarized as follows. The weighted-average yield, based

**Table of Contents**

on amortized cost, has been computed for tax-exempt state and municipals on a tax-equivalent basis using the prevailing federal statutory tax rate of 34.0 percent. The distributions are based on contractual maturity with the exception of equity securities. Equity securities with no stated contractual maturities are included in the After ten years maturity distribution. Expected maturities may differ from contractual maturities because borrowers have the right to call or prepay obligations with or without call or prepayment penalties.

**Maturity distribution of available-for-sale portfolio**

December 31, 2012	Within one year		After one but within five years		After five but within ten years		After ten years		Total	
	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield
Amortized cost:										
U.S. Government-sponsored enterprises			\$ 15,770	3.16%	\$ 13,605	3.81%			\$ 29,375	3.46%
State and municipals:										
Taxable	\$ 240	2.72%			4,780	4.93	\$ 11,591	5.05%	16,611	4.98
Tax-exempt			8,914	1.93	14,216	3.94	22,350	6.40	45,480	4.75
Corporate debt securities			3,011	6.18	1,027	6.01			4,038	6.14
Mortgage-backed securities:										
U.S. Government agencies			3,020	1.75	14,661	1.04	3,851	2.81	21,532	1.46
U.S. Government-sponsored enterprises	3	6.18	6,770	1.02	12,262	1.00	3,833	2.31	22,868	1.23
Equity securities:										
Preferred										
Common							488	4.70	488	4.70
<b>Total</b>	<b>\$ 243</b>	<b>2.76%</b>	<b>\$ 37,485</b>	<b>2.61%</b>	<b>\$ 60,551</b>	<b>2.73%</b>	<b>\$ 42,113</b>	<b>5.31%</b>	<b>\$ 140,392</b>	<b>3.47%</b>
Fair value:										
U.S. Government-sponsored enterprises			\$ 17,242		\$ 15,689				\$ 32,931	
State and municipals:										
Taxable	\$ 243				5,370		\$ 13,081		18,694	
Tax-exempt			9,004		14,555		23,829		47,388	
Corporate debt securities			2,705		1,166				3,871	
Mortgage-backed securities:										
U.S. Government agencies			3,033		14,520		4,001		21,554	
U.S. Government-sponsored enterprises	3		6,779		12,232		3,854		22,868	
Equity securities:										
Preferred										
Common							474		474	
<b>Total</b>	<b>\$ 246</b>		<b>\$ 38,763</b>		<b>\$ 63,532</b>		<b>\$ 45,239</b>		<b>\$ 147,780</b>	

**Loan Portfolio:**

Economic factors and how they affect loan demand are of extreme importance to Peoples and the overall banking industry, as lending is a primary business activity. Loans are the most significant component of earning assets and they generate the greatest amount of revenue for it. Similar to the investment portfolio, there are risks inherent in the loan portfolio that must be understood and considered in managing the lending function. These risks include IRR, credit concentrations and fluctuations in demand. Changes in economic conditions and interest rates affect these risks which influence loan demand, the composition of the loan portfolio and profitability of the lending function.

**Table of Contents**

The composition of the loan portfolio at year-end for the past five years is summarized as follows:

**Distribution of loan portfolio**

December 31	2012		2011		2010		2009		2008	
	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
Commercial	\$ 170,379	36.58%	\$ 160,828	36.13%	\$ 112,526	28.80%	\$ 82,287	24.52%	\$ 71,723	22.65%
Real estate:										
Commercial	158,798	34.09	145,554	32.70	136,910	35.04	116,294	34.66	107,084	33.82
Residential	117,527	25.23	118,125	26.54	119,424	30.56	116,150	34.62	120,813	38.16
Consumer	19,069	4.10	20,596	4.63	21,912	5.60	20,802	6.20	16,988	5.37
Loans, net	465,773	100.00%	445,103	100.00%	390,772	100.00%	335,533	100.00%	316,608	100.00%
Less: allowance for loan loss	6,581		5,349		4,100		3,337		3,002	
Net loans	\$ 459,192		\$ 439,754		\$ 386,672		\$ 332,196		\$ 313,606	

Loans, net increased \$20.7 million or 4.7 percent to \$465.8 million at December 31, 2012, from \$445.1 million at the end of 2011. Business loans, including commercial loans and commercial mortgages, increased \$22.8 million to \$329.2 million at December 31, 2012, from \$306.4 million at year-end 2011. The strength of its loan demand was impacted by asset quality issues and merger related business disruptions of its competitors. Residential mortgages and consumer loans decreased \$0.6 million and \$1.5 million comparing December 31, 2012 and 2011.

Loans averaged \$462.1 million in 2012, an increase of \$41.5 million or 9.8 percent compared to \$420.6 million in 2011. Taxable loans increased \$39.2 million, while tax-exempt loans rose \$2.3 million. Due to the increase in loan demand, the loan portfolio played a more prominent role in its earning asset mix. As a percentage of earning assets, average loans equaled 76.1 percent in 2012 compared to 75.5 percent in 2011.

The prime rate was unchanged at 3.25 percent for 2012. The continuation of low interest rates caused the tax-equivalent yield on its loan portfolio to decrease 43 basis points to 5.21 percent in 2012 from 5.64 percent in 2011. The effect of market rates on its loan portfolio's yield can be further evidenced by evaluating quarterly loan yields, which continued to decline during 2012. After being unchanged in the first and second quarters at 5.45 percent, the tax-equivalent yield on the loan portfolio fell 11 basis points to 5.34 percent in the third quarter. Loan yields declined further in the fourth quarter, decreasing 10 basis points. With no anticipated date for change in general market rates in the near term, the yield on the loan portfolio may continue to decline as there are adjustable-rate loans in the portfolio that will reprice downward throughout the year. Moreover, increased competition will prompt more aggressive pricing for fixed rate intermediate term loans and lower yields further.

The maturity distribution and sensitivity information of the loan portfolio by major classification at December 31, 2012, is summarized as follows:

**Maturity distribution and interest sensitivity of loan portfolio**

December 31	Within one year	After one but within five years	After five years	Total
Maturity schedule:				
Commercial	\$ 25,996	\$ 53,640	\$ 90,743	\$ 170,379
Real estate:				
Commercial	10,189	40,093	108,516	158,798
Residential	5,473	22,074	89,980	117,527
Consumer	4,531	8,692	5,846	19,069
Total	\$ 46,189	\$ 124,499	\$ 295,085	\$ 465,773



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Predetermined interest rates	\$ 23,586	\$ 49,581	\$ 32,527	\$ 105,694
Floating or adjustable interest rates	22,603	74,918	262,558	360,079
Total	\$ 46,189	\$ 124,499	\$ 295,085	\$ 465,773

**Table of Contents**

As previously mentioned, there are numerous risks inherent in the loan portfolio. Peoples manages the portfolio by employing sound credit policies and utilizing various modeling techniques in order to limit the effects of such risks. In addition, it utilizes private mortgage insurance ( PMI ) and guaranteed Small Business Administration and Federal Home Loan Bank of Pittsburgh ( FHLB-Pgh ) loan programs to mitigate credit risk in the loan portfolio.

In an attempt to limit IRR and liquidity strains, Peoples continually examine the maturity distribution and interest rate sensitivity of the loan portfolio. For 2012, market interest rates remained at historically low levels. Given the potential for rates to rise in the future, it continued to place emphasis on originating short-term, fixed-rate and adjustable-rate loans. Fixed-rate loans represented 22.7 percent of the loan portfolio at December 31, 2012, compared to floating or adjustable-rate loans at 77.3 percent. Fixed-rate loans increased \$9.1 million to \$105.7 million at December 31, 2012 from \$96.6 million at December 31, 2011. Comparatively, floating or adjustable-rate loans increased \$11.6 million in 2012. Approximately 39.0 percent of the loan portfolio is expected to reprice within the next 12 months.

Additionally, its secondary market mortgage banking program provides it with an additional source of liquidity and a means to limit Peoples exposure to IRR. Through this program, Peoples is able to competitively price conforming one-to-four family residential mortgage loans without taking on IRR which would result from retaining these long-term, low fixed-rate loans on its books. The loans originated are subsequently sold in the secondary market, with the sales price locked in at the time of commitment, thereby greatly reducing its exposure to IRR.

Loan concentrations are considered to exist when the total amount of loans to any one borrower, or a multiple number of borrowers engaged in similar business activities or having similar characteristics, exceeds 10.0 percent of loans outstanding in any one category. Peoples provides deposit and loan products and other financial services to individual and corporate customers in its four-county market area. There are no significant concentrations of credit risk from any individual counterparty or groups of counterparties, except for geographic concentrations.

In addition to the risks inherent in its loan portfolio, in the normal course of business, Peoples is also a party to financial instruments with off-balance sheet risk to meet the financing needs of its customers. These instruments include legally binding commitments to extend credit, unused portions of lines of credit and commercial letters of credit, and may involve, to varying degrees, elements of credit risk and IRR in excess of the amount recognized in the financial statements.

Credit risk is the principal risk associated with these instruments. Peoples involvement and exposure to credit loss in the event that the instruments are fully drawn upon and the customer defaults is represented by the contractual amounts of these instruments. In order to control credit risk associated with entering into commitments and issuing letters of credit, Peoples employs the same credit quality and collateral policies in making commitments that it uses in other lending activities. Peoples evaluates each customer's creditworthiness on a case-by-case basis, and if deemed necessary, obtain collateral. The amount and nature of the collateral obtained is based on its credit evaluation.

The contractual amounts of off-balance sheet commitments at year-end for the past three years are summarized as follows:

**Distribution of off-balance sheet commitments**

<b>December 31</b>	<b>2012</b>	<b>2011</b>	<b>2010</b>
Commitments to extend credit	\$ 8,563	\$ 7,429	\$ 5,617
Unused portions of lines of credit	57,133	45,320	32,225
Commercial letters of credit	11,646	17,051	18,170
Total	\$ 77,342	\$ 69,800	\$ 56,012

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## **Table of Contents**

Peoples records an allowance for off-balance sheet credit losses, if deemed necessary, separately as a liability. No allowance was deemed necessary at December 31, 2012 and 2011. Peoples does not anticipate that losses, if any, that may occur as a result of funding off-balance sheet commitments, would have a material adverse effect on its operating results or financial position.

### **Asset Quality**

Peoples is committed to developing and maintaining sound, quality assets through its credit risk management policies and procedures. Credit risk is the risk to earnings or capital which arises from a borrower's failure to meet the terms of their loan agreement. Peoples manages credit risk by diversifying the loan portfolio and applying policies and procedures designed to foster sound lending practices. These policies include certain standards that assist lenders in making judgments regarding the character, capacity, capital structure and collateral of the borrower.

With regard to managing its exposure to credit risk in light of general devaluations in real estate values, Peoples has established maximum loan-to-value ratios for commercial mortgage loans not to exceed 75.0 percent of the lower of cost or appraised value. With regard to residential mortgages, customers with loan-to-value ratios between 80.0 percent and 100.0 percent are required to obtain PMI. There are no residential mortgage loans outstanding with loan-to-value ratios in excess of 100.0 percent. The 80.0 percent loan-to-value threshold provides a cushion in the event the property is devalued. PMI is used to protect us from loss in the event loan-to-value ratios exceed 80.0 percent and the customer defaults on the loan. Written appraisals are obtained prior to final approval for all real estate loans. Appraisals are performed by an independent appraiser engaged by it, not the customer, who is either state certified or state licensed depending upon collateral type and loan amount.

With respect to lending procedures, lenders must determine the borrower's ability to repay the credit based on prevailing and expected market conditions prior to requesting approval for the loan. The board of directors establishes and reviews, at least annually, the lending authority for all loan officers and branch managers. Credits beyond the scope of the loan officers and branch managers are forwarded to the loan committee. This committee, comprised of senior management, attempts to assure the quality of the loan portfolio through careful analysis of credit applications, adherence to credit policies and the examination of outstanding loans and delinquencies. These procedures assist in the early detection and timely follow-up of problem loans. Credits having an aggregated relationship of \$2.5 million are subject to approval by its board of directors.

Credit risk is also minimized by quarterly internal reviews of the loan portfolio by the loan quality committee. These reviews aid Peoples in identifying deteriorating financial conditions of borrowers, allowing Peoples to assist customers in remedying these situations.

Nonperforming assets consist of nonperforming loans and foreclosed assets. Nonperforming loans include nonaccrual loans, restructured loans and accruing loans past due 90 days or more. For a discussion of its policy regarding nonperforming assets and the recognition of interest income on impaired loans, refer to the notes entitled, "Summary of significant accounting policies Nonperforming assets," and "Loans, net and allowance for loan losses" in the Notes to Consolidated Financial Statements of Peoples Financial Services Corp. located elsewhere in this joint proxy statement/prospectus.

Information concerning nonperforming assets for the past five years is summarized as follows. The table includes credits classified for regulatory purposes and all material credits that cause management to have serious doubts as to the borrower's ability to comply with present loan repayment terms.

**Table of Contents****Distribution of nonperforming assets**

<b>December 31</b>	<b>2012</b>	<b>2011</b>	<b>2010</b>	<b>2009</b>	<b>2008</b>
<b>Nonaccrual loans:</b>					
Commercial	\$ 2,278	\$ 5,871	\$ 5,490	\$ 59	\$ 244
<b>Real estate:</b>					
Commercial	4,171	1,170	371	2,469	358
Residential	1,485	889	630		227
Consumer			22		
<b>Total nonaccrual loans</b>	<b>7,934</b>	<b>7,930</b>	<b>6,513</b>	<b>2,528</b>	<b>829</b>
<b>Restructured loans:</b>					
Commercial	1,641	1,667		559	
<b>Real estate:</b>					
Commercial					4,042
Residential					
Consumer					
<b>Total restructured loans</b>	<b>1,641</b>	<b>1,667</b>		<b>559</b>	<b>4,042</b>
<b>Accruing loans past due 90 days or more:</b>					
Commercial	324	12	123	21	177
<b>Real estate:</b>					
Commercial	22			218	68
Residential	21	337			
Consumer	494	311	269		
<b>Total accruing loans past due 90 days or more</b>	<b>861</b>	<b>660</b>	<b>392</b>	<b>239</b>	<b>245</b>
<b>Total nonperforming loans</b>	<b>10,436</b>	<b>10,257</b>	<b>6,905</b>	<b>3,326</b>	<b>5,116</b>
<b>Foreclosed assets</b>	<b>2,003</b>	<b>399</b>	<b>3,387</b>	<b>5,534</b>	<b>5,171</b>
<b>Total nonperforming assets</b>	<b>\$ 12,439</b>	<b>\$ 10,656</b>	<b>\$ 10,292</b>	<b>\$ 8,860</b>	<b>\$ 10,287</b>
<b>Nonperforming loans as a percentage of loans, net</b>	<b>2.24%</b>	<b>2.30%</b>	<b>1.77%</b>	<b>0.99%</b>	<b>1.63%</b>
<b>Nonperforming assets as a percentage of loans, net and foreclosed assets</b>	<b>2.66%</b>	<b>2.39%</b>	<b>2.61%</b>	<b>2.60%</b>	<b>3.23%</b>

Peoples maintains the allowance for loan losses at a level it believes adequate to absorb probable credit losses related to individually evaluated loans, as well as probable incurred losses inherent in the remainder of the loan portfolio as of the balance sheet date. The balance in the allowance for loan losses account is based on past events and current economic conditions. Peoples employs the FFIEC Interagency Policy Statement, as amended, and GAAP in assessing the adequacy of the allowance account. Under GAAP, the adequacy of the allowance account is determined based on the provisions of FASB Accounting Standards Codification ( ASC ) 310 for loans specifically identified to be individually evaluated for impairment and the requirements of FASB ASC 450, for large groups of smaller-balance homogeneous loans to be collectively evaluated for impairment.

Peoples follows its systematic methodology in accordance with procedural discipline by applying it in the same manner regardless of whether the allowance is being determined at a high point or a low point in the economic cycle. Each quarter, its loan review division identifies those loans to be individually evaluated for impairment and those to be collectively evaluated for impairment utilizing a standard criteria. Internal loan review grades are assigned quarterly to loans identified to be individually evaluated. A loan's grade may differ from period to period based on current conditions and events, however, it consistently utilizes the same grading system each quarter. Peoples consistently uses loss experience from the latest twelve quarters in determining the historical loss factor for each pool collectively evaluated for impairment. Qualitative factors are evaluated in the



**Table of Contents**

same manner each quarter and are adjusted within a relevant range of values based on current conditions to assure directional consistency of the allowance for loan loss account. Regulators, in reviewing the loan portfolio as part of the scope of a regulatory examination, may require the Company to increase its allowance for loan losses.

For a further discussion of its accounting policies for determining the amount of the allowance and a description of the systematic analysis and procedural discipline applied, refer to the note entitled, "Summary of significant accounting policies - Allowance for loan losses," in the Notes to Consolidated Financial Statements of Peoples Financial Services Corp. located elsewhere in this joint proxy statement/prospectus.

A reconciliation of the allowance for loan losses and an illustration of charge-offs and recoveries by major loan category for the past five years are summarized as follows:

**Reconciliation of allowance for loan losses**

<b>December 31</b>	<b>2012</b>	<b>2011</b>	<b>2010</b>	<b>2009</b>	<b>2008</b>
Allowance for loan losses at beginning of period	\$ 5,349	\$ 4,100	\$ 3,337	\$ 3,002	\$ 2,451
Loans charged-off:					
Commercial	258	374	1,360	419	49
Real estate:					
Commercial	100	77		948	93
Residential	96	9	25	46	4
Consumer	148	139	104	134	100
Total	602	599	1,489	1,547	246
Loans recovered:					
Commercial	12	1	19	48	11
Real estate:					
Commercial		2		50	
Residential	74	1		3	34
Consumer	53	50	31	46	39
Total	139	54	50	147	84
Net loans charged-off	463	545	1,439	1,400	162
Provision for loan losses	1,695	1,794	2,202	1,735	713
Allowance for loan losses at end of period	\$ 6,581	\$ 5,349	\$ 4,100	\$ 3,337	\$ 3,002
Ratios:					
Net loans charged-off as a percentage of average loans outstanding	0.10%	0.13%	0.40%	0.43%	0.05%
Allowance for loan losses as a percentage of period end loans	1.41%	1.20%	1.05%	0.99%	0.95%

The allowance for loan losses increased \$1,232 to \$6,581 at December 31, 2012, from \$5,349 at the end of 2011. The increase resulted from a provision for loan losses of \$1,695 exceeding net loans charged-off of \$463. The allowance for loan losses, as a percentage of loans, net of unearned income, was 1.41 percent at the end of 2012, compared to 1.20 percent at the end of 2011.

Past due loans not satisfied through repossession, foreclosure or related actions are evaluated individually to determine if all or part of the outstanding balance should be charged against the allowance for loan losses account. Any subsequent recoveries are credited to the allowance account. Net loans charged-off decreased \$82 or 15.0 percent to \$463 in 2012 from \$545 in 2011. Net charge-offs, as a percentage of average loans outstanding, equaled 0.10 percent in 2012 and 0.13 percent in 2011.



**Table of Contents**

The allocation of the allowance for loan losses for the past five years is summarized as follows:

**Allocation of the allowance for loan losses**

December 31	2012		2011		2010		2009		2008	
	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
Allocated allowance:										
Specific:										
Commercial	\$ 327	1.11%	\$ 698	1.89%	\$ 663	1.51%	\$ 108	2.58%	\$ 243	0.38%
Real Estate:										
Commercial	239	1.53	40	1.76	122	2.28	578	0.31	331	1.39
Residential	283	0.33	71	0.28	9	0.17	18	0.11	30	0.05
Consumer	6		1		31	0.01	17	0.01		
Total specific	855	2.97	810	3.93	825	3.97	721	3.01	604	1.82
Formula:										
Commercial	1,697	35.47	1,349	34.24	1,033	27.28	178	21.94	152	22.27
Real Estate:										
Commercial	1,862	32.56	1,475	30.94	1,262	32.75	1,434	34.35	1,233	32.43
Residential	923	24.90	690	26.26	717	30.39	728	34.51	608	38.11
Consumer	228	4.10	197	4.63	212	5.61	199	6.19	151	5.37
Total formula	4,710	97.03	3,711	96.07	3,224	96.03	2,539	96.99	2,144	98.18
Total allocated allowance	5,565	100.00%	4,521	100.00%	4,049	100.00%	3,260	100.00%	2,748	100.00%
Unallocated allowance	1,016		828		51		77		254	
Total	\$ 6,581		\$ 5,349		\$ 4,100		\$ 3,337		\$ 3,002	

The allocated element of the allowance for loan losses account increased \$1,044 to \$5,565 at December 31, 2012, compared to \$4,521 at December 31, 2011. Both the specific and formula portions of the allowance for loan losses increased from the end of 2011. The specific portion of the allowance for impairment of loans individually evaluated under FASB ASC 310, increased \$45 to \$855 at December 31, 2012, from \$810 at year-end 2011. In addition, the formula portion of the allowance for loans collectively evaluated for impairment under FASB ASC 450, increased \$999 to \$4,710 at December 31, 2012, from \$3,711 at December 31, 2011. The total loss factor for collectively evaluated loans increased from year-end 2011 due an increase in the qualitative factors related to the continued unrest in the economic climate.

The unallocated element equaled \$1,016 representing 15.4 percent of the total allowance for loan losses at December 31, 2012, compared to \$828 or 15.5 percent at December 31, 2011. Peoples believes the increase in the unallocated element was appropriate given the significant growth in the loan portfolio and the higher amount of commercial loan originations, which have a greater degree of complexity as compared to other loan types. Moreover, the increase is directionally consistent in accordance with supervisory guidance on the allowance for loan losses.

As is inherent with all estimates, the allowance for loan losses methodology is subject to a certain level of imprecision as it provides reasonable, but not absolute, assurance that the allowance will be able to absorb probable losses, in their entirety, as of the financial statement date. Factors, among others, including judgments made in identifying those loans considered impaired, appraisals of collateral values and measurements of certain qualitative factors, all cause this imprecision and support the establishment of the unallocated element. Peoples believes the unallocated element is sufficient to cover any inherent losses in the loan portfolio that have not been identified as part of the allocated element at December 31, 2012.



**Table of Contents**

The coverage ratio, the allowance for loan losses account, as a percentage of nonperforming loans, is an industry ratio used to test the ability of the allowance account to absorb potential losses arising from nonperforming loans. The coverage ratio was 63.1 percent at December 31, 2012, compared to 52.1 percent at December 31, 2011. Peoples believes that its allowance account was adequate to absorb probable credit losses at December 31, 2012.

**Deposits**

Peoples deposit base is the primary source of funds to support its operations. Peoples offer a variety of deposit products to meet the needs of its individual and commercial customers. Similar to the banking industry, it also experienced strong demand for its deposit products for the third consecutive year. Total deposits grew \$80.0 million or 16.2 percent to \$574.3 million at December 31, 2012, from \$494.3 million at the end of 2011. As aforementioned, the deposit increase in 2012 included a reclassification of approximately \$30.0 million of deposits previously classified as short-term borrowings. In comparison, total deposits increased \$55.5 million or 12.7 percent in 2011. For 2012, interest-bearing accounts increased \$70.7 million or 17.6 percent. Its success in acquiring deposits was impacted by the acquisition of a primary competitor in the market by a large regional financial institution in 2010. Being the only community bank in its market area, Peoples has the distinct competitive advantage of being able to offer customers direct access to senior management with the autonomy to make prompt decisions regarding customer accounts. Its deposit gathering was also significantly affected by the influx of deposits from natural gas drilling activities within its market area. As a result, Peoples experienced an aggregate increase in interest-bearing transaction accounts, which include money market, NOW and savings accounts, of \$61.9 million. Noninterest-bearing accounts rose \$9.3 million or 10.0 percent, partially due to the increase in commercial relationships.

The average amount of, and the rate paid on, the major classifications of deposits for the past three years are summarized as follows:

**Deposit distribution**

Year Ended December 31	2012		2011		2010	
	Average Balance	Average Rate	Average Balance	Average Rate	Average Balance	Average Rate
Interest-bearing:						
Money market accounts	\$ 37,277	0.56%	\$ 39,927	0.63%	\$ 36,829	0.75%
NOW accounts	75,930	0.58	49,299	0.58	42,992	0.70
Savings accounts	208,309	0.61	194,523	0.80	187,007	1.08
Time deposits less than \$100	79,899	2.13	75,216	2.31	70,269	2.44
Time deposits \$100 or more	32,790	2.12	28,729	2.06	20,253	1.90
Total interest-bearing	434,205	0.99%	387,694	1.14%	357,350	1.31%
Noninterest-bearing	96,722		81,224		72,846	
Total deposits	\$ 530,927		\$ 468,918		\$ 430,196	

Total deposits averaged \$530.9 million in 2012, an increase of \$62.0 million or 13.2 percent, compared to \$468.9 million in 2011. Average noninterest-bearing deposits increased \$15.5 million or 19.1 percent, while average interest-bearing accounts grew \$46.5 million or 12.0 percent. With regard to average interest-bearing deposits, average total time deposits increased \$8.7 million and average savings accounts increased \$13.8 million. Peoples continued to experience strong growth in these account types, as customers continued to receive lease payments and royalties from gas companies for drilling rights to their properties. The change in average NOW accounts was impacted primarily by the previously mentioned reclassification of short-term borrowings.

**Table of Contents**

As a result of a strong liquidity position, Peoples did not have to aggressively compete for deposits in 2012. In an effort to mitigate stress placed on its tax-equivalent net interest margin from reduction in the repricing yields on earning assets, Peoples aggressively lowered its deposit rates. However being a community bank, it still wanted to retain its current customer base and protect its market share despite realizing the need to lower operating expenses. For 2012, it introduced promotional rates on a long-term certificate of deposit with an 84-month maturity term, in order to entice depositors to lock in for a longer term at comparatively lower interest rates than historically offered. As a result of the actions taken, with respect to pricing, its cost of deposits fell 15 basis points to 0.99 percent in 2012, from 1.14 percent in 2011. In anticipation of market rates remaining at current levels, Peoples expects its cost of deposits to be favorable. However, no assurance can be given that interest rates will remain low. In addition, should competition increase in its market areas, it may need to compete more aggressively for deposits to support its liquidity position, thereby adversely affecting its deposit costs.

Volatile deposits, time deposits \$100 or more, decreased \$1.5 million to \$35.2 million at December 31, 2012, from \$36.7 million at the end of 2011. Large denomination time deposits averaged \$32.8 million in 2012, an increase of \$4.1 million or 14.1 percent from \$28.7 million in 2011. Peoples average cost of these funds increased 6 basis points to 2.12 percent in 2012, from 2.06 percent in 2011. This type of funding is susceptible to withdrawal by the depositor as they are particularly price sensitive and are therefore not considered to be a strong source of liquidity.

Maturities of time deposits \$100 or more for the past three years are summarized as follows:

**Maturity distribution of time deposits \$100 or more**

<b>December 31</b>	<b>2012</b>	<b>2011</b>	<b>2010</b>
Within three months	\$ 5,148	\$ 6,984	\$ 7,492
After three months but within six months	1,016	2,212	1,574
After six months but within twelve months	2,985	3,552	2,223
After twelve months	26,076	23,987	15,997
<b>Total</b>	<b>\$ 35,225</b>	<b>\$ 36,735</b>	<b>\$ 27,286</b>

In addition to deposit gathering, it has in place a secondary source of liquidity to fund operations through exercising existing credit arrangements with the FHLB-Pgh. Peoples had only minimal reliance on this type of funding in 2012 and 2011. For a further discussion of its borrowings and their terms, refer to the note entitled, Short-term borrowings, in the Notes to Consolidated Financial Statements of Peoples Financial Services Corp. located elsewhere in this joint proxy statement/prospectus.

**Market Risk Sensitivity:**

Market risk is the risk to its earnings and/or financial position resulting from adverse changes in market rates or prices, such as interest rates, foreign exchange rates or equity prices. Peoples exposure to market risk is primarily IRR associated with its lending, investing and deposit gathering activities. During the normal course of business, Peoples is not exposed to foreign exchange risk or commodity price risk. Its exposure to IRR can be explained as the potential for change in its reported earnings and/or the market value of its net worth. Variations in interest rates affect the underlying economic value of its assets, liabilities and off-balance sheet items. These changes arise because the present value of future cash flows, and often the cash flows themselves, change with interest rates. The effects of the changes in these present values reflect the change in its underlying economic value, and provide a basis for the expected change in future earnings related to interest rates. Interest rate changes affect earnings by changing net interest income and the level of other interest-sensitive income and operating expenses. IRR is inherent in the role of banks as financial intermediaries. However, a bank with a high degree of

**Table of Contents**

IRR may experience lower earnings, impaired liquidity and capital positions, and most likely, a greater risk of insolvency. Therefore, banks must carefully evaluate IRR to promote safety and soundness in their activities.

The FOMC has maintained the target range for the federal funds rate at 0 to 25 basis points and has indicated that economic conditions are likely to continue to warrant these exceptionally low interest rate levels for some time. Given these conditions, IRR and the ability to effectively manage it, are extremely critical to both bank management and regulators. The FFIEC recently issued an advisory reiterating the importance of effective corporate governance, policies and procedures, risk measuring and monitoring systems, stress testing and internal controls related to the IRR exposure of depository institutions. According to the advisory, the bank regulators believe that the current financial market and economic conditions present significant risk management challenges to all financial institutions. Although the bank regulators recognize that some degree of IRR is inherent in banking, they expect institutions to have sound risk management practices in place to measure, monitor and control IRR exposure. The advisory states that the adequacy and effectiveness of an institution's IRR management process and the level of IRR exposure are critical factors in the bank regulators' evaluation of an institution's sensitivity to changes in interest rates and capital adequacy. Material weaknesses in risk management processes or high levels of IRR exposure relative to capital will require corrective action. Peoples believes its risk management practices with regard to IRR were sound, suitable and adequate given the level of IRR exposure at December 31, 2012.

The Asset/Liability Committee (ALCO), comprised of members of its board of directors, senior management and other appropriate officers, oversees its IRR management program. Specifically, ALCO analyzes economic data and market interest rate trends, as well as competitive pressures, and utilizes several computerized modeling techniques to reveal potential exposure to IRR. This allows management to monitor and attempt to control the influence these factors may have on its rate sensitive assets (RSA), rate sensitive liabilities (RSL) and overall operating results and financial position.

With respect to evaluating its exposure to IRR on earnings, Peoples utilizes a gap analysis model that considers repricing frequencies of RSA and RSL. Gap analysis attempts to measure its interest rate exposure by calculating the net amount of RSA and RSL that reprice within specific time intervals. A positive gap occurs when the amount of RSA repricing in a specific period is greater than the amount of RSL repricing within that same time frame and is indicated by a RSA/RSL ratio greater than 1.0. A negative gap occurs when the amount of RSL repricing is greater than the amount of RSA and is indicated by a RSA/RSL ratio less than 1.0. A positive gap implies that earnings will be impacted favorably if interest rates rise and adversely if interest rates fall during the period. A negative gap tends to indicate that earnings will be affected inversely to interest rate changes.

Peoples interest rate sensitivity gap position, illustrating RSA and RSL at their related carrying values, is summarized as follows. The distributions in the table are based on a combination of maturities, call provisions, repricing frequencies and prepayment patterns. Adjustable-rate assets and liabilities are distributed based on the repricing frequency of the instrument. Mortgage instruments are distributed in accordance with estimated cash flows, assuming there is no change in the current interest rate environment.

**Table of Contents****Interest rate sensitivity**

<b>December 31, 2012</b>	<b>Due within three months</b>	<b>Due after three months but within twelve months</b>	<b>Due after one year but within five years</b>	<b>Due after five years</b>	<b>Total</b>
<b>Rate-sensitive assets:</b>					
Interest-bearing deposits in other banks	\$ 1,126				\$ 1,126
Federal funds sold	17,180				17,180
Investment securities available-for-sale	8,489	\$ 14,173	\$ 68,735	\$ 56,383	147,780
Loans held for sale	1,917				1,917
Loans, net	106,692	74,795	214,561	69,725	465,773
<b>Total rate-sensitive assets</b>	<b>\$ 135,404</b>	<b>\$ 88,968</b>	<b>\$ 283,296</b>	<b>\$ 126,108</b>	<b>\$ 633,776</b>
<b>Rate-sensitive liabilities:</b>					
Money market accounts	\$ 21,419		\$ 20,481		\$ 41,900
NOW accounts	66,833	30,571			97,404
Savings accounts	163,295		51,957		215,252
Time deposits less than \$100	10,913	14,765	43,883	12,647	82,208
Time deposits \$100 or more	5,148	4,001	16,968	9,108	35,225
Short-term borrowings	12,764				12,764
Long-term debt	10,205	836	2,089		13,130
<b>Total rate-sensitive liabilities</b>	<b>\$ 290,577</b>	<b>\$ 50,173</b>	<b>\$ 135,378</b>	<b>\$ 21,755</b>	<b>\$ 497,883</b>
<b>Rate-sensitivity gap:</b>					
Period	\$ (155,173)	\$ 38,795	\$ 147,918	\$ 104,353	
Cumulative	\$ (155,173)	\$ (116,378)	\$ 31,540	\$ 135,893	
<b>RSA/RSL ratio:</b>					
Period	0.47	1.77	2.09	5.80	
Cumulative	0.47	0.66	1.07	1.27	1.27

At December 31, 2012, Peoples was in a negative gap position with a cumulative one-year RSA/RSL ratio of 0.66. Similarly, at December 31, 2011, its cumulative one-year RSA/RSL ratio was 0.65. Given the economic conditions which included an exceptionally low short-term interest rate environment, the focus of ALCO during 2012 was to reduce the negative gap position in order to provide equilibrium between RSA and RSL. Specifically throughout 2012, Peoples attempted to increase the volume of loans with short repricing terms in order to restore a balanced IRR position. In addition, Peoples began offering preferential rates on longer-term certificates of deposit, including 72- and 84-month maturities. The positive impact on its gap position from implementing these strategic initiatives was partially negated as customer interest in transaction type accounts became more popular as a means of storing funds obtained from natural gas drilling activities. ALCO will reemphasize these strategies in 2013 in an attempt to restore equilibrium between RSA and RSL. However, these forward-looking statements are qualified in the aforementioned section entitled *Forward-Looking Statements* in this MD&A.

Static gap analysis, although a credible measuring tool, does not fully illustrate the impact of interest rate changes on future earnings. First, market rate changes normally do not equally or simultaneously affect all categories of assets and liabilities. Second, assets and liabilities that can contractually reprice within the same period may not do so at the same time or to the same magnitude. Third, the interest rate sensitivity table presents a one-day position and variations occur daily as it adjusts its rate sensitivity throughout the year. Finally, assumptions must be made in constructing such a table. For example, the conservative nature of its Asset/Liability Management Policy assigns personal NOW accounts to the Due after three months but within twelve months repricing interval and personal money market accounts to the Due after one year but within five years repricing interval. In reality, these accounts may reprice less frequently and in different magnitudes than changes in general market interest rate levels.

## **Table of Contents**

Peoples utilizes a simulation model to address the failure of the static gap model to address the dynamic changes in the balance sheet composition or prevailing interest rates and to enhance its asset/liability management. This model creates *pro forma* net interest income scenarios under various interest rate shocks. Given instantaneous and parallel shifts in general market rates of plus 100 basis points, its projected net interest income for the 12 months ending December 31, 2013, would decrease slightly at 0.4 percent from model results using current interest rates. Model results under a minus 100 basis point scenario were not meaningful, as the majority of short-term general market rates are already near zero.

Peoples will continue to monitor its IRR position in 2013 and employ deposit and loan pricing strategies and direct the reinvestment of loan and investment payments and prepayments in order to maintain a favorable IRR position.

Financial institutions are affected differently by inflation than commercial and industrial companies that have significant investments in fixed assets and inventories. Most of its assets are monetary in nature and change correspondingly with variations in the inflation rate. It is difficult to precisely measure the impact inflation has on Peoples, however, it believe that its exposure to inflation can be mitigated through its asset/liability management program.

## **Liquidity**

Liquidity management is essential to Peoples continuing operations as it gives it the ability to meet its financial obligations as they come due, as well as to take advantage of new business opportunities as they arise. Its financial obligations include, but are not limited to, the following:

Funding new and existing loan commitments;

Payment of deposits on demand or at their contractual maturity;

Repayment of borrowings as they mature;

Payment of lease obligations; and

Payment of operating expenses.

Peoples liquidity position is impacted by several factors which include, among others, loan origination volumes, loan and investment maturity structure and cash flows, demand for core deposits and certificate of deposit maturity structure and retention. Peoples manage these liquidity risks daily, thus enabling management to effectively monitor fluctuations in its position and to adapt its position according to market influence and balance sheet trends. Peoples also forecasts future liquidity needs and develop strategies to ensure adequate liquidity at all times.

Historically, core deposits have been Peoples primary source of liquidity because of their stability and lower cost, in general, than other types of funding. Providing additional sources of funds are loan and investment payments and prepayments and the ability to sell both available-for-sale securities and mortgage loans held for sale. Peoples believes its liquidity is adequate to meet both present and future financial obligations and commitments on a timely basis.

Peoples maintains a Contingency Funding Plan to address liquidity in the event of a funding crisis. Examples of some of the causes of a liquidity crisis include, among others, natural disasters, war, events causing reputational harm and severe and prolonged asset quality problems. The Plan recognizes the need to provide alternative funding sources in times of crisis that go beyond its core deposit base. As a result, it has created a funding program that ensures the availability of various alternative wholesale funding sources that can be used whenever appropriate. Identified alternative funding sources include:

FHLB-Pgh liquidity contingency line of credit;

Federal Reserve Bank discount window;

**Table of Contents**

Internet certificates of deposit;

Brokered deposits;

Institutional Deposit Corporation deposits;

Repurchase agreements; and

Federal funds purchased.

Based on its liquidity position at December 31, 2012, Peoples does not anticipate the need to utilize any of these sources in the near term.

Peoples employs a number of analytical techniques in assessing the adequacy of its liquidity position. One such technique is the use of ratio analysis to illustrate its reliance on noncore funds to fund its investments and loans maturing after 2013. At December 31, 2012, its noncore funds consisted of time deposits in denominations of \$100 or more, repurchase agreements, short-term borrowings and long-term debt. Large denomination time deposits are particularly not considered to be a strong source of liquidity since they are very interest rate sensitive and are considered to be highly volatile. At December 31, 2012, its net noncore funding dependence ratio, the difference between noncore funds and short-term investments to long-term assets, was 3.7 percent. Its net short-term noncore funding dependence ratio, noncore funds maturing within one year, less short-term investments to long-term assets equaled -1.7 percent. Comparatively, its ratios equaled 13.6 percent and 6.4 percent at the end of 2011, which indicated a decrease in its reliance on noncore funds. Peoples believes that by supplying adequate volumes of short-term investments and implementing competitive pricing strategies on deposits, it can ensure adequate liquidity to support future growth.

The Consolidated Statements of Cash Flows present the change in cash and cash equivalents from operating, investing and financing activities. Cash and cash equivalents consist of cash on hand, cash items in the process of collection, noninterest-bearing and interest-bearing deposits with other banks and federal funds sold. Cash and cash equivalents increased \$17.5 million for the year ended December 31, 2012. Conversely, for the year ended December 31, 2011, cash and cash equivalents decreased \$7.3 million. During 2012, cash provided by operating and financing activities more than offset cash used in investing activities.

Operating activities provided net cash of \$11.2 million in 2012 and \$8.9 million in 2011. Net income, adjusted for the effects of noncash expenses such as depreciation and the provision for loan losses is the primary source of funds from operations.

Net cash provided by financing activities equaled \$39.4 million in 2012 and \$49.0 million in 2011. Deposit gathering, which is Peoples predominant financing activity, increased significantly in both 2012 and 2011. Deposit gathering provided a net cash inflow in 2012 of \$80.0 million and \$55.5 million in 2011. Partially offsetting the cash provided by deposit gathering in 2012 was a \$31.0 million net decrease in short-term borrowings and a \$5.8 million repayment of long-term debt.

Peoples primary investing activities involve transactions related to its investment and loan portfolios. Net cash used in investing activities totaled \$33.1 million in 2012, a decrease of \$32.1 million from \$65.2 million in 2011. Net cash used in lending activities was \$23.4 million and \$52.7 million in 2012 and 2011. Activities related to its investment portfolio used net cash of \$7.7 million in 2012 and \$12.2 million in 2011.

Peoples anticipates its liquidity position to be stable in 2013. Although it is expecting loan demand to continue to be strong, it expects to fund such demand through deposit gathering and payments and prepayments on loans and investments. As the infrastructure for natural gas drilling grows, deposit receipts from royalties are anticipated to ramp up. Moreover, continued weakness in economic conditions and equity markets may result in increased interest in bank deposits, as consumers continue to save rather than spend. However, Peoples cannot predict the economic climate or the savings habits of consumers. Should economic conditions improve, deposit

**Table of Contents**

gathering may be negatively impacted as depositors seek alternative investments in the market. Regardless of economic conditions and stock market fluctuations, it believes that through constant monitoring and adherence to its liquidity plan, it will have the means to provide adequate cash to fund its normal operations in 2013.

**Capital Adequacy**

Peoples believes a strong capital position is essential to its continued growth and profitability. Peoples strives to maintain a relatively high level of capital to provide its depositors and stockholders with a margin of safety. In addition, a strong capital base allows it to take advantage of profitable opportunities, support future growth and provide protection against any unforeseen losses.

Bank regulatory agencies consider capital to be a significant factor in ensuring the safety of a depositor's accounts. These agencies have adopted minimum capital adequacy requirements that include mandatory and discretionary supervisory actions for noncompliance. Peoples and Peoples Neighborhood Bank's risk-based capital ratios are strong and have consistently exceeded the minimum regulatory capital ratios of 4.0 percent and 8.0 percent required for adequately capitalized institutions. Peoples ratio of tier I capital to risk-weighted assets and off-balance sheet items was 12.1 percent at December 31, 2012, and 11.6 percent at December 31, 2011. Its total capital ratio was 13.4 percent at December 31, 2012 and 12.7 percent at December 31, 2011. Similarly, its leverage ratio, which equaled 9.2 percent at December 31, 2012, and 9.4 percent at December 31, 2011, exceeded the minimum of 4.0 percent for capital adequacy purposes. Peoples Neighborhood Bank reported tier I capital, total capital and leverage ratios of 11.6 percent, 12.8 percent and 8.8 percent at December 31, 2012, and 11.0 percent, 12.1 percent and 8.9 percent at December 31, 2011. Based on the most recent notification from the FDIC, Peoples Neighborhood Bank was categorized as well capitalized at December 31, 2012 and 2011. There are no conditions or events since this notification that it believes have changed Peoples Neighborhood Bank's category. For a further discussion of these risk-based capital standards and supervisory actions for noncompliance, refer to the note entitled, "Regulatory matters," in the Notes to Consolidated Financial Statements of Peoples Financial Services Corp. located elsewhere in this joint proxy statement/prospectus.

Stockholders' equity increased \$6.6 million to \$66.2 million or \$21.46 per share at December 31, 2012, from \$59.6 million or \$19.11 per share at December 31, 2011. Net income of \$9.1 million was offset by net cash dividends declared of \$2.6 million and common shares repurchases of \$1.1 million. Other comprehensive income related to an increase in the market value of investment securities available-for-sale increased capital by \$1.2 million.

Peoples declared dividends of \$0.86 per share in 2012, compared to \$0.80 per share in 2011. The dividend payout ratio, dividends declared as a percent of net income, equaled 29.4 percent in 2012 and 32.3 percent in 2011. Peoples board of directors intends to continue paying cash dividends in the future. However, its ability to declare and pay dividends in the future is based on its operating results, financial and economic conditions, capital and growth objectives, appropriate dividend restrictions and other relevant factors. Peoples rely on dividends received from its subsidiary, Peoples Neighborhood Bank, for payment of dividends to stockholders. Peoples Neighborhood Bank's ability to pay dividends is subject to federal and state regulations. For a further discussion on its ability to declare and pay dividends in the future and dividend restrictions, refer to the note entitled, "Regulatory matters," in the Notes to Consolidated Financial Statements of Peoples Financial Services Corp. located elsewhere in this joint proxy statement/prospectus.

Peoples has in the past periodically purchased shares of its common stock under a board-approved stock repurchase program. Under this program, it repurchased 39,100 shares for \$1,183 in 2012 and 30,300 shares for \$835 in 2011.



**Table of Contents****Review of Financial Performance**

Peoples experienced another successful year in 2012, as evidenced by a \$1,303 or 16.7 percent increase in earnings to \$9,120 or \$2.93 per share from \$7,817 or \$2.49 per share in 2011. Strong net interest income growth was the major factor leading to the record earnings. Greater operating efficiency and the recognition of investment tax credits also contributed to the favorable earnings growth. Return on average assets ( ROAA ) and return on average equity ( ROAE ) improved significantly in comparison to the previous year. ROAA was 1.42 percent for the year ended December 31, 2012, compared to 1.33 percent for the year ended December 31, 2011. ROAE was 14.91 percent in 2012 compared to 14.80 percent in 2011.

Tax-equivalent net interest income rose \$824 or 3.5 percent in 2012. Growth in earning assets exceeding the growth in interest-bearing liabilities was the primary factor leading to the increase in net interest income. Partially offsetting the increase was a decrease in the net interest spread between the tax-equivalent yield on earning assets and its cost of funds. Its net interest margin equaled 3.97 percent in 2012, a 21 basis point reduction compared to 4.18 percent in 2011.

With regard to noninterest income, revenue generated by its secondary mortgage banking activities experienced a marked improvement in 2012. Net income generated in its secondary mortgage department grew nearly three times the amount generated in 2011. Service charges, fees, commissions and other increased 9.2 percent. It also realized gains on the sale of investment securities available for sale of \$383 and recognized a \$306 impairment charge on other real estate owned.

Noninterest expense decreased \$597 or 3.9 percent to \$14,713 in 2012 from \$15,310 in 2011. Salaries and employee benefits expenses increased \$612 or 9.5 percent as a result of additional staffing and normal merit increases. In addition, Peoples experienced a \$201 or 7.0 percent increase in occupancy and equipment expense due to system upgrades and additions, as well as, increases in utility, building repair and real estate tax costs. Other expenses decreased \$1,410 or 23.5 percent comparing 2012 and 2011. The recognition of a penalty on the extinguishment of long-term debt in 2011 and a reduction in the cost associated with FDIC insurance in 2012 were the primary reasons for the decrease. Its productivity improved as evidenced by the change in the operating efficiency ratio. The operating efficiency ratio, defined as noninterest expense divided by the total of net interest income and noninterest income, is an industry ratio used to measure productivity. Its operating efficiency ratio improved to 53.5 percent in 2012 compared to 56.1 percent in 2011.

**Net Interest Income:**

Net interest income is the fundamental source of earnings for commercial banks. Moreover, fluctuations in the level of noninterest income can have the greatest impact on net profits. Net interest income is defined as the difference between interest revenue, interest and fees earned on interest-earning assets, and interest expense, the cost of interest-bearing liabilities supporting those assets. The primary sources of earning assets are loans and investment securities, while interest-bearing deposits and borrowings comprise interest-bearing liabilities. Net interest income is impacted by:

Variations in the volume, rate and composition of earning assets and interest-bearing liabilities;

Changes in general market interest rates; and

The level of nonperforming assets.

Changes in net interest income are measured by the net interest spread and net interest margin. Net interest spread, the difference between the average yield earned on earning assets and the average rate incurred on interest-bearing liabilities, illustrates the effects changing interest rates have on profitability. Net interest margin, net interest income as a percentage of average earning assets, is a more comprehensive ratio, as it reflects not only the spread, but also the change in the composition of interest-earning assets and interest-bearing liabilities. Tax-exempt loans and investments carry pretax yields lower than their taxable counterparts. Therefore, in order

**Table of Contents**

to make the analysis of net interest income more comparable, tax-exempt income and yields are reported in this analysis on a tax-equivalent basis using the prevailing federal statutory tax rate of 34.0 percent.

Similar to all banks, Peoples considers the maintenance of an adequate net interest margin to be of primary concern. The current economic environment has been very challenging for the banking industry. In addition to market rates and competition, nonperforming asset levels are of particular concern for the banking industry and may place additional pressure on net interest margins. Nonperforming assets may increase given the state of the economy and soft labor markets. No assurance can be given as to how general market conditions will change or how such changes will affect net interest income. Therefore, it believes through prudent deposit and loan pricing practices, careful investing, and constant monitoring of nonperforming assets, its net interest margin will remain strong.

Peoples analyzes interest income and interest expense by segregating rate and volume components of earning assets and interest-bearing liabilities. The impact changes in the interest rates earned and paid on assets and liabilities, along with changes in the volumes of earning assets and interest-bearing liabilities, have on net interest income are summarized as follows. The net change or mix component, attributable to the combined impact of rate and volume changes within earning assets and interest-bearing liabilities categories, has been allocated proportionately to the change due to rate and the change due to volume.

**Net interest income changes due to rate and volume**

	2012 vs 2011			2011 vs 2010		
	Increase (decrease) attributable to			Increase (decrease) attributable to		
	Total	Rate	Volume	Total	Rate	Volume
Interest income:						
Loans:						
Taxable	\$ 988	\$ (1,179)	\$ 2,167	\$ 2,222	\$ (443)	\$ 2,665
Tax-exempt	98	(33)	131	373	(105)	478
Investments:						
Taxable	(293)	(849)	556	(344)	(227)	(117)
Tax-exempt	(483)	(95)	(388)	(556)	(41)	(515)
Interest-bearing deposits	(2)	(1)	(1)	8	3	5
Federal funds sold	(11)		(11)	8	23	(15)
Total interest income	297	(2,157)	2,454	1,711	(790)	2,501
Interest expense:						
Money market accounts	(42)	(26)	(16)	(27)	(49)	22
NOW accounts	158	2	156	(16)	(56)	40
Savings accounts	(287)	(392)	105	(460)	(538)	78
Time deposits less than \$100	(36)	(142)	106	24	(93)	117
Time deposits \$100 or more	104	17	87	206	34	172
Short-term borrowings	(144)	(66)	(78)	(79)	(137)	58
Long-term debt	(280)	(38)	(242)	(507)	(80)	(427)
Total interest expense	(527)	(645)	118	(859)	(919)	60
Net interest income	\$ 824	\$ (1,512)	\$ 2,336	\$ 2,570	\$ 129	\$ 2,441

For the year ended December 31, 2012, tax-equivalent net interest income increased \$824 to \$24,092 from \$23,268 in 2011. A positive volume variance offset partially by a negative rate variance led to the improvement.

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**Table of Contents**

Changes in the volumes of earning assets and interest-bearing liabilities contributed to an increase of \$2,336 in net interest income. Average earning assets grew \$50.2 million to \$607.4 million in 2012 from \$557.2 million in 2011 and accounted for a \$2,454 increase in interest income. Average loans, net increased \$41.5 million or 9.8 percent, which caused interest income to increase \$2,298. Similarly, average investments increased \$12.5 million or 10.3 percent comparing 2012 and 2011, which resulted in increased interest income of \$168.

Average interest-bearing liabilities rose \$28.7 million or 6.4 percent to \$478.2 million in 2012 from \$449.5 million in 2011. The growth resulted in a net increase in interest expense of \$118. Large denomination time deposits averaged \$4.1 million more in 2012 and caused interest expense to increase \$87. An increase of \$4.7 million in average time deposits less than \$100 added \$106 to interest expense. In addition, interest-bearing transaction accounts, including money market, NOW and savings accounts grew \$37.8 million, which in aggregate caused a \$245 increase in interest expense. Short-term borrowings averaged \$11.2 million less and reduced interest expense \$78 while long-term debt averaged \$6.7 million less and reduced interest expense by \$242 comparing 2012 and 2011.

An unfavorable rate variance occurred as the decrease in the tax-equivalent yield on earning assets was more than the reduction in the cost of funds. As a result, tax-equivalent net interest income decreased \$1,512. The tax-equivalent yield on earning assets decreased 38 basis points to 4.81 percent in 2012 from 5.19 percent in 2011, resulting in a reduction in interest income of \$2,157. Specifically, the tax-equivalent yield on the loan portfolio decreased 28 basis points to 5.36 percent in 2012 from 5.64 percent in 2011. The decline in the tax-equivalent yield on the loan portfolio was a reflection of the condition of general market rates. Loan yield reductions caused interest income to decrease \$1,212, representing 56.2 percent of the entire reduction in interest income due to changes in rates.

The reduction in interest income was mitigated by a decrease of \$645 in interest expense, which resulted from a 18 basis point decrease in the cost of funds to 1.07 percent in 2012 from 1.25 percent in 2011. Peoples experienced reductions in the rates paid on all major deposit categories with the exception of time deposits of \$100 or more. Specifically, the cost of money market, NOW and savings accounts decreased 14 basis points comparing 2012 and 2011. This decrease resulted in a reduction in interest expense of \$416. With regard to time deposits, the average rate paid for time deposits less than \$100 decreased 18 basis points while time deposits \$100 or more increased 6 basis points, which together resulted in a \$125 decrease in interest expense. The average rate paid on short-term borrowings declined 19 basis points, resulting in a \$66 reduction in interest expense. Interest expense was reduced \$38 from a 16 basis point decline in the average rate paid on long-term debt.

The average balances of assets and liabilities, corresponding interest income and expense and resulting average yields or rates paid are summarized as follows. Averages for earning assets include nonaccrual loans. Investment averages include available-for-sale securities at amortized cost. Income on investment securities and loans is adjusted to a tax-equivalent basis using the prevailing federal statutory tax rate of 34.0 percent.

**Table of Contents****Summary of net interest income**

	2012			2011		
	Average Balance	Interest Income/ Expense	Average Interest Rate	Average Balance	Interest Income/ Expense	Average Interest Rate
<b>Assets:</b>						
Earning assets:						
Loans:						
Taxable	\$ 424,033	\$ 22,627	5.34%	\$ 384,839	\$ 21,639	5.62%
Tax-exempt	38,020	2,162	5.69	35,790	2,064	5.77
Investments:						
Taxable	99,026	2,350	2.37	79,797	2,643	3.31
Tax-exempt	35,049	2,032	5.80	41,781	2,515	6.02
Interest-bearing deposits	1,240	10	0.81	1,177	12	1.02
Federal funds sold	10,050	23	0.23	13,832	34	0.25
Total earning assets	607,418	29,204	4.81%	557,216	28,907	5.19%
Less: allowance for loan losses	5,905			4,757		
Other assets	39,282			35,143		
Total assets	\$ 640,795			\$ 587,602		
<b>Liabilities and Stockholders Equity:</b>						
Interest-bearing liabilities:						
Money market accounts	\$ 37,277	208	0.56%	\$ 39,927	250	0.63%
NOW accounts	75,930	443	0.58	49,299	285	0.58
Savings accounts	208,309	1,270	0.61	194,523	1,557	0.80
Time deposits less than \$100	79,899	1,704	2.13	75,216	1,740	2.31
Time deposits \$100 or more	32,790	695	2.12	28,729	591	2.06
Short-term borrowings	26,952	166	0.62	38,115	310	0.81
Long-term debt	17,104	626	3.66	23,735	906	3.82
Total interest-bearing liabilities	478,261	5,112	1.07%	449,544	5,639	1.25
Noninterest-bearing deposits	96,722			81,224		
Other liabilities	4,647			3,997		
Stockholders equity	61,165			52,837		
Total liabilities and stockholders equity	\$ 640,795			\$ 587,602		
Net interest income/spread		\$ 24,092	3.74%		\$ 23,268	3.94%
Net interest margin			3.97%			4.18%
Tax-equivalent adjustments:						
Loans		\$ 735			\$ 702	
Investments		690			855	
Total adjustments		\$ 1,425			\$ 1,557	

Note: Average balances were calculated using average daily balances. Interest income on loans includes fees of \$280 in 2012, \$222 in 2011 and \$364 in 2010. Available-for-sale securities, included in investment securities, are stated at amortized cost with the related average unrealized holding gains (losses) of \$7,383 in 2012, \$5,523 in 2011 and \$(1,264) in 2010 included in other assets. Tax-equivalent adjustments were calculated using the prevailing federal statutory tax rate of 34.0 percent.



**Table of Contents****Summary of net interest income (continued)**

	Average Balance	2010 Interest Income/Expense	Average Interest Rate
<b>Assets:</b>			
Earning assets:			
Loans:			
Taxable	\$ 337,511	\$ 19,417	5.75%
Tax-exempt	26,757	1,691	6.32
Investments:			
Taxable	82,923	2,987	3.60
Tax-exempt	50,033	3,071	6.14
Interest-bearing deposits	654	4	0.61
Federal funds sold	19,181	26	0.14
<b>Total earning assets</b>	<b>517,059</b>	<b>27,196</b>	<b>5.26%</b>
Less: allowance for loan losses	3,882		
Other assets	35,306		
<b>Total assets</b>	<b>\$ 548,483</b>		
<b>Liabilities and Stockholders Equity:</b>			
Interest-bearing liabilities:			
Money market accounts	\$ 36,829	277	0.75%
NOW accounts	42,992	301	0.70
Savings accounts	187,007	2,017	1.08
Time deposits less than \$100	70,269	1,716	2.44
Time deposits \$100 or more	20,253	385	1.90
Short-term borrowings	32,615	389	1.19
Long-term debt	34,866	1,413	4.05
<b>Total interest-bearing liabilities</b>	<b>424,831</b>	<b>6,498</b>	<b>1.53%</b>
Noninterest-bearing deposits	72,846		
Other liabilities	4,037		
Stockholders equity	46,769		
<b>Total liabilities and stockholders equity</b>	<b>\$ 548,483</b>		
<b>Net interest income/spread</b>		<b>\$ 20,698</b>	<b>3.73%</b>
<b>Net interest margin</b>			<b>4.00%</b>
Tax-equivalent adjustments:			
Loans		\$ 575	
Investments		1,044	
<b>Total adjustments</b>		<b>\$ 1,619</b>	

**Provision for Loan Losses**

Peoples evaluates the adequacy of the allowance for loan losses account on a quarterly basis utilizing its systematic analysis in accordance with procedural discipline. Peoples takes into consideration certain factors such as composition of the loan portfolio, volumes of nonperforming loans, volumes of net charge-offs, prevailing economic conditions and other relevant factors when determining the adequacy of the allowance

for loan losses account. Peoples makes monthly provisions to the allowance for loan losses account in order to maintain the allowance at an appropriate level. The provision for loan losses equaled \$1,695 in 2012 and

**Table of Contents**

\$1,794 in 2011. Based on its most recent evaluation at December 31, 2012, it believes that the allowance was adequate to absorb any known or potential losses in its portfolio.

**Noninterest Income**

Peoples noninterest income decreased \$721 or 13.0 percent to \$4,846 in 2012 from \$5,567 in 2011. Revenue received from its secondary mortgage department increased \$604 in 2012. Included in noninterest revenue in 2011 was a \$1,671 gain on the sale of a commercial property held as other real estate. In comparison, a net change of \$339 was recognized in 2012 related to other real estate owned. Service charges, fees, commissions and others increased \$272 comparing 2012 and 2011.

**Noninterest Expense**

In general, its noninterest expense is categorized into three main groups, including employee-related expense, occupancy and equipment expense and other expenses. Employee-related expenses are costs associated with providing salaries, including payroll taxes and benefits to its employees. Occupancy and equipment expenses, the costs related to the maintenance of facilities and equipment, include depreciation, general maintenance and repairs, real estate taxes, rental expense offset by any rental income and utility costs. Other expenses include general operating expenses such as marketing, other taxes, stationery and supplies, contractual services, insurance, including FDIC assessment and loan collection costs. Several of these costs and expenses are variable while the remainder is fixed. Peoples utilizes budgets and other related strategies in an effort to control the variable expenses.

Its noninterest expense decreased \$597 or 3.9 percent to \$14,713 in 2012 from \$15,310 in 2011. Increases in employee and occupancy and equipment expenses were more than offset by the reduction in other expenses.

The major components of noninterest expense for the past three years are summarized as follows:

**Noninterest expense**

<b>Year Ended December 31</b>	<b>2012</b>	<b>2011</b>	<b>2010</b>
<b>Salaries and employee benefits expense:</b>			
Salaries and payroll taxes	\$ 5,903	\$ 5,350	\$ 4,744
Employee benefits	1,144	1,085	754
Salaries and employee benefits expense	7,047	6,435	5,498
<b>Occupancy and equipment expenses:</b>			
Occupancy expense	911	907	858
Equipment expense	2,169	1,972	1,643
Occupancy and equipment expenses	3,080	2,879	2,501
<b>Other expenses:</b>			
FDIC insurance and assessments	472	755	787
Professional fees and outside services	602	879	640
Other taxes	391	431	389
Stationery and supplies	482	416	379
Advertising	497	495	403
Penalty assessed on prepayment of long-term debt		509	718
Other	2,142	2,511	1,930
Other expenses	4,586	5,996	5,246
Total noninterest expense	\$ 14,713	\$ 15,310	\$ 13,245





**Table of Contents**

Salaries and employee benefits expense increased \$612 or 9.5 percent to \$7,047 in 2012 from \$6,435 in 2011. Salaries and payroll taxes increased \$553 or 10.3 percent, while employee benefits expense increased \$59 or 5.4 percent. The increase in the salaries and payroll taxes component was directly related to additional staffing and annual merit increases. The increase in employee benefits expense resulted primarily from an increases in contributions to the deferred compensation plan and profit sharing as a result of the increase in earnings.

For 2012, occupancy and equipment expense increased \$201 or 7.0 percent to \$3,080 from \$2,879 in 2011. Specifically, building-related costs increased \$4 while equipment-related costs increased \$197. The increase in equipment expense resulted from additional costs, including maintenance and depreciation, associated with upgrades and additions to information systems.

Other expenses decreased \$1,410 to \$4,586 in 2012 from \$5,996 in 2011. The decline was principally due to the nonrecurrence of a penalty on the 2011 payoff of long-term debt and the reduction in the FDIC assessment rate in 2012.

**Income Taxes:**

Peoples income tax expense decreased \$372 to \$1,985 in 2012 from \$2,357 in 2011. In 2011, it executed a subscription agreement to become a limited partner in an elderly housing project which affords Peoples approximately \$4.0 million of investment tax credits over a 10-year period beginning in 2012. Accordingly, it recognized investment tax credits from this housing project of \$725 in 2012.

The difference between the amount of income tax currently payable and the provision for income tax expense reflected in the income statements arises from temporary differences. Temporary differences are differences between the tax bases of assets and liabilities and their reported amounts in the financial statements, which result in deferred tax assets or liabilities. Peoples performs quarterly reviews on the tax criteria related to the recognition of deferred tax assets. It decided not to establish a valuation reserve for the deferred tax assets since it is likely that these assets will be realized through carry-back to taxable income in prior years and by future reversals of existing taxable temporary differences or, to a lesser extent, through future taxable income.

## **Table of Contents**

### **Management's Discussion and Analysis of Financial Condition and Results of Operations**

#### **of Peoples Financial Services Corp.**

#### **Years Ended December 31, 2011 and 2010**

Management's Discussion and Analysis appearing on the following pages should be read in conjunction with the Consolidated Financial Statements of Peoples Financial Services Corp. found elsewhere in this joint proxy statement/prospectus.

### **Forward-Looking Statements**

In addition to the historical information contained in this document, the discussion presented may contain and, from time to time, may make, certain statements that constitute forward-looking statements. Words such as expects, anticipates, believes, estimates and other similar expressions or future or conditional verbs such as will, should, would and could are intended to identify such forward-looking statements. These statements are not historical facts, but instead represent the current expectations, plans or forecasts of Peoples and its subsidiaries regarding its future operating results, financial position, asset quality, credit reserves, credit losses, capital levels, dividends, liquidity, service charges, cost savings, effective tax rate, impact of changes in fair value of financial assets and liabilities, impact of new accounting and regulatory guidance, legal proceedings and other matters relating to Peoples and the securities that Peoples may offer from time to time. These statements are not guarantees of future results or performance and involve certain risks, uncertainties and assumptions that are difficult to predict, change over time and are often beyond its control. Actual outcomes and results may differ materially from those expressed in, or implied by, forward-looking statements.

You should not place undue reliance on any forward-looking statement and should consider the uncertainties and risks discussed in the section entitled Risk Factors, in this joint proxy statement/prospectus, among others, and in any of Peoples subsequent Securities and Exchange Commission (SEC) filings. Forward-looking statements speak only as of the date they are made, and Peoples undertakes no obligation to update any forward-looking statement to reflect the impact of circumstances or events that arise after the date the forward-looking statement was made. Notes to the Consolidated Financial Statements of Peoples Financial Services Corp. referred to in the Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A) are incorporated by reference into the MD&A. Certain prior period amounts have been reclassified to conform with the current year's presentation.

### **Critical Accounting Policies**

Peoples financial statements are prepared in accordance with accounting principles generally accepted in the United States of America (GAAP). The preparation of financial statements in conformity with GAAP requires Peoples to establish critical accounting policies and make accounting estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements, as well as the reported amounts of revenues and expenses during those reporting periods.

For a discussion of the recent Accounting Standards Updates (ASU) issued by the Financial Accounting Standards Board (FASB) refer to Note 1 entitled Summary of significant accounting policies Recent accounting standards, in the Notes to Consolidated Financial Statements of Peoples Financial Services Corp. found elsewhere in this joint proxy statement/prospectus.

An accounting estimate requires assumptions about uncertain matters that could have a material effect on the financial statements if a different amount within a range of estimates were used or if estimates changed from period to period. Readers of this report should understand that estimates are made considering facts and circumstances at a point in time, and changes in those facts and circumstances could produce results that differ from when those estimates were made. Significant estimates that are particularly susceptible to material change within the near term relate to the determination of allowance for loan losses, determination of other-than-

## **Table of Contents**

temporary impairment, fair value of financial instruments, the valuations of real estate acquired in connection with foreclosures or satisfaction of loans and the valuation of loans deferred tax assets and liabilities. Actual amounts could differ from those estimates.

Peoples maintains the allowance for loan losses at a level it believes adequate to absorb probable credit losses related to individually evaluated loans, as well as probable incurred losses inherent in the remainder of the loan portfolio as of the balance sheet date. The balance in the allowance for loan losses account is based on past events and current economic conditions.

The allowance for loan losses account consists of an allocated element and an unallocated element. The allocated element consists of a specific portion for the impairment of loans individually evaluated and a formula portion for loss contingencies on those loans collectively evaluated. The unallocated element, if any, is used to cover inherent losses that exist as of the evaluation date, but which have not been identified as part of the allocated allowance using its impairment evaluation methodology due to limitations in the process.

Peoples' management monitors the adequacy of the allocated portion of the allowance quarterly and adjusts the allowance for any deficiencies through normal operations. This ongoing evaluation reduces potential differences between estimates and actual observed losses. The determination of the level of the allowance for loan losses is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available. Accordingly, management cannot ensure that charge-offs in future periods will not exceed the allowance for loan losses or that additional increases in the allowance for loan losses will not be required, resulting in an adverse impact on operating results.

In determining the requirement to record an other-than-temporary impairment on securities owned by Peoples, four main characteristics are considered including: (i) the length of time and the extent to which the fair value has been less than amortized cost; (ii) the financial condition and near-term prospects of the issuer; (iii) whether the market decline was affected by macroeconomic conditions and (iv) whether the entity has the intent to sell the debt security or more likely than not will be required to sell the debt security before its anticipated recovery. The assessment of whether an other-than-temporary impairment exists involves a high degree of subjectivity and judgment and is based on information available to management at a point in time.

Fair values of financial instruments, in cases where quoted market prices are not available, are based on estimates using present value or other valuation techniques which are subject to change.

Real estate acquired in connection with foreclosures or in satisfaction of loans is adjusted to fair value based upon current estimates derived through independent appraisals less cost to sell. However, proceeds realized from sales may ultimately be higher or lower than those estimates.

Deferred tax assets and liabilities are recognized for the estimated future tax effects of temporary differences by applying enacted statutory tax rates to differences between the financial statement carrying amounts and the tax bases of existing assets and liabilities. The amount of deferred tax assets is reduced, if necessary, to the amount that, based on available evidence, will more likely than not be realized. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes.

For a further discussion of Peoples' critical accounting policies, refer to Note 1 entitled, "Summary of significant accounting policies," in the Notes to Consolidated Financial Statements of Peoples Financial Services Corp. found elsewhere in this joint proxy statement/prospectus. This note lists the significant accounting policies used by Peoples in the development and presentation of the financial statements. This MD&A, the Notes to Consolidated Financial Statements of Peoples Financial Services Corp. and other financial statement disclosures identify and address key variables and other qualitative and quantitative factors that are necessary for the understanding and evaluation of Peoples' financial position, results of operations and cash flows.

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**Table of Contents****Review of Financial Position**

Total assets increased \$62.8 million or 11.3 percent to \$621.4 million at December 31, 2011, from \$558.6 million at December 31, 2010. Total assets averaged \$587.6 million in 2011, an increase of \$39.1 million or 7.1 percent from \$548.5 million in 2010. Earning assets averaged \$557.2 million and equaled 94.8 percent of total average assets in 2011, compared to \$517.1 million or 94.3 percent of total average assets in 2010.

The balance sheet growth was driven by an increase in total deposits of \$55.5 million or 12.7 percent to \$494.3 million at the end of 2011, from \$438.8 million at year-end 2010. Total interest-bearing deposits increased \$36.2 million or 9.9 percent, while noninterest-bearing deposits rose \$19.3 million or 26.2 percent. Now account growth of \$12.9 million and time deposit increases of \$16.2 million were primarily responsible for the change in interest-bearing deposits in 2011. Short-term interest rates remained at historically low levels in 2011. As a result, Peoples experienced a 28 basis point reduction in its cost of funds to 1.25 percent in 2011 from 1.53 percent in 2010.

Loans, net increased \$54.3 million or 13.9 percent to \$445.1 million at December 31, 2011, from \$390.8 million at December 31, 2010. Loans averaged \$420.6 million and represented 75.5 percent of average earning assets in 2011, compared to \$364.3 million or 70.4 percent in 2010. Corresponding with the reductions in short-term interest rates, the prime rate remained at 3.25 percent over the course of 2011. The tax-equivalent yield on the loan portfolio decreased 15 basis points to 5.64 percent in 2011 from 5.79 percent in 2010. Excess deposits not used to fund loans were directed into the investment portfolio. Investment securities available-for-sale increased \$18.1 million to \$139.9 million at the end of 2011 from \$121.8 million at December 31, 2010. Similar to loan yields, the tax-equivalent yield on the investment portfolio declined 32 basis points in 2011. Overall, Peoples experienced a 7 basis point reduction in the tax-equivalent yield on earning assets to 5.19 percent in 2011 from 5.26 percent in 2010.

Stockholders' equity equaled \$59.6 million or \$19.11 per share at December 31, 2011, and \$50.5 million or \$16.07 per share at December 31, 2010. Peoples leverage ratio improved to 9.42 percent at the end of 2011, compared to 9.19 percent at December 31, 2010. The leverage ratio, as well as all of its capital ratios, exceeded regulatory standards for well capitalized institutions. Accumulated other comprehensive income (loss) increased \$4.5 million from year-end 2010, which resulted directly from an increase in the fair value of investment securities available-for-sale.

**Investment Portfolio**

Investment securities available-for-sale increased \$18.1 million to \$139.9 million at December 31, 2011, from \$121.8 million at December 31, 2010. Security purchases totaled \$38.1 million in 2011, with the majority of the purchases occurring in the third and fourth quarters of the year. Specifically, all of the 2011 purchases consisted of U.S. Government agency and U.S. Government-sponsored enterprise mortgage-backed securities.

Repayments of investment securities totaled \$3.5 million in 2011. Peoples received proceeds of \$22.5 million from the sale of investment securities in 2011. During the first quarter of 2011, Peoples developed and began implementing an investment portfolio reconstitution plan aimed primarily at reducing exposure to interest rate risk by shortening the average life and duration of the investment portfolio. Changes in interest rates can have a material adverse effect on the market value of Peoples investment portfolio which in turn may negatively impact its liquidity, capital and earnings. Despite indications from the Federal Open Market Committee ( FOMC ) that rates will remain at historical lows for some time, there remains a high potential for rates to rise rapidly and materially in the future given their current levels. Accordingly, Peoples evaluated the composition, maturity and interest sensitivity of the investment portfolio and determined that a restructuring of the portfolio was warranted in order to reduce its exposure. As a result of implementing such plan, Peoples has effectively reduced the average life of the investment portfolio from 9.5 years at December 31, 2010, to 4.1 years at December 31, 2011. More importantly, Peoples has reduced its market value exposure by \$4.5 million given a

**Table of Contents**

gradual interest rate shock of plus 200 basis points over one year comparing year-end 2010 to 2011. A secondary benefit of implementing the plan was the mitigation of the possibility of being subject to alternative minimum tax in the future. In the normal course of business, Peoples generates a substantial amount of tax-exempt income from its investment in state and municipal obligations and loans to local school districts and municipalities. As a result of its investment in a limited partnership which affords it significant tax credits in the future, Peoples began selling certain long-term tax-exempt investments in 2011. Moreover, the determination to sell certain of these state and municipal obligations included an evaluation of the credit risk of the issuers given the recent financial problems of some government entities. Net gains recognized on the sale of investment securities available-for-sale totaled \$25 in 2011. Peoples reported net unrealized holding gains, included as a separate component of stockholders' equity of \$3.6 million, net of income taxes of \$1.9 million, at December 31, 2011, and a net unrealized loss of \$834, net of income tax benefits of \$430, at December 31, 2010.

Peoples recognized other-than-temporary impairments ( OTTI ) of \$87 in 2011 and \$164 in 2010 as a result of writing down certain common equity securities. For additional information related to OTTI refer to Note 3 entitled "Investment securities available-for-sale," in the Notes to Consolidated Financial Statements of Peoples Financial Services Corp. located elsewhere in this joint proxy statement/prospectus. Peoples evaluated the common equity securities portion of the portfolio during the third quarter of 2011 to determine the potential for such investments to recover in value. Based on this evaluation, Peoples sold certain equity positions in order to reduce its exposure to future earning reductions through write-downs on OTTI. As a result of this action, its holdings of common equity securities decreased from \$1,227 at December 31, 2010, to \$567 at December 31, 2011.

Investment securities averaged \$121.6 million and equaled 21.8 percent of average earning assets in 2011, compared to \$133.0 million and 25.7 percent in 2010. The tax-equivalent yield on the investment portfolio decreased 32 basis points to 4.24 percent in 2011 from 4.56 percent in 2010.

At December 31, 2011 and 2010, there were no securities of any individual issuer, except for U.S. Government agency mortgage-backed securities, that exceeded 10.0 percent of stockholders' equity.

**Loan Portfolio**

Loans, net increased \$54.3 million or 13.9 percent to \$445.1 million at December 31, 2011, from \$390.8 million at the end of 2010. Reductions in residential mortgages and consumer loans were more than offset by an increase in business lending. Business loans, including commercial loans and commercial mortgages, increased \$56.9 million to \$306.4 million at December 31, 2011, from \$249.5 million at year-end 2010. Residential mortgage loans decreased \$1.3 million to \$118.1 million at the close of 2011 from \$119.4 million at December 31, 2010. Consumer loans decreased \$1.3 million to \$20.6 million at December 31, 2011, from \$21.9 million at December 31, 2010.

Loans averaged \$420.6 million in 2011, an increase of \$56.4 million or 15.5 percent compared to \$364.2 million in 2010. Taxable loans increased \$47.4 million, while tax-exempt loans rose \$9.0 million. Due to the increase in loan demand, the loan portfolio played a more prominent role in Peoples' earning asset mix. As a percentage of earning assets, average loans equaled 75.5 percent in 2011 compared to 70.4 percent in 2010.

The low interest rate environment caused the tax-equivalent yield on Peoples' loan portfolio to decrease 15 basis points to 5.64 percent in 2011 from 5.79 percent in 2010. The effect of market rates on its loan portfolio's yield can be further evidenced by evaluating quarterly loan yields, which continued to decline during 2011. After being relatively unchanged in the first and second quarters, the tax-equivalent yield on the loan portfolio fell 10 basis points to 5.61 percent in the third quarter. Loan yields declined again in the fourth quarter, decreasing 8 basis points.

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**Table of Contents**

Fixed-rate loans represented 21.7 percent of the loan portfolio at December 31, 2011, compared to 27.9 percent at the end of 2010. Fixed-rate loans decreased \$12.6 million or 11.5 percent to \$96.6 million at December 31, 2011 from \$109.2 million at December 31, 2010. Comparatively, floating or adjustable-rate loans increased \$66.9 million or 23.8 percent in 2011. Approximately 40.1 percent of the loan portfolio is expected to reprice within the next 12 months.

The volume of mortgages originated by Peoples and subsequently sold in the secondary market totaled \$7.2 million in 2011, a decrease of \$2.8 million from \$10.0 million in 2010. Gains realized on the sale of these loans were \$230 in 2011 and \$289 in 2010. Residential mortgage loans serviced for the Federal National Mortgage Association ( FNMA ) totaled \$38.7 million at December 31, 2011, an increase of \$4.0 million or 11.5 percent from \$34.7 million at the end of 2010. Mortgage loans held for sale totaled \$569 at December 31, 2011, and \$30 at the end of 2010.

**Asset Quality**

The banking industry experienced substantial improvement in asset quality in 2011. For all FDIC-insured commercial banks, nonperforming loans and leases decreased 21.9 percent at December 31, 2011, from the end of 2010. The ratio of nonperforming assets to total assets for these institutions decreased to 1.58 percent at December 31, 2011, from 2.08 percent at year-end 2010. In addition, net charge-offs for these institutions decreased 40.3 percent comparing 2011 and 2010. As a result, FDIC-insured commercial banks reduced their loan loss provisions 52.7 percent in 2011. As a percentage of total loans, the allowance for loan losses for FDIC-insured commercial banks equaled 2.73 percent at the end of 2011, down from 3.42 percent at the end of 2010.

Similar to the banking industry, Peoples continued to experience asset quality improvements in 2011. The economic recovery in Peoples market area aided by the impact of natural gas drilling continued to favorably affect its commercial customer base and the market values of the collateral supporting their loans with us. Despite a sizable increase in the overall loan portfolio, the amount of nonperforming assets was relatively unchanged comparing year-end 2011 and 2010. Nonperforming assets decreased to 2.39 percent of loans, net and foreclosed assets at December 31, 2011, from 2.61 percent at the end of 2010. A decrease of \$3.0 million in foreclosed assets offset increases of \$3.1 million in nonaccrual loans and loans with terms modified under troubled debt restructures.

Peoples maintains the allowance for loan losses at a level its believes adequate to absorb probable credit losses related to individually evaluated loans, as well as probable incurred losses inherent in the remainder of the loan portfolio as of the balance sheet date. The balance in the allowance for loan losses account is based on past events and current economic conditions. Peoples employs the FFIEC Interagency Policy Statement, as amended, and GAAP in assessing the adequacy of the allowance account.

The allowance for loan losses increased \$1,249 to \$5,349 at December 31, 2011, from \$4,100 at the end of 2010. The increase resulted from a provision for loan losses of \$1,794 exceeding net loans charged-off of \$545. The allowance for loan losses, as a percentage of loans, net of unearned income, was 1.20 percent at the end of 2011, compared to 1.05 percent at the end of 2010. Net loans charged-off decreased \$894 or 62.1 percent to \$545 in 2011 from \$1,439 in 2010. Net charge-offs, as a percentage of average loans outstanding, equaled 0.13 percent in 2011 and 0.40 percent in 2010.

The allocated element of the allowance for loan losses account increased \$472 to \$4,521 at December 31, 2011, compared to \$4,049 at December 31, 2010. The specific allowance for loan losses decreased while the formula portion of the allowance for loan losses increased from the end of 2010. The specific portion of the allowance for impairment of loans individually evaluated under FASB Accounting Standards Codification ( ASC ) 310, declined \$15 to \$810 at December 31, 2011, from \$825 at year-end 2010 due primarily to a decrease in the amount of loans individually evaluated with a corresponding allowance recorded. The amount of

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**Table of Contents**

impaired loans having sufficient collateral coverage increased to \$9.3 million for December 31, 2011 from \$7.0 million at the end of 2010. No allowance is considered necessary to absorb potential losses on these loans as the collateral, based on appraised values, should meet or exceed any shortfall in case of default. In addition, the formula portion of the allowance for loans collectively evaluated for impairment under FASB ASC 450, increased \$472 to \$4,521 at December 31, 2011, from \$4,049 at December 31, 2010. The total loss factor for collectively evaluated loans increased from year-end 2010 due to a higher amount of average net charge-offs for the past twelve quarters and an increase in the qualitative factors.

The unallocated element equaled \$828 representing 15.5 percent of the total allowance for loan losses at December 31, 2011, compared to \$51 or 1.2 percent at December 31, 2010. Peoples believes the increase in the unallocated element was appropriate given the significant growth in the loan portfolio and the higher amount of commercial loan originations, which have a greater degree of complexity as compared to other loan types. Moreover, the increase is directionally consistent in accordance with supervisory guidance on the allowance for loan losses.

The coverage ratio, the allowance for loan losses account, as a percentage of nonperforming loans, is an industry ratio used to test the ability of the allowance account to absorb potential losses arising from nonperforming loans. The coverage ratio was 52.1 percent at December 31, 2011, compared to 59.4 percent at December 31, 2010.

**Deposits**

Total deposits grew \$55.5 million or 12.7 percent to \$494.3 million at December 31, 2011, from \$438.8 million at the end of 2010. In comparison, total deposits increased \$28.7 million or 7.0 percent in 2010. For 2011, interest-bearing accounts increased \$36.2 million or 9.9 percent. Interest-bearing transaction accounts, which include money market, NOW and savings accounts, increased \$20.1 million in 2011. Noninterest-bearing accounts rose \$19.3 million or 26.2 percent, partially due to the increase in commercial relationships.

Total deposits averaged \$468.9 million in 2011, an increase of \$38.7 million or 9.0 percent, compared to \$430.2 million in 2010. Average noninterest-bearing deposits increased \$8.4 million or 11.5 percent, while average interest-bearing accounts grew \$30.3 million or 8.5 percent. With regard to average interest-bearing deposits, average total time deposits increased \$13.4 million. Interest-bearing transaction accounts increased, as average money market, NOW and savings accounts grew \$3.1 million, \$6.3 million and \$7.5 million in 2011.

Volatile deposits, time deposits \$100 or more, increased \$9.4 million to \$36.7 million at December 31, 2011, from \$27.3 million at the end of 2010. Large denomination time deposits averaged \$28.7 million in 2011, an increase of \$8.5 million or 42.1 percent from \$20.2 million in 2010. Peoples' average cost of these funds increased 16 basis points to 2.06 percent in 2011, from 1.90 percent in 2010.

**Market Risk Sensitivity**

With respect to evaluating its exposure to interest rate risk on earnings, Peoples utilizes a gap analysis model that considers repricing frequencies of rate sensitive assets ( RSA ) and rate sensitive liabilities ( RSL ). Gap analysis attempts to measure its interest rate exposure by calculating the net amount of RSA and RSL that reprice within specific time intervals. A positive gap occurs when the amount of RSA repricing in a specific period is greater than the amount of RSL repricing within that same time frame and is indicated by a RSA/RSL ratio greater than 1.0. A negative gap occurs when the amount of RSL repricing is greater than the amount of RSA and is indicated by a RSA/RSL ratio less than 1.0. A positive gap implies that earnings will be impacted favorably if interest rates rise and adversely if interest rates fall during the period. A negative gap tends to indicate that earnings will be affected inversely to interest rate changes.



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**Table of Contents**

At December 31, 2011, Peoples was in a negative gap position with a cumulative one-year RSA/RSL ratio of 0.65. Similarly, at December 31, 2010, its cumulative one-year RSA/RSL ratio was 0.42. The change in its RSA/RSL ratio from the previous year-end resulted primarily from a \$55.7 million or 36.8 percent increase in RSA maturing or repricing within one year, coupled with a \$36.1 million or 10.2 percent decrease in RSL maturing or repricing within one year. The increase in RSA resulted primarily from a \$42.5 million increase in loans, net maturing or repricing within the next 12 months. In addition to the increase in loans, a \$11.0 million decrease in federal funds sold, more than offset increases of \$23.7 million in investment securities and \$0.5 million in loans held for sale. With regard to RSL, a decrease in interest-bearing transaction accounts of \$46.8 million partially offset by increases in total time deposits of \$3.2 million, short-term borrowings of \$5.1 million and long-term debt of \$2.4 explains the total change in RSL maturing or repricing within one year.

**Liquidity**

At December 31, 2011, noncore funds consisted of time deposits in denominations of \$100 or more, repurchase agreements, short-term borrowings and long-term debt. Large denomination time deposits are particularly not considered to be a strong source of liquidity since they are very interest rate sensitive and are considered to be highly volatile. At December 31, 2011, net noncore funding dependence ratio, the difference between noncore funds and short-term investments to long-term assets, was 13.6 percent. Peoples net short-term noncore funding dependence ratio, noncore funds maturing within one year, less short-term investments to long-term assets equaled -6.4 percent. Comparatively, its ratios equaled 1.8 percent and -1.0 percent at the end of 2010, which indicated an increase in its reliance on noncore funds. The increase in noncore funding reliance resulted primarily from an increase in short-term borrowings and time deposits \$100 or more.

The Consolidated Statements of Cash Flows present the change in cash and cash equivalents from operating, investing and financing activities. Cash and cash equivalents consist of cash on hand, cash items in the process of collection, noninterest-bearing and interest-bearing deposits with other banks and federal funds sold. Cash and cash equivalents decreased \$7.3 million for the year ended December 31, 2011. Similarly, for the year ended December 31, 2010, cash and cash equivalents decreased \$1.1 million. During 2011, cash provided by operating and financing activities was more than offset by cash used in investing activities.

Operating activities provided net cash of \$8.9 million in 2011 and \$11.4 million in 2010. Net income, adjusted for the effects of noncash expenses such as depreciation and the provision for loan losses is the primary source of funds from operations.

Net cash provided by financing activities equaled \$49.0 million in 2011 and \$33.2 million in 2010. Deposit gathering, which is Peoples predominant financing activity, increased significantly in both 2011 and 2010. Deposit gathering provided a net cash inflow in 2011 of \$55.6 million and \$28.7 million in 2010. Partially offsetting the cash provided by deposit gathering in 2011 was \$0.8 million in funds used for the repurchase of common shares, \$2.5 million for the payment of dividends to stockholders and \$8.4 million for repayment of long-term debt.

Peoples primary investing activities involve transactions related to its investment and loan portfolios. Net cash used in investing activities totaled \$65.2 million in 2011, an increase of \$19.5 million from \$45.7 million in 2010. The demand for loans increased due to a loss of a major competitor along with other competitors experiencing asset quality problems. Net cash used in lending activities was \$52.7 million and \$57.1 million in 2011 and 2010. Activities related to its investment portfolio used net cash of \$12.2 million in 2011 and provided net cash of \$10.8 million in 2010. Repayments, coupled with sales, of investment securities amounted to \$25.9 million in 2011, were more than offset by purchases of investment securities of \$38.1 million. Conversely, in 2010, repayments of \$84.0 million were more than the \$73.2 million in purchases of investment securities.

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**Table of Contents****Capital Adequacy**

Peoples and Peoples Neighborhood Bank's risk-based capital ratios are strong and have consistently exceeded the minimum regulatory capital ratios of 4.0 percent and 8.0 percent required for adequately capitalized institutions. Peoples ratio of Tier I capital to risk-weighted assets and off-balance sheet items was 11.6 percent at December 31, 2011, and 11.7 percent at December 31, 2010. Total capital ratio was 12.7 percent at the close of both 2011 and 2010. Similarly, the leverage ratio, which equaled 9.4 percent at December 31, 2011, and 9.2 percent at December 31, 2010, exceeded the minimum of 4.0 percent for capital adequacy purposes. Peoples Neighborhood Bank reported tier I capital, total capital and leverage ratios of 11.0 percent, 12.1 percent and 8.9 percent at December 31, 2011, and 10.9 percent, 11.9 percent and 8.5 percent at December 31, 2010. Peoples Neighborhood Bank was categorized as well capitalized at December 31, 2011 and 2010.

Stockholders' equity increased 9.1 million to \$59.6 million or \$19.11 per share at December 31, 2011, from \$50.5 million or \$16.07 per share at December 31, 2010. Net income of \$7.8 million, was offset by net cash dividends declared of \$2.5 million and, common shares repurchases of \$0.8 million. Other comprehensive income related to an increase in the market value of investment securities available-for-sale increased capital by \$4.6 million. Peoples declared dividends of \$0.80 per share in 2011, compared to \$0.79 per share in 2010. The dividend payout ratio, dividends declared as a percent of net income, equaled 32.3 percent in 2011 and 38.2 percent in 2010.

**Review of Financial Performance**

Peoples experienced a successful year in 2011, as evidenced by a \$1,332 or 20.5 percent increase in earnings to \$7,817 or \$2.49 per share from \$6,485 or \$2.07 per share in 2010. Strong net interest income growth was the major factor leading to the record earnings. Greater operating efficiency and a higher amount of noninterest income also contributed to the favorable earnings growth. Return on average assets ( ROAA ) and return on average equity ( ROAE ) improved significantly in comparison to the previous year. ROAA was 1.33 percent for the year ended December 31, 2011, compared to 1.18 percent for the year ended December 31, 2010. ROAE was 14.80 percent in 2011 compared to 13.87 percent in 2010.

Tax-equivalent net interest income rose \$2,570 or 12.4 percent in 2011. Growth in earning assets exceeding the growth in interest-bearing liabilities was the primary factor leading to the increase in net interest income. Also contributing to the increase was an improvement in the net interest spread between the tax-equivalent yield on earning assets and its cost of funds. Net interest margin equaled 4.18 percent in 2011, an 18 basis point improvement compared to 4.00 percent in 2010.

With regard to noninterest income, revenue generated by Peoples' Wealth Management Division experienced a marked improvement in 2011. With the downturn in the housing market, net income generated in its secondary mortgage department decreased 17.0 percent. Service charges, fees, commissions and other decreased 14.2 percent. Peoples also realized gains on the sale of foreclosed assets of \$1,671, and a net gain of \$25 on the sale of investment securities available for sale.

Noninterest expense increased \$2,065 or 15.6 percent to \$15,310 in 2011 from \$13,245 in 2010. Salaries and employee benefits expenses increased \$937 or 17.0 percent as a result of additional staffing and normal merit increases. In addition, Peoples experienced a \$378 or 15.1 percent increase in occupancy and equipment expense due to system upgrades and additions, as well as, increases in utility, building repair and real estate tax costs. Other expenses increased \$750 or 14.3% comparing 2011 and 2010. Peoples productivity improved as evidenced by the change in the operating efficiency ratio. The operating efficiency ratio, defined as noninterest expense divided by the total of net interest income and noninterest income, is an industry ratio used to measure productivity. Peoples operating efficiency ratio improved to 56.1 percent in 2011 compared to 56.7 percent in 2010.

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**Table of Contents****Net Interest Income**

For the year ended December 31, 2011, tax-equivalent net interest income increased \$2,570 to \$23,268 from \$20,698 in 2010. A positive volume and rate variance led to the improvement.

Changes in the volumes of earning assets and interest-bearing liabilities contributed to an increase of \$2,441 in net interest income. Average earning assets grew \$40.1 million to \$557.2 million in 2011 from \$517.1 million in 2010 and accounted for a \$2,501 increase in interest income. Average loans, net increased \$56.4 million or 15.5 percent, which caused interest income to increase \$3,143. Conversely, average investments declined \$11.4 million or 8.6 percent comparing 2011 and 2010, which resulted in reduced interest income of \$632.

Average interest-bearing liabilities rose \$24.7 million or 5.8 percent to \$449.5 million in 2011 from \$424.8 million in 2010. The growth resulted in a net increase in interest expense of \$60. Having the greatest impact was a \$8.5 million increase in large denomination time deposits, which caused interest expense to increase \$172. An increase of \$4.9 million in average time deposits less than \$100 added \$117 to interest expense. In addition, interest-bearing transaction accounts, including money market, NOW and savings accounts grew \$16.9 million, which in aggregate caused a \$140 increase in interest expense. Short-term borrowings averaged \$5.5 million more and added \$58 to interest expense while long-term debt averaged \$11.1 million less and reduced interest expense by \$427 comparing 2011 and 2010.

A favorable rate variance occurred as the decrease in the tax-equivalent yield on earning assets was less than the reduction in the cost of funds. As a result, tax-equivalent net interest income increased \$129. The tax-equivalent yield on earning assets decreased 7 basis points to 5.19 percent in 2011 from 5.26 percent in 2010, resulting in a reduction in interest income of \$790. Specifically, the tax-equivalent yield on the loan portfolio decreased 15 basis points to 5.64 percent in 2011 from 5.79 percent in 2010. The decline in the tax-equivalent yield on the loan portfolio was a reflection of the condition of general market rates. Loan yield reductions caused interest income to decrease \$548, representing 69.4 percent of the entire reduction in interest income due to changes in rates.

The reduction in interest income was mitigated by a decrease of \$919 in interest expense, which resulted from a 28 basis point decrease in the cost of funds to 1.25 percent in 2011 from 1.53 percent in 2010. Peoples experienced significant reductions in the rates paid on all major deposit categories with the exception of time deposits of \$100 or more. Specifically, the cost of money market, NOW and savings accounts decreased 12 basis points, 12 basis points and 28 basis points comparing 2011 and 2010. These decreases resulted in reductions in interest expense of \$49, \$56 and \$538. With regard to time deposits, the average rate paid for time deposits less than \$100 decreased 13 basis points while time deposits \$100 or more increased 16 basis points, which together resulted in a \$59 decrease in interest expense. The average rate paid on short-term borrowings declined 38 basis points, resulting in a \$137 reduction in interest expense.

**Provision for Loan Losses**

Peoples evaluates the adequacy of the allowance for loan losses account on a quarterly basis utilizing its systematic analysis in accordance with procedural discipline. Peoples takes into consideration certain factors such as composition of the loan portfolio, volumes of nonperforming loans, volumes of net charge-offs, prevailing economic conditions and other relevant factors when determining the adequacy of the allowance for loan losses account. Peoples makes monthly provisions to the allowance for loan losses account in order to maintain the allowance at an appropriate level. The provision for loan losses equaled \$1,794 in 2011 and \$2,202 in 2010.

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**Table of Contents****Noninterest Income**

Noninterest income increased \$1,277 or 29.8 percent to \$5,567 in 2011 from \$4,290 in 2010. Revenue received from Peoples Wealth Management Division increased \$352 or 115.4 percent as a result of acquiring an existing investment advisory business in the fourth quarter of 2010. Included in noninterest revenue in 2011 was a \$1,671 gain on the sale of a commercial property held as other real estate. Service charges, fees, commissions and others declined \$487, while continued weakness in the housing market contributed to a \$71 reduction in mortgage banking income.

**Noninterest Expense**

Salaries and employee benefits expense increased \$937 or 17.0 percent to \$6,435 in 2011 from \$5,498 in 2010. Salaries and payroll taxes increased \$606 or 12.8 percent, while employee benefits expense increased \$331 or 43.9 percent. The increase in the salaries and payroll taxes component was directly related to the hiring of business development personnel, additional staffing in the Wealth Management Division and annual merit increases. The increase in employee benefits expense resulted primarily from an increases in contributions to the deferred compensation plan and profit sharing as a result of the increase in earnings.

For 2011, occupancy and equipment expense increased \$378 or 15.1 percent to \$2,879 from \$2,501 in 2010. Specifically, building-related costs increased \$49 or 5.7 percent while equipment-related costs increased \$329 or 20.0 percent. The increase in equipment expense resulted from additional costs, including maintenance and depreciation, associated with upgrades and additions to information systems. Higher utility costs, building repairs and real estate taxes were the primary factors causing the increase in occupancy expense.

Other expenses increased \$750 or 14.3 percent to \$5,996 in 2011 from \$5,246 in 2010. The increase was due largely to incurring \$404 of expenses from damages to four of its community banking offices caused by a flood in the third quarter of 2011. In addition, fees associated with accounts receivable financing product increased \$162 for 2011. Balances carried in this product grew significantly in 2011, ending the year at \$5,053 from \$564 at the end of 2010.

**Income Taxes**

Peoples income tax expense increased \$920 to \$2,357 in 2011, from \$1,437 in 2010. The increase resulted from higher net income before income taxes, coupled with a lower amount of tax-exempt interest revenue as a percentage of total interest revenue. Peoples utilizes loans and investments of tax-exempt organizations to mitigate its tax burden, as interest revenue from these sources is not taxable by the federal government. Tax-exempt interest revenue, as a percentage of total interest revenue, declined to 11.0 percent in 2011 from 12.3 percent in 2010. Its effective tax rate increased to 23.2 percent in 2011, compared to 18.1 percent in 2010.

**Quantitative and Qualitative Disclosures about Market Risk**

Market risk is the risk to Peoples earnings and/or financial position resulting from adverse changes in market rates or prices, such as interest rates, foreign exchange rates or equity prices. Peoples exposure to market risk is primarily interest rate risk ( IRR ) associated with lending, investing and deposit gathering activities. During the normal course of business, we are not exposed to foreign exchange risk or commodity price risk. Peoples exposure to IRR can be explained as the potential for change in reported earnings and/or the market value of net worth. Variations in interest rates affect the underlying economic value of assets, liabilities and off-balance sheet items. These changes arise because the present value of future cash flows, and often the cash flows themselves, change with interest rates. The effects of the changes in these present values reflect the change in Peoples underlying economic value, and provide a basis for the expected change in future earnings related to interest rates. Interest rate changes affect earnings by changing net interest income and the level of other interest-sensitive income and operating expenses. IRR is inherent in the role of banks as financial intermediaries.

**Table of Contents**

However, a bank with a high degree of IRR may experience lower earnings, impaired liquidity and capital positions, and most likely, a greater risk of insolvency. Therefore, banks must carefully evaluate IRR to promote safety and soundness in their activities.

The overnight borrowing rate has been subject to a range of 0% to 0.25% since the Federal Open Market Committee ( FOMC ) adopted their accommodative monetary policy. The FOMC has also acted in concert to drive longer term rates to historic lows as well as operating as a backstop to the financial industry through direct infusions of capital by implementing their quantitative easing policies. While there has been some indication that the FOMC 's accommodating position may change, there are no immediate signs that the current environment will warrant this action.

The projected impact of instantaneous changes in interest rates on Peoples net interest income and economic value of equity at June 30, 2013, is summarized as follows:

Changes in Interest Rates (basis points)	June 30, 2013 % Change in			
	Net Interest Income		Economic Value of Equity	
	Metric	Policy	Metric	Policy
+400	(4.7)	N/A	(11.0)	N/A
+300	(3.4)	(30.0)	(7.9)	(30.0)
+200	(2.3)	(20.0)	(5.2)	(25.0)
+100	(1.2)	(10.0)	(2.6)	(15.0)
Static				
-100	(2.4)	(10.0)	8.9	(15.0)
-200	(7.7)	(20.0)	11.3	(25.0)

**Description of Peoples Capital Securities**

The authorized capital stock of Peoples consists of twelve million five hundred thousand (12,500,000) shares of common stock, \$2.00 par value, and five hundred thousand (500,000) shares of preferred stock, \$5.00 par value. Peoples is proposing to increase its authorized number of common stock to twenty-five million (25,000,000) shares. See Peoples Proposal 2: Amendment to Peoples Articles of Incorporation to Increase Authorized Number of Shares below.

As of the record date for the Peoples special meeting, there were 3,087,406 shares of Peoples common stock issued and outstanding, 253,845 shares held by Peoples as treasury stock, and no shares of Peoples preferred stock issued or outstanding. There are no other shares of capital stock of Peoples authorized, issued or outstanding.

Peoples has no options, warrants or other rights authorized, issued or outstanding other than options and rights granted under Peoples various stock compensation and dividend reinvestment plans.

**Description of Peoples Common Stock****Dividends**

The holders of Peoples common stock share ratably in dividends when and if declared by Peoples board of directors from legally available funds. Declaration and payment of cash dividends by Peoples depends upon cash dividend payments to it by Peoples Neighborhood Bank, which is Peoples primary source of revenue and cash flow. Peoples is a legal entity separate and distinct from Peoples Neighborhood Bank. Accordingly, the right of Peoples, and consequently the right of creditors and shareholders of Peoples, to participate in any distribution of

## **Table of Contents**

the assets or earnings of any subsidiary is necessarily subject to the prior claims of creditors of the subsidiary, except to the extent that claims of Peoples in its capacity as a creditor may be recognized.

### ***Pre-Emptive Rights, Redemption***

Holders of Peoples common stock do not have pre-emptive rights to acquire any additional shares of Peoples common stock. Peoples common stock is not subject to redemption.

### ***Liquidation Rights***

In the event of Peoples liquidation, dissolution or winding-up, whether voluntary or involuntary, holders of Peoples common stock will share ratably in any of its assets or funds that are available for distribution to its shareholders after satisfaction, or adequate provision is made for satisfaction, of its liabilities, and after payment of any liquidation preferences of any outstanding shares of Peoples preferred stock.

### ***Preferred Stock***

Peoples board of directors is authorized to issue shares of Peoples preferred stock, without shareholder approval. Peoples board will determine the rights, qualifications, limitations and restrictions of each series of Peoples preferred stock at the time of issuance, including without limitation, rights as to dividends, voting and convertibility into shares of Peoples common stock. Shares of Peoples preferred stock may have dividend, redemption, voting, and liquidation rights that take priority over the Peoples common stock, and may be convertible into Peoples common stock.

### ***Anti-Takeover Article and Bylaw Provisions***

Peoples articles of incorporation and bylaws contain certain provisions that may have the effect of deterring or discouraging an attempt to take control of Peoples. Among other things these provisions:

Empower Peoples board of directors, without shareholder approval, to issue shares of Peoples preferred stock the terms of which, including voting power, are set by Peoples board of directors;

Divide Peoples board of directors into three classes serving staggered three-year terms;

Require that shares with at least 75 % or, in certain instances, a majority of total voting power approve the repeal or amendment of certain provisions of Peoples articles of incorporation;

Eliminate cumulative voting in the election of directors; and

Require advance notice of nominations for the election of directors and the presentation of shareholder proposals at meetings of shareholders.

The Pennsylvania Business Corporation Law of 1988, as amended, also contains certain provisions applicable to Peoples that may have the effect of deterring or discouraging an attempt to take control of Peoples. These provisions, among other things:

Require that, following any acquisition by any person or group of 20% of a public corporation's voting power, the remaining shareholders have the right to receive payment for their shares, in cash, from such person or group in an amount equal to the fair value of the shares, including an increment representing a proportion of any value payable for control of the corporation (Subchapter 25E of the Pennsylvania Business Corporation Law);

Prohibit for five years, subject to certain exceptions, a business combination (which includes a merger or consolidation of the corporation or a sale, lease or exchange of assets) with a person or group beneficially owning 20% or more of a public corporation's voting power (Subchapter 25F of the Pennsylvania Business Corporation Law);

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**Table of Contents**

Prevent a person or group acquiring different levels of voting power (20%, 33% and 50%) from voting any shares over the applicable threshold, unless disinterested shareholders approve such voting rights (Subchapter 25G of the Pennsylvania Business Corporation Law);

Require any person or group that publicly announces that it may acquire control of a corporation, or that acquires or publicly discloses an intent to acquire 20% or more of the voting power of a corporation, to disgorge to the corporation any profits that it receives from sales of the corporation's equity securities purchased over the prior 24 or subsequent 18 months (Subchapter 25H of the Pennsylvania Business Corporation Law);

Expand the factors and groups (including shareholders) which a corporation's board of directors can consider in determining whether an action is in the best interests of the corporation;

Provide that a corporation's board of directors need not consider the interests of any particular group as dominant or controlling;

Provide that a corporation's directors, in order to satisfy the presumption that they have acted in the best interests of the corporation, need not satisfy any greater obligation or higher burden of proof with respect to actions relating to an acquisition or potential acquisition of control;

Provide that actions relating to acquisitions of control that are approved by a majority of disinterested directors are presumed to satisfy the directors' standard, unless it is proven by clear and convincing evidence that the directors did not assent to such action in good faith after reasonable investigation; and

Provide that the fiduciary duty of a corporation's directors is solely to the corporation and may be enforced by the corporation or by a shareholder in a derivative action, but not by a shareholder directly.

The Pennsylvania Business Corporation Law also explicitly provides that the fiduciary duty of directors does not require them to:

Redeem any rights under, or to modify or render inapplicable, any shareholder rights plan;

Render inapplicable, or make determinations under, provisions of the Pennsylvania Business Corporation Law relating to control transactions, business combinations, control-share acquisitions or disgorgement by certain controlling shareholders following attempts to acquire control; or

Act as the board of directors, a committee of the board or an individual director, solely because of the effect the action might have on an acquisition or potential acquisition of control of the corporation or the consideration that might be offered or paid to shareholders in such an acquisition.

**Comparison of Shareholders' Rights**

Upon completion of the merger, Penseco shareholders will become Peoples shareholders, and their rights will be governed by the articles of incorporation and bylaws of Peoples, as amended in accordance with the merger. Each of Peoples and Penseco is, and the combined company will be, a Pennsylvania business corporation governed by the Pennsylvania Business Corporation Law.

The following is a summary of the material differences among the pre-merger rights of Penseco and Peoples shareholders and their post-merger rights as shareholders of Peoples, giving effect to the planned amendments to the articles of incorporation and bylaws of Peoples. This discussion is not a complete statement of all differences affecting the rights of Penseco and Peoples shareholders, and this discussion is qualified



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in its entirety by reference to the Pennsylvania Business Corporation Law, the articles of incorporation and bylaws of Penseco and Peoples, and the post-merger articles of incorporation and bylaws of Peoples, which are attached to this document as Exhibits 4 and 5 to the merger agreement.

## **Table of Contents**

### **Number of Authorized Shares of Capital Stock**

Peoples, pre-merger. The articles of incorporation currently authorize 12,500,000 shares of common stock and 500,000 shares of preferred stock.

Peoples, post-merger. Upon approval and adoption by the shareholders of the proposed amendment to Peoples' articles of incorporation pursuant to the terms of the merger agreement, the articles of incorporation will authorize 25,000,000 shares of common stock and 500,000 shares of preferred stock.

Penseco. The articles of incorporation authorize 15,000,000 shares of common stock.

### **Share Certificates**

Peoples, pre- and post-merger. Peoples' amended articles and bylaws allow for the representation of share ownership in certificated and uncertificated form.

Penseco. The bylaws of Penseco allow for the representation of share ownership in certificated and uncertificated form.

### **Annual Shareholder Meeting**

Peoples, pre- and post-merger. The annual meeting of shareholders shall be held no later than May 31 each year as fixed by the board of directors.

Penseco. The date of the annual meeting is fixed each year by the board of directors.

### **Special Meetings of Shareholders**

Peoples, pre- and post-merger. Special meetings of shareholders may be called at any time by the chairman of the board, the President, a majority of the board of directors or of its executive committee.

Penseco. Special meetings of the shareholders may be called at any time by the chairman, president, or board of directors of Penseco.

### **Notice of Shareholder Meetings**

Peoples, pre- and post-merger. Unless required otherwise by law, each shareholder is entitled to notice of a meeting of shareholders at least ten days before the meeting.

Penseco. Unless required otherwise by law, each shareholder is entitled to notice of a meeting of shareholders at least ten days before the meeting.

### **Fixing the Record Date**

Peoples, pre- and post-merger. The board of directors may fix a time as the record date for the event not more than 90 days prior to the date of any meeting, the date fixed for the payment of dividend, the date for the allotment of rights, and the date when any change or conversion of shares will be made or go in effect.

Penseco. The board of directors may fix a time as the record date for the event not more than 90 days prior to the date of any meeting, the date fixed for the payment of dividend, the date for the allotment of rights, and the date when any change or conversion of shares will be made or go in effect.

## **Table of Contents**

### **Composition of the Board of Directors**

**Peoples, pre-merger.** The current bylaws of Peoples require that the board of directors be comprised of between five and 25 directors. The board of directors is divided into three classes of directors, and each director in a class serves a three-year term such that only the terms of directors in a single class expire in a given year. Upon a vacancy on the board of directors, the majority of the remaining directors will fill the open position. Directors who reach the mandatory retirement age of 70 years retire at the next annual meeting of shareholders following their 70<sup>th</sup> birthday.

**Peoples, post-merger.** The proposed amendment to Peoples bylaws requires that for 3 years following the effective time of the merger Peoples board of directors be comprised of 14 directors with Peoples selecting 6 members and Penseco selecting 8 members from their current boards of directors unless 80% of the board of directors determines otherwise, director nominees shall be selected, or recommended for the board of directors selection, by a nominating committee comprised solely of independent directors, and more particularly as follows:

a subcommittee comprised solely of continuing Peoples directors will select, or recommend for the board's selection, the director nominees for each directorship held by an incumbent continuing Peoples director whose term is expiring, and

a subcommittee comprised solely of continuing Penseco directors will select, or recommend for the board's selection, the director nominees for each directorship held by an incumbent continuing Penseco director whose term is expiring.

The directors will be divided as equally as possible among three classes of directors. Each director in a class will serve a three-year term such that only the terms of directors in a single class expire in a given year. Directors who reach the mandatory retirement age of 73 years retire at end of their term. However, those directors who are appointed in connection with the merger are eligible to stand for one additional 3 year term of office regardless of age. These bylaw provisions may only be amended upon the approval of 80% of the directors of the entire board of directors.

Successors to vacant positions will be selected in the manner above for three years after the merger unless 80% of Peoples board of directors determines otherwise after the effective time of the merger. After three years, the majority of the remaining board of directors will fill vacant positions.

**Penseco.** The current bylaws of Penseco require that the board be comprised of a number of directors as fixed from time to time by resolution of the board of directors. The board of directors is divided into four classes of directors nearly equal in number as possible, each director in a class serves a four-year term such that only the terms of directors in a single class expire in a given year. Upon a vacancy on the board of directors, the majority of the remaining directors will fill the open position.

### **Composition of Board of Director Committees**

**Peoples, pre-merger.** Other than requiring the chairman of the board, the President and not less than one or more than three other directors to serve on the executive committee, there currently are no restrictions regarding the composition of board of director committees in the articles of incorporation or bylaws of Peoples.

**Peoples, post-merger.** The proposed amendment to Peoples bylaws requires that, for 3 years after the merger, all committees of the board of directors have pro rata representation of directors of Peoples prior to the merger and directors formerly of Penseco. The committees will be comprised accordingly for three years unless 80% of the board of directors of Peoples determines otherwise after the effective time of the merger.

**Penseco.** The bylaws require that there shall be three standing committees of the board consisting of the nominating and corporate governance committee, the audit committee and the compensation committee and such

## **Table of Contents**

other committees as the board shall establish. Each of the three standing committees shall consist of at least three directors. All other committees may consist of one or more directors as the board of directors may determine.

### **Advance Notice Requirement for Nomination of Candidates for Director**

Peoples, pre- and post-merger. Shareholders wishing to nominate a candidate for election to the board of directors must notify the Secretary of the Peoples in writing not less than 60 days prior to the date of any meeting of shareholder called for the election of directors. The notice must contain:

1. The name and address of the proposed nominee;
2. The age of the proposed nominee;
3. The principal occupation of the proposed nominee;
4. The number of shares the proposed nominee owns of Peoples;
5. The total number of shares that, to the knowledge of the notifying shareholder, that will be voting for the proposed nominee;
6. The name and residence address of the notifying shareholder; and
7. The number of shares the notifying shareholder owns of Peoples.

Shareholders who wish to include their nomination in the proxy materials of Peoples also must comply with the timing and information requirements of the Securities and Exchange Commission Rule 14a-8 promulgated under the Securities Exchange Act of 1934.

Penseco. Shareholders wishing to nominate a candidate for election to the board of directors must notify the Secretary of Penseco in writing not later than 60 days nor earlier than 90 days prior to the first anniversary of the preceding year's annual meeting. However, in the event that the date of the annual meeting is more than 30 days before or more than 60 days after such anniversary date, notice by the shareholder must be received no earlier than the 90<sup>th</sup> day prior to the annual meeting and not later than the 60<sup>th</sup> day prior to the annual meeting or the 15<sup>th</sup> day following the day on which public announcement of the date of the meeting is first made by Penseco.

### **Advance Notice Requirement for Business to be Conducted at Annual Meeting**

Peoples, pre- and post-merger. Shareholders who wish to have their proposals considered at an annual meeting of shareholders but not included in Peoples' proxy materials must submit notice of their proposal to the principal executive offices addressed to the attention of the President or Secretary (i) in the case of an annual meeting that is called for a date that is within thirty (30) days before or after the anniversary date of the immediately preceding annual meeting of shareholders, not less than sixty (60) days nor more than ninety (90) days prior to such anniversary date, provided, that a proposal submitted by shareholder for inclusion in the Peoples' proxy statement for an annual meeting which is appropriate for inclusion therein and otherwise complies with Securities Exchange Act of 1934 Rule 14a-8 (including timeliness), or any successor rule, shall be deemed to have also been submitted timely pursuant to these by laws and (ii) in the case of an annual meeting that is called for a date that is not within thirty (30) days before or after the anniversary date of the immediately preceding annual meeting, or in the case of a special meeting, not later than the close of business on the fifth (5th) day following the earlier of the day on which notice of the date of the meeting was mailed or public disclosure of the meeting date (which shall include disclosure of the meeting date given to a national securities exchange or the Financial Industry Regulatory Authority) was made.

Each such Shareholder Notice must set forth:

- (i) the name and address of the shareholder who intends to bring the business before the meeting ( Proposing Shareholder );

### **Table of Contents**

- (ii) the name and address of the beneficial owner, if different than the Proposing Shareholder, or any of the shares of Peoples which are owned of record and beneficially by the Proposing Shareholder and the number which are owned beneficially by any beneficial owner;
- (iii) any interest (other than an interest solely as a shareholder) which the Proposing Shareholder or a beneficial owner has in the business being proposed by the Proposing Shareholder;
- (iv) a description of all arrangements and understandings between the Proposing Shareholder and any beneficial owner and any other person or persons (naming such person or persons) pursuant to which the proposal in the shareholder notice is being made;
- (v) a description of the business which the Proposing Shareholder seeks to bring before the meeting, the reason for doing so and, if a specific action is to be proposed, the text of the resolution or resolutions which the Proposing Shareholder proposes that Peoples adopt; and
- (vi) a representation that the Proposing Shareholder is at the time of giving the shareholder notice, was or will be on the record date for the meeting, and will be on the meeting date a holder of record of shares of Peoples entitled to vote at such meeting, and intends to appear in person or by proxy at the meeting to bring the business specified in the shareholder notice before the meeting.

Penseco. Shareholders who wish to have their proposals considered at an annual meeting of shareholders but not included in Penseco's proxy materials must submit notice of their proposal to the principal executive offices of Penseco not later than 120 days prior to the anniversary date of the initial proxy materials or of a notice of the meeting by Penseco in connection with the immediately preceding annual meeting of shareholders. The notice must contain with respect to each proposal:

1. A description of the proposal and the reasons for bringing the proposal to the consideration of the shareholders;
2. The name and address of the shareholder making the proposal;
3. The class and number of shares beneficially owned by the proposing shareholder and by any person in a voting group with the proposing shareholder with respect to Penseco;
4. The identification of any person retained by the proposing shareholder to solicit votes for the passage of the proposal along with a brief description of the terms of the employment; and
5. Any material interest the proposing shareholder has with respect to the proposal.

Shareholders who wish to include their proposal in the proxy materials of Penseco must comply with the timing and information requirements of the Securities & Exchange Commission Rule 14a-8 promulgated under the Securities Exchange Act of 1934.

### **Amendment of Articles of Incorporation**

Peoples, pre- and post-merger. A majority of the votes cast by all shareholders entitled to vote on the matter may amend the articles of incorporation. However, the provisions of Article 7 relating to shareholder approval of fundamental transactions and Article 9 relating to factors the board may consider relating to fundamental transactions may not be repealed, altered or amended, in any respect whatsoever, unless such repeal, alteration or amendment is approved by either (a) the affirmative vote of shareholders entitled to cast at least 75% of the votes which all shareholders of Peoples are entitled to cast or (b) the affirmative vote of at least 66-2/3% of the members of the board of directors of Peoples and the affirmative vote of shareholders entitled to cast at least a majority of the votes which all shareholders of Peoples are entitled to cast.

Penseco. The affirmative vote of a majority of total votes eligible to be cast at a meeting on a proposal submitted by the board of directors may amend the articles of incorporation. However, the affirmative vote of at least 75% of the outstanding shares of common stock is required to amend article Fifth of the articles of incorporation relating to shareholder approval of mergers, consolidations, liquidations, or dissolutions.

## **Table of Contents**

### **Amendment of Bylaws**

**Peoples, pre-merger.** The bylaws may be amended by (a) the affirmative vote of at least seventy-five percent (75%) of the outstanding shares of common stock or (b) by the affirmative vote of a majority of the members of the board of directors, with the exception of Sections 10.2. and 10.3. of the bylaws which requires the affirmative vote of seventy-five percent (75%) or more of the members of the board of directors, subject to the power of the shareholders to change such action of the board of directors by the affirmative vote of at least seventy-five percent (75%) of the outstanding shares of common stock.

**Peoples, post-merger.** Generally, the means by which the bylaws can be amended will not change after the merger. However, the provisions relating to the composition of the board of directors, mandatory retirement of directors, filling of vacancies of the board of directors, and the composition of committees of the board of directors for three years following the merger may only be amended by an affirmative vote of 80% of the board of directors.

**Penseco.** Shareholders may amend the bylaws by a majority vote provided that notice of the proposed amendments are sent to shareholders at least 10 days prior to the meeting at which such amendments are voted. Except as to bylaws fixing the qualifications, classification or terms of office of directors, the board of directors may amend Penseco's bylaws subject to the power of the shareholders to change such action.

### **Fundamental Changes**

**Peoples, pre- and post-merger.** Peoples' articles of incorporation require the approval of at least 75% of the outstanding shares of Peoples for the merger, consolidation, share exchange, sale, lease, exchange or other transfer of the assets, liquidation or dissolution of Peoples or any similar transaction. However, if such transaction is approved by at least 66-2/3% of the members of the entire Board, then only a majority of the outstanding shares of Peoples is required to approve the transaction.

**Penseco.** Penseco's articles of incorporation require the approval of at least 75% of the outstanding shares of Penseco for the merger, consolidation, liquidation or dissolution of Penseco.

### **Anti-Takeover Provisions Applicable to Registered Corporations**

**Peoples, pre- and post-merger.** Peoples is a registered corporation. Accordingly, Peoples is subject to the following anti-takeover provisions of Chapter 25 of the Pennsylvania Business Corporation Law, which contain a wide variety of transactional and status exemptions, exclusions, and safe harbors.

Subchapter 25E (relating to control transactions) provides that if any person or group of persons were to acquire more than 20% of the voting power of Peoples, then the remaining shareholders could demand from such person or group of persons the fair value of their shares, including a proportionate amount of any control premium.

Subchapter 25F (relating to business combinations) delays for five years and imposes conditions upon business combinations between an interested shareholder and a covered corporation, unless the business combination or share acquisition is approved by Peoples' board of directors prior to the date the person became an interested shareholder. Business combination is defined broadly to include various transactions utilizing a corporation's assets for purchase price amortization or refinancing purposes. An interested shareholder for this purpose is defined generally as the beneficial owner of at least 20% of a corporation's voting shares.

Subchapter 25G (relating to control-share acquisitions) prevents a person who has acquired 20% or more of the voting power of a covered corporation from voting the shares unless the disinterested shareholders approve the voting rights.



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## **Table of Contents**

Subchapter 25H (relating to disgorgement) requires persons (1) who acquire 20% or more of the voting power of a covered corporation or (2) announce that they may acquire such control, and then sell shares within 18 months after the happening of (1) or (2) to disgorge the profits made from the transaction. Any profits from sales of equity securities of Peoples by the person or group during the 18-month period belong to Peoples if the securities that were sold were acquired during the 18-month period or with 24-months prior thereto.

Subchapter 25I (relating to severance payments) provides for a minimum severance payment to certain employees terminated within two years of the approval of a control-share acquisition under Subchapter 25G.

Subchapter 25J (relating to business combination transactions-labor contracts) prohibits the abolishment of certain labor contracts in connection with a control-share acquisition under Subchapter 25G.

Penseco. Penseco is a registered corporation. Accordingly, Penseco is subject to the anti-takeover provisions of Chapter 25 of the Pennsylvania Business Corporation Law described above.

### **Directors Duty to Consider a Merger or Combination with Another Corporation**

Peoples, pre- and post-merger. Pennsylvania Business Corporation Law states that in considering a transaction such as a merger or combination with another corporation:

1. A director can consider a number of factors and groups in determining whether the transaction is in the best interests in Peoples;
2. A director need not consider the interests of any particular group as dominant or controlling;
3. Directors, in order to satisfy the presumption that they have acted in the best interests of Peoples, need not satisfy any special burden of proof;
4. Actions approved by a majority of disinterested directors are presumed to satisfy these standards unless clear and convincing evidence shows that the directors did not assent to the action in good faith after reasonable investigation; and
5. The fiduciary duty of a director is owed only to Peoples and may be enforced by Peoples or a shareholder in a derivative action but not by a shareholder directly.

In addition to these provisions in the Pennsylvania Business Corporation Law, Peoples articles of incorporation further provide that its board of directors when evaluating any offer of another party to (i) make a tender or exchange offer for any equity security of Peoples, (ii) merge or consolidate Peoples with another corporation, (iii) purchase or otherwise acquire all or substantially all of the properties and assets of Peoples or (iv) engage in any transaction similar to, or having similar effects as, any of the foregoing transactions, shall, in connection with the exercise of its judgment in determining what is in the best interests of Peoples and its shareholders, give due consideration to all relevant factors, including without limitation the social and economic effects of the proposed transaction on the depositors, employees, suppliers, customers and other constituents of Peoples and its subsidiaries and on the communities in which Peoples and its subsidiaries operate or are located, the business reputation of the other party, and the board of directors' evaluation of the then value of Peoples in a freely negotiated sale and of the future prospects of this corporation as an independent entity.

Penseco. In addition to the provisions of Pennsylvania Business Corporation Law, Penseco's articles of incorporation further provide that its board of directors may, if it deems it advisable, oppose a tender or other offer for Penseco's securities, whether the offer is in cash or in the securities of a corporation or otherwise. When considering whether to oppose an offer, the board of directors may, but is not legally obligated to, consider any pertinent issue. Though the board of directors is not legally obligated to consider the following, the articles of incorporation give examples of factors the board of directors may consider:



**Table of Contents**

Whether the offer price is acceptable based on the historical and present operating results or financial condition of Penseco;

Whether a more favorable price could be obtained for Penseco's securities in the future;

The reputation and business practice of the offeror and its management and affiliates as they would affect the shareholders, employees, depositors and customers of Penseco and its subsidiaries and the future value of Penseco's stock;

The value of the securities (if any) which the offeror is offering in exchange for Penseco's securities based on an analysis of the worth of Penseco as compared the other entity whose securities are being offered; and

Any antitrust or other legal and regulatory issues that are raised by the offer.

If Penseco's board of directors determines that an offer should be rejected, it may take any lawful action to accomplish its purpose. The articles of incorporation give these examples:

Advising shareholders not to accept the offer;

Litigation against the offeror;

Filing complaints with all governmental and regulatory authorities;

Acquiring the offeror corporation's own securities;

Selling or otherwise issuing authorized but unissued securities or treasury stock or granting options with respect thereto;

Acquiring a company to create an antitrust or other regulatory problem for the offeror; and

Obtaining a more favorable offer from another individual or entity.

**Peoples Proposal No. 2:**

**Amendment to Peoples' Articles of Incorporation to**

**Increase Authorized Number of Shares**

Peoples' articles of incorporation currently authorize twelve million five hundred thousand (12,500,000) shares of common stock, \$2.00 par value per share and five hundred thousand (500,000) shares of series preferred stock, no par value per share. As of September 30, 2013, there were 3,087,406 shares of common stock issued and outstanding and no shares of series preferred stock issued and outstanding. Of the remaining 9,412,594 authorized but unissued shares of common stock, 5,600 shares are reserved for issuance upon the exercise of outstanding stock options under the Peoples' stock option plans and in connection with the corporation's Dividend Reinvestment and Stock Purchase Plan, as well. In order to complete the merger with Penseco, Peoples must issue an additional 4,466,086 shares to Penseco shareholders. While, Peoples does have enough authorized shares to complete the merger, in the future, Peoples may need additional authorized but unissued shares available for issuance, from time to time, as may be necessary in connection with future financings, investment opportunities, acquisitions of other

companies, the declaration of stock dividends, stock splits or other distributions, or for other corporate purposes.

On June 28, 2013, Peoples board of directors approved and adopted resolutions to amend Article 4 of the Peoples articles of incorporation to increase the number of authorized shares of common stock from 12,500,000 shares to 25,000,000 shares. This increase in the number of authorized shares requires that Peoples shareholders adopt the amendment to the Peoples articles of incorporation. A true and correct copy of the amended and restated articles of incorporation, reflecting the proposed amendment, is set forth in Exhibit 4 to Annex A to this proxy statement/prospectus, which is incorporated in its entirety into this proxy statement/prospectus.

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**Table of Contents**

Except in relation to the merger with Pensco and as otherwise described in this proxy statement/prospectus, Peoples has no present plans, undertakings or arrangements for issuing additional shares after the merger. The board of directors believes that it is advisable to have the ability to authorize additional shares to enable Peoples, as the need may arise, to take prompt advantage of market conditions and favorable opportunities for the acquisition of other companies without the delay and expense of holding a special meeting of shareholders. The future issuance of shares of stock may dilute the present equity ownership position of current holders. The proposed amendment is not intended to have an anti-takeover effect. The issuance, however, of any of the shares may potentially have an anti-takeover effect by making it more difficult to obtain shareholder approval of actions, such as certain business combinations or removal of management.

Unissued shares of common stock and series preferred stock are available for issuance at the discretion of the Peoples board of directors, from time to time, for any proper corporate purpose, generally without further action of the shareholders, upon the affirmative vote of a majority of the members of the board of directors. If the proposed amendment is adopted by the Peoples shareholders, the Peoples board of directors is not likely to solicit shareholder approval to issue the additional authorized shares, except to the extent that approval may be required by law, regulation or any agreement governing the trading of the Peoples stock.

To provide sufficient shares for the future needs, the Peoples board of directors believes that it is in the best interest of the corporation for the shareholders to approve and adopt the amendment to Article 4 of the articles of incorporation. The Peoples board of directors believes that the increase in the number of authorized shares is necessary to provide Peoples with as much flexibility as possible to issue additional shares for proper purposes, including financing, acquisitions, stock splits, stock dividends, employee incentive plans, and other similar purposes.

As a result, the board of directors proposes that Peoples Articles of Incorporation be amended and restated to revise Article 4 of the Articles of Incorporation to read in full and in its entirety as follows:

4. The aggregate number of shares of common stock which the corporation shall have authority to issue is Twenty-Five Million (25,000,000) shares of common stock, \$2.00 par value.

The affirmative vote of a majority of the votes cast by all Peoples shareholders entitled to vote thereon is required to approve and adopt this amendment.

**Peoples board of directors unanimously recommends a vote FOR the proposal to amend Article 4 of Peoples Articles of Incorporation, as amended.**

**Peoples Proposal 3:**

**Advisory (Non-Binding) Vote on Golden Parachute Compensation**

In accordance with the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, the board of directors of Peoples is providing its shareholders with the opportunity to cast an advisory vote on the golden parachute compensation payable to the named executive officers of Peoples and Pensco in connection with the merger at the special meeting through the following resolution:

RESOLVED, that the compensation that may be paid or become payable to the named executive officers in connection with the merger, as disclosed in the tables entitled Golden Parachute Compensation for the Named Executive Officers of Peoples Financial Services Corp. on page 84 and Golden Parachute Compensation for the Named Executive Officers of Pensco Financial Services Corporation on page 86 together with the accompanying narrative discussions relating to the named executive officers golden parachute compensation and the agreements or understandings pursuant to which such compensation may be paid or become payable, as set forth in the sections of this proxy statement/prospectus titled Summary of Peoples Golden Parachute Arrangements and Summary of Pensco Golden Parachute Arrangements are hereby APPROVED.

## **Table of Contents**

The vote on this proposal is a vote separate and apart from the vote on the proposal to approve and adopt the merger agreement. Accordingly, you may vote to approve this proposal and not to approve and adopt the merger proposal, and vice versa. Because the vote is advisory in nature only, it will not be binding on either Peoples or Peoples Neighborhood Bank regardless of whether the merger agreement is approved and adopted. Accordingly, as the compensation to be paid in connection with the merger is contractual with the executives, regardless of the outcome of this advisory vote, such compensation will be payable, subject only to the conditions applicable to such payment, if the merger agreement is approved and adopted and the merger is completed.

**The Peoples board of directors unanimously recommends that its shareholders vote FOR approval, on an advisory (non-binding) basis, of the golden parachute compensation payable to the named executive officers of Peoples and Pensco in connection with the merger.**

### **Pensco Proposal 2:**

#### **Advisory (Non-Binding) Vote on Golden Parachute Compensation**

In accordance with the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, the board of directors of Pensco is providing its shareholders with the opportunity to cast an advisory vote on the golden parachute compensation, that is compensation based on or related to the proposed merger, payable to the named executive officers of Pensco in connection with the merger, at the special meeting through the following resolution:

RESOLVED, that the compensation that may be paid or become payable to the named executive officers in connection with the merger, as disclosed in the table entitled Golden Parachute Compensation for the Named Executive Officers of Pensco Financial Services Corporation on page 86, together with the accompanying narrative discussion relating to the named executive officers golden parachute compensation and the agreements or understandings pursuant to which such compensation may be paid or become payable, as set forth in the section of this proxy statement/prospectus titled Summary of Pensco Golden Parachute Arrangements is hereby APPROVED.

The vote on this proposal is a vote separate and apart from the vote on the proposal to approve and adopt the merger agreement. Accordingly, you may vote to approve this proposal and not to approve and adopt the merger proposal, and vice versa. Because the vote is advisory in nature only, it will not be binding on either Pensco or Penn Security Bank and Trust Company regardless of whether the merger agreement is approved and adopted. Accordingly, as the compensation to be paid in connection with the merger is contractual with the executives, regardless of the outcome of this advisory vote, such compensation will be payable, subject only to the conditions applicable to such payment, if the merger agreement is approved and adopted and the merger is completed.

**The Pensco board of directors unanimously recommends that its shareholders vote FOR the proposal to approve, on an advisory basis, the compensation of the named executive officers of Pensco that is based on or related to the proposed merger.**

### **Proposal:**

#### **Adjournment or Postponement of Special Meeting**

In the event that either Peoples or Pensco does not have sufficient votes for a quorum or to approve and adopt the merger agreement at their special meetings of shareholders, they intend to adjourn or postpone their meetings to permit further solicitation of proxies. Peoples and Pensco can only use proxies they receive at the time of their special meeting to vote for adjournment or postponement, if necessary, by submitting the question of adjournment or postponement to shareholders as a separate matter for consideration.

## **Table of Contents**

The boards of directors of Peoples and Penseco recommend that their respective shareholders mark their proxy in favor of the adjournment or postponement proposal so that their proxy may be used to vote for adjournment or postponement if necessary. If shareholders properly execute their proxy, Peoples and Penseco will consider that those shareholders voted in favor of the adjournment or postponement proposal unless their proxy indicates otherwise. If Peoples or Penseco adjourn or postpone their special meeting, they will not give notice of the time and place of the adjourned or postponed meeting other than by an announcement of such time and place at their special meeting.

### **Experts**

The consolidated financial statements of Peoples, as of December 31, 2012 and 2011, and for the years then ended, appearing elsewhere in this joint proxy statement/prospectus and in the registration statement have been included in reliance upon the report of ParenteBeard LLP, independent registered public accounting firm, which is included herein upon authority of ParenteBeard LLP as experts in accounting and auditing.

The consolidated financial statements of Penseco, as of December 31, 2012 and 2011, and for the years then ended, incorporated by reference into this joint proxy statement/prospectus and in the registration statement have been included in reliance upon the report of McGrail Merkel Quinn & Associates, P.C., independent registered public accounting firm, which is included herein upon authority of McGrail Merkel Quinn & Associates, P.C. as experts in accounting and auditing.

### **Legal Matters**

The validity of the Peoples common stock to be issued in the merger and certain other legal and certain tax matters relating to the merger are being passed upon for Peoples by Bybel Rutledge LLP, Lemoyne, PA. Certain tax matters relating to the merger are being passed upon for Penseco by Pepper Hamilton LLP, Philadelphia, PA

### **Where You Can Find More Information**

Penseco files annual, quarterly or current reports, proxy and information statements, or other information with the SEC. Penseco files these reports with the SEC under the Securities Exchange Act of 1934, as amended. You may read and copy this information at the SEC's Public Reference Room at 100 F Street, N.E., Washington, D.C. 20549. You may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330.

The SEC also maintains an Internet site that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC. That site is <http://www.sec.gov>. Penseco's SEC filings are also available on its website at <http://www.pennsecurity.com> in the Investor Relations section. The information on Penseco's website is not incorporated into this joint proxy statement/prospectus.

Peoples filed a registration statement with the SEC under the Securities Act of 1933, as amended, relating to the Peoples common stock offered to the Penseco shareholders in connection with the merger. The registration statement contains additional information about the Peoples common stock. You may read and copy the registration statement at the SEC's reference facilities described above.

### **Incorporation of Certain Information by Reference**

This document incorporates by reference important business and financial information about Penseco that is not included in or delivered with these materials. The following documents, filed with the SEC by Penseco, are incorporated by reference in this document:

## **Table of Contents**

Penseco's Annual Report on Form 10-K for the year ended December 31, 2012, filed with the SEC, on March 14, 2013.

Penseco's Proxy Statement for its 2013 annual meeting of shareholders, filed on April 1, 2013, to the extent incorporated by reference into its Annual Report on Form 10-K for the year ended December 31, 2012.

Penseco's Quarterly Reports on Form 10-Q for the quarters ended March 31, 2013, filed with the SEC, on May 9, 2013 and June 30, 2013, filed with the SEC, on August 8, 2013.

Penseco's Current Reports on Form 8-K, filed with the SEC, on May 10, June 28, July 29, August 16, and September 18, 2013. Penseco also incorporates by reference in these materials additional documents filed by it with the SEC under Sections 13(a), 13(c), 14 or 15(d) of the Securities Exchange Act of 1934 after the date of this proxy statement/prospectus and prior to the earlier of the date of the special meetings or the termination of the merger agreement; provided, however, that Penseco is not incorporating any information deemed furnished but not filed. The incorporated documents are deemed part of this proxy statement/prospectus as of the date of filing of each document.

Any statement contained in these materials or in a document incorporated by reference in these materials will be deemed to be modified or superseded to the extent that a statement contained herein or in any later filed document that also is incorporated by reference herein modifies or supersedes the statement. Any statement so modified or superseded should not be deemed, except as so modified or superseded, to constitute a part of this proxy statement/prospectus. You should read all information appearing in this proxy statement/prospectus in conjunction with the information and financial statements, including notes thereto, appearing in the documents incorporated by reference, except to the extent stated in this paragraph. All information in this proxy statement/prospectus is qualified in its entirety by the information in those documents.

You may obtain copies of the information incorporated by reference in this document. (See "How to Obtain More Information" in this document for information on how to make a request for information.)

All information contained or incorporated by reference in these materials about Penseco was supplied or verified by Penseco. All information contained in these materials about Peoples was supplied or verified by Peoples.

### **Other Business**

As of the date of this document, Peoples and Penseco's boards of directors know of no matters that will be presented for consideration at either special meeting other than as described in this document. However, if any other matter ancillary to the conduct of the meeting properly comes before either special meeting or any adjournments or postponements thereof and is voted upon, the form of proxy confers authority to the individuals named as proxies therein to vote the shares represented by such proxies as to any such matters according to the recommendation of Peoples and Penseco's management.

### **Shareholder Proposals**

#### **Peoples Annual Meeting**

If the shareholders of Peoples and Penseco approve and adopt the merger agreement, Peoples will have its 2014 annual meeting of shareholders no later than May 31, 2014. Any shareholder who wishes to submit a proposal for inclusion in Peoples' proxy statement for its 2014 annual meeting of shareholders was required to deliver the proposal in writing to the President of Peoples at Peoples' principal offices, not later than November 18, 2013. All other shareholder proposals must be received between December 18, 2013 and January 21, 2013.



**Table of Contents**

**Penseco Annual Meeting**

If the merger agreement is approved and adopted and the merger takes place, Penseco will not have an annual meeting of its shareholders in 2014. If the merger does not take place and Penseco does hold its 2014 annual meeting of shareholders, any shareholder who wishes to submit a proposal for inclusion in Penseco's proxy statement for its 2014 annual meeting of shareholders was required to deliver the proposal in writing to the President of Penseco at its principal executive offices no later than December 2, 2013. If next year's annual meeting is held on a date more than 30 calendar days before or after May 7, 2014, a shareholder proposal must be received by a reasonable time before Penseco begins to print and mail its proxy solicitation for such annual meeting. Any shareholder proposals will be subject to the requirements of the proxy rules adopted by the SEC.

Penseco's bylaws provide that, in order for a shareholder to make nominations for the election of directors or proposals for business to be brought before the 2014 annual meeting, a shareholder must deliver notice of such nominations and/or proposals to the Corporate Secretary not less than 60 days or more than 90 days prior to May 7, 2014. However, if the date of Penseco's annual meeting is more than 30 days before or more than 60 days after May 7, 2014, notice must be received not less than 60 days nor more than 90 days prior to the annual meeting date or no later than 15 days after public announcement of the date of the annual meeting. A copy of the bylaws may be obtained from Penseco.

**Table of Contents**

**Consolidated Financial Statements of Peoples Financial Services Corp.**

**Index**

	Page
<b><u>Consolidated Financial Statements December 31, 2012 and 2011</u></b>	
<u>Report of Independent Registered Public Accounting Firm</u>	F-2
<u>Consolidated Balance Sheets</u>	F-3
<u>Consolidated Statements of Operations</u>	F-4
<u>Consolidated Statements of Stockholders' Equity</u>	F-5
<u>Consolidated Statements of Cash Flows</u>	F-6
<u>Notes to Consolidated Financial Statements</u>	F-7
<b><u>Consolidated Financial Statements Six months Ended June 30, 2013 (Unaudited)</u></b>	
<u>Consolidated Balance Sheets</u>	F-45
<u>Consolidated Statements of Operations</u>	F-46
<u>Consolidated Statements of Stockholders' Equity</u>	F-47
<u>Consolidated Statements of Cash Flows</u>	F-48
<u>Notes to Consolidated Financial Statements</u>	F-49

**Table of Contents**

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

Board of Directors and Stockholders

Peoples Financial Services Corp.

Hallstead, Pennsylvania

We have audited the accompanying consolidated balance sheets of Peoples Financial Services Corp. and subsidiaries (the Company) as of December 31, 2012 and 2011, and the related consolidated statements of income and comprehensive income, changes in stockholders' equity and cash flows for each of the years in the three-year period ended December 31, 2012. The Company's management is responsible for these consolidated financial statements. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 2012 and 2011, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2012 in conformity with accounting principles generally accepted in the United States of America.

Allentown, Pennsylvania

August 12, 2013

**Table of Contents****Peoples Financial Services Corp.****CONSOLIDATED BALANCE SHEETS****(Dollars in thousands, except share data)**

<b>December 31</b>	<b>2012</b>	<b>2011</b>
<b>Assets:</b>		
Cash and due from banks	\$ 9,777	\$ 9,488
Interest-bearing deposits in other banks	1,126	1,071
Federal funds sold	17,180	
Investment securities available-for-sale	147,780	139,899
Loans held for sale	1,917	569
Loans, net	465,773	445,103
Less: allowance for loan losses	6,581	5,349
 Net loans	 459,192	 439,754
Premises and equipment, net	8,685	7,916
Accrued interest receivable	3,272	3,448
Other assets	22,594	19,259
 Total assets	 \$ 671,523	 \$ 621,404
<b>Liabilities:</b>		
Deposits:		
Noninterest-bearing	\$ 102,322	\$ 92,985
Interest-bearing	471,989	401,298
 Total deposits	 574,311	 494,283
Short-term borrowings	12,764	43,791
Long-term debt	13,130	18,927
Accrued interest payable	425	284
Other liabilities	4,697	4,506
 Total liabilities	 605,327	 561,791
<b>Stockholders equity:</b>		
Common stock, par value \$2.00; authorized 12,500,000 shares; issued 3,341,251 shares	6,683	6,683
Capital surplus	3,155	3,141
Retained earnings	57,781	51,342
Accumulated other comprehensive income	4,876	3,645
Less: treasury stock, at cost: 2012, 256,995 shares; 2011, 222,395 shares	6,299	5,198
 Total stockholders equity	 66,196	 59,613
 Total liabilities and stockholders equity	 \$ 671,523	 \$ 621,404

See notes to consolidated financial statements



**Table of Contents****Peoples Financial Services Corp.****CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME**

(Dollars in thousands, except per share data)

<b>Year Ended December 31</b>	<b>2012</b>	<b>2011</b>	<b>2010</b>
<b>Interest income:</b>			
Interest and fees on loans:			
Taxable	\$ 22,627	\$ 21,639	\$ 19,417
Tax-exempt	1,427	1,362	1,116
Interest and dividends on investment securities available-for-sale			
Taxable	2,325	2,610	2,943
Tax-exempt	1,342	1,660	2,027
Dividends	25	33	44
Interest on interest-bearing deposits in other banks	10	12	4
Interest on federal funds sold	23	34	26
<b>Total interest income</b>	<b>27,779</b>	<b>27,350</b>	<b>25,577</b>
<b>Interest expense:</b>			
Interest on deposits	4,320	4,423	4,696
Interest on short-term borrowings	166	310	389
Interest on long-term debt	626	906	1,413
<b>Total interest expense</b>	<b>5,112</b>	<b>5,639</b>	<b>6,498</b>
<b>Net interest income</b>	<b>22,667</b>	<b>21,711</b>	<b>19,079</b>
Provision for loan losses	1,695	1,794	2,202
<b>Net interest income after provision for loan losses</b>	<b>20,972</b>	<b>19,917</b>	<b>16,877</b>
<b>Noninterest income:</b>			
Service charges, fees and commissions	3,227	2,955	3,442
Wealth management income	625	657	305
Mortgage banking income	950	346	417
Net gain on sale of investment securities available-for-sale	383	25	346
Other-than-temporary impairment of investment equity securities		(87)	(164)
Impairment of other real estate owned	(306)		
Net gain (loss) on sale of other real estate owned	(33)	1,671	(56)
<b>Total noninterest income</b>	<b>4,846</b>	<b>5,567</b>	<b>4,290</b>
<b>Noninterest expense:</b>			
Salaries and employee benefits expense	7,047	6,435	5,498
Net occupancy and equipment expense	3,080	2,879	2,501
Other expenses	4,586	5,996	5,246
<b>Total noninterest expense</b>	<b>14,713</b>	<b>15,310</b>	<b>13,245</b>
<b>Income before income taxes</b>	<b>11,105</b>	<b>10,174</b>	<b>7,922</b>
Provision for income tax expense	1,985	2,357	1,437

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Net income	9,120	7,817	6,485
<b>Other comprehensive income:</b>			
Unrealized gain on investment securities available-for-sale	2,248	6,725	2,339
Reclassification adjustment for net gain on sales included in net income	(383)	(25)	(346)
Reclassification adjustment for other-than-temporary impairment		87	164
Income tax expense related to other comprehensive income	634	2,308	733
Other comprehensive income, net of income taxes	1,231	4,479	1,424
Comprehensive income	\$ 10,351	\$ 12,296	\$ 7,909
<b>Per share data:</b>			
Net income:			
Basic	\$ 2.93	\$ 2.49	\$ 2.07
Diluted	\$ 2.93	\$ 2.49	\$ 2.06
Average common shares outstanding:			
Basic	3,117,098	3,136,663	3,139,606
Diluted	3,117,976	3,138,167	3,141,468
Dividends declared	\$ 0.86	\$ 0.80	\$ 0.79
See notes to consolidated financial statements			

F-4

Table of Contents

## Peoples Financial Services Corp.

## CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY

(Dollars in thousands, except per share data)

	Common Stock	Capital Surplus	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total
<b>For the Three Years Ended December 31, 2012</b>						
<b>Balance, December 31, 2009</b>	\$ 6,683	\$ 3,098	\$ 42,043	\$ (2,258)	\$ (4,596)	\$ 44,970
Net income			6,485			6,485
Other comprehensive income, net of income taxes				1,424		1,424
Dividends declared: \$0.79 per share			(2,480)			(2,480)
Reissuance under option plan: 5,575 shares		20			97	117
<b>Balance, December 31, 2010</b>	6,683	3,118	46,048	(834)	(4,499)	50,516
Net income			7,817			7,817
Other comprehensive income, net of income taxes				4,479		4,479
Dividends declared: \$0.80 per share			(2,523)			(2,523)
Reissuance under option plan: 7,425 shares		23			136	159
Repurchase and held: 30,300 shares					(835)	(835)
<b>Balance, December 31, 2011</b>	6,683	3,141	51,342	3,645	(5,198)	59,613
Net income			9,120			9,120
Other comprehensive income, net of income taxes				1,231		1,231
Dividends declared: \$0.86 per share			(2,681)			(2,681)
Reissuance under option plan: 4,500 shares		14			82	96
Repurchase and held: 39,100 shares					(1,183)	(1,183)
<b>Balance, December 31, 2012</b>	\$ 6,683	\$ 3,155	\$ 57,781	\$ 4,876	\$ (6,299)	\$ 66,196

See notes to consolidated financial statements



**Table of Contents****Peoples Financial Services Corp.****CONSOLIDATED STATEMENTS OF CASH FLOWS**

(Dollars in thousands, except per share data)

Year Ended December 31,	2012	2011	2010
<b>Cash flows from operating activities:</b>			
Net income	\$ 9,120	\$ 7,817	\$ 6,485
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization of premises and equipment	849	837	719
Amortization of intangibles	150	366	258
Provision for loan losses	1,695	1,794	2,202
Net loss (gain) on sale of other real estate owned	33	(1,671)	56
Impairment of other real estate owned	306		
Net loss on disposal of equipment		88	
Net amortization of investment securities available-for-sale	2,067	761	290
Amortization of deferred loan costs	280	222	261
Net gain on sale of investment securities available-for-sale	(383)	(25)	(346)
Other-than-temporary impairment of investment equity securities		87	164
Net income from investment in life insurance	(381)	(378)	(322)
Life insurance proceeds			(320)
Deferred income tax benefit	(349)	(183)	(188)
Net change in:			
Loans held for sale	(1,348)	(539)	740
Accrued interest receivable	176	(445)	(423)
Other assets	(1,336)	(1,329)	869
Accrued interest payable	141	(27)	(135)
Other liabilities	192	1,540	1,126
Net cash provided by operating activities	11,212	8,915	11,436
<b>Cash flows from investing activities:</b>			
Proceeds from sale of investment securities available-for-sale	4,832	22,497	64,439
Proceeds from repayment of investment securities available-for-sale	22,545	3,459	19,605
Purchases of investment securities available-for-sale	(35,077)	(38,119)	(73,261)
Net increase in lending activities	(23,418)	(52,693)	(57,118)
Purchases of premises and equipment	(1,618)	(603)	(1,448)
Proceeds from investment in life insurance			549
Purchases of investment in life insurance	(450)	(2,000)	
Proceeds from sale of other real estate owned	62	2,254	2,270
Purchase premium on investment advisory service			(750)
Net cash used in investing activities	(33,124)	(65,205)	(45,714)
<b>Cash flows from financing activities:</b>			
Net increase in deposits	80,028	55,549	28,696
Repayment of long-term debt	(5,797)	(8,409)	(11,414)
Net increase (decrease) in short-term borrowings	(31,027)	5,067	18,285
Repurchase of common shares	(1,183)	(835)	
Reissuance of common shares	96	159	117
Cash dividends paid	(2,681)	(2,523)	(2,480)
Net cash provided by financing activities	39,436	49,008	33,204

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Net increase (decrease) in cash and cash equivalents	17,524	(7,282)	(1,074)
Cash and cash equivalents at beginning of year	10,559	17,841	18,915
Cash and cash equivalents at end of year	\$ 28,083	\$ 10,559	\$ 17,841

**Supplemental disclosures:**

Cash paid during the period for:

Interest	\$ 4,971	\$ 5,666	\$ 6,633
Income taxes	1,800	2,575	354
Noncash items:			
Transfers of loans to other real estate	\$ 2,005	595	\$ 179
Loans to facilitate sale of other real estate		\$ 3,000	
See notes to consolidated financial statements			

F-6

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**Table of Contents**

**Peoples Financial Services Corp.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Dollars in thousands, except per share data)**

**1. Summary of significant accounting policies:**

**Nature of operations:**

Peoples Financial Services Corp., a bank holding company incorporated under the laws of Pennsylvania, provides a full range of financial services through its wholly-owned subsidiary, Peoples Neighborhood Bank ( Peoples Bank ), including its subsidiaries, Peoples Advisors, LLC, Peoples Financial Leasing, LLC and Peoples Neighborhood Abstract, LLC (collectively, the Company ). The Company services its retail and commercial customers through twelve full-service community banking offices located within the Lackawanna, Susquehanna and Wyoming counties of Northern Pennsylvania and Broome county of Southern New York.

Peoples Bank is a state non-member bank under the jurisdiction of the Pennsylvania Department of Banking and the Federal Deposit Insurance Corporation. Peoples Bank s primary product is loans to small- and medium-sized businesses. Other lending products include one-to-four family residential mortgages and consumer loans. Peoples Bank primarily funds its loans by offering open time deposits to commercial enterprises and individuals. Other deposit product offerings include certificates of deposits and various demand deposit accounts.

Peoples Advisors, LLC, a member managed limited liability company, provides investment advisory services to individuals and small businesses. Peoples Financial Leasing, LLC, provides employee leasing services to Peoples Bank.

Peoples Neighborhood Abstract, LLC, a limited liability company, offers title insurance and abstract services to residential and commercial mortgage loan customers.

Peoples Advisors, LLC; Peoples Financial Leasing, LLC and Peoples Neighborhood Abstract, LLC did not meet the quantitative thresholds for required segment disclosure in conformity with accounting principles generally accepted in the United States of America ( GAAP ). Peoples Bank s twelve community banking offices, all similar with respect to economic characteristics, share a majority of the following aggregation criteria: (i) products and services; (ii) operating processes; (iii) customer bases; (iv) delivery systems; and (v) regulatory oversight. Accordingly, they were aggregated into a single operating segment.

The Company faces competition primarily from commercial banks, thrift institutions and credit unions within the Northeastern Pennsylvania market, many of which are substantially larger in terms of assets and capital. In addition, mutual funds and security brokers compete for various types of deposits, and consumer, mortgage, leasing and insurance companies compete for various types of loans and leases. Principal methods of competing for banking and permitted nonbanking services include price, nature of product, quality of service and convenience of location.

The Company and Peoples Bank are subject to regulations of certain federal and state regulatory agencies and undergo periodic examinations.

**Basis of presentation:**

The consolidated financial statements of the Company have been prepared in conformity with GAAP, Regulation S-X and reporting practices applied in the banking industry. All significant intercompany balances and transactions have been eliminated in consolidation. The Company also presents herein condensed parent company only financial information regarding Peoples Financial Services Corp. ( Parent Company ). Prior period amounts are reclassified when necessary to conform with the current year s presentation. Such reclassifications had no effect on net income.

**Table of Contents**

**Peoples Financial Services Corp.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Dollars in thousands, except per share data)**

**1. Summary of significant accounting policies (continued):**

**Basis of presentation (continued):**

The Company has evaluated events and transactions occurring subsequent to the balance sheet date of December 31, 2012, for items that should potentially be recognized or disclosed in these financial statements. The evaluation was conducted through the date these financial statements were issued.

**Estimates:**

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Significant estimates that are particularly susceptible to material change in the near term relate to the determination of the allowance for loan losses, fair value of financial instruments, the valuation of real estate acquired in connection with foreclosures or in satisfaction of loans, the valuation of deferred tax assets, and determination of other-than-temporary impairment losses on securities. Actual results could differ from those estimates.

**Investment securities available-for-sale:**

All of the Company's investment securities are classified as available-for-sale and are intended to be held for an indefinite period of time, but not necessarily to maturity. The Company may sell these securities for the purpose of implementing asset/liability strategies or in response to changes in interest rates, prepayments, liquidity needs, capital requirements or other circumstances identified by management. Available-for-sale securities are carried at estimated fair value. Unrealized gains and losses, net of their related income tax effect, are included in other comprehensive income, which is reported as a separate component of stockholders' equity. Realized gains and losses are computed using the specific identification method and are included in noninterest income. Premiums are amortized and discounts are accreted over the contractual lives of investment securities using the interest method.

Declines in the fair value of available-for-sale securities below their amortized cost that are deemed to be other-than-temporary are reflected in earnings as realized losses. Management evaluates each investment security for other-than-temporary impairment ( OTTI ) at least quarterly, and more frequently when economic or market concerns warrant an evaluation. Factors considered in determining whether an OTTI was incurred include: (i) the length of time and the extent to which the fair value has been less than amortized cost, (ii) the financial condition and near-term prospects of the issuer, (iii) whether the market decline was affected by macroeconomic conditions, and (iv) whether the Company has the intent to sell the debt security or more likely than not will be required to sell the debt security before its anticipated recovery. The assessment of whether an OTTI decline exists involves a high degree of subjectivity and judgment and is based on information available to management at a point in time.

**Loans held for sale:**

Loans held for sale consist of one-to-four family residential mortgages originated and intended for sale in the secondary market. The loans are carried in aggregate at the lower of cost or estimated market value, based upon current delivery prices in the secondary mortgage market. Net unrealized losses are recognized through a valuation allowance by corresponding charges to income. Gains or losses on the sale of these loans are recognized in noninterest income at the time of sale using the specific identification method. Loan origination fees, net of certain direct loan origination costs, are included in net gains or losses upon the sale of the related



**Table of Contents**

**Peoples Financial Services Corp.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Dollars in thousands, except per share data)**

**1. Summary of significant accounting policies (continued):**

**Loans held for sale (continued):**

mortgage loan. All loans are sold without recourse. The aggregate cost of these loans was lower than their estimated market value at December 31, 2012 and 2011, accordingly, no valuation allowance was deemed necessary.

**Loans, net:**

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are stated at their outstanding unpaid principal balances, net of deferred fees or costs. Interest income is accrued on the principal amount outstanding. Loan origination fees, net of certain direct origination costs, are deferred and recognized over the contractual life of the related loan as an adjustment to yield using the effective interest method. Premiums and discounts on purchased loans are amortized as adjustments to interest income using the effective interest method. Delinquency fees are recognized in income when chargeable, assuming collectability is reasonably assured.

Transfers of financial assets, which include loan participation sales, are accounted for as sales, when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when: (i) the assets have been isolated from the Company; (ii) the transferee obtains the right, free of conditions that constrain it from taking advantage of that right, to pledge or exchange the transferred assets and (iii) the Company does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

The loan portfolio is segmented into commercial and retail loans. Commercial loans consist of commercial and commercial real estate loans. Retail loans consist of residential real estate and other consumer loans.

The Company makes commercial loans for real estate development and other business purposes required by the customer base. The Company's credit policies determine advance rates against the different forms of collateral that can be pledged against commercial loans. Typically, the majority of loans will be limited to a percentage of their underlying collateral values such as real estate values, equipment, eligible accounts receivable and inventory. Individual loan advance rates may be higher or lower depending upon the financial strength of the borrower and/or term of the loan. The assets financed through commercial loans are used within the business for its ongoing operation. Repayment of these kinds of loans generally comes from the cash flow of the business or the ongoing conversion of assets. Commercial real estate loans include long-term loans financing commercial properties. Repayment of these loans are dependent upon either the ongoing cash flow of the borrowing entity or the resale of or lease of the subject property. Commercial real estate loans typically require a loan to value of not greater than 75% and vary in terms.

Residential mortgages are secured by the borrower's residential real estate in either a first or second lien position. Residential mortgages have varying loan rates depending on the financial condition of the borrower and the loan to value ratio. Residential mortgages may have amortizations up to 30 years. Consumer loans include installment loans, car loans, and overdraft lines of credit. The majority of these loans are unsecured.

**Off-balance sheet financial instruments:**

In the ordinary course of business, the Company has entered into off-balance sheet financial instruments consisting of commitments to extend credit, unused portions of lines of credit and standby letters of credit. These



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**Table of Contents**

**Peoples Financial Services Corp.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Dollars in thousands, except per share data)**

**1. Summary of significant accounting policies (continued):**

**Off-balance sheet financial instruments (continued):**

financial instruments are recorded in the financial statements when they are funded. Fees on commercial letters of credit and on unused available lines of credit are recorded as service charges, fees and commissions and are included in noninterest income when earned. The Company records an allowance for off-balance sheet credit losses, if deemed necessary, separately as a liability. No allowance was deemed necessary at December 31, 2012 and 2011.

**Nonperforming assets:**

Nonperforming assets consist of nonperforming loans and other real estate owned. Nonperforming loans include nonaccrual loans, troubled debt restructured loans and accruing loans past due 90 days or more. Past due status is based on contractual terms of the loan. Generally, a loan is classified as nonaccrual when it is determined that the collection of all or a portion of interest or principal is doubtful or when a default of interest or principal has existed for 90 days or more, unless the loan is well secured and in the process of collection. When a loan is placed on nonaccrual, interest accruals discontinue and uncollected accrued interest is reversed against income in the current period. Interest collections after a loan has been placed on nonaccrual status are credited to a suspense account until either the loan is returned to performing status or charged-off. The interest accumulated in the suspense account is credited to income if the nonaccrual loan is returned to performing status. However, if the nonaccrual loan is charged-off, the accumulated interest is applied as a reduction to principal at the time the loan is charged-off. A nonaccrual loan is returned to performing status when the loan is current as to principal and interest and has performed according to the contractual terms for a minimum of six months.

Troubled debt restructured loans are loans with original terms, interest rate, or both, that have been modified as a result of a deterioration in the borrower's financial condition. Interest income on these loans is recognized when earned, using the interest method. The Company offers a variety of modifications to borrowers. The modification categories offered can generally fall within the following categories:

**Rate Modification** A modification in which the interest rate is changed to a below market rate.

**Term Modification** A modification in which the maturity date, timing of payments or frequency of payments is changed.

**Interest Only Modification** A modification in which the loan is converted to interest only payments for a period of time.

**Payment Modification** A modification in which the dollar amount of the payment is changed, other than an interest only modification described above.

**Combination Modification** Any other type of modification, including the use of multiple categories above.



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The Company segments loans into risk categories based on relevant information about the ability of borrowers to service their debt such as current financial information, historical payment experience, credit documentation, public information, and current economic trends, among other factors. Loans are individually analyzed for credit risk by classifying them within the Company's internal risk rating system. The Company's risk rating classifications are defined as follows:

Pass- A loan to borrowers with acceptable credit quality and risk that is not adversely classified as Substandard, Doubtful, Loss nor designated as Special Mention.

F-10

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**Table of Contents**

**Peoples Financial Services Corp.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Dollars in thousands, except per share data)**

**1. Summary of significant accounting policies (continued):**

**Nonperforming assets (continued):**

**Special Mention** A loan that has potential weaknesses that deserves management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or in the institution's credit position at some future date. Special Mention loans are not adversely classified since they do not expose the Company to sufficient risk to warrant adverse classification.

**Substandard** A loan that is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the bank will sustain some loss if the deficiencies are not corrected.

**Doubtful** A loan classified as Doubtful has all the weakness inherent in one classified Substandard with the added characteristic that the weaknesses make the collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.

**Loss** A loan classified as Loss is considered uncollectible and of such little value that their continuance as bankable loans is not warranted. This classification does not mean that the loan has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be effected in the future.

Other real estate owned is comprised of properties acquired through foreclosure proceedings or in-substance foreclosures. A loan is classified as in-substance foreclosure when the Company has taken possession of the collateral regardless of whether formal foreclosure proceedings take place. Other real estate owned is included in other assets and recorded at fair value less cost to sell at the time of acquisition, establishing a new cost basis. Any excess of the loan balance over the recorded value is charged to the allowance for loan losses. Subsequent declines in the recorded values of the properties prior to their disposal and costs to maintain the assets are included in other expenses. Any gain or loss realized upon disposal of other real estate owned is included in noninterest income or noninterest expense.

**Allowance for loan losses:**

The allowance for loan losses represents management's estimate of losses inherent in the loan portfolio as of the balance sheet date. The allowance for loan losses account is maintained through a provision for loan losses charged to earnings. Loans, or portions of loans, determined to be confirmed losses are charged against the allowance account and subsequent recoveries, if any, are credited to the account. A loss is considered confirmed when information available at the financial statement date indicates the loan, or a portion thereof, is uncollectible. Nonaccrual, troubled debt restructured and large delinquent commercial and real estate loans are reviewed monthly to determine if carrying value reductions are warranted or if these classifications should be changed. Consumer loans are considered losses when they are 120 days past due, except those expected to be recovered through insurance or collateral disposition proceeds.

Management evaluates the adequacy of the allowance for loan losses account quarterly. This assessment is based on past charge-off experience, known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay, the estimated value of underlying

collateral, composition of the loan portfolio, current economic conditions and other relevant factors. This evaluation is inherently subjective as it requires material estimates that may be susceptible to significant revision as more information becomes available. Regulators, in reviewing the loan portfolio as part of the scope of a regulatory examination, may require the Company to increase its allowance for loan losses.

**Table of Contents****Peoples Financial Services Corp.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(Dollars in thousands, except per share data)****1. Summary of significant accounting policies (continued):****Allowance for loan losses (continued):**

The allowance for loan losses is maintained at a level believed to be adequate to absorb probable credit losses related to specifically identified loans, as well as probable incurred losses inherent in the remainder of the loan portfolio as of the balance sheet date. The allowance for loan losses consists of an allocated element and an unallocated element. The allocated element consists of a specific allowance for impaired loans individually evaluated under Financial Accounting Standards Board ( FASB ) Accounting Standards Codification ( ASC ) 310, Receivables, and a formula portion for loss contingencies on those loans collectively evaluated under FASB ASC 450, Contingencies.

A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. All amounts due according to the contractual terms means that both the contractual interest and principal payments of a loan will be collected as scheduled in the loan agreement. Factors considered by management in determining impairment include payment status, ability to pay and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. The Company recognizes interest income on impaired loans, including the recording of cash receipts, for nonaccrual, restructured loans or accruing loans depending on the status of the impaired loan. Loans considered impaired under FASB ASC 310 are measured for impairment based on the present value of expected future cash flows discounted at the loan's effective interest rate or the fair value of the collateral if the loan is collateral dependent. If the present value of expected future cash flows discounted at the loan's effective interest rate or the fair value of the collateral, if the loan is collateral dependent, is less than the recorded investment in the loan, including accrued interest and net deferred loan fees or costs, the Company will recognize the impairment by adjusting the allowance for loan losses account through charges to earnings as a provision for loan losses.

The formula portion of the allowance for loan losses relates to large pools of smaller-balance homogeneous loans and those identified loans considered not individually impaired having similar characteristics as these loan pools. Loss contingencies for each of the major loan pools are determined by applying a total loss factor to the current balance outstanding for each individual pool. The total loss factor is comprised of a historical loss factor using a loss migration method plus a qualitative factor, which adjusts the historical loss factor for changes in trends, conditions and other relevant factors that may affect repayment of the loans in these pools as of the evaluation date. Loss migration involves determining the percentage of each pool that is expected to ultimately result in loss based on historical loss experience. Historical loss factors are based on the ratio of net loans charged-off to loans, net, for each of the major groups of loans evaluated and measured for impairment under FASB ASC 450. The historical loss factor for each pool is a weighted average of the Company's historical net charge-off ratio for the most recent rolling twelve quarters. Management adjusts these historical loss factors by a qualitative factor that represents a number of environmental risks that may cause estimated credit losses associated with the current portfolio to differ from historical loss experience. These environmental risks include: (i) changes in lending policies and procedures including underwriting standards and collection, charge-off and recovery practices; (ii) changes in the composition and volume of the portfolio; (iii) changes in national, local and industry conditions, including the effects of such changes on the value of underlying collateral for collateral-dependent loans; (iv) changes in the volume and severity of classified loans, including past due, nonaccrual, troubled debt restructures and other loan modifications; (v) changes in the levels of, and trends in, charge-offs and recoveries;

**Table of Contents****Peoples Financial Services Corp.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(Dollars in thousands, except per share data)****1. Summary of significant accounting policies (continued):****Allowance for loan losses (continued):**

(vi) the existence and effect of any concentrations of credit and changes in the level of such concentrations; (vii) changes in the experience, ability and depth of lending management and other relevant staff; (viii) changes in the quality of the loan review system and the degree of oversight by the board of directors; and (ix) the effect of external factors such as competition and legal and regulatory requirements on the level of estimated credit losses in the current loan portfolio. Each environmental risk factor is assigned a value to reflect improving, stable or declining conditions based on management's best judgment using relevant information available at the time of the evaluation. Adjustments to the factors are supported through documentation of changes in conditions in a narrative accompanying the allowance for loan loss calculation.

The unallocated element is used to cover inherent losses that exist as of the evaluation date, but which have not been identified as part of the allocated allowance using the above impairment evaluation methodology due to limitations in the process. One such limitation is the imprecision of accurately estimating the impact current economic conditions will have on historical loss rates. Variations in the magnitude of impact may cause estimated credit losses associated with the current portfolio to differ from historical loss experience, resulting in an allowance that is higher or lower than the anticipated level. Management establishes the unallocated element of the allowance by considering a number of environmental risks similar to the ones used for determining the qualitative factors. Management continually monitors trends in historical and qualitative factors, including trends in the volume, composition and credit quality of the portfolio. The reasonableness of the unallocated element is evaluated through monitoring trends in its level to determine if changes from period to period are directionally consistent with changes in the loan portfolio. Management believes the level of the allowance for loan losses was adequate to absorb probable credit losses as of December 31, 2012.

**Premises and equipment, net:**

Land is stated at cost. Premises, equipment and leasehold improvements are stated at cost less accumulated depreciation and amortization. The cost of routine maintenance and repairs is expensed as incurred. The cost of major replacements, renewals and betterments is capitalized. When assets are retired or otherwise disposed of, the cost and related accumulated depreciation and amortization are eliminated and any resulting gain or loss is reflected in noninterest income. Depreciation and amortization are computed principally using the straight-line method based on the following estimated useful lives of the related assets, or in the case of leasehold improvements, to the expected terms of the leases, if shorter:

Premises and leasehold improvements	7	40 years
Furniture, fixtures and equipment	3	10 years

**Intangible assets:**

Intangible assets are tested for impairment annually or when circumstances arise indicating impairment has occurred. Any impairment losses arising from such testing would be reported in the Consolidated Statements of Income and Comprehensive Income as a separate line item within operations. There were no impairment losses recognized as a result of periodic impairment testing in 2012, 2011 and 2010.

**Restricted equity securities:**

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As a member of the Federal Home Loan Bank of Pittsburgh ( FHLB ), the Company is required to purchase and hold stock in the FHLB to satisfy membership and borrowing requirements. This stock is restricted in that it can

F-13

**Table of Contents**

**Peoples Financial Services Corp.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Dollars in thousands, except per share data)**

**1. Summary of significant accounting policies (continued):**

**Restricted equity securities (continued):**

only be redeemed by the FHLB or to another member institution, and all redemptions of FHLB stock must be at par. As a result of these restrictions, FHLB stock is unlike other investment securities as there is no trading market for FHLB stock and the transfer price is determined by FHLB membership rules and not by market participants. The carrying value of restricted stock is included in other assets.

**Bank owned life insurance:**

The Company invests in bank owned life insurance ( BOLI ) as a source of funding for employee benefit expenses. BOLI involves the purchasing of life insurance by Peoples Bank on certain of its employees. The Company is the owner and beneficiary of the policies. This life insurance investment is carried at the cash surrender value of the underlying policies and is included in other assets. Income from increases in cash surrender value of the policies is included in noninterest income.

**Statements of Cash Flows:**

The Consolidated Statements of Cash Flows are presented using the indirect method. For purposes of cash flow, cash and cash equivalents include cash on hand, cash items in the process of collection, noninterest-bearing and interest-bearing deposits in other banks and federal funds sold.

**Fair value of financial instruments:**

The Company uses fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosure under GAAP. Fair value estimates are calculated without attempting to estimate the value of anticipated future business and the value of certain assets and liabilities that are not considered financial. Accordingly, such assets and liabilities are excluded from disclosure requirements.

In accordance with FASB ASC 820, Fair Value Measurements and Disclosures, fair value is the price that would be received to sell an asset or transfer a liability in an orderly transaction between market participants at the measurement date. Fair value is best determined based upon quoted market prices. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. In that regard, the derived fair value estimates cannot be substantiated by comparison to independent markets. In many cases, these values cannot be realized in immediate settlement of the instrument.

Current fair value guidance provides a consistent definition of fair value, which focuses on exit price in an orderly transaction that is not a forced liquidation or distressed sale between participants at the measurement date under current market conditions. If there has been a significant decrease in the volume and level of activity for the asset or liability, a change in valuation technique or the use of multiple valuation techniques may be appropriate. In such instances, determining the price at which willing market participants would transact at the measurement date under current market conditions depends on the facts and circumstances and requires the use of significant judgment. The fair value is a reasonable point within the range that is most representative of fair value under current market conditions.





**Table of Contents**

**Peoples Financial Services Corp.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Dollars in thousands, except per share data)**

**1. Summary of significant accounting policies (continued):**

**Fair value of financial instruments (continued):**

In accordance with GAAP, the Company groups its assets and liabilities generally measured at fair value into three levels based on market information or other fair value estimates in which the assets and liabilities are traded or valued and the reliability of the assumptions used to determine fair value. These levels include:

Level 1: Unadjusted quoted prices of identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

Level 2: Significant other observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.

Level 3: Significant unobservable inputs that reflect a reporting entity's own assumptions about the assumptions that market participants would use in pricing an asset or liability.

The following methods and assumptions were used by the Company to construct the summary table in Note 11 containing the fair values and related carrying amounts of financial instruments:

**Cash and cash equivalents:** The carrying values of cash and cash equivalents as reported on the balance sheet approximate fair value.

**Investment securities available-for-sale:** The fair values of marketable equity securities are based on quoted market prices from active exchange markets. The fair values of debt securities are based on pricing from a matrix pricing model.

**Loans held for sale:** The fair values of loans held for sale are based upon current delivery prices in the secondary mortgage market.

**Net loans:** For adjustable-rate loans that reprice frequently and with no significant credit risk, fair values are based on carrying values. The fair values of other nonimpaired loans are estimated using discounted cash flow analysis, using interest rates currently offered in the market for loans with similar terms to borrowers of similar credit risk. Fair values for impaired loans are estimated using discounted cash flow analysis determined by the loan review function or underlying collateral values, where applicable.

**Accrued interest receivable:** The carrying value of accrued interest receivable as reported on the balance sheet approximates fair value.

**Restricted equity securities:** The carrying values of restricted equity securities approximate fair value, due to the lack of marketability for these securities.

**Deposits:** The fair values of noninterest-bearing deposits and savings, NOW and money market accounts are the amounts payable on demand at the reporting date. The fair value estimates do not include the benefit that results from such low-cost funding provided by the deposit liabilities

compared to the cost of borrowing funds in the market. The carrying values of adjustable-rate, fixed-term time deposits approximate their fair values at the reporting date. For fixed-rate time deposits, the present value of future cash flows is used to estimate fair values. The discount rates used are the current rates offered for time deposits with similar maturities.

**Short-term borrowings:** The carrying values of short-term borrowings approximate fair value.

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**Table of Contents**

**Peoples Financial Services Corp.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Dollars in thousands, except per share data)**

**1. Summary of significant accounting policies (continued):**

**Fair value of financial instruments (continued):**

**Long-term debt:** The fair value of fixed-rate long-term debt is based on the present value of future cash flows. The discount rate used is the current rate offered for long-term debt with the same maturity.

**Accrued interest payable:** The carrying value of accrued interest payable as reported on the balance sheet approximates fair value.

**Off-balance sheet financial instruments:**

The majority of commitments to extend credit, unused portions of lines of credit and standby letters of credit carry current market interest rates if converted to loans. Because such commitments are generally unassignable to either the Company or the borrower, they only have value to the Company and the borrower. None of the commitments are subject to undue credit risk. The estimated fair values of off-balance sheet financial instruments are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the counterparties' credit standing. The fair value of off-balance sheet financial instruments was not material at December 31, 2012 and December 31, 2011.

**Advertising:**

The Company follows the policy of charging marketing and advertising costs to expense as incurred. Advertising expense for the years ended December 31, 2012, 2011 and 2010 was \$497, \$495 and \$403, respectively.

**Income taxes:**

The Company accounts for income taxes in accordance with the income tax accounting guidance set forth in FASB ASC Topic 740, *Income Taxes*. ASC Topic 740 sets out a consistent framework to determine the appropriate level of tax reserves to maintain for uncertain tax positions.

Deferred income taxes are provided on the balance sheet method whereby deferred tax assets are recognized for deductible temporary differences and deferred tax liabilities are recognized for taxable temporary differences. Temporary differences are the differences between the reported amounts of assets and liabilities and their tax basis. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion of the deferred tax assets will not be realized. Deferred tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the effective date. A tax position is recognized as a benefit only if it is more likely than not that the tax position would be sustained in a tax examination, with a tax examination being presumed to occur. The amount recognized is the largest amount of tax benefit that has a likelihood of being realized on examination of more than 50 percent. For tax positions not meeting the more likely than not threshold, no tax benefit is recorded. Under the more-likely-than-not threshold guidelines, the Company believes no significant uncertain tax positions exist, either individually or in the aggregate, that would give rise to the non-recognition of an existing tax benefit. The Company had no material unrecognized tax benefits or accrued interest and penalties for any year in the three-year period ended December 31, 2012.

As applicable, the Company recognizes accrued interest and penalties assessed as a result of a taxing authority examination through income tax expense. The Company files consolidated income tax returns in the United States of America and various states' jurisdictions. The Company is no longer subject to federal and state income tax examinations by taxing authorities for years before 2009.



**Table of Contents**

**Peoples Financial Services Corp.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Dollars in thousands, except per share data)**

**1. Summary of significant accounting policies (continued):**

**Other comprehensive income:**

The components of other comprehensive income and their related tax effects are reported in the Consolidated Statements of Income and Comprehensive Income. The accumulated other comprehensive income included in the Consolidated Balance Sheets relates entirely to net unrealized gains and losses on investment securities available-for-sale.

**Earnings per share:**

Basic earnings per share represent income available to common stockholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings per share reflect additional common shares that would have been outstanding if dilutive potential common shares had been issued, as well as any adjustment to income that would result from the assumed issuance. Potential common shares that may be issued by the Company relate solely to outstanding stock options, and are determined using the treasury stock method.

Stock options for 6,200, 6,200 and 9,779 shares of common stock were not considered in computing diluted earnings per share for the years ended December 31, 2012, 2011 and 2010, because they were anti-dilutive.

**Stock-based compensation:**

As of December 31, 2012 and 2011, all stock options were fully vested and there are no unrecognized compensation costs related to stock options. The Company has not granted stock options after 2005.

**Recent accounting standards:**

In February, 2013, the FASB issued Accounting Standards Update ( ASU ) No. 2013-02, Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income . The objective of this ASU is to improve the reporting of reclassifications out of accumulated other comprehensive income. This ASU requires an entity to report the effect of significant reclassifications out of accumulated other comprehensive income, by component, on the respective line items in the income statement if the amount being reclassified is required under GAAP to be reclassified in its entirety to net income. Reclassifications that are not required under GAAP to be reclassified in their entirety to net income in the same reporting period are required to be cross referenced to other GAAP disclosures that provide additional detail about those amounts. This is the case when a portion of the amount reclassified out of accumulated other comprehensive income is reclassified to a balance sheet account rather than directly to income or expense in the same reporting period. For example, some portion of net periodic pension cost is immediately reported in net income, but other portions may be capitalized to an asset balance such as fixed assets or inventory. An entity with significant defined benefit pension costs reclassified out of accumulated other comprehensive income but not to net income in its entirety in the same reporting period should identify the amount of each pension cost component reclassified out of accumulated other comprehensive income and make reference to the relevant pension cost disclosure that provides greater detail about these reclassifications.

The amendments do not change the current requirements for reporting net income or other comprehensive income in financial statements. However, the amendments require an entity to provide information about the amounts reclassified out of accumulated other comprehensive income by component. In addition, an entity is required to present, either on the face of the statement where net income is presented or in the notes, significant amounts reclassified out of accumulated other comprehensive income.



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**Table of Contents**

**Peoples Financial Services Corp.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Dollars in thousands, except per share data)**

**1. Summary of significant accounting policies(continued):**

**Recent accounting standards (continued):**

The provisions of this ASU are effective for public entities prospectively for reporting periods beginning after December 15, 2012. The adoption of ASU 2013-02 on January 1, 2013, is not expected to have a material effect on the operating results or financial position of the Company.

In May 2011, the FASB issued ASU No. 2011-04, *Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*. This update amends FASB ASC Topic 820, *Fair Value Measurements*, to bring GAAP for fair value measurements in line with International Accounting Standards. The Update clarifies existing guidance for items such as: the application of the highest and best use concept to non-financial assets and liabilities; the application of fair value measurement to financial instruments classified in a reporting entity's stockholder's equity; and disclosure requirements regarding quantitative information about unobservable inputs used in the fair value measurements of level 3 assets. The Update also creates an exception to Topic 820 for entities which carry financial instruments within a portfolio or group, under which the entity is now permitted to base the price used for fair valuation upon a price that would be received to sell the net asset position or transfer a net liability position in an orderly transaction. The Update also allows for the application of premiums and discounts in a fair value measurement if the financial instrument is categorized in level 2 or 3 of the fair value hierarchy. Lastly, the ASU contains new disclosure requirements regarding fair value amounts categorized as level 3 in the fair value hierarchy such as: disclosure of the valuation process used; effects of and relationships between unobservable inputs; usage of nonfinancial assets for purposes other than their highest and best use when that is the basis of the disclosed fair value; and categorization by level of items disclosed at fair value, but not measured at fair value for financial statement purposes. For public entities, this Update is effective for interim and annual periods beginning after December 15, 2011. Early adoption was not permitted. The Company adopted this update on January 1, 2012 and the new disclosures are included in Note 11.

In June 2011, the FASB issued ASU No. 2011-05, *Presentation of Comprehensive Income*. The provisions of this update amend FASB ASC Topic 220, *Comprehensive Income*, to facilitate the continued alignment of GAAP with International Accounting Standards. The Update prohibits the presentation of the components of comprehensive income in the statement of stockholder's equity. Reporting entities are allowed to present either: a statement of comprehensive income, which reports both net income and other comprehensive income; or separate statements of net income and other comprehensive income. Under previous GAAP, all three presentations were acceptable. Regardless of the presentation selected, the Reporting Entity is required to present all reclassifications between other comprehensive and net income on the face of the new statement or statements. The provisions of this Update were effective for fiscal years and interim periods beginning after December 31, 2011 for public entities. The Company adopted this update on January 1, 2012, and the components of comprehensive income are included in these financial statements.

**2. Cash and due from banks:**

The Federal Reserve Act, as amended, imposes reserve requirements on all depository institutions. The Company's required reserve balances, which were satisfied through the restriction of vault cash, were \$3,293 and \$1,224 at December 31, 2012 and 2011, respectively.

**Table of Contents****Peoples Financial Services Corp.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Dollars in thousands, except per share data)

**3. Investment securities available-for-sale:**

The amortized cost and fair value of investment securities available-for-sale aggregated by investment category at December 31, 2012 and 2011, are summarized as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
<b>December 31, 2012</b>				
U.S. Government-sponsored enterprises	\$ 29,375	\$ 3,556		\$ 32,931
State and municipals:				
Taxable	16,611	2,083		18,694
Tax-exempt	45,480	2,035	\$ 127	47,388
Corporate debt securities	4,038	139	306	3,871
Mortgage-backed securities:				
U.S. Government agencies	21,532	173	151	21,554
U.S. Government-sponsored enterprises	22,868	129	129	22,868
Common equity securities	488	17	31	474
Total	\$ 140,392	\$ 8,132	\$ 744	\$ 147,780

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
<b>December 31, 2011</b>				
U.S. Government-sponsored enterprises	\$ 29,671	\$ 3,105		\$ 32,776
State and municipals:				
Taxable	18,120	1,608		19,728
Tax-exempt	38,217	1,693	\$ 224	39,686
Corporate debt securities	4,462	330	942	3,850
Mortgage-backed securities:				
U.S. Government agencies	16,827	185	100	16,912
U.S. Government-sponsored enterprises	26,396	66	199	26,263
Equity securities:				
Preferred	54	63		117
Common	629	22	84	567
Total	\$ 134,376	\$ 7,072	\$ 1,549	\$ 139,899

The Company had net unrealized gains of \$4,876, net of deferred income taxes of \$2,512 at December 31, 2012, and \$3,645, net of deferred income taxes of \$1,878, at December 31, 2011. Proceeds from the sale of investment securities available-for-sale amounted to \$4,832 in 2012, \$22,497 in 2011 and \$64,439 in 2010. Gross gains of \$538, \$341 and \$784 were realized on the sale of securities in 2012, 2011 and 2010, respectively. Gross losses realized on the sale of securities were \$155, \$316 and \$438 in 2012, 2011 and 2010, respectively. The income tax provision applicable to net realized gains amounted to \$130, \$9 and \$118 in 2012, 2011 and 2010, respectively.





**Table of Contents****Peoples Financial Services Corp.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(Dollars in thousands, except per share data)****3. Investment securities available-for-sale (continued):**

The maturity distribution of the fair value, which is the net carrying amount, of the debt securities classified as available-for-sale at December 31, 2012, is summarized as follows:

<b>December 31, 2012</b>	<b>Fair Value</b>
Within one year	\$ 243
After one but within five years	28,951
After five but within ten years	36,780
After ten years	36,910
	102,884
Mortgage-backed securities	44,422
<b>Total</b>	<b>\$ 147,306</b>

Securities with a carrying value of \$89,699 and \$105,135 at December 31, 2012 and 2011, respectively, were pledged to secure public deposits and repurchase agreements as required or permitted by law.

Securities and short-term investment activities are conducted with a diverse group of government entities, corporations and state and local municipalities. The counterparty's creditworthiness and type of collateral is evaluated on a case-by-case basis. At December 31, 2012 and 2011, there were no significant concentrations of credit risk from any one issuer, with the exception of U.S. Government agencies and sponsored enterprises that exceeded 10.0 percent of stockholders' equity.

The fair value and gross unrealized losses of investment securities available-for-sale with unrealized losses for which an OTTI has not been recognized at December 31, 2012 and 2011, aggregated by investment category and length of time that the individual securities have been in a continuous unrealized loss position, are summarized as follows:

	<b>Less Than 12 Months</b>		<b>12 Months or More</b>		<b>Total</b>	
	<b>Fair Value</b>	<b>Unrealized Losses</b>	<b>Fair Value</b>	<b>Unrealized Losses</b>	<b>Fair Value</b>	<b>Unrealized Losses</b>
<b>December 31, 2012</b>						
U.S. Government-sponsored enterprises						
State and municipals:						
Taxable						
Tax-exempt	\$ 12,483	\$ 127			\$ 12,483	\$ 127
Corporate debt securities			\$ 2,705	\$ 306	2,705	306
Mortgage-backed securities:						
U.S. Government agencies	11,934	146	838	5	12,772	151
U.S. Government-sponsored enterprises	9,042	83	4,229	46	13,271	129
Common equity securities			106	31	106	31

Total	\$ 33,459	\$ 356	\$ 7,878	\$ 388	\$ 41,337	\$ 744
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F-20

**Table of Contents****Peoples Financial Services Corp.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(Dollars in thousands, except per share data)****3. Investment securities available-for-sale (continued):**

	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
<b>December 31, 2011</b>						
U.S. Government-sponsored enterprises						
State and municipals:						
Taxable						
Tax-exempt	\$ 1,142	\$ 39	\$ 2,859	\$ 185	\$ 4,001	\$ 224
Corporate debt securities	970	61	2,130	881	3,100	942
Mortgage-backed securities:						
U.S. Government agencies	10,785	100			10,785	100
U.S. Government-sponsored enterprises	21,825	199			21,825	199
Common equity securities			195	84	195	84
Total	\$ 34,722	\$ 399	\$ 5,184	\$ 1,150	\$ 39,906	\$ 1,549

The Company had 57 investment securities, consisting of 36 tax-exempt state and municipal obligations, two corporate debt securities, 19 mortgage-backed securities and two common equity securities that were in unrealized loss positions at December 31, 2012. Of these securities, seven mortgage-backed securities and each of the corporate debt and common equity securities were in continuous unrealized loss positions for 12 months or more. The unrealized losses on the common equity securities were a direct reflection of reductions in stock values in the financial industry sector, as a whole, and was not a result of credit or other issues that would cause the Company to realize an OTTI charge. Management does not consider the unrealized losses on the debt securities, as a result of changes in interest rates, to be OTTI based on historical evidence that indicates the cost of these securities is recoverable within a reasonable period of time in relation to normal cyclical changes in the market rates of interest. Moreover, because there has been no material change in the credit quality of the issuers or other events or circumstances that may cause a significant adverse impact on the fair value of these securities, and management does not intend to sell these securities and it is unlikely that the Company will be required to sell these securities before recovery of their amortized cost basis, which may be maturity, the Company does not consider the unrealized losses to be OTTI at December 31, 2012. There was no OTTI recognized for the year ended December 31, 2012.

The Company had 31 investment securities, consisting of six tax-exempt state and municipal obligations, three corporate debt securities, 18 mortgage-backed securities and four common equity securities that were in unrealized loss positions at December 31, 2011. Of these securities, four state and municipal obligations, two corporate debt securities and each of the common equity securities were in continuous unrealized loss positions for 12 months or more. OTTI of \$87 and \$164 was recognized for the year ended December 31, 2011 and 2010, respectively. The impairment was the result of writing down common equity securities based on quoted market prices. In reaching the determination to record the impairment, management reviewed the facts and circumstances available surrounding the securities, including the duration and amount of the unrealized loss, the financial condition of the issuers and the prospects for a change in market value within a reasonable period of time. Based on its assessment, management determined that the impairments were other-than-temporary and that a charge to operating results was appropriate for the securities. The charges were recognized based entirely on the assessment of the credit quality deterioration of the underlying companies.

**Table of Contents****Peoples Financial Services Corp.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(Dollars in thousands, except per share data)****4. Loans, net and allowance for loan losses:**

The major classifications of loans outstanding, net of deferred loan origination fees and costs at December 31, 2012 and 2011 are summarized as follows. Net deferred loan costs were \$589 December 31, 2012 and \$563 at December 31, 2011.

<b>December 31</b>	<b>2012</b>	<b>2011</b>
Commercial	\$ 170,379	\$ 160,828
Real estate:		
Commercial	158,798	145,554
Residential	117,527	118,125
Consumer	19,069	20,596
<b>Total</b>	<b>\$ 465,773</b>	<b>\$ 445,103</b>

Fixed-rate loans totaled \$105,694 and \$96,587, while loans with adjustable interest rates were \$360,079 and \$348,516, respectively, at December 31, 2012 and 2011. Loans outstanding to directors, executive officers, principal stockholders or to their affiliates totaled \$5,492 and \$2,568 at December 31, 2012 and 2011, respectively. Advances and repayments during 2012 totaled \$7,732 and \$4,808 respectively. These loans are made during the ordinary course of business at the Company's normal credit terms. There were no related party loans that were classified as nonaccrual, past due, or restructured or considered a potential credit risk at December 31, 2012 and 2011.

Payment risk is a function of the economic climate in which the Company's lending activities are conducted. Economic downturns in the economy generally or in a particular sector could cause cash flow problems for customers and make loan payments more difficult. The Company attempts to minimize this risk by not being exposed to loan concentrations of a single customer or a group of customers, the loss of any one or more of whom would have a materially adverse effect on its financial condition. Finally, collateral risk can occur if the Company's position in collateral taken as security for loan repayment is not adequate. The Company minimizes collateral risk by avoiding loan concentrations to particular borrowers, by perfecting liens on collateral and by obtaining appraisals on property prior to extending loans. The Company attempts to mitigate its exposure to these and other types of risks by stratifying authorization requirements by loan size and complexity.

At December 31, 2012, the majority of the Company's loans were at least partially secured by real estate in Northeastern Pennsylvania. Therefore, a primary concentration of credit risk is directly related to the real estate market in this area. Changes in the general economy, local economy or in the real estate market could affect the ultimate collectability of this portion of the loan portfolio. Management does not believe there are any other significant concentrations of credit risk that could affect the loan portfolio.

The analysis of changes affecting the allowance for loan losses for each of the years in the three-year period ended December 31, 2012, is summarized as follows:

	<b>2012</b>	<b>2011</b>	<b>2010</b>
Beginning balance, January 1	\$ 5,349	\$ 4,100	\$ 3,337
Charge-offs	(602)	(599)	(1,489)
Recoveries	139	54	50
Provisions	1,695	1,794	2,202
<b>Ending balance, December 31</b>	<b>\$ 6,581</b>	<b>\$ 5,349</b>	<b>\$ 4,100</b>



**Table of Contents****Peoples Financial Services Corp.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Dollars in thousands, except per share data)

**4. Loans, net and allowance for loan losses (continued):**

The changes in the allowance for loan losses account by major classification of loan for the year ended December 31, 2012, were as follows:

December 31, 2012	Commercial	Real estate		Consumer	Unallocated	Total
		Commercial	Residential			
Allowance for loan losses:						
Beginning balance, January 1, 2012	\$ 2,047	\$ 1,515	\$ 761	\$ 198	\$ 828	\$ 5,349
Charge-offs	(258)	(100)	(96)	(148)		(602)
Recoveries	12		74	53		139
Provisions	223	686	467	131	188	1,695
Ending balance	\$ 2,024	\$ 2,101	\$ 1,206	\$ 234	\$ 1,016	\$ 6,581
Ending balance: individually evaluated for impairment	327	239	283	6		855
Ending balance: collectively evaluated for impairment	\$ 1,697	\$ 1,862	\$ 923	\$ 228	\$ 1,016	\$ 5,726
Loans receivable:						
Ending balance	\$ 170,379	\$ 158,798	\$ 117,527	\$ 19,069		\$ 465,773
Ending balance: individually evaluated for impairment	5,169	7,137	1,522	6		13,834
Ending balance: collectively evaluated for impairment	\$ 165,210	\$ 151,661	\$ 116,005	\$ 19,063		\$ 451,939

The changes in the allowance for loan losses account by major classification of loan for the year ended December 31, 2011, were as follows:

December 31, 2011	Commercial	Real estate		Consumer	Unallocated	Total
		Commercial	Residential			
Allowance for loan losses:						
Beginning balance, January 1, 2011	\$ 1,696	\$ 1,384	\$ 726	\$ 243	\$ 51	\$ 4,100
Charge-offs	(374)	(77)	(9)	(139)		(599)
Recoveries	1	2	1	50		54
Provisions	724	206	43	44	777	1,794
Ending balance	\$ 2,047	\$ 1,515	\$ 761	\$ 198	\$ 828	\$ 5,349

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Ending balance: individually evaluated for impairment	698	40	71	1	810	
Ending balance: collectively evaluated for impairment	\$ 1,349	\$ 1,475	\$ 690	\$ 197	\$ 828	\$ 4,539
Loans receivable:						
Ending balance	\$ 160,828	\$ 145,554	\$ 118,125	\$ 20,596	\$ 445,103	
Ending balance: individually evaluated for impairment	8,433	7,832	1,226	1	17,492	
Ending balance: collectively evaluated for impairment	\$ 152,395	\$ 137,722	\$ 116,899	\$ 20,595	\$ 427,611	

F-23



**Table of Contents****Peoples Financial Services Corp.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Dollars in thousands, except per share data)

**4. Loans, net and allowance for loan losses (continued):**

The following tables present the major classification of loans summarized by the aggregate pass rating and the classified ratings of special mention, substandard and doubtful within the Company's internal risk rating system at December 31, 2012 and 2011:

<b>December 31, 2012:</b>	<b>Pass</b>	<b>Special Mention</b>	<b>Substandard</b>	<b>Doubtful</b>	<b>Total</b>
Commercial	\$ 161,236	\$ 5,752	\$ 1,113	\$ 2,278	\$ 170,379
Real estate:					
Commercial	146,205	5,302	3,120	4,171	158,798
Residential	116,042			1,485	117,527
Consumer	19,058	11			19,069
Total	\$ 442,541	\$ 11,065	\$ 4,233	\$ 7,934	\$ 465,773

<b>December 31, 2011:</b>	<b>Pass</b>	<b>Special Mention</b>	<b>Substandard</b>	<b>Doubtful</b>	<b>Total</b>
Commercial	\$ 145,145	\$ 7,262	\$ 2,550	\$ 5,871	\$ 160,828
Real estate:					
Commercial	136,166	3,223	4,995	1,170	145,554
Residential	117,236			889	118,125
Consumer	20,587	9			20,596
Total	\$ 419,134	\$ 10,494	\$ 7,545	\$ 7,930	\$ 445,103

Information concerning nonaccrual loans by major loan classification at December 31, 2012 and 2011 is summarized as follows:

<b>December 31,</b>	<b>2012</b>	<b>2011</b>
Commercial	\$ 2,278	\$ 5,871
Real estate:		
Commercial	4,171	1,170
Residential	1,485	889
Consumer		
Total	\$ 7,934	\$ 7,930

**Table of Contents****Peoples Financial Services Corp.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Dollars in thousands, except per share data)

**4. Loans, net and allowance for loan losses (continued):**

The major classification of loans by past due status are summarized as follows:

<b>December 31, 2012</b>	<b>30-59 Days Past Due</b>	<b>60-89 Days Past Due</b>	<b>Greater than 90 Days</b>	<b>Total Past Due</b>	<b>Current</b>	<b>Total Loans</b>	<b>Loans &gt; 90 Days and Accruing</b>
Commercial	\$ 883	\$ 255	\$ 324	\$ 1,462	\$ 168,917	\$ 170,379	\$ 324
Real estate:							
Commercial	2,268	245	22	2,535	156,263	158,798	22
Residential	1,528		21	1,549	115,978	117,527	21
Consumer	411	192	494	1,097	17,972	19,069	494
Total	\$ 5,090	\$ 692	\$ 861	\$ 6,643	\$ 459,130	\$ 465,773	\$ 861

<b>December 31, 2011</b>	<b>30-59 Days Past Due</b>	<b>60-89 Days Past Due</b>	<b>Greater than 90 Days</b>	<b>Total Past Due</b>	<b>Current</b>	<b>Total Loans</b>	<b>Loans &gt; 90 Days and Accruing</b>
Commercial	\$ 408	\$ 324	\$ 12	\$ 744	\$ 160,084	\$ 160,828	\$ 12
Real estate:							
Commercial	2,177			2,177	143,377	145,554	
Residential	976	217	362	1,555	116,570	118,125	337
Consumer	335	98	311	744	19,852	20,596	311
Total	\$ 3,896	\$ 639	\$ 685	\$ 5,220	\$ 439,883	\$ 445,103	\$ 660

**Table of Contents****Peoples Financial Services Corp.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Dollars in thousands, except per share data)

**4. Loans, net and allowance for loan losses (continued):**

The following tables summarize information concerning impaired loans at December 31, 2012 and 2011 by major loan classification:

December 31, 2012	Recorded Investment	Unpaid Principal Balance	Related Allowance	For the Year Ended Average Recorded Investment	Interest Income Recognized
With no related allowance:					
Commercial	\$ 3,782	\$ 3,782		\$ 4,792	\$ 114
Real estate:					
Commercial	3,354	3,354		1,632	72
Residential	359	359		771	
Consumer					
<b>Total</b>	<b>7,495</b>	<b>7,495</b>		<b>7,195</b>	<b>186</b>
With an allowance recorded:					
Commercial	1,387	1,387	\$ 327	2,798	10
Real estate:					
Commercial	3,783	3,783	239	3,749	120
Residential	1,163	1,163	283	910	
Consumer	6	6	6	2	
<b>Total</b>	<b>6,339</b>	<b>6,339</b>	<b>855</b>	<b>7,459</b>	<b>130</b>
Commercial	5,169	5,169	327	7,590	124
Real estate:					
Commercial	7,137	7,137	239	5,381	192
Residential	1,522	1,522	283	1,681	
Consumer	6	6	6	2	
<b>Total</b>	<b>\$ 13,834</b>	<b>\$ 13,834</b>	<b>\$ 855</b>	<b>\$ 14,654</b>	<b>\$ 316</b>

**Table of Contents****Peoples Financial Services Corp.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Dollars in thousands, except per share data)

**4. Loans, net and allowance for loan losses (continued):**

<b>December 31, 2011</b>	<b>Recorded Investment</b>	<b>Unpaid Principal Balance</b>	<b>Related Allowance</b>	<b>For the Year Ended Average Recorded Investment</b>	<b>Interest Income Recognized</b>
<b>With no related allowance:</b>					
Commercial	\$ 4,316	\$ 4,316		\$ 5,759	\$ 198
<b>Real estate:</b>					
Commercial	4,136	4,136		4,123	187
Residential	889	889		948	
Consumer				10	1
<b>Total</b>	<b>9,341</b>	<b>9,341</b>		<b>10,840</b>	<b>386</b>
<b>With an allowance recorded:</b>					
Commercial	4,117	4,117	\$ 698	3,504	46
<b>Real estate:</b>					
Commercial	3,696	3,696	40	2,940	233
Residential	337	337	71	108	11
Consumer	1	1	1	8	
<b>Total</b>	<b>8,151</b>	<b>8,151</b>	<b>810</b>	<b>6,560</b>	<b>290</b>
Commercial	8,433	8,433	698	9,263	244
<b>Real estate:</b>					
Commercial	7,832	7,832			