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Potomac Bancshares, Inc. (OTC Pink - PTBS)

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November 19, 2015

Price:	\$7.90	EPS *	2014A:	\$ 0.64	P/E	2014A:	12.3x
52 Wk. Range:	\$7.07 - \$8.80	(FY: DEC)	2015E:	\$ 0.72		2015E:	11.0x
Div/Div Yld:	\$0.21 / 2.7%		2016E:	\$ 0.80		2016E:	9.9x
Shrs/Mkt Cap:	3.4 mm / \$26 mm	Book Value:		\$ 9.28	Price/Book Value:		0.85x

* Diluted.

Background

Founded in 1871, Potomac Bancshares, Inc. (the "Company") is a Charles Town, West Virginia bank holding company for the Bank of Charles Town. With approximately \$335 million in assets as of September 30, 2015, the Company conducts operations through its main office and branch office facilities in Jefferson and Berkeley Counties (WV), Washington County (MD) and Loudoun County (VA). The Bank provides various banking products and services for individuals, businesses, and local governments. Deposit products include noninterest-bearing and interest-bearing checking accounts, savings accounts, certificates of deposits, money market accounts, and individual retirement accounts. The Bank also offers loan products comprising commercial, financial, and agricultural loans; mortgage loans on real estate properties; secondary market and adjustable rate mortgage loans; equipment loans and construction financing products; and retail loan products consisting of home equity lines of credit. In addition, the Bank provides financial management, investment, trust, and brokerage services, as well as online banking services. The Company's shares are quoted on the OTC Pink Sheet marketplace under the symbol "PTBS". With this report, we initiate coverage of the Company.

Third Quarter Earnings Increased 23%

Potomac Bancshares reported excellent third quarter results. Earnings were up 23% from the year-ago period (25% on a per share basis), while balance sheet growth was also strong and asset quality improved from the year-ago level. Profitability metrics, such as ROAE and ROAA were much higher than those at most of the Company's peers, and the Bank's newer locations in Maryland and Virginia are continuing to build traction. With the stock trading at a discount to book value, the Company has been (wisely in our view) repurchasing shares, and insiders have been adding to their positions as well. All in all, it was a very encouraging quarter.

Potomac Bancshares' net income in 2015's third quarter was \$685,000, or \$0.20 per diluted share, which was up from \$556,000, or \$0.16 per diluted share, in the year-ago quarter. The majority of the earnings improvement came from a solid increase in net interest income as well as a drop in the provision for loan losses, the latter reflecting progress that the Company is making in credit quality. Net interest income increased 6% to \$2,866,000 in 2015's third quarter, up from \$2,694,000 in the year-ago quarter, with the majority of that growth being due to average earning asset growth. Margins have been holding relatively stable. Noninterest income for the third quarter of 2015 totaled \$1,069,000, compared to a \$1,154,000 in the year-ago quarter, while noninterest expense was \$2,922,000 in 2015's third quarter, which was up 5% from 2,796,000 in the year-ago quarter. There was no provision for loan losses in the current quarter, versus \$223,000 in the year-ago quarter.

Earnings were also strong on a year-to-date basis. For the first nine months of 2015, Potomac Bancshares reported net income of \$1,828,000, or \$0.54 per diluted share, versus \$1,551,000, or \$0.46 per diluted share, in the year-ago period. Net interest income grew 4%, noninterest income decreased 4% and noninterest expense increased 4% over this period. The provision for loan losses declined to \$97,000 in the first nine months of 2015 from \$753,000 in the year-ago period. Balance sheet growth

ASSETS: \$335 MM

HQ: CHARLES TOWN, WV

CONTACT:
ROBERT F. BARONNER, CEO
DEAN J. COGNETTI, CFO
304-725-8431

3RD QUARTER HIGHLIGHTS:

**THIRD QUARTER RESULTS
WERE ENCOURAGING**

EPS: \$0.20 vs. \$0.16

**NET INTEREST INCOME WAS
UP 6%**

**MOST OF THE INCREASE WAS
FROM HIGHER AVERAGE
EARNING ASSETS**

**NONINTEREST INCOME
DECREASED SLIGHTLY**

**FIRST NINE MONTHS
HIGHLIGHTS:**

EPS: \$0.54 vs. \$0.46

BALANCE SHEET GROWTH WAS STRONG AND BENEFITTED FROM THE TWO OFFICES OPENED IN 2014

EQUITY/ASSETS: 9.3%

POTOMAC BANCSHARES HAS BETTER PROFITABILITY RATIOS THAN ITS PEERS

THE SHARES TRADE AT A DISCOUNT TO THE GROUP BASED ON EARNINGS AND BOOK VALUE

WE VIEW THE LONG-TERM OUTLOOK FOR THE SHARES FAVORABLY

THE DIVIDEND YIELD IS SLIGHTLY LOWER BUT POTOMAC HAS A LOWER PAYOUT RATIO, WHICH COULD ALLOW FOR BETTER DIVIDEND GROWTH

ASSET QUALITY HAS IMPROVED SIGNIFICANTLY FROM THE YEAR-AGO DATE

NPAs/ASSETS: 2.01%

THE BANK RECEIVED PAYMENT ON A NONPERFORMING ASSET TOTALING NEARLY \$2.95 MILLION IN THE FOURTH QUARTER

RESERVES/LOANS: 0.98%

**EPS:
2014A: \$ 0.64
2015E: \$ 0.72
2016E: \$ 0.80**

was strong as well. From September 30, 2014 to September 30, 2015, gross loans increased 10% to \$276 million, while assets increased 8% to \$335 million and deposits grew 9% to \$292 million. Part of this growth obviously resulted from the additions of the locations in Hagerstown, MD (opened in January 2014) and Middleburg, VA (opened in April 2013). The Company remains well capitalized to maintain this growth, as its stockholders' equity was \$31.1 million (all of this is common equity, with no intangibles), or 9.29% of assets, at September 30, 2015.

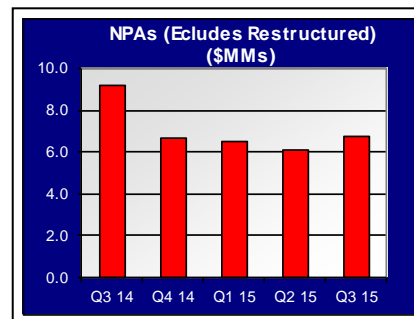
Potomac Bancshares Compares Quite Favorably to its Peers

Potomac Bancshares's performance has been impressive, and most of its operating metrics that we monitor are superior to the median figures of its peer group. For example, the Company's most recent annualized return on average assets was 0.83%, versus 0.69% for the median of West Virginia public banks with less than \$5 billion in assets, while its annualized return on average equity was 8.71%, versus 5.80% for the group. Asset quality was slightly worse for Potomac, but not overly so. Despite Potomac's superior profitability ratios, its shares trade at a discount to its WV peers, as can be seen by PTBS trading at 11.1x trailing 12 month EPS, versus 13.7x for the peer group, and 0.85x tangible book value, versus a peer group figure of 0.96x. And while the dividend yield is slightly lower for PTBS, the payout ratio is also lower, meaning that Potomac probably has more room to increase cash dividends in the future. One of the strongest relationships between performance and valuation that exists for community banks is the one between ROAE and the market-to-book value ratio. One way that we sometimes try to assess this relationship is to divide ROAE by the market to book value ratio for individual banks, which essentially gives us a "return on the market value of equity" figure. It is a highly relevant figure from an investor's standpoint. In the case of PTBS, the ratio is 10.2%, which was the second best (highest) out of the WV peer banks that we considered. Potomac's stock buybacks should help to better align its valuation with its performance and growth, especially over time. For these reasons, we believe the outlook for the stock is relatively favorable.

PEER GROUP COMPARISON: PTBS VS. WV PUBLIC BANKS UNDER \$5 BB							
	ROAA MRQ	ROAE MRQ	NPAs/ Assets	Dividend Yield	Dividend Payout	Price/ EPS	Price/Tang. Book Value
PTBS	0.83%	8.71%	2.01%	2.66%	29%	11.1x	0.85x
Peer Median	0.69%	5.80%	1.92%	2.87%	36%	13.7x	0.96x

NPAs Have Improved and Should Drop Further

As of September 30, 2015, nonperforming assets (which we define as nonaccruing assets, over 90 day past due loans that are still accruing and OREO) were \$6.7 million, or 2.01% of assets, versus \$6.1 million, or 1.87% of total assets, at June 30, 2015 and \$9.2 million, or 2.97% of total assets, at September 30, 2014. (Excluded from these figures are restructured loans that are accruing.) Unless there are significant new nonaccruals that show up, we expect the level of NPAs to drop by year end, as the Company recently announced that it received payment on a nonperforming loan totaling nearly \$2.95 million early in the fourth quarter. The allowance for loan losses was \$2.7 million (0.98% of gross loans) at September 30, 2015, versus \$3.6 million (1.45% of gross loans) at the year-ago date



Projections

Based on the strength of the most recent quarter, we are estimating 2015 earnings of \$2.4 million, or \$0.72 per diluted share. We are projecting earnings of \$2.7 million, or \$0.80 per diluted share, for 2016. These projections could vary widely depending on changing economic and credit conditions.

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