

July 15, 2011

**National Bankshares Inc. (NKSH-NASDAQ-US\$25.94)**  
*NKSH Continues to Report Solid Earnings; Raise 2011 Estimate*

RATING: Neutral                      SECTOR: Banks & Specialty Finance  
 TARGET PRICE: NA                    SECTOR RECOMMENDATION: Market-weight  
 BASIS OF TARGET: NA.

**Maintain Neutral rating, but would purchase on weakness from current levels.** NKSH provides a great combination of steady profitability, very strong capital levels and relatively low levels of problem assets. Selling at a 32% premium to stated book value shows the market has not totally ignored these positive fundamentals. Should these shares weaken due to market conditions and the current negative attitude toward financial institutions in general, we could easily envision upgrading the shares if the valuation metrics become more compelling.

**The June quarter was slightly above our expectations.** NKSH reported \$.61/share compared to \$.58 in the prior year and our forecast of \$.60/share. The top line was in-line with our forecast as slightly higher average earning asset growth offset a nine basis point compression in the net interest margin. Non-interest revenues were above our forecast and operating expenses were in-line with our expectations. The loan loss provision totaled \$753 thousand compared to our projection of \$825 thousand. The provision covered net charge-offs by \$249 thousand increasing the loan loss reserve to \$8.5 million.

**We are raising our estimates for the second half of the year.** We are raising our forecast for the current year from \$2.37/share to \$2.41/share due to the one cent upside in the June quarter and our expectations for slightly stronger earnings in the second half of the year. While we have lowered our assumptions for the margin in the second year, a more optimistic outlook for provision levels and fee revenue more than offset our very modest revisions for net interest income.

**Asset quality trends looked encouraging.** NKSH improved its asset quality metrics on a sequential basis from a relatively strong base compared to peers. Total NPAs fell from \$10.8 million at the end of March to \$8.7 million at June 30<sup>th</sup>. Both accruing restructured credits and accruing loans past due 90 days or more decreased on a sequential basis as well. NKSH appears well reserved relative to its current levels of problem assets.

**NKSH has a very strong balance sheet.** In addition to the low level of NPAs and health loan loss reserve, NKSH is extremely well capitalized. Equity was nearly 13.2% of total assets at quarter-end and tangible common equity was 12.2% of tangible assets. NKSH has no TARP-related capital. Loans are under 67% of deposits and the deposit base is 65% transactional and savings accounts. The company has seen some modest growth in commercial loans of late. Real estate construction credits are a modest 8% of total loans.

**The semi-annual dividend provides an attractive current yield.** NKSH increased its semi-annual dividend payment to \$.48/share in its last declaration. The annual payout of \$.98/share provides a healthy 3.7% yield that should help provide downside support for the stock.

**Disclosure Code: I2, C**

Important disclosures and analyst certifications are in the Disclosure Section.

**Valuation Data**

FYE Dec	2009A	2010A	2011E	
Projected P/E:	12.6x	11.6x	10.8x	
<b>Projected</b>				
<b>EPS:</b>	Q1	\$0.49	\$0.54	\$0.58A
	Q2	\$0.48	\$0.58	\$0.61A
	Q3	\$0.54	\$0.58	\$0.61
	Q4	\$0.55	\$0.55	\$0.61
Total		\$2.06	\$2.24	\$2.41

**Basis of Estimate:** GAAP Net Income

**Trading & Operating Data**

52-Wk Range:	\$21.27-\$32.80
Dividend Indicated FY1:	\$0.96
Dividend Yield Indicated:	3.7%
Volume 60-Day Avg (Th):	10.78
Avg. Shares O/S- LQ:	6.9
Market Value (\$M):	\$179.9
Fiscal Year End:	12.00
Book Value PS LQtr:	\$19.65
Price/BV:	1.3x
Ret on Equity T4Q:	12.3%
ROA LFY:	1.5%
Tangible Book Value:	\$18.06
(source: Baseline)	

**Company Profile**

National Bankshares is the holding company of The National Bank of Blacksburg. NKSH provides a full line of banking, trust, and investment products and services throughout the southwestern region of Virginia. National operates 25 branches and had over \$1.0 billion in assets as of the end of Q2 2011.

**RISK PROFILE:** Average

**RISK CONSIDERATIONS:** general economic risks, interest rate sensitivity, stock liquidity, asset quality trends

	National Bankshares											
	Actual & Estimated Earnings											
	2011 Projected	Fourth Quarter-E	Third Quarter-E	Second Quarter-A	First Quarter-A	2010 Actual	Fourth Quarter-A	Third Quarter-A	Second Quarter-A	First Quarter-A	2009 Actual	2008 Actual
<b>Income Statement:</b>												
Net interest income (TE)	\$44,391	\$11,138	\$11,107	\$11,080	\$11,066	\$41,803	\$10,654	\$10,442	\$10,466	\$10,241	\$38,647	\$34,693
Tax equivalent adjustment	3,881	975	975	951	980	3,822	992	881	969	980	3,985	3,398
Net interest income	40,510	10,163	10,132	10,129	10,086	37,981	9,662	9,561	9,497	9,261	34,662	31,294
Provision for loan losses	3,003	700	750	753	800	3,409	1,200	710	852	647	1,634	1,119
Net interest income after provision	37,507	9,463	9,382	9,376	9,286	34,572	8,462	8,851	8,645	8,614	33,028	30,175
Trust income	1,103	275	275	307	246	1,118	272	316	261	269	1,053	1,231
Other	7,025	1,800	1,750	1,797	1,678	7,243	1,893	1,783	1,851	1,716	7,779	7,874
Core non-interest income	8,128	2,075	2,025	2,104	1,924	8,361	2,165	2,099	2,112	1,985	8,832	9,105
Gain on security transactions	(4)	0	0	(14)	10	(14)	(13)	2	11	(14)	(28)	(18)
Gain on sales of loans	0	0	0	0	0	0	0	0	0	0	0	0
Other	0	0	0	0	0	0	0	0	0	0	0	0
Total non-interest income	8,124	2,075	2,025	2,090	1,934	8,347	2,152	2,101	2,123	1,971	8,804	9,087
Salaries and benefits	11,402	2,850	2,825	2,823	2,904	10,963	2,758	2,695	2,654	2,856	11,336	11,168
Occupancy expenses	1,753	450	445	435	423	1,875	456	451	477	491	1,792	1,751
Amortization of intangibles	1,082	270	270	271	271	1,083	271	270	271	271	1,093	1,120
Other operating expenses	10,052	2,950	2,920	2,496	2,486	9,206	2,335	2,410	2,295	2,166	9,632	7,985
Core non-interest expense	24,289	6,120	6,060	6,025	6,084	23,127	5,820	5,826	5,697	5,784	23,853	22,024
Non-recurring expenses	0	0	0	0	0	0	0	0	0	0	0	0
Total non-interest expenses	24,289	6,120	6,060	6,025	6,084	23,127	5,820	5,826	5,697	5,784	23,853	22,024
Pretax income	21,342	5,418	5,347	5,441	5,136	19,792	4,794	5,126	5,071	4,801	17,979	17,238
Provision for taxes	4,598	1,138	1,123	1,225	1,112	4,223	987	1,129	1,075	1,032	3,660	3,645
Net income	\$16,744	\$4,280	\$4,224	\$4,216	\$4,024	\$15,569	\$3,807	\$3,997	\$3,996	\$3,769	\$14,319	\$13,593
Cumulative effect of accounting change	0	0	0	0	0	0	0	0	0	0	0	0
Available for common	\$16,744	\$4,280	\$4,224	\$4,216	\$4,024	\$15,569	\$3,807	\$3,997	\$3,996	\$3,769	\$14,319	\$13,593
Average diluted shares	6,954	6,960	6,950	6,947	6,957	6,951	6,957	6,947	6,947	6,953	6,943	6,932
Net income	16,744	4,280	4,224	4,216	4,024	15,569	3,807	3,997	3,996	3,769	14,319	13,593
Non-recurring items	(3)	0	0	(9)	7	(9)	(9)	1	7	(9)	(19)	(11)
Pro forma net income	16,742	4,280	4,224	4,207	4,031	15,559	3,798	3,998	4,003	3,760	14,300	13,583
<b>Earnings per share - diluted</b>	<b>\$2.41</b>	<b>\$0.61</b>	<b>\$0.61</b>	<b>\$0.61</b>	<b>\$0.58</b>	<b>\$2.24</b>	<b>\$0.55</b>	<b>\$0.58</b>	<b>\$0.58</b>	<b>\$0.54</b>	<b>\$2.06</b>	<b>\$1.96</b>
<b>Adjusted earnings per share</b>	<b>\$2.41</b>	<b>\$0.61</b>	<b>\$0.61</b>	<b>\$0.61</b>	<b>\$0.58</b>	<b>\$2.24</b>	<b>\$0.55</b>	<b>\$0.58</b>	<b>\$0.58</b>	<b>\$0.54</b>	<b>\$2.06</b>	<b>\$1.96</b>
<b>Assumptions:</b>												
Average earning assets	\$969,017	\$977,025	\$972,165	\$967,328	\$959,550	\$928,130	\$944,837	\$928,140	\$929,888	\$909,654	\$912,724	\$843,032
Growth - earning assets	4.4%	0.5%	0.5%	0.8%	1.6%	1.7%	1.8%	-0.2%	2.2%	0.0%	8.3%	3.5%
Net interest margin	4.60%	4.56%	4.57%	4.59%	4.68%	4.52%	4.47%	4.50%	4.53%	4.57%	4.24%	4.13%
Avg earning assets/avg assets	94.00%	93.75%	93.75%	94.16%	94.35%	93.76%	93.76%	93.72%	93.97%	93.60%	93.73%	93.64%
Avg equity/avg assets	13.11%	13.20%	13.20%	13.16%	12.90%	13.03%	13.21%	13.18%	12.91%	12.81%	12.11%	12.07%
Effective tax rate	21.54%	21.00%	21.00%	22.51%	21.65%	21.34%	20.59%	22.03%	21.20%	21.50%	20.36%	21.14%
<b>Projected:</b>												
Average assets	\$1,030,843	\$1,042,160	\$1,036,976	\$1,027,361	\$1,016,979	\$989,879	\$1,007,740	\$990,306	\$989,598	\$971,844	\$973,738	\$900,294
Average equity	\$135,185	\$137,565	\$136,881	\$135,160	\$131,191	\$128,958	\$133,122	\$130,535	\$127,713	\$124,529	\$117,887	\$108,892
Return on average assets	1.62%	1.64%	1.63%	1.64%	1.58%	1.57%	1.51%	1.62%	1.62%	1.55%	1.47%	1.51%
Return on average equity	12.39%	12.45%	12.34%	12.48%	12.27%	12.07%	11.44%	12.25%	12.52%	12.11%	12.15%	12.51%
Efficiency ratio	46.25%	46.32%	46.15%	45.75%	46.80%	46.10%	45.45%	46.45%	45.25%	47.36%	50.29%	50.29%

Source: Company Reports and Davenport & Company estimates

## National Bankshares Inc.

NKSH

1) 10/16/08	2) 05/13/09	3) 07/16/10	4) 10/15/10	5) 02/11/11
Buy \$22	Neutral NA	Buy \$28	Buy 30	Neutral NA

**Disclosure Section**

As of 07/05/11, Davenport's ratings of covered companies were distributed as follows: 53.2% Buy, 46.2% Neutral, 0.6% Sell  
 As of 07/05/11, Davenport's percentages of covered companies that were investment banking clients within the past 12 months by rating were: 12.5% Buy, 5.6% Neutral, 0.0% Sell

**Companies Mentioned in this Report and Associated Disclosures**

National Bankshares Inc. (NKSH - NASDAQ):I2, C

**Description of Rating System**

- Buy** These shares offer attractive long-term appreciation potential from current prices. We would expect these shares to outperform the market over a longer-term horizon and long-term investors can buy at current prices.
- Neutral** These shares should perform roughly in-line with the current market. We neither encourage the purchase nor the sale of these securities at current prices.
- Reduce/Sell** These shares have more downside risk than upside potential at current prices. We expect these shares to underperform the market at current prices.

**Risk Profile Considerations**

This risk classification has been determined primarily from considering the level and predictability of earnings, the volatility of the stock relative to the market, applicable debt ratings, the composition and level of the company's capital structure, the dependence on key customers, and other relevant risk considerations.

**Description of Possible Disclosure Codes**

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- I2** Davenport or its affiliates expects to receive or intends to seek compensation for investment banking services from the subject company in the next 3 months.
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- C** Any other actual, material conflict of interest of the Research Analyst or Davenport and its affiliates, of which Davenport and its affiliates or the Research Analyst knows, or has reason to know, at the time of this report.

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**Additional information is available upon request.**

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**Certification**

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