

April 16, 2010

National Bankshares Inc. (NKSH-NASDAQ-US\$27.49)
Yet Another Steady Quarter; Valuation Appears Fair

RATING: Neutral SECTOR: Banks & Specialty Finance
TARGET PRICE: US\$NA SECTOR RECOMMENDATION: Market-weight
BASIS OF TARGET: N/A

Strong Performance Continues. NKSH continues to put up great quarterly results during a tough period for the banking industry. While the company's overall credit picture weakened a bit in the first quarter, when compared to peers NKSH's credit quality remains one of the best in the region. On top of that the company continues to maintain a very healthy capital base, which will allow them to absorb any future credit losses that may arise and support loan growth once the economy improves. We also note that National remains one of the most profitable community banks in the region, posting consistent ROA north of 1.50% and ROE north of 12% - quite an accomplishment considering the headwinds that the industry has had to endure.

Stock Appears Fairly Valued. While we remain impressed with NKSH's performance and comforted by their credit quality and capital position, the stock continues to look fairly valued. Currently, NKSH shares are trading at nearly 1.7 times the current tangible book value and 12.8 times our 2011 EPS estimate. We feel that these are fair multiples for this high-quality bank, but have trouble justifying a meaningfully higher price objective over the next 12 months. Longer-term, we feel earnings and book value growth will naturally support upside potential for NKSH shares, but at the present time we would prefer to wait for a more attractive entry point before recommending purchase. We note that the dividend remains well-covered and currently yields over 3%. NKSH has been one of the few banks to maintain and even grow the dividend over the last few years.

First Quarter Results as Expected. NKSH reported earnings of \$0.54/share in the first quarter, which was in-line with our expectations and marked a 10% increase over last year's Q1 earnings. Compared to our estimates, expense controls fully offset a higher than expected loan loss provision and lower than expected non-interest income. Loan growth remains minimal as demand for credit stays suppressed.

Margin Continues to Impress. There are only a few banks that can brag about a net interest margin north of 4.50% and NKSH is one. For the quarter, NKSH's NIM came in at 4.57%, a six basis point improvement over Q4 and four basis points ahead of our estimate. We believe that there is likely still a bit of room for improvement near-term, although our 2011 NIM estimate of 4.40% assumes NKSH gives back a bit of margin once interest rates begin to rise.

Credit Profile Remains Sound. NKSH ended the quarter with a nonperforming loan to total loan ratio of 1.31%, which is up from 1.14% at year-end and still quite low relative to peers. The company charged off 0.29% of average loans (annualized), which was the highest amount so far this cycle. NKSH remains well-reserved with a LLR/Loans ratio of 1.21%, up from 1.17% at year end. Even with the slight deterioration in Q1, NKSH's credit profile remains quite sound. Finally, NKSH ended the quarter with tangible common equity/tangible assets and Tier 1 ratios north of 11.6% and 16%, respectively.

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

Disclosure Code: I2

Important disclosures and analyst certifications are in the Disclosure Section.

Valuation Data (source: Baseline)

FYE Dec	2009A	2010E	2011E
Projected P/E:	13.3x	12.8x	12.8x

Projected

EPS:	Q1	Q2	Q3	Q4	Total
	\$0.49	\$0.48	\$0.54	\$0.53	\$2.06
	\$0.54	\$0.55	\$0.53	\$0.53	\$2.15
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Basis of Estimate: GAAP Net Income

Trading & Operating Data

52-Wk Range:	\$18.08-\$29.48
Dividend Indicated FY1:	\$0.86
Dividend Yield Indicated:	3.1%
Volume 60-Day Avg (Th):	10.78
Avg. Shares O/S- LQ:	6.9
Market Value (\$M):	\$190.5
Fiscal Year End:	12.00
Book Value PS LQtr:	\$18.25
Price/BV:	1.6x
Ret on Equity TTM:	12.3%
ROA TTM:	1.5%
Tangible Book Value:	\$16.47

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 nearly \$993 million in assets as of the end of Q1 2010.

Davenport & Company
Last updated: April 16, 2010

	National Bankshares Actual & Estimated Earnings												
	2011 Projected	2010 Projected	Fourth Quarter- 2010	Third Quarter-E 2010	Second Quarter-E 2010	First Quarter-A 2010	2009 Actual	Fourth Quarter-A 2009	Third Quarter-A 2009	Second Quarter-A 2009	First Quarter-A 2009	2008 Actual	2007 Actual
Income Statement:													
Net interest income (TE)	\$41,498	\$41,355	\$10,275	\$10,368	\$10,471	\$10,241	\$38,647	\$10,254	\$9,735	\$9,459	\$9,199	\$34,693	\$32,239
Tax equivalent adjustment	4,000	3,950	1,000	1,000	1,000	980	3,985	935	995	1,022	1,033	3,998	3,447
Net interest income	37,498	37,375	9,275	9,368	9,471	9,261	34,662	9,319	8,740	8,437	8,166	31,294	29,024
Provision for loan losses	1,600	2,397	550	600	600	647	1,634	681	305	278	370	1,119	423
Net interest income after provision	35,898	34,978	8,725	8,768	8,871	8,614	33,028	8,638	8,435	8,159	7,796	30,175	28,601
Trust income													
Other	1,175	1,094	285	275	265	269	1,053	261	255	261	276	1,231	1,333
Core non-interest income	7,650	7,746	2,080	2,000	1,950	1,716	7,779	2,063	1,974	1,911	1,831	7,874	7,376
Gain on security transactions	8,825	8,840	2,365	2,275	2,215	1,985	8,832	2,324	2,229	2,172	2,107	9,105	8,709
Gain on sales of loans	0	(14)	0	0	0	(14)	(28)	(11)	(17)	0	0	(18)	0
Other	0	0	0	0	0	0	0	0	0	0	0	0	0
Total non-interest income	8,825	8,826	2,365	2,275	2,215	1,971	8,804	2,313	2,212	2,172	2,107	9,087	8,709
Salaries and benefits	12,000	11,731	3,000	2,950	2,925	2,856	11,336	2,927	2,784	2,794	2,831	11,168	10,773
Occupancy expenses	1,851	1,851	455	455	450	491	1,792	448	450	425	469	1,751	1,743
Amortization of intangibles	1,100	1,081	270	270	270	271	1,093	271	271	273	1,120	1,138	
Other operating expenses	10,500	9,966	2,650	2,600	2,550	2,166	9,632	2,506	2,386	2,688	2,052	7,985	7,302
Core non-interest expense	25,500	24,629	6,375	6,275	6,195	5,784	23,853	6,152	5,891	6,180	5,630	22,024	20,956
Non-recurring expenses	0	0	0	0	0	0	0	0	0	0	0	0	0
Total non-interest expenses	25,500	24,629	6,375	6,275	6,195	5,784	23,853	6,152	5,891	6,180	5,630	22,024	20,956
Pre-tax income	19,223	19,175	4,715	4,768	4,891	4,801	17,979	4,799	4,756	4,151	4,273	17,238	16,404
Provision for taxes	4,229	4,194	1,037	1,049	1,076	1,032	3,660	1,004	976	794	886	3,645	3,729
Net income	\$14,994	\$14,981	\$3,677	\$3,719	\$3,815	\$3,769	\$14,319	\$3,795	\$3,780	\$3,357	\$3,387	\$13,593	\$12,675
Cumulative effect of accounting change available for common	0	0	0	0	0	0	0	0	0	0	0	0	0
Available for common	\$14,994	\$14,981	\$3,677	\$3,719	\$3,815	\$3,769	\$14,319	\$3,795	\$3,780	\$3,357	\$3,387	\$13,593	\$12,675
Average diluted shares	6,975	6,965	6,975	6,965	6,965	6,953	6,943	6,954	6,948	6,950	6,920	6,932	6,985
Net income	14,994	14,981	3,677	3,719	3,815	3,769	14,319	3,795	3,780	3,357	3,387	13,593	12,675
Non-recurring items	0	(9)	0	0	0	(9)	(9)	(7)	(11)	0	0	(11)	0
Pro forma net income	14,994	14,971	3,677	3,719	3,815	3,760	14,300	3,787	3,769	3,357	3,387	13,583	12,675
Earnings per share - diluted	\$2.15	\$2.15	\$0.53	\$0.53	\$0.55	\$0.54	\$2.06	\$0.55	\$0.54	\$0.48	\$0.49	\$1.96	\$1.82
Pro forma earnings per share	\$2.15	\$2.15	\$0.53	\$0.53	\$0.55	\$0.54	\$2.06	\$0.54	\$0.54	\$0.48	\$0.49	\$1.96	\$1.82
Assumptions:													
Average earning assets	\$943,141	\$911,247	\$913,297	\$911,474	\$910,564	\$909,654	\$912,724	\$909,411	\$916,773	\$922,876	\$901,837	\$843,032	\$814,426
Growth - earning assets	3.5%	-0.2%	0.2%	0.1%	0.1%	0.0%	8.3%	-0.8%	-0.7%	2.3%	5.6%	3.5%	3.6%
Net interest margin	4.40%	4.56%	4.50%	4.55%	4.60%	4.57%	4.26%	4.51%	4.26%	4.10%	4.08%	4.13%	3.98%
Avg earning assets/avg assets	93.00%	93.15%	93.00%	93.00%	93.00%	93.60%	93.73%	93.84%	94.07%	94.03%	93.00%	93.64%	93.93%
Avg equity/avg assets	13.50%	13.00%	13.20%	13.10%	12.90%	12.81%	12.11%	12.62%	12.09%	11.71%	12.00%	12.07%	11.60%
Effective tax rate	22.00%	21.87%	22.00%	22.00%	22.00%	21.50%	20.36%	20.92%	20.52%	19.13%	22.00%	21.14%	22.73%
Projected:													
Average assets	\$1,014,130	\$978,256	\$982,040	\$980,080	\$979,101	\$971,844	\$973,738	\$969,092	\$974,574	\$981,514	\$960,824	\$900,294	\$867,061
Return on average assets	1.46%	1.55%	1.50%	1.52%	1.56%	1.55%	1.47%	1.57%	1.55%	1.37%	1.41%	1.51%	1.46%
Return on average equity	10.95%	11.78%	11.35%	11.59%	12.08%	12.11%	12.15%	12.41%	12.83%	11.68%	11.98%	12.51%	12.60%
Efficiency ratio	50.67%	49.07%	50.44%	49.63%	48.83%	47.36%	50.24%	48.96%	49.31%	53.13%	49.80%	50.29%	48.20%

Source: Company Reports and Davenport & Company estimates

National Bankshares Inc.

NKSH

1) 10/16/08	2) 05/13/09
Buy \$22	Neutral NA

**Disclosure Section**

As of 03/31/10, Davenport's ratings of covered companies were distributed as follows: 55.3% Buy, 43.7% Neutral, 1.0% Sell
 As of 03/31/10, Davenport's percentages of covered companies that were investment banking clients within the past 12 months by rating were: 14.5% Buy, 9.2% Neutral, 0.0% Sell

Companies Mentioned in this Report and Associated Disclosures

National Bankshares Inc. (NKSH - NASDAQ):I2

Description of Rating System

- Strong Buy** These shares are viewed as compelling short and long-term investment opportunities. We expect these shares to materially outperform the market over the next 12 months. Aggressive purchase is recommended at current prices.
- 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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- A4** The Research Analyst or a member of the Analyst's household owns rights for the securities of the subject company.
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- A6** The Research Analyst or a member of the Analyst's household has futures contracts on the securities of the subject company.
- A7** The Research Analyst or a member of the Analyst's household has a short position in the common stock of the subject company.
- A8** The Research Analyst or a member of the Analyst's household owns a debt security issued by the subject company.
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- I/F** Davenport or its affiliates received fixed income investment banking fees from this company within the past 12 months.
- S/C** The subject company was a non-investment banking – securities related services client of Davenport or its affiliates for which compensation was received during the past 12-months.

- N/C** The subject company was a non-securities services client of Davenport or its affiliates for which compensation was received during the past 12-months.
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- SCC** The Research Analyst received non-investment banking related compensation from the subject company in the past 12 months.
- U** Davenport or its affiliates managed or co-managed a public offering of securities for the subject company in the past 12 months.
- 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.

One James Center • Post Office Box 85678 • Richmond, Virginia • 23285-5678 • Telephone (804) 780-2000.

Certification

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Allan G. Bach