

Lowering Price Target

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Banks/Thriffs

National Bankshares, Inc. (NKSH-\$18.55)

Buy (1)

Company Statistics

| | |
|----------------------------|-----------------|
| 12-month Price Target: | \$21 |
| 52-wk Range: | \$15.00-\$21.98 |
| Market Capitalization (M): | \$129 |
| Shares Outstanding (M) fd: | 6.9 |
| Avg. Daily Vol. (000): | 3.1 |
| Dividend: | \$0.82 |
| Yield: | 4.4% |
| Price/Book Value: | 117% |
| Price/Tangible Book Value: | 133% |
| Equity/Assets: | 11.8% |
| NPAs +90/Assets: | 0.48% |
| NCO Ratio: | 0.13% |
| Reserves/Loans: | 1.02% |

Financials

| FYE Dec | 2005A | 2006A | 2007A | 2008A | 2009E | |
|--------------|--------|---------------|---------------|---------------|---------------|---------------|
| P/E Ratio: | 10.5x | 10.3x | 10.2x | 9.5x | 8.9x | |
| ROE: | 13.74% | 13.42% | 12.58% | 12.51% | 12.49% | |
| ROA: | 1.52% | 1.51% | 1.46% | 1.51% | 1.52% | |
| EPS: | | | | | | |
| | Q1 | \$0.42 | \$0.43 | \$0.45 | \$0.46 | \$0.50 |
| | Q2 | \$0.45 | \$0.46 | \$0.45 | \$0.50 | \$0.52 |
| | Q3 | \$0.44 | \$0.46 | \$0.46 | \$0.52 | \$0.53 |
| | Q4 | \$0.46 | \$0.46 | \$0.46 | \$0.52 | \$0.53 |
| Total | | \$1.77 | \$1.80 | \$1.82 | \$1.96 | \$2.07 |
| Prior EPS: | | | | | | |
| | Q1 | -- | -- | -- | -- | \$0.51 |
| | Q2 | -- | -- | -- | -- | \$0.51 |
| | Q3 | -- | -- | -- | -- | \$0.52 |
| | Q4 | -- | -- | -- | -- | \$0.52 |
| Total | | -- | -- | -- | -- | \$2.06 |

Company Description

National Bankshares, Inc., is the bank holding company for The National Bank of Blacksburg. The company, headquartered in Blacksburg, VA, operates in Southwestern Virginia in an area commonly known as New River Valley and the communities of Tazewell and Bluefield through a total of 26 full-service banking offices.

NKSH: THIS IS HOW TO RUN A BANK, MAINTAIN BUY (1)

Key Points

- National Bankshares reported diluted Q4'08 EPS of \$0.52 versus \$0.52 in the previous quarter and \$0.46 from one year ago bringing EPS for 2008 to \$1.96 from \$1.82 in 2007.
- **Margin Contracts, Remains Above Four Percent.** The net interest margin contracted 14 bps from the previous quarter, but was 25 bps higher than one year ago at 4.20%. The squeeze on the NIM was based primarily on a decline of 5% (ann.) in tax-equivalent net interest income from the prior quarter as total interest income increased 4% and total interest expense increased 20%, respectively.
- **Provision Elevated, Based Primarily on Loan Growth.** Loans grew by 21% on an annualized sequential basis to \$577M from \$548M in the prior quarter and 10% from one year ago. Nonperforming assets plus loans 90 days past due totaled \$4.4M, or 0.48% of assets, essentially flat from \$4.3M (0.48% of assets) in the prior quarter. The company's loan loss provision was \$604,000 in the fourth quarter compared to \$280,000 in Q3'08 and \$294,000 one year ago. The elevated LLP kept the loan loss reserve ratio at 1.02% of loans compared to 1.01% in the prior quarter and 0.99% one year ago as the company's loan portfolio experienced a high level of growth.
- **Forgoes TARP.** NKSH decided to forgo taking any monies from the U.S. Treasury through the Capital Purchase Program due to its already strong capital position.
- **Tweaking Estimates.** We are adjusting our 2009 EPS estimate to \$2.07 from \$2.06. NKSH currently trades at 8.9x our '09 EPS estimate, and 117% of book value (133% of tangible book value) versus our view of peer group averages of 13.8x and 75% (98% of tangible book value), respectively.
- **Reiterating Our Buy (1) Rating and Adjusting Our Price Target.** We are maintaining our Buy (1) rating and lowering our price target to \$21 from \$22. Our price target is based on 10.1x our '09 EPS estimate and 123% of projected Q4'09 book value and implies a total potential return (including estimated dividends of \$0.84 per share) of approximately 18%. We continue to believe, and the most recent quarterly results reflect a company that, in our opinion, should trade above peer group levels. Of primary importance in the current banking environment are profitability, capital, and credit quality. National's profitability continues to outpace peers as does its asset quality while the company continues to maintain capital levels that are some of the highest of the small-cap banks that we follow.

Margin contracted from prior quarter, but still remains above four percent

NPAs+90 to total assets were 0.48% compared to peer group average of 2.06% at quarter end

Additional Discussion

National Bankshares reported diluted Q4'08 EPS of \$0.52 versus \$0.52 in the previous quarter and \$0.46 from one year ago, bringing EPS for 2008 to \$1.96 from \$1.82 in 2007.

Net Interest Income: The tax-equivalent net interest income declined 5% (annualized) from the prior quarter, but increased 10% from the year-ago period to \$9.0M. Total interest income decreased 3% from one year ago while total interest expense fell 20% from the comparable period.

Noninterest Income: Fee income increased 13% (ann.) from the previous quarter and 7% from the year-ago period. The sequential increase in operating fee income was driven primarily by a 32% (ann.) increase in other non-interest income that was partially offset by a 7% (ann.) decline in trust revenue.

Noninterest Expense: Expenses were up 14% on an annualized sequential basis even as compensation/benefits and occupancy expenses declined by 4% (ann.), in aggregate, from Q3'08. However, annual non-interest expense for 2008 was only 5% higher than 2007.

Loan and Deposit Growth: Loans grew by 21% on an annualized sequential basis to \$577M from \$548M in the prior quarter and 10% from one year ago while deposits grew 16% (ann.) to \$818M from \$786M in Q3'08 and 5% from one year ago.

Net Interest Margin: The net interest margin contracted 14 bps from the previous quarter, but was 25 bps higher than one year ago at 4.20%.

Asset Quality: Asset quality held steady from the prior quarter as total NPAs+90 increased only slightly from \$4.3M to \$4.4M at the end of the fourth quarter, while the NPA to total assets ratio remained at 0.48% (current peer group average is 2.06%). Net charge-offs were \$181,000 versus \$112,000 sequentially and \$118,000 one year ago. The annualized net charge-off ratio increased to 0.13% from 0.08% in the previous quarter and 0.09% one year ago (current peer group average is 0.93%). The company's loan loss provision was \$604,000 in the fourth quarter compared to \$280,000 in Q3'08 and \$294,000 one year ago. The elevated LLP kept the loan loss reserve ratio at 1.02% of loans compared to 1.01% in the prior quarter and 0.99% one year ago as the company's loan portfolio experienced a high level of growth.

Profitability: ROA for the quarter was 1.45% versus 1.61% in Q3'08 and 1.46% in Q4'07 while ROE for the quarter was 12.10% compared to 13.20% in the prior quarter and 12.33% one year ago. Current peer group averages are negative for both metrics.

Capital: National Bankshares' equity-to-assets ratio declined to 11.8% from 12.1% in the previous quarter and remained flat from one year ago. Total shareholders' equity increased to \$110.1M from \$109.5M in Q3'08 while book value per share was \$15.89 (tangible book was \$13.91) versus \$15.80 (\$13.78) from the comparable period.

We are adjusting our 2009 EPS estimate to \$2.07 from \$2.06. NKSH currently trades at 8.9x our '09 EPS estimate, and 117% of book value (133% of tangible book value) versus our view of peer group averages of 13.8x and 75% (98% of tangible book value), respectively.

We are maintaining our Buy (1) rating and adjusting our price target to \$21 from \$22. Our price target is based on 10.1x our '09 EPS estimate and 123% of projected Q4'09 book value and implies a total potential return (including estimated dividends of \$0.84 per share) of approximately 18%.

Risks to the achievement of our price target could include the company's failure to meet or exceed earnings forecasts as well as a negative change in investor sentiment toward bank stocks. As with all of our bank stocks, EPS can be adversely affected by, among other factors, the local and national economy, which could impact loan growth, asset quality, and the interest rate environment.

National Bankshares, Inc. (NKSH-OTC)

(Smil, except per share data)

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| 2005 | 2006 | 2007 | 2008 | 2009E | | 4Q07 | 1Q08 | 2Q08 | 3Q08 | 4Q08 | 1Q09E | 2Q09E | 3Q09E | 4Q09E |
|---------------------------|---------|---------|---------|---------|------------------------------|---------|---------|---------|---------|---------|---------|---------|---------|---------|
| Income Statement | | | | | | | | | | | | | | |
| \$34.19 | \$32.50 | \$32.47 | \$34.68 | \$36.75 | Net Interest Income, FTE | \$8.14 | \$8.11 | \$8.50 | \$9.09 | \$8.98 | \$9.00 | \$9.16 | \$9.25 | \$9.34 |
| 2% | -3% | 0% | 7% | 6% | % change vs. prior year | 1% | 3% | 3% | 11% | 10% | 11% | 8% | 2% | 4% |
| 0.57 | 0.05 | 0.42 | 1.12 | 1.17 | Loan Loss Provision | 0.29 | 0.10 | 0.14 | 0.28 | 0.60 | 0.29 | 0.28 | 0.30 | 0.30 |
| -52% | -91% | 763% | 165% | 4% | % change vs. prior year | 3167% | NM | 938% | 135% | 105% | 186% | 107% | 6% | -50% |
| 7.61 | 8.80 | 8.76 | 9.18 | 9.51 | Total Noninterest Income | 2.20 | 2.30 | 2.25 | 2.28 | 2.36 | 2.36 | 2.37 | 2.38 | 2.39 |
| 7% | 16% | 0% | 5% | 4% | % change vs. prior year | -4% | 5% | -1% | 7% | 7% | 3% | 6% | 4% | 2% |
| 21.90 | 21.67 | 20.96 | 22.02 | 23.20 | Total Noninterest Expense | 5.10 | 5.46 | 5.31 | 5.53 | 5.73 | 5.76 | 5.79 | 5.82 | 5.84 |
| 8% | -1% | | 3% | 5% | % change vs. prior year | -5% | 4% | -4% | 8% | 12% | 5% | 9% | 5% | 2% |
| 0.00 | 0.00 | 0.00 | (0.09) | 0.00 | Nonrecurring Gains (Expense) | 0.00 | 0.00 | (0.02) | (0.08) | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| 19.34 | 19.58 | 19.85 | 20.62 | 21.90 | Net Income Before Taxes | 4.95 | 4.85 | 5.29 | 5.49 | 5.00 | 5.32 | 5.47 | 5.52 | 5.59 |
| 36% | 35% | 36% | 33% | 34% | Effective Tax Rate | 34% | 35% | 35% | 35% | 29% | 34% | 34% | 34% | 34% |
| \$1.77 | \$1.80 | \$1.82 | \$1.96 | \$2.07 | Diluted EPS, Stated | \$0.46 | \$0.46 | \$0.50 | \$0.52 | \$0.52 | \$0.50 | \$0.52 | \$0.53 | \$0.53 |
| \$1.77 | \$1.80 | \$1.82 | \$1.99 | \$2.07 | Dil. EPS, Operating* | \$0.46 | \$0.46 | \$0.50 | \$0.52 | \$0.52 | \$0.50 | \$0.52 | \$0.53 | \$0.53 |
| 2% | 2% | 1% | 9% | 4% | % change vs. prior year | 2% | 2% | 10% | 13% | 11% | 10% | 4% | 1% | 3% |
| \$0.71 | \$0.73 | \$0.76 | \$0.80 | \$0.84 | Common Dividend/Share | \$0.39 | \$0.00 | \$0.39 | \$0.00 | \$0.41 | \$0.00 | \$0.42 | \$0.00 | \$0.42 |
| 39% | 40% | 41% | 40% | 40% | Payout Ratio | 84% | 0% | 78% | 0% | 80% | 0% | 81% | 0% | 80% |
| 7.05 | 7.04 | 7.00 | 6.94 | 6.93 | Avg. Diluted Shares | 6.99 | 6.95 | 6.93 | 6.93 | 6.93 | 6.93 | 6.93 | 6.93 | 6.93 |
| Balance Sheet | | | | | | | | | | | | | | |
| \$292.7 | \$320.4 | \$316.2 | \$311.0 | \$314.1 | Cash & Securities | \$316.2 | \$340.1 | \$309.7 | \$307.5 | \$311.0 | \$311.7 | \$312.5 | \$313.3 | \$314.1 |
| 493.5 | 501.7 | 524.8 | 576.7 | 600.1 | Loans | 524.8 | 528.7 | 535.8 | 548.0 | 576.7 | 582.4 | 588.3 | 594.2 | 600.1 |
| 3% | 2% | 3% | 10% | 4% | % change vs. prior year | 5% | 5% | 5% | 6% | 10% | 10% | 10% | 8% | 4% |
| 5.4 | 5.2 | 5.2 | 5.9 | 6.4 | Loan Loss Reserves | 5.2 | 5.2 | 5.3 | 5.5 | 5.9 | 6.0 | 6.1 | 6.2 | 6.4 |
| 17.1 | 16.0 | 14.8 | 13.7 | 12.7 | Total Intangibles | 14.8 | 14.6 | 14.3 | 14.0 | 13.7 | 13.5 | 13.2 | 12.9 | 12.7 |
| 43.7 | 35.3 | 37.1 | 39.9 | 38.7 | Other Assets | 37.1 | 33.6 | 40.3 | 38.4 | 39.9 | 37.9 | 38.0 | 38.2 | 38.7 |
| 841.5 | 868.2 | 887.6 | 935.4 | 959.2 | Total Assets | 887.6 | 911.7 | 894.9 | 902.3 | 935.4 | 939.5 | 945.9 | 952.4 | 959.2 |
| 6% | 3% | 2% | 5% | 3% | % change vs. prior year | 2% | 3% | 2% | 5% | 5% | 3% | 6% | 6% | 3% |
| 745.6 | 764.7 | 776.3 | 817.8 | 842.7 | Deposits | 776.3 | 795.1 | 781.1 | 786.0 | 817.8 | 824.0 | 830.2 | 836.4 | 842.7 |
| 6% | 3% | 2% | 5% | 3% | % change vs. prior year | 2% | 3% | 1% | 5% | 5% | 4% | 6% | 6% | 3% |
| 0.4 | 0.1 | 0.1 | 0.0 | 0.0 | Other Borrowings | 0.1 | 0.1 | 0.1 | 0.1 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| - | - | - | - | - | Preferred Equity | - | - | - | - | - | - | - | - | - |
| 91.9 | 96.8 | 104.8 | 110.1 | 118.7 | Common Equity | 104.8 | 109.0 | 107.4 | 109.5 | 110.1 | 113.6 | 114.3 | 117.9 | 118.7 |
| 91.9 | 96.8 | 104.8 | 110.1 | 118.7 | Total Equity | 104.8 | 109.0 | 107.4 | 109.5 | 110.1 | 113.6 | 114.3 | 117.9 | 118.7 |
| 66% | 66% | 68% | 71% | 71% | Loans/Deposits | 68% | 66% | 69% | 70% | 71% | 71% | 71% | 71% | 71% |
| 493.8 | 494.9 | 511.2 | 539.5 | 588.3 | Average Loans | 521.0 | 525.1 | 529.7 | 540.9 | 562.5 | 579.6 | 585.4 | 591.2 | 597.1 |
| 770.0 | 779.0 | 807.9 | 841.4 | 882.1 | Avg. Earning Assets (EA) | 816.2 | 833.8 | 844.6 | 833.0 | 854.4 | 872.2 | 878.8 | 885.4 | 892.0 |
| 8% | 1% | 4% | 4% | 5% | % change vs. prior year | 3% | 3% | 5% | 4% | 5% | 5% | 4% | 6% | 4% |
| 90.4 | 94.2 | 100.8 | 108.6 | 115.0 | Avg. Equity | 103.7 | 107.0 | 108.9 | 109.0 | 109.4 | 111.8 | 113.9 | 116.1 | 118.3 |
| 10.9% | 11.1% | 11.8% | 11.8% | 12.4% | Equity/Assets | 11.8% | 12.0% | 12.0% | 12.1% | 11.8% | 12.1% | 12.1% | 12.4% | 12.4% |
| 8.9% | 9.3% | 10.1% | 10.3% | 11.1% | Tangible Equity/Assets | 10.1% | 10.4% | 10.4% | 10.6% | 10.3% | 10.7% | 10.7% | 11.0% | 11.1% |
| \$13.10 | \$13.86 | \$15.07 | \$15.89 | \$17.12 | Book Value/Share | \$15.07 | \$15.72 | \$15.50 | \$15.80 | \$15.89 | \$16.39 | \$16.49 | \$17.01 | \$17.12 |
| Profitability | | | | | | | | | | | | | | |
| 1.52% | 1.51% | 1.46% | 1.51% | 1.52% | Return on Assets (ROA) | 1.46% | 1.44% | 1.55% | 1.61% | 1.45% | 1.49% | 1.52% | 1.54% | 1.53% |
| 13.74% | 13.42% | 12.58% | 12.52% | 12.49% | Return on Equity (ROE) | 12.33% | 11.95% | 12.81% | 13.20% | 12.10% | 12.45% | 12.58% | 12.56% | 12.38% |
| 4.44% | 4.16% | 3.98% | 4.12% | 4.18% | Net Interest Margin | 3.95% | 3.93% | 4.00% | 4.34% | 4.20% | 4.18% | 4.17% | 4.18% | 4.19% |
| -5% | -6% | -4% | 3% | 2% | % change vs. prior year | -3% | -1% | -1% | 9% | 6% | 6% | 4% | -4% | 0% |
| 50% | 50% | 48% | 49% | 48% | Efficiency Ratio | 47% | 52% | 51% | 46% | 48% | 48% | 48% | 48% | 47% |
| 18% | 21% | 21% | 21% | 21% | Nonint. Income/Total Rev. | 21% | 22% | 21% | 20% | 21% | 21% | 21% | 20% | 20% |
| 35% | 41% | 42% | 42% | 41% | Nonint. Income/Nonint. Exp. | 43% | 42% | 42% | 41% | 41% | 41% | 41% | 41% | 41% |
| Credit Quality | | | | | | | | | | | | | | |
| 0.13% | 0.16% | 0.29% | 0.48% | 0.46% | NPAs + 90/Assets | 0.29% | 0.33% | 0.40% | 0.48% | 0.48% | 0.47% | 0.47% | 0.47% | 0.46% |
| 1.10% | 1.03% | 0.99% | 1.02% | 1.06% | Reserves/Loans | 0.99% | 0.99% | 0.98% | 1.01% | 1.02% | 1.03% | 1.04% | 1.05% | 1.06% |
| 495% | 365% | 201% | 132% | - | Reserves/NPAs + 90 | 201% | 175% | 147% | 128% | 132% | - | - | - | - |
| 0.17% | 0.07% | 0.10% | 0.09% | 0.11% | Net Charge-off Ratio | 0.09% | 0.07% | 0.07% | 0.08% | 0.13% | 0.10% | 0.11% | 0.12% | 0.12% |
| 67% | 14% | 80% | 235% | 176% | LLP/NC0's | 249% | 110% | 141% | 250% | 334% | 197% | 174% | 168% | 168% |
| Market Information | | | | | | | | | | | | | | |
| \$23.50 | \$24.10 | \$17.10 | \$19.45 | | End of Period (EOP) Price | \$17.10 | \$17.99 | \$17.99 | \$16.50 | \$19.45 | | | | |
| 13.31x | 13.38x | 9.36x | 9.78x | | EOP Price/LTM EPS | 9.36x | 9.80x | 9.57x | 8.51x | 9.78x | | | | |
| 179% | 174% | 113% | 122% | | EOP Price/EOP Book Value | 113% | 114% | 116% | 104% | 122% | | | | |
| 3.1% | 3.1% | 4.6% | 4.2% | | EOP Current Div. Yield | 4.6% | 4.3% | 4.3% | 4.7% | 4.2% | | | | |

* Operating EPS excludes gains/losses in investment securities, OREO, and other nonrecurring items.

IMPORTANT DISCLOSURES

Price Chart

NKSH

| | | | | | | | |
|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|
| 1) 02/01/06 | 2) 04/03/06 | 3) 04/21/06 | 4) 04/20/07 | 5) 07/20/07 | 6) 10/22/07 | 7) 02/08/08 | 8) 04/18/08 |
| Buy (1) \$26 | Buy (1) \$27 | Buy (1) \$26 | Buy (1) \$25 | Buy (1) \$24 | Buy (1) \$22 | Buy (1) \$23 | Buy (1) \$22 |



Scott & Stringfellow, Inc.'s rating distribution by percentage (as of December 31, 2008):

| | | | |
|-------------------------------|-------|--|------|
| All companies under coverage: | | All companies under coverage to which it has provided investment banking services in the previous 12 months: | |
| Buy (1) | 50.7% | Buy (1) | 5.3% |
| Hold (2) | 45.8% | Hold (2) | 6.8% |
| Underweight/Sell (3) | 3.6% | Underweight/Sell (3) | 0.0% |
| Not Rated (NR) | 0.0% | Not Rated (NR) | 0.0% |
| Suspended (SP) | 0.0% | Suspended (SP) | 0.0% |

Scott & Stringfellow, Inc., Ratings System:

The Scott & Stringfellow, Inc., Stock Rating System consists of three separate ratings. The appropriate rating is determined by a stock's estimated 12-month total return potential, which consists of the percentage price change to the 12-month price target and the current yield on anticipated dividends. A 12-month price target is the analyst's best estimate of the market price of the stock in 12 months. A 12-month price target is highly subjective and the result of numerous assumptions, including company, industry, and market fundamentals, both on an absolute and relative basis, as well as investor sentiment, which can be highly volatile.

The definition of each rating is as follows:

- Buy (1): estimated total return potential greater than or equal to 10%
- Hold (2): estimated total return potential greater than or equal to 0% and less than 10%
- Underweight (3): estimated total return potential less than 0%

- NR: Not Rated
- NA: Not Applicable
- NM: Not Meaningful
- SP: Suspended

Stocks rated Buy (1) are required to have a published 12-month price target, while it is not required on stocks rated Hold (2) and Underweight (3).

Scott & Stringfellow, Inc., Equity Research Disclosures as of February 9, 2009

| Company | Disclosure |
|----------------------------------|------------|
| National Bankshares, Inc. (NKSH) | 1, 6, 8 |

ADDITIONAL INFORMATION IS AVAILABLE UPON REQUEST

Scott & Stringfellow, Inc., Equity Research Disclosure Legend

1. Scott & Stringfellow, Inc., makes a market in the securities of the subject company.
2. The analyst serves as an officer, director, or advisory board member of the subject company.

3. The analyst or a member of the analyst's household owns shares of the subject company.
4. Scott & Stringfellow, Inc., has managed or co-managed a public offering of securities for the subject company in the last 12 months.
5. Scott & Stringfellow, Inc., has received compensation for investment banking services from the subject company in the last 12 months.
6. Scott & Stringfellow, Inc., expects to receive or intends to seek compensation for investment banking services from the subject company in the next three months.
7. Scott & Stringfellow, Inc., or its affiliates beneficially own 1% or more of the common stock of the subject company as calculated in accordance with Section 13(d) of the Securities Exchange Act of 1934.
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9. An affiliate of Scott & Stringfellow, Inc., received compensation from the subject company for products or services other than investment banking services during the past 12 months. The analyst or employees of Scott & Stringfellow, Inc., with the ability to influence the substance of this report know or have reason to know the foregoing facts.

For valuation methodology and related risk factors on Buy (1)-rated stocks, please refer to the body text of this report or to individual reports on any covered companies referenced in this report.

The analyst(s) principally responsible for preparation of this report received compensation that is based upon many factors, including the firm's overall investment banking revenue.

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OTHER DISCLOSURES

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