

February 13, 2012

**National Bankshares Inc. (NKSH-NASDAQ-US\$28.55)**

*NKSH has strong fundamentals - would buy on weakness.*

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

**National Bankshares (NKSH) continues to report better than average results.**

NKSH earnings translated into an impressive 1.71% return on average assets and a 12.89% return on average equity during 2011. This level of profitability would be impressive during good economic times, but is particularly noteworthy in the current macro environment. We like this conservatively run bank and would be a buyer on weakness from current price levels. The shares sell for 11.2 times our current year estimate and a 40% premium to book value that we feel is warranted given the company's overall quality. A recent raised semi-annual dividend now provides an attractive 3.6% yield.

**A FDIC insurance credit lead to a fourth quarter upside surprise.** NKSH reported \$.70 in Q4 compared to \$.55 in the prior year. These results were above our point estimate of \$.63 primarily due to a \$372K credit for FDIC insurance assessment. Higher than expected earning asset growth essentially offset greater than forecast margin compression. For the full year, NKSH earned \$2.54 versus \$2.24 in 2010.

**We are assuming a strong net interest margin (NIM) comes under modest pressure.** The NIM fell 14 basis points on a sequential comparison to 4.50% in Q4. Relatively lackluster loan demand, lower yields on investment securities and relatively modest re-pricing opportunities on deposits should combine in 2012 to make additional NIM compression likely. We have not changed our 2012 forecast of \$2.55 per share.

**Asset quality continues to be a strong point for these shares.** Total non-performing assets (NPAs) declined sequentially from \$6.1MM to \$5.5MM at year-end. This represents a mere 0.51% of assets and the reserve for loan losses now stands at 214% of non-accrual loans. Foreclosed property remains modest at only \$1.5MM. Accruing restructured loans have increased over the course of the year to \$4.8MM at December 31<sup>st</sup>. Net charge-offs were \$962K in Q4 and the \$753K provision allowed a small decrease in the reserve during the quarter. Net credit losses for the full year were only \$2.1MM and the provision over the past twelve months was \$2.9MM. Compared to peers NKSH has minimal NPAs and very low credit losses.

**Balance sheet strength is another key attribute.** NKSH has no wholesale borrowings and a loan-to-deposit ratio of only 64% at year-end. Demand, transactional and savings accounts make up 66% of total deposits. Equity is an extremely strong 13.2% of assets. While a source of financial strength, the ability to leverage this capital is becoming an increasing challenge in a slow growth economy. NKSH paid out 39% of earnings in dividends during 2011.

**Disclosure Code: I2, C**

Important disclosures and analyst certifications are in the Disclosure Section.

**Valuation Data**

FYE Dec	2010A	2011A	2012E	
Projected P/E:	12.7x	11.2x	11.2x	
<b>Projected</b>				
<b>EPS:</b>	Q1	\$0.54	\$0.58	\$0.60
	Q2	\$0.58	\$0.61	\$0.63
	Q3	\$0.58	\$0.65	\$0.65
	Q4	\$0.55	\$0.70	\$0.67
Total		\$2.24	\$2.54	\$2.55

**Basis of Estimate:** GAAP Net Income

**Trading & Operating Data**

52-Wk Range:	\$22.57-\$31.16
Dividend Indicated FY1:	\$1.04
Dividend Yield Indicated:	3.6%
Volume 60-Day Avg (Th):	10.39
Avg. Shares O/S- LQ:	6.9
Market Value (\$M):	\$198.0
Fiscal Year End:	12.00
Book Value PS LQtr:	\$20.36
Price/BV:	1.4x
Ret on Equity T4Q:	13.0%
ROA LFY:	1.5%
(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 2011.

**RISK PROFILE:** Average

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

Davenport & Company  
Last updated: February 13, 2012

National Bankshares  
Actual & Estimated Earnings

	2012 Projected	2011 Actual	2010 Actual	2009 Actual
<b>Income Statement:</b>				
Net interest income (TE)	\$45,277	\$44,635	\$41,803	\$38,647
Tax equivalent adjustment	3,840	3,873	3,822	3,985
Net interest income	41,437	40,762	37,981	34,662
Provision for loan losses	2,500	2,949	3,409	1,634
Net interest income after provision	38,937	37,813	34,572	33,028
Trust income	1,185	1,087	1,118	1,053
Other	7,500	7,312	7,243	7,779
Core non-interest income	8,685	8,399	8,361	8,832
Gain on security transactions	0	11	(14)	(28)
Gain on sales of loans	0	0	0	0
Other	0	0	0	0
Total non-interest income	8,685	8,410	8,347	8,804
Salaries and benefits	11,700	11,357	10,963	11,336
Occupancy expenses	1,680	1,599	1,875	1,792
Amortization of intangibles	1,077	1,083	1,093	1,093
Other operating expenses	9,925	9,299	9,206	9,632
Core non-interest expense	24,382	23,338	23,127	23,853
Non-recurring expenses	0	0	0	0
Total non-interest expenses	24,382	23,338	23,127	23,853
Pretax income	23,240	22,885	19,792	17,979
Provision for taxes	5,521	5,247	4,223	3,660
Net income	\$17,718	\$17,638	\$15,569	\$14,319
Cumulative effect of accounting change	0	0	0	0
Available for common	\$17,718	\$17,638	\$15,569	\$14,319
Average diluted shares	6,952	6,950	6,951	6,943
Net income	17,718	17,638	15,569	14,319
Non-recurring items	0	(17)	(9)	(19)
Pro forma net income	17,718	17,621	15,559	14,300
<b>Earnings per share - diluted</b>	<b>\$2.55</b>	<b>\$2.54</b>	<b>\$2.24</b>	<b>\$2.06</b>
<b>Adjusted earnings per share</b>	<b>\$2.55</b>	<b>\$2.54</b>	<b>\$2.24</b>	<b>\$2.06</b>
<b>Assumptions:</b>				
Average earning assets	\$1,019,845	\$972,895	\$928,130	\$912,724
Growth - earning assets	4.8%	4.8%	1.7%	8.3%
Net interest margin	4.44%	4.48%	4.52%	4.24%
Avg earning assets/avg assets	94.31%	94.28%	93.76%	93.73%
Avg equity/avg assets	13.65%	13.70%	13.03%	12.11%
Effective tax rate	23.76%	22.93%	21.34%	20.36%
<b>Projected:</b>				
Average assets	\$1,081,347	\$1,031,886	\$989,879	\$973,738
Average equity	\$147,604	\$136,821	\$128,958	\$117,887
Return on average assets	1.64%	1.86%	1.75%	1.47%
Return on average equity	12.00%	12.89%	12.48%	12.15%
Efficiency ratio	45.18%	44.45%	45.75%	50.24%

Source: Company Reports and Davenport & Company estimates

## National Bankshares Inc.

NKSH

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

**Disclosure Section**

As of 01/01/12, Davenport's ratings of covered companies were distributed as follows: 65.71% Buy, 34.29% Neutral, 0.0% Sell  
 As of 01/01/12, Davenport's percentages of covered companies that were investment banking clients within the past 12 months by rating were: 10.87% Buy, 8.33% 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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- I** Davenport or its affiliates received compensation for investment banking services from the subject company in the past 12 months.
- 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.
- 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.

- O** As of the end of the month immediately preceding the date of this report (or the end of the second most recent month if the report date is less than 10 calendar days after the end of the most recent month), Davenport or its affiliates beneficially owned 1% or more of any class of common equity securities of the subject company calculated in accordance with Section 13(d) of the Securities Exchange Act of 1934.
- 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.**

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**Certification**

As the primary author of this report, I hereby certify that the views and opinions expressed herein accurately reflect my personal views and opinions about the principal subject(s) of this report. Further, I hereby certify that no part of my compensation was, is, or will be directly or indirectly related to the specific recommendations or personal views expressed here.

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