

# National Bankshares Inc.

BANK

NASDAQ: NKSH - \$35.20

RATING: HOLD  
12-Month Price Target: \$36.00

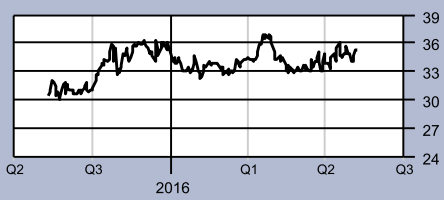
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## MARKET DATA

Market Cap.	\$246.4 Mil.
Price/Book	136%
Price/Tang. Book	141%
* As of	06/30/2016
52-Week High	\$37.10
52-Week Low	\$29.17
3-Mo. Avg. Daily Volume	6,395
Dividend Yield	3.30%
Total Assets	\$1.2 Bil.
* As of	06/30/2016
ROE	8.50%
* As of	06/30/2016
ROTE	8.80%
Shares Outstanding (Mil)	7.0
Annual Dividend	\$1.16
Institutional Ownership	34.1%
Insider Ownership	3.3%

1 Year Price History for NKSH



National Bankshares, Inc. is the Blacksburg, Virginia-based financial holding company of the National Bank of Blacksburg, a community bank operating 26 branches in Southwest Virginia. For historical perspective, the National Bank of Blacksburg was first chartered in 1891 as the Bank of Blacksburg.

## Reducing Estimates Post 10-Q Filing for Lower NIM

	EPS							P/E
	Mar	Jun	Sep	Dec	Year	Growth	Est. Change	
2015A	\$0.57	\$0.59	\$0.60	\$0.51	\$2.28	(6.2)%	—	15.4x
2016E	\$0.54A	\$0.55A	\$0.56	\$0.59	\$2.24	(1.8)%	(\$0.05)	15.7x
2017E	\$0.54	\$0.58	\$0.60	\$0.62	\$2.34	4.5%	(\$0.05)	15.0x

**Updating estimates following 10-Q filing; maintaining HOLD rating.** After publishing our initial thoughts on NKSH's 2Q16 earnings release ([click here](#) for a link to our "First Look" note), we held off on formally updating estimates pending further financial disclosure in the 10-Q filing. With the 10-Q now published, we are formally updating our estimates. Specifically, we are reducing our EPS estimates by \$0.05 in both 2016 and 2017. While we certainly recognize the company's superior profitability and lower risk profile (1.28% 2Q16 ROA and 14.4% TCE), over the next twelve months we do not see a meaningful catalyst to send shares significantly higher. We anticipate profitability metrics will remain excellent but in lieu of more substantial earnings growth, we think upside in the share price will be limited. As a result, we are maintaining our HOLD rating and \$36 price target. Below are incremental takeaways from the quarter:

**Tweaking estimates lower on reduced net interest margin assumptions.** The biggest surprise to us with 2Q16 results was the level of net interest margin compression. NKSH's NIM compressed by 14 bps sequentially to 3.52%. With the disclosure of a full average balance sheet in the 10-Q filing, it appears there were a number of factors driving the compression: (1) average loan yields declined 4 bps sequentially to 4.90% (we expect this trend to continue in the 4-8 bps range per quarter), (2) securities yields declined by 38 bps sequentially to 3.38%, and (3) an adverse mix shift negatively impacted NII (average loan balances were flat qtr/qtr while securities balances grew 7% qtr/qtr). Of these factors, we do expect the negative mix shift should reverse itself in 3Q15. EOP loan growth in 2Q was quite strong at 3.8% sequentially unannualized, but with this growth coming primarily at the end of the quarter, average balances were flat and liquidity was deployed into lower yielding securities. However, we do believe loan and securities yields will remain under pressure and as a result, we now model a full year NIM of 3.56% in 2016 (down from our prior modeling of 3.66%) and 3.47% in 2017 (down from our prior modeling of 3.66%).

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**Loan growth bounces back after a soft first quarter driven by commercial.** Recall loan balances fell 2% sequentially in 1Q16 and given management commentary we had expected a rebound in 2Q. This did indeed play out with EOP loans growing 3.8% sequentially. This result was actually slightly stronger than our estimate for 3% sequential growth. Among categories, commercial real estate balances (NKSH's largest category) grew 3.3% sequentially while consumer real estate balances (NKSH's second largest category) grew 2.3% sequentially. Our model anticipates loan growth for this year and next will be in the mid-single digit range.

**Efficiency remains a calling card of the institution.** Noninterest expenses declined 6.7% sequentially, which when coupled with 10% fee income growth, drove the efficiency ratio back below 50% to 49.3%. While we had expected a seasonal rebound in fees (which is a small contributor to revenues anyway), the expense reduction was a positive surprise result. With the exception of a seasonal bump in the expense base in 1Q17, we anticipate the ~\$6.2 million noninterest expense base will approximate a good run-rate going forward.

**Credit metrics continue their downward trend.** Total NPA balances (including accruing TDRs) fell 19% sequentially to 2.35% of loans & OREO. This is a solid improvement from the 2.90% this metric stood at EOP 1Q16. However, NCO's did come in above our estimate at 37 bps of average loans annualized (we had modeled 25 bps). The net result of which was a higher than expected provision (\$654k versus our \$511k estimate). As of quarter end, reserves stood at 130 bps of loans.

**Capital levels remain robust.** TCE ended the quarter at 14.44%, essentially flat versus the prior quarter as NKSH paid its semi-annual \$0.55 per share dividend in the quarter. TBVPS ticked up \$0.11 sequentially to \$24.99.

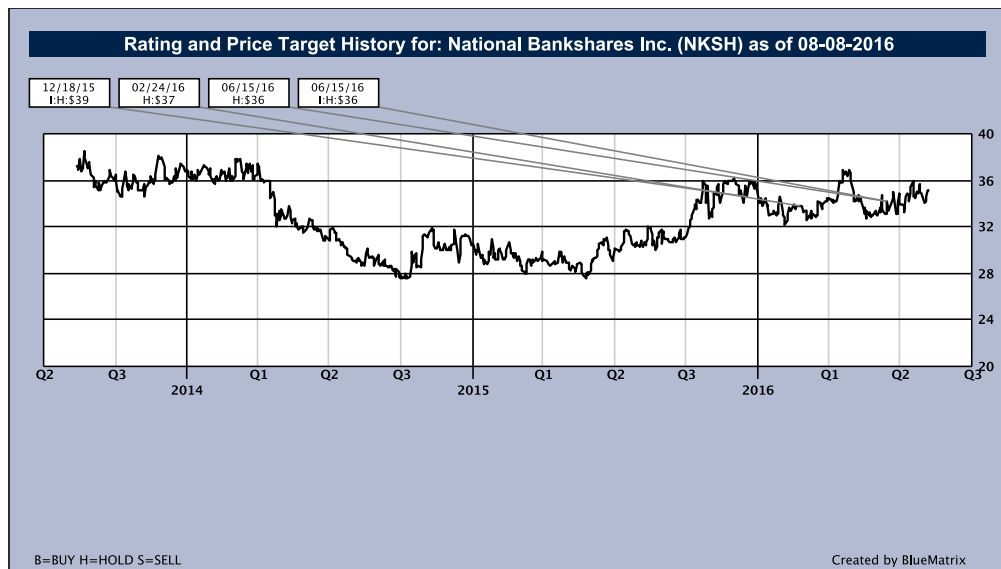


## APPENDIX

Time of dissemination: August 09, 2016, 07:32 EDT.

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### IMPORTANT DISCLOSURES:



#### Price Target

Our 12-month price target is \$36.

#### Valuation Methodology

Our price target assumes shares trade at 15x our 2017 EPS estimate, in twelve months time, which is just slightly above the current peer median. We believe this valuation is justified by the company's strong profitability and risk profile.

#### Risk Factors

Risks include (1) deterioration in the southwest Virginia economy, (2) deterioration in asset quality, (3) a lower than expected interest rate environment, (4) integration risk if NKSH were to pursue an acquisition, (5) succession risk if/when current CEO James Rakes retires and (6) a decrease in bank stock valuations more broadly.

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##### Sandler O'Neill + Partners

Rating	Count	Percent	IB Serv./Past 12 Mos.	
			Count	Percent
BUY [B]	154	49.68	57	37.01
HOLD [H]	153	49.35	28	18.30
SELL [S]	3	0.97	0	0.00

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