

NATIONAL BANKSHARES INC

Form 10-Q

May 08, 2013

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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D. C. 20549

FORM 10-Q

☒ QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934

For the quarterly period ended March 31, 2013

☐ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934

For the transition period from \_\_\_\_\_ to \_\_\_\_\_  
Commission File Number 0-15204

NATIONAL BANKSHARES, INC.  
(Exact name of registrant as specified in its charter)

Virginia  
(State or other jurisdiction of incorporation or organization)

54-1375874  
(I.R.S. Employer Identification No.)

101 Hubbard Street  
P. O. Box 90002  
Blacksburg, VA  
(Address of principal executive offices)

24062-9002  
(Zip Code)

(540) 951-6300  
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. ☒ Yes ☐ No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). ☒ Yes ☐ No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer ☐ Accelerated filer ☒ Non-accelerated filer ☐ Smaller reporting company ☐  
(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).  
☐ Yes ☒ No

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Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Class	Outstanding at May 1, 2013
Common Stock, \$1.25 Par Value	6,947,974

(This report contains 52 pages)

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## Part I

## Financial Information

## Item 1. Financial Statements

National Bankshares, Inc. and Subsidiaries  
Consolidated Balance Sheets

\$ in thousands, except per share data	(Unaudited) March 31, 2013	December 31, 2012
<b>Assets</b>		
Cash and due from banks	\$ 10,674	\$ 14,783
Interest-bearing deposits	107,176	96,597
Securities available for sale, at fair value	191,540	189,815
Securities held to maturity (fair value approximates \$174,218 at March 31, 2013 and \$170,846 at December 31, 2012)	166,947	160,539
Restricted stock, at cost	1,414	1,689
Mortgage loans held for sale	313	2,796
<b>Loans:</b>		
Loans, net of unearned income and deferred fees	574,958	592,162
Less allowance for loan losses	(8,291)	(8,349)
Loans, net	566,667	583,813
Premises and equipment, net	10,237	10,401
Accrued interest receivable	5,878	6,247
Other real estate owned, net	1,094	1,435
Intangible assets and goodwill	9,106	9,377
Bank-owned life insurance	20,690	20,523
Other assets	6,767	6,346
<b>Total assets</b>	<b>\$ 1,098,503</b>	<b>\$ 1,104,361</b>
<b>Liabilities and Stockholders' Equity</b>		
Noninterest-bearing demand deposits	\$ 144,815	\$ 144,252
Interest-bearing demand deposits	449,992	455,713
Savings deposits	72,420	69,063
Time deposits	269,892	277,738
<b>Total deposits</b>	<b>937,119</b>	<b>946,766</b>
Accrued interest payable	146	139
Other liabilities	7,878	7,347
<b>Total liabilities</b>	<b>945,143</b>	<b>954,252</b>
Commitments and contingencies	---	---
<b>Stockholders' Equity</b>		
Preferred stock, no par value, 5,000,000 shares authorized; none issued and outstanding	---	---
Common stock of \$1.25 par value. Authorized 10,000,000 shares; issued and outstanding 6,947,974 shares at March 31, 2013 and December 31, 2012	8,685	8,685
Retained earnings	148,378	144,162
Accumulated other comprehensive loss, net	(3,703)	(2,738)

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Total stockholders' equity	153,360	150,109
Total liabilities and stockholders' equity	\$ 1,098,503	\$ 1,104,361

See accompanying notes to consolidated financial statements.

National Bankshares, Inc. and Subsidiaries  
Consolidated Statements of Income  
Three Months Ended March 31, 2013 and 2012  
(Unaudited)

\$ in thousands, except per share data	March 31, 2013	March 31, 2012
Interest Income		
Interest and fees on loans	\$ 8,319	\$ 8,878
Interest on interest-bearing deposits	58	71
Interest on securities – taxable	1,539	1,589
Interest on securities – nontaxable	1,648	1,576
Total interest income	11,564	12,114
Interest Expense		
Interest on time deposits of \$100,000 or more	268	425
Interest on other deposits	1,411	1,692
Total interest expense	1,679	2,117
Net interest income	9,885	9,997
Provision for loan losses	671	672
Net interest income after provision for loan losses	9,214	9,325
Noninterest Income		
Service charges on deposit accounts	588	631
Other service charges and fees	60	49
Credit card fees	740	794
Trust income	289	326
BOLI income	188	200
Other income	150	99
Realized securities gains, net (includes accumulated other comprehensive income reclassification adjustments for unrealized net gains in available-for-sale securities of \$95 for the three months ended March 31, 2013 and \$44 for the three months ended March 31, 2012)	95	53
Total noninterest income	2,110	2,152
Noninterest Expense		
Salaries and employee benefits	2,940	2,956
Occupancy and furniture and fixtures	432	397
Data processing and ATM	393	392
FDIC assessment	136	109
Credit card processing	552	572
Intangible assets amortization	271	271
Net costs of other real estate owned	75	48
Franchise taxes	258	162



Other operating expenses	889	804
Total noninterest expense	5,946	5,711
Income before income taxes	5,378	5,766
Income tax expense (includes income tax expense from reclassification items of \$33 for the three months ended March 31, 2013 and \$15 for the three months ended March 31, 2012)	1,162	1,337
Net Income	\$ 4,216	\$ 4,429
Basic net income per share	\$ 0.61	\$ 0.64
Fully diluted net income per share	\$ 0.60	\$ 0.64
Weighted average number of common shares outstanding – basic	6,947,974	6,939,974
Weighted average number of common shares outstanding – diluted	6,969,073	6,954,637
Dividends declared per share	\$---	\$---

See accompanying notes to consolidated financial statements.

National Bankshares, Inc. and Subsidiaries  
Consolidated Statements of Comprehensive Income  
Three Months Ended March 31, 2013 and 2012  
(Unaudited)

\$ in thousands	March 31, 2013	March 31, 2012
Net Income	\$ 4,216	\$ 4,429
Other Comprehensive Loss, Net of Tax		
Unrealized holding losses on available for sale securities net of taxes of (\$487) and (\$489) for the periods ended March 31, 2013 and 2012, respectively	(903)	(907)
Reclassification adjustment, net of taxes of (\$33) and (\$15) for the periods ended March 31, 2013 and 2012, respectively	(62)	(29)
Other comprehensive loss, net of taxes of (\$520) and (\$504) for the periods ended March 31, 2013 and 2012, respectively	(965)	(936)
Total Comprehensive Income	\$ 3,251	\$ 3,493

See accompanying notes to consolidated financial statements.

National Bankshares, Inc. and Subsidiaries  
Consolidated Statements of Changes in Stockholders' Equity  
Three Months Ended March 31, 2013 and 2012  
(Unaudited)

	Common	Retained	Accumulated Other Comprehensive	Total
\$ in thousands	Stock	Earnings	Loss	
Balances at December 31, 2011	\$ 8,675	\$ 133,945	\$ (1,321 )	\$ 141,299
Net income	---	4,429	---	4,429
Other comprehensive loss, net of tax (\$504)	---	---	(936 )	(936 )
Balances at March 31, 2012	\$ 8,675	\$ 138,374	\$ (2,257 )	\$ 144,792
Balances at December 31, 2012	\$ 8,685	\$ 144,162	\$ (2,738 )	\$ 150,109
Net income	---	4,216	---	4,216
Other comprehensive loss, net of tax (\$520)	---	---	(965 )	(965 )
Balances at March 31, 2013	\$ 8,685	\$ 148,378	\$ (3,703 )	\$ 153,360

See accompanying notes to consolidated financial statements.

National Bankshares, Inc. and Subsidiaries  
Consolidated Statements of Cash Flows  
Three Months Ended March 31, 2013 and 2012  
(Unaudited)

\$ in thousands	March 31, 2013	March 31, 2012
Cash Flows from Operating Activities		
Net income	\$ 4,216	\$ 4,429
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	671	672
Depreciation of bank premises and equipment	188	192
Amortization of intangibles	271	271
Amortization of premiums and accretion of discounts, net	47	56
Gains on sales and calls of securities available for sale, net	(95 )	(44 )
Gains on calls of securities held to maturity, net	---	(9 )
(Gains) losses and write-downs on other real estate owned	11	(24 )
Increase in cash value of bank-owned life insurance	(167 )	(179 )
Net change in:		
Mortgage loans held for sale	2,483	1,252
Accrued interest receivable	369	129
Other assets	99	124
Accrued interest payable	7	(15 )
Other liabilities	531	803
Net cash provided by operating activities	8,631	7,657
Cash Flows from Investing Activities		
Net change interest-bearing deposits	(10,579 )	(2,946 )
Proceeds from calls, principal payments, sales and maturities of securities available for sale	36,460	41,146
Proceeds from calls, principal payments and maturities of securities held to maturity	4,042	13,846
Purchases of securities available for sale	(39,040 )	(66,041 )
Purchases of securities held to maturity	(10,483 )	(9,239 )
Net change in restricted stock	(274 )	22
Purchases of loan participations	(900 )	---
Collections of loan participations	51	90
Loan originations and principal collections, net	16,952	3,116
Proceeds from disposal of other real estate owned	677	573
Recoveries on loans charged off	25	23
Additions to bank premises and equipment	(24 )	(362 )
Net cash used in investing activities	(3,093 )	(19,772 )
Cash Flows from Financing Activities		
Net change in time deposits	(7,846 )	(5,023 )
Net change in other deposits	(1,801 )	17,482
Net cash provided by (used in) financing activities	(9,647 )	12,459
Net change in cash and due from banks	(4,109 )	344

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Cash and due from banks at beginning of period	14,783	11,897
Cash and due from banks at end of period	\$ 10,674	\$ 12,241

Supplemental Disclosures of Cash Flow Information

Interest paid on deposits and borrowed funds	\$1,672	\$2,132
Income taxes paid	59	196

Supplemental Disclosure of Noncash Activities

Loans charged against the allowance for loan losses	\$754	\$700
Loans transferred to other real estate owned	347	---
Unrealized net losses on securities available for sale	(1,485 )	(1,440 )

See accompanying notes to consolidated financial statements.

National Bankshares, Inc. and Subsidiaries  
Notes to Consolidated Financial Statements  
March 31, 2013  
(Unaudited)

\$ in thousands, except per share data

Note 1: General

The consolidated financial statements of National Bankshares, Inc. (“NBI”) and its wholly-owned subsidiaries, The National Bank of Blacksburg (“NBB”) and National Bankshares Financial Services, Inc. (“NBFS”) (collectively, the “Company”), conform to accounting principles generally accepted in the United States of America and to general practices within the banking industry. The accompanying interim period consolidated financial statements are unaudited; however, in the opinion of management, all adjustments consisting of normal recurring adjustments, which are necessary for a fair presentation of the consolidated financial statements, have been included. The results of operations for the three months ended March 31, 2013 are not necessarily indicative of results of operations for the full year or any other interim period. The interim period consolidated financial statements and financial information included in this Form 10-Q should be read in conjunction with the notes to consolidated financial statements included in the Company’s 2012 Form 10-K/A. The Company posts all reports required to be filed under the Securities and Exchange Act of 1934 on its web site at [www.nationalbankshares.com](http://www.nationalbankshares.com).

Subsequent events have been considered through the date when the Form 10-Q was issued.

Note 2: Stock-Based Compensation

The Company had a stock option plan, the 1999 Stock Option Plan, that was adopted in 1999 and that was terminated on March 9, 2009. Incentive stock options were granted annually to key employees of NBI and its subsidiaries from 1999 to 2005 and none have been granted since 2005. All of the stock options are vested.

Options	Shares	Weighted Average Exercise Price Per Share	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding at January 1, 2013	69,000	\$ 23.75		
Exercised	---	---		
Forfeited or expired	---	---		
Outstanding March 31, 2013	69,000	\$ 23.75	3.58	\$ 771
Exercisable at March 31, 2013	69,000	\$ 23.75	3.58	\$ 771

There were no shares exercised during the three months ended March 31, 2013 and 2012. As of March 31, 2013, there was no unrecognized compensation expense related to stock options.

## Note 3: Loan Portfolio

The loan portfolio, excluding loans held for sale, was comprised of the following.

	March 31, 2013	December 31, 2012
Real estate construction	\$50,848	\$50,313
Consumer real estate	139,694	143,262
Commercial real estate	294,578	304,308
Commercial non real estate	35,478	37,349
Public sector and IDA	26,686	26,169
Consumer non real estate	28,581	31,714
Gross loans	575,865	593,115
Less unearned income and deferred fees	(907 )	(953 )
Loans, net of unearned income and deferred fees	\$574,958	\$592,162

## Note 4: Allowance for Loan Losses, Nonperforming Assets and Impaired Loans

The allowance for loan losses methodology incorporates individual evaluation of impaired loans and collective evaluation of groups of non-impaired loans. The Company performs ongoing analysis of the loan portfolio to determine credit quality and to identify impaired loans. Credit quality is rated based on the loan's payment history, the borrower's current financial situation and value of the underlying collateral.

Impaired loans are those loans that have been modified in a troubled debt restructure ("TDR" or "restructure") and larger, non-homogeneous loans that are in nonaccrual or exhibit payment history or financial status that indicate the probability that collection will not occur according to the loan's terms. Generally, impaired loans are given risk ratings that indicate higher risk, such as "classified" or "other assets especially mentioned." Impaired loans are individually evaluated to determine appropriate reserves and are measured at the lower of the invested amount or the fair market value. Impaired loans with an impairment loss are designated nonaccrual. Please refer to Note 1 of the Company's 2012 Form 10-K/A, "Summary of Significant Accounting Policies" for additional information on evaluation of impaired loans and associated specific reserves, and policies regarding nonaccruals, past due status and charge-offs.

Troubled debt restructurings impact the estimation of the appropriate level of the allowance for loan losses. If the restructuring included forgiveness of a portion of principal or accrued interest, the charge-off is included in the historical charge-off rates applied to the collective evaluation methodology. Further, restructured loans are individually evaluated for impairment, with amounts below fair value accrued in the allowance for loan losses. TDRs that experience a payment default are examined to determine whether the default indicates collateral dependency or cash flows below those that were included in the fair value measurement. TDRs, as well as all impaired loans, that are determined to be collateral dependent or for which decreased cash flows indicate a decline in fair value are charged down to fair value.

The Company evaluated characteristics in the loan portfolio and determined major segments and smaller classes within each segment. These characteristics include collateral type, repayment sources, and (if applicable) the borrower's business model. The methodology for calculating reserves for collectively-evaluated loans is applied at the class level.

## Portfolio Segments and Classes

During the first quarter of 2013, the Company segregated certain loans that were included within the classes of the Residential Real Estate segment, including Equity lines, Residential closed-end first liens and Residential closed-end junior liens. The newly-segregated loans are secured by residential real estate collateral that is owned by investors and



for which the primary repayment source is rental income. The new class in the Residential Real Estate segment allows the Company to address credit risks characteristic of investor-owned residential real estate. Segregating the investor-owned residential real estate did not have a significant impact on the calculation of the allowance for loan losses. Consistent with accounting guidance, prior periods have not been restated and are shown as originally published using the segments and classes in effect for the period.

The segments and classes used in determining the allowance for loan losses, beginning with the first quarter of 2013 are as follows.

Real Estate Construction	Commercial Non Real Estate
Construction, residential	Commercial and Industrial
Construction, other	
	Public Sector and IDA
Consumer Real Estate	Public sector and IDA
Equity lines	
Residential closed-end first liens	Consumer Non Real Estate
Residential closed-end junior liens	Credit cards
Investor-owned residential real estate	Automobile
	Other consumer loans
Commercial Real Estate	
Multifamily real estate	
Commercial real estate, owner occupied	
Commercial real estate, other	

#### Historical Loss Rates

The Company's allowance methodology for collectively-evaluated loans applies historical loss rates by class to current class balances as part of the process of determining required reserves. Class loss rates are calculated as the net charge-offs for the class as a percentage of average class balance. The annualized current-year loss rate is averaged with that of prior periods to obtain the historical loss rate. Prior to the first quarter of 2013, one historical loss rate for each class was calculated and applied to current class balance to obtain the allocation for historical loss rates.

Beginning with the first quarter of 2013, two loss rates for each class are calculated: total net charge-offs for the class as a percentage of average class loan balance ("class loss rate"), and total net charge-offs for the class as a percentage of average classified loans in the class ("classified loss rate"). Classified loans are those with risk ratings of "substandard" or higher. Net charge-offs in both calculations include charge-offs and recoveries of classified and non-classified loans as well as those associated with impaired loans. Class historical loss rates are applied to non-classified loan balances at the reporting date, and classified historical loss rates are applied to classified balances at the reporting date.

The revised calculation and application of historical loss rates impacted the calculation of reserves for collectively-evaluated loans. Under the former methodology, the class historical loss rates were applied to all collectively-evaluated loans and would have resulted in a total allocation of \$2,712. Under the revised methodology, class historical loss rates are applied to only non-classified loans, resulting in an allocation of \$2,624. In addition, the classified historical loss rate resulted in an allocation of \$900, for a total allocation based on historical loss rates of \$3,524. Consistent with accounting guidance, prior periods have not been restated and are shown as originally published using the methodology in effect for the period.

#### Risk Factors

In addition to historical loss rates, risk factors pertinent to each class are analyzed to estimate reserves for collectively-evaluated loans. Factors include changes in national and local economic and business conditions, the nature and volume of classes within the portfolio, loan quality and loan officers' experience. Prior to the first quarter of 2013, management also reviewed the Company's lending policies and loan review system to determine whether changes had occurred during the quarter that affected credit risk. Until the first quarter of 2013, no changes were found to affect credit risk and no additional allocations were applied. During the first quarter of 2013, the Company incorporated to the allowance methodology a factor for changes in the Company's lending policies and a factor for changes in the quality of the Company's loan review, and set standard allocations for associated risk. The addition of

the factors formalized and standardized a practice already in place and did not have a significant impact on the calculation of the allowance for loan losses.

Factor allocations applied to each class are increased for loans rated special mention and increased to a greater extent for loans rated classified. The Company allocates additional reserves for “high risk” loans, determined to be junior lien mortgages, high loan-to-value loans and interest-only loans.

A detailed analysis showing the allowance roll-forward by portfolio segment and related loan balance by segment follows.

Activity in the Allowance for Loan Losses for the Three Months Ended March 31, 2013

Real			Commercial	Public
Estate	Consumer	Commercial	Non Real	Sector
Construction	Real Estate	Real Estate	Estate	and ID