

Title: NKSH: A Risk Averse and Discounted Growth Stock

National Bankshares (NKSH) released their earnings report for Q2 2019 last week. Investors should focus on the firm's impressive Year over Year growth, their sizable non-interest revenues, and discounted P/B ratio. All of these factors present investors with an opportunity to buy a long-term growth stock at a low price, especially when compared to the at-large banking sector. The optimism of National Bankshares insiders, who spent thousands of dollars on stock buybacks, further confirms the stock's upside potential.

The headquarters of National Bankshares are in Blacksburg, Virginia. Their 25 office locations all offer the company's full services, which include deposit accounts, credit cards, trust funds, and different types of loans. In addition, the company owns National Bank, a community bank that has been doing business for over 100 years. National Bankshares have about \$1.3B in assets (according to their latest earnings report) and a market cap of over \$227M. They compensate their CEO, Brad Denardo, a modest \$826K per year. To put that into perspective, banks that have a market cap between \$100M and \$400M pay their CEOs, on average, \$1.2M annually.

Having said that, National Bankshares' management is more than generous with its shareholders. The company's bi-annual dividend, which they recently increased, has a strong 4% yield. Investors should also expect another raise, which will come in the form of stock returns. Revenues are growing thanks to the company's conservative business model and attentiveness to shareholders and customers alike.

Management is enjoying healthy returns on invested assets and the firm has an impressive source of non-interest income, which makes National Bankshares more than equipped to weather through a market downturn and harsh macroeconomic conditions. National Bankshares insiders are also spending hundreds of thousands to buyback shares and the company is trading at 1.15 times its book value, a discounted price for a bank. NKSH stock has underperformed the sector in 2019, making its current stock even more lucrative, especially long-term bank investors.

Earnings Highlights

On Thursday, August 8, National Bankshares released their earnings for Q2 2019. Its revenues give us plenty of reasons to be optimistic about NKSH's stock.

- During the first six months of 2019, net income was \$8.4M and diluted EPS were \$1.26, which is a remarkable YoY increase. During the same period in 2018, the company's net income and diluted EPS were \$7.3M and \$1.05, respectively.
- Return on average equity and return on average assets both suggest that the company has healthy and risk-averse finances.
- The firm has a highly desirable efficiency ratio, which is driven by sizable non-interest revenues that are growing YoY.

- Because National Bankshares continue to adhere to their conservative business model, the company has more than enough assets to weather through a market downturn or recession.

The latest earnings report shows that National Bankshares are increasing their revenues by remaining risk-averse and cautious. "While our proven business model continues to deliver good results, we're also committing time and resources to new initiatives as we adapt and grow in a changing marketplace".

Banking institutions invest their customer deposits and shareholder funds in revenue-generating assets like interest-bearing loans and equity trust funds. They pay depositors and shareholders back in interest and equity/dividend returns, respectively. Because of this, banks have to issue loans to low-risk borrowers who are less likely to default in order to generate strong revenues. They must also establish a healthy non-interest revenue stream in order to minimize risk. Moreover, the volatility and quality of a bank's assets can tell us a lot about the level of risk that their depositors and shareholders are exposed to.

National Bankshares, Inc. and Subsidiaries
Consolidated Statements of Income
(Unaudited)

(\$ in thousands, except for share and per share data)	Three Months Ended		Six Months Ended	
	June 30, 2019	June 30, 2018	June 30, 2019	June 30, 2018
Interest Income				
Interest and fees on loans	\$ 8,460	\$ 7,622	\$ 16,729	\$ 15,154
Interest on federal funds	---	---	---	---
Interest on interest-bearing deposits	382	226	641	398
Interest on securities - taxable	1,603	1,746	3,286	3,354
Interest on securities - nontaxable	848	1,132	1,775	2,304
Total interest income	11,293	10,726	22,431	21,210
Interest Expense				
Interest on time deposits	419	116	716	237
Interest on other deposits	1,495	1,029	2,991	1,989
Total interest expense	1,914	1,145	3,707	2,226
Net interest income	9,379	9,581	18,724	18,984
Provision for loan losses	55	342	255	(130)
Net interest income after provision for loan losses	9,324	9,239	18,469	19,114
Noninterest Income				
Service charges on deposit accounts	607	694	1,197	1,364
Other service charges and fees	51	34	103	67
Credit card fees	356	365	665	709
Trust income	371	374	768	776
Bank-owned life insurance	232	228	451	456
Other income	231	173	1,141	519
Realized securities gain, net	8	---	20	---
Total noninterest income	1,856	1,868	4,345	3,891
Noninterest Expense				
Salaries and employee benefits	3,802	3,545	7,623	7,239
Occupancy and furniture and fixtures	477	491	942	963
Data processing and ATM	789	607	1,540	1,340
FDIC assessment	82	90	167	181
Intangibles and goodwill amortization	---	12	---	25
Net cost of other real estate owned	3	164	28	249
Franchise taxes	333	320	647	651
Write-down of insurance receivable	---	287	---	2,010
Other operating expenses	967	908	1,971	1,930
Total noninterest expense	6,453	6,424	12,918	14,588
Income before income tax expense	4,727	4,683	9,896	8,417
Income tax expense	733	642	1,459	1,080
Net Income	\$ 3,994	\$ 4,041	\$ 8,437	\$ 7,337
Basic net income per share	\$ 0.61	\$ 0.58	\$ 1.26	\$ 1.05
Fully diluted net income per share	\$ 0.61	\$ 0.58	\$ 1.26	\$ 1.05
Weighted average number of common shares outstanding				
Basic	6,505,574	6,957,974	6,669,853	6,957,974
Diluted	6,505,574	6,957,974	6,669,853	6,957,974
Dividends declared per share	\$ 0.67	\$ 0.58	\$ 0.67	\$ 0.58
Dividend payout ratio	---	---	51.67%	55.01%
Book value per share	\$ 28.26	\$ 26.71	\$ 28.26	\$ 26.71

Source: National Bankshares press release

The return on average assets ratio a key way to measure a bank's profitability. It indicates the percentage returns or profits on each dollar that a firm has in assets (customer deposits). National Bankshares had a 1.32% return on average assets during Q1 and Q2 of this year. In comparison to the same period in 2018, the firm had a 1.30% return on average assets. This means that National Bankshares are more than capable of honoring its expenses towards interest-bearing deposit accounts.

Another key measure is the return on average equity, which shows us how much a bank generates in revenues for each dollar that shareholders invested. National Bankshares have a return on average equity of 8.97% because the company is wisely investing stockholder equity into revenue-generating operations.

Another important performance metric is the efficiency ratio, which measures a bank's non-interest revenues against its expenses. A bank with a high efficiency ratio is more likely to suffer if borrowers fail to pay back their loans because it heavily relies on interest revenues. Meanwhile, an institution that has an efficiency ratio of 50% or less is less prone to damages caused by defaults and market downturns.

The efficiency ratio is calculated as follows: $\text{Non-interest expenses} / (\text{non interest income} + \text{net interest income} - \text{provision for loan losses})$.

National Bankshares had an efficiency ratio of 48.7% during Q1 and Q2 of 2019. The Virginia-based firm had a 58.8% efficiency ratio during the first half of 2018. This shows investors that National Bankshares have more than enough assets to cover loan defaults in case of a market sell-off or an unfavorable macroeconomic environment.

In fact, out of all outstanding loans with unearned interest income, only 0.01% have been past due for over 90 days. Moreover, the percentage of nonperforming assets out of the total unearned income and fees is only 0.86%.

Stock Performance



NKSH is currently trading at 1.25 times its book value. During Q3 and Q4 of 2018, the average P/B ratio for S&P 500 financial institutions was 1.44. This puts NKSH's relatively low P/B ratio at a desirable level for value investors. It indicates that the company's stock is trading at a discounted price. NKSH is extra lucrative because regional banks are more likely to enjoy higher returns over a small period of time than larger and multinational institutions.

Source: [Yahoo Finance](#)

The chart above compares NKSH's 2019 year-to-date performance with larger banks, namely JP Morgan ([JPM](#)), Citigroup ([C](#)), and Capital One ([COF](#)). It also includes the KBW Bank ETF ([KWBW](#)), which closely tracks the performance of the at-large banking sector, including both regional and larger institutions.

NKSH stock has been declining since the turn of the year, despite the fact that KWBW grew by 8.6% during 2019. Moreover, the larger banks are enjoying returns that are even bigger than the sector's ETF.

Going forward, NKSH's relatively low stock price presents investors with an opportunity to buy low. Even more so when we consider the company's conservative business model, low-risk loans, and P/B ratio. In fact, National Bankshares insiders are buying back stocks in large amounts, which highlights their optimistic outlook about the future.

On August 5, 2019, National Bankshares EVP Hunter Gregg Strader bought \$71.34K worth of the company's stock at \$35.67 per share. Beforehand, other company insiders spent \$475K on stock buybacks. Jack Lewis led the pack by spending \$110K on stock buybacks at an average cost of \$36.50 per share.

Only one analyst is current covering NKSH's stock price. Nonetheless, their projections further confirm that the company is trading at a discounted price. The analyst recently increased their target stock price for National Bankshares to \$41.00, which is 17% higher than its current level.

Downside Risks

As always, investors should also consider the risks associated with any stock idea. The main risk that National Bankshares face is the possibility of lower interest revenues. If the Federal Reserve embraces a more dovish approach and cuts interest rates again in 2019, National Bankshares' revenues might take a hit. However, the impact will most likely be minimal for several reasons.

If anything, a rate cut will help the firm will cut back on interest expenses, which have been increasing YoY and QoQ over the last 12 to 18 months. Moreover, certain sources of revenue are likely to grow if the Fed takes a more dovish policy stance. This is because the demand for loans and credit card spending will booth tick to the upside, which will allow National Bankshares to increase both interest and non-interest revenues.

Lastly, NKSH stock comes with a strong dividend that has a near 4% yield. If the stock price declines in response to rate cuts (or for any other reason), the dividend will act as a cushion that minimizes the damage.

Going Forward

Investors should keep a close eye on how National Bankshares expand their operations and non-interest revenues in the future. This gives shareholders a clear idea of what to expect and how NKSH stock will react to rate cuts or any other events.

On Thursday, after National Bankshares released their earnings, CEO Denardo reaffirmed the firm's "commitment to continually improve our organization for the benefit of our customers, communities, and shareholders". As long as the company keeps growing its revenues and maintains high-quality lending practices, investors should expect strong returns that will come in many forms.

Douglas Hughes

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