May 21, 2019

First Community Bankshares (FCBC)

By: Nancy A. Bush, CFA
NAB Research, LLC
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Price: **$33.46**
52-week price range: $27.06-$36.48

EPS Estimates: 2018A: $2.18
2019E: $2.26
2020E: $2.32
Q219E: **$0.57** (versus **$0.54** in 2Q18)

Tangible Book Value: $14.89
Price/TBV: 2.25x
Annual Dividend: $1.00
Dividend Yield: 2.99%
Market Capitalization: $527.2 million

--Whatever happened to Virginia?...
--This high-quality community bank has been engaged in an extensive "do-over" in the last few years...
--Still a lot of consolidation to be done here...Will First Community return to the game?

Whatever happened to Virginia?...

Back in the day—when banking dinosaurs roamed the land—Virginia was the place that every banker wanted to be. The state was deemed to be the bridge between the Southeast and the major banking markets in the Northeast, and the perpetual growth characteristics of the government-centric northern Virginia region made it a "must-have" market for the large Southeastern regional banks. **All of this remains true—especially the part about growth in the northern part of the state, where the federal government continues to expand and companies like Amazon can find the tech-savvy employees that they need.**

But for some reason the state is just not as prominent in discussions about banking as it used to be. We are old enough to remember the days when the banks of the Southeast paid large premiums for Virginia franchises—such as the purchase of Roanoke-based **Dominion Bankshares** by **First Union** in 1992 and the acquisition of Richmond-based **Crestar** by **SunTrust Banks Inc. (STI)** in 1998. Both were preceded in 1991 by the merger of the then-NCNB—now **Bank of America Corp. (BAC)**—with the product of a "busted" deal, **C&S Sovran** (of Atlanta and Norfolk, respectively), a merger that had ironically been done to avoid a hostile takeover by NCNB and its acquisitive CEO, Hugh McColl. **So if the reader thinks that the early 1990s were a wild and woolly time for Virginia banks, then he would be right.**

Things have been a lot quieter lately. There is still a lot going on in Virginia banking presently, but it does not have quite the marquee quality that it had in the early years of banking consolidation. Perhaps because the largest franchises are already well-consolidated or perhaps because of the **historically conservative nature** of the Virginia community banks, the spotlight in the last couple of years has fallen more on banks to the south, in the **Carolinas and Tennessee most specifically.** Much of that attention has been due to the formation of the Southeastern mega-community banks, most notably of **Pinnacle Financial Partners (PNFP), South State Bancorp. (SSB), United Community Banks (UCBI)**, and others that have emphasized expansion in the Carolinas, Georgia and Tennessee. There has been interest in Virginia expansion—most notably expansion into the Richmond area—on the part of a number of banks, but banking in the more rural parts of Virginia has largely remained the purview of the smaller community banking segment.

There has been plenty of intra-state consolidation. As we were researching this piece, we came across a mid-2017 article in "Virginia Business" that cited 28 completed or announced banking mergers in the state since 2013, and several noteworthy deals have happened since. **Towne Bank (TOWN)** of Hampton Roads has been an especially busy acquirer, completing three significant deals since 2015—**Franklin Financial Corp.** of Richmond, **Monarch Financial Holdings** (operations in Chesapeake and northeastern North Carolina) and most recently **Paragon Commercial Bank** (of Raleigh), adding $3 billion in deposits in the process. Towne—also an active acquirer of insurance agencies—stands at $11.2 billion in assets at year-end 2018 and is quietly claiming the mantle as Virginia's "mega-community" bank.

First Community has gone in a different direction...

We think that the community banks have an advantage over most of their larger brethren—they are more easily able to change (or correct) their strategic direction. And this one has done it, big time. There are times when scrolling through a bank's past earnings and press releases is a snooze-fest, and then there is the occasional bank where a seismic event is revealed through regulatory filings. We have seen one recent example of such a rethink at **Atlantic Capital (ACBI)** of Atlanta, where management decided that their foray into retail banking in Tennessee was pulling them away from their robust core business of commercial lending in Atlanta, and they wisely decided to sell the Tennessee franchise and focus on their traditional strengths and on the building of profitable ancillary businesses.

First Community seems to have done something even more profound—it changed its whole operating philosophy, along with its management team. We were reading the earnings release for the fourth quarter and full year 2012, and we noted the words of then-CEO, John Mendez as he discussed the company's growth metrics for the year: two acquisitions, 26% growth in the balance sheet, a 36 bps improvement in the net interest margin, net income up 42% for the year. And Mr. Mendez ended his optimistic earnings commentary with these words: "This is an illustration of the capacity that exists in the continued consolidation of financial services in our markets at attractive price points and with the substantial cost savings that are afforded through the leverage of our systems and management team."

Sounds great, right? Apparently—not so much. In August of 2013, Mr. Mendez and the Board of First Community parted ways for undisclosed reasons, but we surmise from the company's subsequent direction that there was a profound disagreement concerning the pace and direction of First Community's growth. In any case, Gary Mills became CEO of the bank (after serving as Chief Credit Officer there since 1998) and President of the holding company, while the Chairman of the Board, William Stafford II, became the permanent holding company CEO two weeks later. These two executives have brought with them an intense internal focus that has resulted in the streamlining and cleansing of the balance sheet, an emphasis on returning excess capital to shareholders, and strategies to improve the bank's branch footprint.

There has been a noteworthy change of tone in the bank's communications with investors…
We have been struck by the absolute 180-degree turn in emphasis here. For one thing, there is none of the expansive verbiage of past quarterly earnings reports but rather a "just the facts, ma'am" recitation of the quarterly results and a synopsis of the quarter's noteworthy achievements. And those achievements have been a litany of simplification—the sale of the bank's insurance brokerage operations, the paying down of FHLB debt and the redemption of preferred stock, the purchase of six branches in southwestern Virginia from Bank of America, the sale of 13 branches in coastal North Carolina and South Carolina, an interesting swap of seven North Carolina branches for six in southwestern Virginia, and on and on.

We had a chat with Mr. Mills, and it was evident that his (and the Board's) focus is not what "the Street" thinks of their bank, but what their shareholders and their customers think of them. The experience of endless due diligence on possible deals in the pre-2013 period had left the company detached from their mission of being a well-performing community bank, no matter what their size, and they have since adopted a stance that emphasizes capital creation and profitability and places asset size as a consequence of the achievement of those attributes. Their message is quite clear—**we're a conservative Virginia bank and we aim to stay that way. And BTW, we'll give as much capital as we can back to our shareholders.**

Indeed, the bank's 1Q19 earnings report spells out these philosophical changes quite clearly. It's seldom that we read in a quarterly earnings release the following statements: "The company's remaining wholesale repurchase agreement of $25 million matured during the first quarter. The Company repaid the borrowing with current liquidity, which should result in annualized net pre-tax savings of $378 thousand. This culminates the Company's 5-year strategic shift back to a more traditional community bank balance sheet, during which the Company paid off $200 million in wholesale debt." And that forthright statement of accomplishment was followed by another: "The company declared a quarterly cash dividend of twenty-five cents ($0.25) per common share, an increase of seven cents ($0.07), or 38.89%, over last second quarter's dividend."

In those two declarations is the "story", to use a Wall Street phrase. The bank will not return to a path of growth that is financed by expensive leverage, but will instead choose to concentrate on balance sheet soundness and managing capital to the adequate level—one which is sufficient to support growth as well as to maintain FCBC's identity as a liquid and conservatively managed organization. It was clear from our talk with Mr. Mills that the return of 100% of earnings at this juncture is the likely result, and that while the bank may also repurchase shares (232,900 shares repurchased in 1Q19), their preference is to reward their shareholders (13% of whom are insiders) with cold, hard cash.

We would also note one other thing that got our attention—this bank is not averse to special dividends. We would note the rarity of special dividends in the financial sector—and in most of corporate America outside the technology sector—so the payment of a special $0.48-per-share dividend (in addition to the regular $0.18 dividend) to FCBC shareholders in the first quarter of 2018 was especially noteworthy. While the bank did not specify a reason for the payment of the special dividend, we surmise that the achievement of some admirable profitability metrics—a 1.50% return on assets and a 14.36% return on average tangible equity—marked a point at which FCBC's management thought that shareholders should be rewarded for their patience during what had been a few years of turmoil and change. While many companies seem averse to the use of special dividends—seeming to think that shareholders will come to expect them to be more regular than "special"—First Community's management seems to have no concern with rewarding their shareholders in this manner and we would not be surprised to see "specials" used again in the future here.

Are they out of the M&A game forever?...

Not likely, we believe. But it's clear that future M&A activity will be different than it was in the past. For one thing, there will not be a trashing of balance sheet quality and soundness to finance deals and balance sheet liquidity and simplicity will be at the forefront of deal considerations. And culture—that elusive ingredient that can make or break a deal—will be of foremost importance in consideration of any whole-bank deals, as the "execution risk is always high" in Mr. Mills' words and the company has already experienced the downside of deals that were not quite the right fit.

Geographic fill-ins or additions to existing businesses will be of the highest priority. As Mr. Mills specified, the company does not see the coastal areas where competition is so intense as being their natural operating area, but sees the juncture of Virginia, North Carolina and Tennessee as having the right mix of commercial businesses (not dependent on agriculture, for example) and consumers who are interested in true community relationship banking as being their natural home. We would also mention that the company does derive a healthy revenue stream from fiduciary and asset management activities, and the company's value—and its values—would seem to us to be a magnet for small teams of wealth managers who might want to align themselves with a sound and conservative bank. **Whatever they buy, it will not be flashy, it will not likely be newsworthy, and it will not be allowed to undo the hard work that has been done over the past six years.**

Bottom Line: The numbers and the story are straightforward…

Just when we were beginning to believe that all banks were desperate to do M&A, it has been pleasing and surprising to discover one that seems to be more interested in maintaining the simplicity of its balance sheet and in earning money for its shareholders. It's seldom in our career that we have encountered a bank (community or otherwise) that seemed so comfortable in bucking the prevailing group-think, and we must admit that First Community is singular in that mission.

While this is admittedly a time when doing deals, growing assets and driving expenses down through consolidation is the prevailing wisdom in banking—and rightly so, given the outlook for modest asset growth and the realities of technological change in the delivery of financial services—we think that such banks as FCBC illustrate that banking is not a "one size fits all" industry, and indeed has never been. **Superior profitability in banking can be achieved in many ways and by banks of many sizes, and a singular focus on the goal of efficient funding achieved through relentless balance sheet focus is one of the avenues to healthy stock valuation and best-in-class risk-adjusted returns.**

So who should own this stock? As Gary Mills said to us, "if you like boring, then we are the sexiest bank around." Well, we love boring, especially when it is accompanied by a big helping of growing dividends. **This may not be a bank known to many—but it should be.**

Nancy A. Bush, CFA
706-438-3098

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Table 1
First Community Bankshares
Earnings Estimates
($ Thousands, Except Per Share Data)

	Q1 2018	Q2 2018	Q3 2018	Q4 2018	Q1 2019	Q2 2019E	2018A	2019E	2020E	Percent Change 19E/18A	20E/19E
Net Interest Income	**$ 22,836**	**22,719**	**22,781**	**24,331**	**22,425**	**22,500**	**92,667**	**89,000**	**90,200**	**(4)**	**1**
Tax Equivalent Adjustment	457	457	456	452	239	250	1,822	1,000	1,800	(45)	80
Loan Loss Provision	495	495	495	908	1,220	750	2,393	3,400	3,000	42	(12)
Subtotal	**21,884**	**21,767**	**21,830**	**22,971**	**20,966**	**21,500**	**88,452**	**84,600**	**85,400**	**(4)**	**1**
Noninterest Income											
Service Charges on Deposits	3,468	3,612	3,803	3,850	3,408	3,500	14,733	14,250	15,500	(3)	9
Wealth Management	794	823	791	854	745	800	3,262	3,200	3,750	(2)	17
Other Service Charges and Fees	1,635	1,991	1,925	2,017	2,049	2,100	7,568	8,000	8,250	6	3
Insurance Commissions	329	338	299	-	-	-	966	-	-	(100)	nm
Gains on Sale of Securities	-	-	(618)	-	-	-	(618)	-	-	(100)	nm
Net FDIC Indemnification Amort.	(382)	(575)	(645)	(579)	(552)	(550)	(2,181)	(2,200)	(2,000)	1	(9)
Other Operating Income	602	827	964	155	2,430	500	2,548	3,900	2,500	53	(36)
Total Noninterest Income	**6,446**	**7,016**	**6,519**	**6,297**	**8,080**	**6,350**	**26,278**	**27,150**	**28,000**	**3**	**3**
Noninterest Expense											
Salaries and Benefits	9,441	8,993	8,983	9,273	9,166	9,100	36,690	36,500	38,000	(1)	4
Occupancy & Equipment Exp.	2,296	2,028	2,060	2,138	2,186	2,100	8,522	8,500	8,500	(0)	-
Service Fees	828	851	1,134	1,047	1,030	1,000	3,860	4,000	4,000	4	-
Advertising	522	461	478	550	524	500	2,011	2,200	2,000	9	(9)
Professional Fees	307	430	337	356	414	350	1,430	1,600	1,000	12	(38)
Amortization of Intangibles	261	263	261	254	246	250	1,039	1,000	1,000	(4)	-
FDIC Premiums	211	252	234	209	168	200	906	800	925	(12)	16
Miscellaneous Charges	-	-	2,588	-	-	-	2,588	-	-	(100)	nm
Other Expenses	3,028	3,939	2,056	3,539	3,051	3,000	12,562	12,000	12,000	(4)	-
Total Noninterest Exp.	**16,894**	**17,217**	**18,131**	**17,366**	**16,785**	**16,500**	**69,608**	**66,600**	**67,425**	**(4)**	**1**
Pretax Income	**11,436**	**11,566**	**10,218**	**11,902**	**12,261**	**11,350**	**45,122**	**45,150**	**45,975**	**0**	**2**
Income Taxes/(Benefit)	2,568	2,500	1,118	2,596	2,630	2,450	8,782	9,500	10,000	8	5
Net Income	**8,868**	**9,066**	**9,100**	**9,306**	**9,631**	**8,900**	**36,340**	**35,650**	**35,975**	**(2)**	**1**
Average Diluted Shares	17,048	16,789	16,612	16,280	15,921	15,750	16,666	15,750	15,500	(5)	(2)
Net Income per Dil. Share	**0.52**	**0.54**	**0.55**	**0.57**	**0.60**	**0.57**	**2.18**	**2.26**	**2.32**	**4**	**3**
Dividends paid per share	**0.66**	**0.18**	**0.21**	**0.21**	**0.21**	**0.25**	**1.26**	**0.96**	**1.15**	**(24)**	**20**
Tax Rate	22.46	21.62	10.94	21.81	21.45	21.59	19.46	21.04	21.75	8	3
Adjusted Tax Rate	25.44	24.59	14.75	24.67	22.95	23.28	22.59	22.75	24.70	1	9
Net Interest Margin	**4.38%**	**4.30%**	**4.36%**	**4.80%**	**4.48%**	**4.50%**	**4.23%**	**4.45%**	**4.40%**	**5**	**(1)**
Average Earning Assets	2,114,027	2,120,416	2,072,460	2,009,666	1,977,597	2,000,000	2,079,142	2,000,000	2,050,000	(4)	2
Overhead Ratio %	57.7%	57.9%	61.9%	56.7%	55.0%	57.2%	58.5%	57.3%	57.0%	(2)	(1)
Tangible Book Value	**$14.27**	**$14.34**	**$14.57**	**$14.69**	**$14.89**	**$15.21**	**$14.69**	**$15.99**	**$17.16**	**9**	**7**
Revenues	29,282	29,735	29,300	30,628	30,505	28,850	118,945	116,150	118,200		
Fees as % of Total Revenue	**22.0**	**23.6**	**22.2**	**20.6**	**26.5**	**22.0**	**22.1**	**23.4**	**23.7**		

Dated: 5/21/19
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Table 2
First Community Bankshares
Average Balance Sheet Summary
($ Thousands)

	Q1 2018	Q2 2018	Q3 2018	Q4 2018	Q1 2019	% Change vs. Last Quarter	% Change vs. Last Year
Assets							
Loans	$ 1,805,839	$ 1,795,094	$ 1,792,284	$ 1,788,570	$ 1,765,132	(1)	(2)
Securities Available for Sale	165,103	190,605	188,975	162,330	145,783	(10)	(12)
Securities Held to Maturity	25,132	25,098	25,064	25,030	12,348	(51)	(51)
Interest-Bearing Deposits	117,953	109,349	66,137	33,736	54,694	62	(54)
Total Earning Assets	**2,114,027**	**2,120,146**	**2,072,460**	**2,009,666**	**1,977,957**	**(2)**	**(6)**
Other Assets	252,284	252,843	253,199	249,056	247,965	(0)	(2)
Total Assets	**2,366,311**	**2,372,989**	**2,325,659**	**2,258,722**	**2,225,922**	**(1)**	**(6)**
Liabilities & Shareholder Equity							
Demand Deposits	462,741	484,776	459,759	458,458	447,023	(2)	(3)
Savings Deposits	518,560	518,055	502,255	494,868	501,276	1	(3)
Time Deposits	493,545	477,691	463,885	450,770	438,454	(3)	(11)
Total Interest-Bearing Deposits	**1,474,846**	**1,480,522**	**1,425,899**	**1,404,096**	**1,386,753**	**(1)**	**(6)**
Other Borrowings	79,444	78,615	76,281	29,526	18,537	(37)	(77)
Total Interest-Bearing Liabilities	**1,554,290**	**1,559,137**	**1,502,180**	**1,433,622**	**1,405,290**	**(2)**	**(10)**
Non-Interest Bearing Deposits	**432,606**	**447,048**	**454,126**	**461,457**	**459,766**	**(0)**	**6**
Other Liabilities	30,142	26,222	28,430	28,188	28,894	3	(4)
Shareholder's Equity	**349,273**	**340,582**	**340,923**	**335,455**	**331,972**	**(1)**	**(5)**
Total Liabilities & Shareholder Equity	**2,366,311**	**2,372,989**	**2,325,659**	**2,258,722**	**2,225,922**	**(1)**	**(6)**
Net Interest Spread	**4.25%**	**4.16%**	**4.22%**	**4.68%**	**4.48%**		
Net Interest Margin	**4.38%**	**4.30%**	**4.36%**	**4.80%**	**4.60%**		

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