

FIRST NATIONAL CORP /VA/
Form 10-Q
May 14, 2007
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended March 31, 2007

or

.. 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: 0-23976

(Exact name of registrant as specified in its charter)

Virginia
(State or other jurisdiction of incorporation or organization)

54-1232965
(I.R.S. Employer Identification No.)

112 West King Street, Strasburg, Virginia
(Address of principal executive offices)

22657
(Zip Code)

(540) 465-9121

(Registrant's telephone number, including area code)

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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 is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer Non-accelerated filer

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date. As of May 11, 2007, 2,922,860 shares of common stock, par value \$1.25 per share, of the registrant were outstanding.

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Table of Contents**Part I Financial Information****Item 1. Financial Statements****FIRST NATIONAL CORPORATION****Consolidated Balance Sheets***(in thousands, except share and per share data)*

	(unaudited) March 31, 2007	December 31, 2006
Assets		
Cash and due from banks	\$ 7,933	\$ 10,368
Interest-bearing deposits in banks	1,862	1,759
Federal funds sold	4,271	8,430
Securities available for sale, at fair value	61,083	60,340
Loans held for sale	104	105
Loans, net of allowance for loan losses, 2007, \$3,962, 2006, \$3,978	424,562	423,151
Premises and equipment, net	18,309	17,603
Interest receivable	1,991	2,038
Other assets	4,104	4,150
Total assets	\$ 524,219	\$ 527,944
Liabilities and Shareholders Equity		
Liabilities		
Deposits:		
Noninterest-bearing demand deposits	\$ 81,368	\$ 83,386
Savings and interest-bearing demand deposits	183,696	167,419
Time deposits	169,752	184,239
Total deposits	\$ 434,816	\$ 435,044
Other borrowings	40,721	45,750
Company obligated mandatorily redeemable capital securities	12,372	12,372
Accrued expenses and other liabilities	2,642	2,223
Commitments and contingencies		
Total liabilities	\$ 490,551	\$ 495,389
Shareholders Equity		
Common stock, par value \$1.25 per share; authorized 8,000,000 shares; issued and outstanding, 2,922,860 shares	\$ 3,653	\$ 3,653
Surplus	1,465	1,465
Retained earnings	30,130	29,104
Unearned ESOP shares	(522)	(546)
Accumulated other comprehensive loss, net	(1,058)	(1,121)

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Total shareholders' equity	\$ 33,668	\$ 32,555
Total liabilities and shareholders' equity	\$ 524,219	\$ 527,944

See Notes to Consolidated Financial Statements

Table of Contents**FIRST NATIONAL CORPORATION****Consolidated Statements of Income**

Three months ended March 31, 2007 and 2006

(in thousands, except per share data)

	(unaudited) March 31, 2007	(unaudited) March 31, 2006
Interest and Dividend Income		
Interest and fees on loans	\$ 7,953	\$ 6,636
Interest on federal funds sold	14	1
Interest on deposits in banks	25	28
Interest and dividends on securities available for sale:		
Taxable interest	535	654
Tax-exempt interest	115	106
Dividends	47	53
Total interest and dividend income	\$ 8,689	\$ 7,478
Interest Expense		
Interest on deposits	\$ 3,542	\$ 2,237
Interest on federal funds purchased	39	77
Interest on company obligated mandatorily redeemable capital securities	236	147
Interest on other borrowings	550	658
Total interest expense	\$ 4,367	\$ 3,119
Net interest income	\$ 4,322	\$ 4,359
Provision for loan losses		85
Net interest income after provision for loan losses	\$ 4,322	\$ 4,274
Noninterest Income		
Service charges	\$ 619	\$ 663
Fees for other customer services	576	471
Gains on sale of loans	73	45
Other operating income	22	43
Total noninterest income	\$ 1,290	\$ 1,222
Noninterest Expense		
Salaries and employee benefits	\$ 1,866	\$ 1,784
Occupancy	246	199
Equipment	318	270
Marketing	128	138
Stationery and supplies	107	105

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Legal and professional fees	168	124
ATM and check card	118	92
Other operating expense	588	545
Total noninterest expense	\$ 3,539	\$ 3,257
Income before income taxes	\$ 2,073	\$ 2,239
Provision for income taxes	670	727
Net income	\$ 1,403	\$ 1,512
Earnings per common share, basic and diluted	\$ 0.48	\$ 0.52

See Notes to Consolidated Financial Statements

Table of Contents**FIRST NATIONAL CORPORATION****Consolidated Statements of Cash Flows**

Three months ended March 31, 2007 and 2006

(in thousands)

	(unaudited) March 31, 2007	(unaudited) March 31, 2006
Cash Flows from Operating Activities		
Net income	\$ 1,403	\$ 1,512
Adjustments to reconcile net income to cash and cash equivalents provided by operating activities:		
Depreciation and amortization	278	230
Origination of loans held for sale	(5,987)	(3,924)
Proceeds from sale of loans available for sale	6,061	3,805
Provision for loan losses		85
Gains on sale of loans	(73)	(45)
Accretion of security discounts	(9)	(12)
Amortization of security premiums	28	45
Shares acquired by leveraged ESOP	24	
Changes in assets and liabilities:		
(Increase) decrease in interest receivable	47	(139)
Decrease in other assets	14	48
Increase in accrued expenses and other liabilities	419	634
Net cash provided by operating activities	\$ 2,205	\$ 2,239
Cash Flows from Investing Activities		
Proceeds from sales of securities available for sale	\$ 652	\$ 1,085
Proceeds from maturities, calls, and principal payments of securities available for sale	1,886	1,987
Purchase of securities available for sale	(3,205)	(2,341)
Decrease in federal funds sold	4,159	
Purchase of premises and equipment	(984)	(1,486)
Net increase in loans	(1,411)	(15,741)
Net cash provided by (used in) investing activities	\$ 1,097	\$ (16,496)
Cash Flows from Financing Activities		
Net increase in demand deposits and savings accounts	\$ 14,259	\$ 4,522
Net increase (decrease) in time deposits	(14,487)	2,256
Proceeds from other borrowings	74,500	39,100
Principal payments on other borrowings	(79,529)	(24,105)
Cash dividends paid	(377)	(351)
Decrease in federal funds purchased		(5,762)
Net cash provided by (used in) financing activities	\$ (5,634)	\$ 15,660
Increase (decrease) in cash and cash equivalents	\$ (2,332)	\$ 1,403

Cash and Cash Equivalents

Beginning	\$ 12,127	\$ 10,447
Ending	\$ 9,795	\$ 11,850

See Notes to Consolidated Financial Statements

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FIRST NATIONAL CORPORATION

Consolidated Statements of Cash Flows

(Continued)

Three months ended March 31, 2007 and 2006

(in thousands)

	(unaudited) March 31, 2007	(unaudited) March 31, 2006
Supplemental Disclosures of Cash Flow Information		
Cash payments for:		
Interest	\$ 4,469	\$ 3,070
Supplemental Disclosures of Noncash Investing Activities		
Unrealized gain (loss) on securities available for sale	\$ 95	\$ (259)

See Notes to Consolidated Financial Statements

Table of Contents**FIRST NATIONAL CORPORATION****Notes to Consolidated Financial Statements***(unaudited)***Note 1. General**

The accompanying unaudited consolidated financial statements of First National Corporation (the Company) and its subsidiaries, including First Bank (the Bank), have been prepared in accordance with U.S. generally accepted accounting principles (GAAP) for interim financial information. Accordingly, they do not include all of the information and footnotes required by GAAP. All significant intercompany balances and transactions have been eliminated. In the opinion of management, the accompanying unaudited consolidated financial statements contain all adjustments and reclassifications consisting of a normal and recurring nature considered necessary to present fairly the financial positions at March 31, 2007 and December 31, 2006, the results of operations, cash flows and changes in shareholders' equity for the three month periods ended March 31, 2007 and 2006. The statements should be read in conjunction with the consolidated financial statements and related notes included in the Annual Report on Form 10-K for the year ended December 31, 2006. Operating results for the three month period ended March 31, 2007 are not necessarily indicative of the results that may be expected for the year ending December 31, 2007.

Note 2. Securities

The Company invests in U.S. agency and mortgage-backed securities, obligations of state and political subdivisions, corporate equity securities and restricted securities. Restricted securities include required equity investments in certain correspondent banks. All of the Company's securities were classified as available for sale at March 31, 2007 and December 31, 2006. Amortized costs and fair values were as follows:

(in thousands)

	March 31, 2007		Unrealized (Losses)	Fair Value
	Amortized Cost	Unrealized Gains		
	Gross	Gross		
U.S. agency and mortgage-backed securities	\$ 47,160	\$ 11	\$ (542)	\$ 46,629
Obligations of states and political subdivisions	11,062	108	(36)	11,134
Corporate equity securities	10	143		153
Restricted securities	3,167			3,167
	\$ 61,399	\$ 262	\$ (578)	\$ 61,083

(in thousands)

	December 31, 2006		Unrealized (Losses)	Fair Value
	Amortized Cost	Unrealized Gains		
	Gross	Gross		
U.S. agency and mortgage-backed securities	\$ 47,076	\$ 6	\$ (653)	\$ 46,429
Obligations of states and political subdivisions	10,273	123	(30)	10,366
Corporate equity securities	10	143		153

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Restricted securities	3,392				3,392	
	\$ 60,751	\$	272	\$	(683)	\$ 60,340

Table of Contents**Notes to Consolidated Financial Statements***(unaudited)*

At March 31, 2007 and December 31, 2006, investments in an unrealized loss position that were temporarily impaired were as follows:

	<i>(in thousands)</i>					
	Less than 12 months		12 months or more		Total	
	Fair Value	Unrealized (Loss)	Fair Value	Unrealized (Loss)	Fair Value	Unrealized (Loss)
U.S. agency and mortgage-backed securities	\$	\$	\$ 38,438	\$ (542)	\$ 38,438	\$ (542)
Obligations of states and political subdivisions	735	(7)	2,308	(29)	3,043	(36)
	\$ 735	\$ (7)	\$ 40,746	\$ (571)	\$ 41,481	\$ (578)

	<i>(in thousands)</i>					
	Less than 12 months		12 months or more		Total	
	Fair Value	Unrealized (Loss)	Fair Value	Unrealized (Loss)	Fair Value	Unrealized (Loss)
U.S. agency and mortgage-backed securities	\$ 15,340	\$ (48)	\$ 29,488	\$ (605)	\$ 44,828	\$ (653)
Obligations of states and political subdivisions	1,142	(5)	1,618	(25)	2,760	(30)
	\$ 16,482	\$ (53)	\$ 31,106	\$ (630)	\$ 47,588	\$ (683)

The tables above provide information about securities that have been in an unrealized loss position for less than twelve consecutive months and securities that have been in an unrealized loss position for twelve consecutive months or more. All of the securities with unrealized losses are considered temporarily impaired and are a result of interest rate factors. These securities have not suffered credit deterioration and the Company has the ability and intent to hold these issues until maturity. At March 31, 2007, there were thirty-five U.S. agency and mortgage-backed securities and ten obligations of state and political subdivisions in an unrealized loss position. Ninety-seven percent of the Company's investment portfolio had AAA credit ratings with a weighted-average repricing term of 3.8 years at March 31, 2007.

Note 3. Loans

Loans at March 31, 2007 and December 31, 2006 are summarized as follows:

	<i>(in thousands)</i>	
	March 31,	December 31,
	2007	2006
Mortgage loans on real estate:		
Construction	\$ 63,957	\$ 60,913
Secured by farm land	1,763	2,507
Secured by 1-4 family residential	108,944	112,323
Other real estate loans	174,245	168,754

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Loans to farmers (except those secured by real estate)	1,969	2,150
Commercial and industrial loans (except those secured by real estate)	50,139	50,854
Consumer loans	22,389	24,423
Deposit overdrafts	323	232
All other loans	4,795	4,973
Total loans	\$ 428,524	\$ 427,129
Allowance for loan losses	3,962	3,978
Loans, net	\$ 424,562	\$ 423,151

Table of Contents**Notes to Consolidated Financial Statements***(unaudited)*

The Company has a credit concentration in mortgage loans on real estate. These loans totaled \$348.9 million, or 82.2% of loans, net of the allowance for loan losses, and \$344.5 million, or 81.4% of loans, net of the allowance for loan losses, at March 31, 2007 and December 31, 2006, respectively. Although the Company believes that its underwriting standards are generally conservative, the ability of its borrowers to meet their mortgage obligations may be affected by local economic conditions. Construction loans totaled \$64.0 million and \$60.9 million, or 15.1% and 14.4% of loans, net of the allowance for loan losses, at March 31, 2007 and December 31, 2006, respectively.

The Company has identified and is monitoring another concentration of credit risk. This concentration involves loans secured by hotels and motels, which totaled \$32.1 million at March 31, 2007, representing 95.3% of total shareholders' equity and 7.6% of loans, net of the allowance for loan losses. At December 31, 2006, this concentration totaled \$28.9 million representing 88.6% of total shareholders' equity and 6.8% of loans, net of the allowance for loan losses. These loans are included in other real estate loans in the above table. The Company experienced no loan losses related to this identified concentration of credit risk during the three month period ended March 31, 2007 and the year ended December 31, 2006.

Note 4. Allowance for Loan Losses

Transactions in the allowance for loan losses for the three months ended March 31, 2007 and 2006 and for the year ended December 31, 2006 were as follows:

	March 31, 2007	<i>(in thousands)</i> December 31, 2006	March 31, 2006
Balance at beginning of year	\$ 3,978	\$ 3,528	\$ 3,528
Provision charged to operating expense		378	85
Loan recoveries	56	320	116
Loan charge-offs	(72)	(248)	(59)
Balance at end of period	\$ 3,962	\$ 3,978	\$ 3,670

Note 5. Other Borrowings

The Bank had unused lines of credit totaling \$80.9 million available with non-affiliated banks at March 31, 2007. This amount primarily consists of a blanket floating lien agreement with the Federal Home Loan Bank of Atlanta (FHLB) under which the Bank can borrow up to 19% of its total assets.

At March 31, 2007, the Bank had borrowings from the FHLB system totaling \$40.0 million which mature through March 29, 2010. The interest rate on these notes payable ranged from 4.88% to 5.52% and the weighted average rate was 5.25%. The Bank had collateral pledged on these borrowings, including real estate loans totaling \$58.0 million at March 31, 2007 and FHLB stock and other investment securities with a book value of \$34.5 million at March 31, 2007.

At March 31, 2007, the Bank had a \$199 thousand note payable, secured by a deed of trust, which requires monthly payments of \$2 thousand and matures January 3, 2016. The fixed interest rate on this loan is 4.00%. The Company also had an unsecured note payable of \$522 thousand, which requires monthly payments of \$11 thousand and matures September 12, 2011. The fixed interest rate on this loan is 7.35%.

Table of Contents**Notes to Consolidated Financial Statements***(unaudited)***Note 6. Capital Requirements**

A comparison of the capital of the Company and the Bank at March 31, 2007 and December 31, 2006 with the minimum regulatory guidelines were as follows:

	<i>(dollars in thousands)</i>		<i>(dollars in thousands)</i>		Minimum To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Actual Amount	Ratio	Minimum Requirement Amount	Ratio	Amount	Ratio
March 31, 2007:						
Total Capital (to Risk Weighted Assets):						
Consolidated	\$ 51,015	11.85%	\$ 34,442	8.00%	N/A	N/A
First Bank	\$ 50,579	11.77%	\$ 34,385	8.00%	\$ 42,981	10.00%
Tier 1 Capital (to Risk Weighted Assets):						
Consolidated	\$ 47,054	10.93%	\$ 17,221	4.00%	N/A	N/A
First Bank	\$ 46,617	10.85%	\$ 17,192	4.00%	\$ 25,788	6.00%
Tier 1 Capital (to Average Assets):						
Consolidated	\$ 47,054	9.04%	\$ 20,820	4.00%	N/A	N/A
First Bank	\$ 46,617	8.97%	\$ 20,791	4.00%	\$ 25,989	5.00%
December 31, 2006:						
Total Capital (to Risk Weighted Assets):						
Consolidated	\$ 49,747	11.34%	\$ 35,101	8.00%	N/A	N/A
First Bank	\$ 49,585	11.32%	\$ 35,042	8.00%	\$ 43,802	10.00%
Tier 1 Capital (to Risk Weighted Assets):						
Consolidated	\$ 45,769	10.43%	\$ 17,551	4.00%	N/A	N/A
First Bank	\$ 45,607	10.41%	\$ 17,521	4.00%	\$ 26,281	6.00%
Tier 1 Capital (to Average Assets):						
Consolidated	\$ 45,769	8.76%	\$ 20,908	4.00%	N/A	N/A
First Bank	\$ 45,607	8.73%	\$ 20,885	4.00%	\$ 26,107	5.00%

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Notes to Consolidated Financial Statements

(unaudited)

Note 7. Company Obligated Mandatorily Redeemable Capital Securities

On March 11, 2003, First National (VA) Statutory Trust I (Trust I), a wholly-owned subsidiary of the Company, was formed for the purpose of issuing redeemable capital securities, commonly known as trust preferred securities. On March 26, 2003, \$3.0 million of trust preferred securities were issued through a pooled underwriting. The securities have a LI