

F & M Bank Corp. (FMBM – OTCQX)

August 1, 2016

Investor Relations Report

Earnings Push Higher in Q2; Dividend Increased Again

Second quarter results for F & M Bank Corp. were quite strong and built upon the positive first quarter momentum, resulting in record quarterly and first half earnings. In the company's press release, the words that management used to describe the bank's local economy and real estate sales were "strong" and "robust", respectively, which certainly caught our eye. The tone from management has been more on the cautiously optimistic side in recent years; therefore, the positive comments following second quarter results give us confidence that the momentum should continue in the second half of the year.

Our 2016 earnings per share estimate moves higher by a nickel to \$2.55 from \$2.50, previously. The strong second quarter results combined with management's positive comments about the state of the local market supports the increase, which could still ultimately prove to be on the conservative side if credit expenses remain low.

F & M Bank Corp.'s strong first half results gave the Board of Directors the confidence to boost the quarterly dividend to \$0.20 per share from \$0.19 previously. The dividend now yields an attractive 3.2%.

FMBM shares have held steady in recent months as investors continue to take a neutral stance towards the community banking sector. As has been the case for some time now, investors are concerned about the sector's ability to generate above average returns given the heightened regulatory environment and low growth economic conditions. Throw in the persistent low interest rate environment, which has a pronounced impact on banks of all sizes, and the result is a confusing situation that has resulted in tepid interest from investors. Positively for FMBM shareholders, the company has delivered consistent earnings, which has supported the dividend growth discussed above. In addition, the stock's valuation levels remain unassuming, which would most likely provide some level of support (relative to other sectors) if the broader market were to weaken.

Company Overview

F & M Bank Corp. is the holding company for Farmers & Merchants Bank. The bank operates twelve branches throughout Western Virginia, including Augusta County, Rockingham County, Shenandoah County and Page County. The bank provides a full suite of commercial and consumer banking products, as well as financial services through Farmers & Merchants Financial Services, mortgage banking services through VBS Mortgage and insurance products through TEB Life Insurance Company. At quarter-end, the bank had \$730.0 million in assets.

F & M Bank Corp.'s common stock trades on the OTCQX exchange under the ticker FMBM.

Last Price: \$24.75
Market Capitalization: \$81.3 million

52 Week Range:
\$20.52 - \$25.00

Annual Dividend: \$0.80
Dividend Yield: 3.2%

Book Value: \$23.20
Tangible Book Value: \$23.11

EPS Actuals and Estimates

FY2014A: \$1.82
FY2015A: \$2.40
FY2016E: \$2.55

Price/Earnings (P/E)

2014A: 13.6x
2015A: 10.3x
2016E: 9.7x

Price/Book Value: 1.1x
Price/Tangible Book Value: 1.1x

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important disclosures

Growth and Efficiency Push Earnings Higher Through the First Half of 2016

F & M Bank Corp. reported second quarter earnings per share of \$0.68, which improved upon the \$0.60 earned in the first quarter and \$0.62 earned in last year's second quarter. For the first half of 2016, F & M Bank Corp. posted earnings to common shareholders of nearly \$4.2 million, or \$1.28 per share, which was up from \$3.8 million, or \$1.15 per share, during the same period last year.

In typical F & M Bank Corp. fashion, the company's second quarter and first half earnings were driven by a strong net interest margin and cost controls. An uptick in loan growth in the second quarter helped to push net interest income higher, which, when combined with the margin strength and low efficiency ratio (a good thing), resulted in record earnings for the bank.

Credit Quality Improves in Q2

Management indicated earlier in the year that they expected some activity in nonperforming assets in the coming months and that is what we got in the second quarter. Net charge-offs totaled \$713 thousand in the second quarter from de minimus amounts in recent quarters. Management has patiently worked with troubled borrowers to remedy past due loan situations, so the uptick in net charge-offs in the second quarter could be an indication that the bank will look to take advantage of the improving real estate conditions to more aggressively work problem loan levels lower. Total nonperforming assets declined by nearly \$1.2 million in the second quarter to \$8.3 million, which represents 1.14% of total assets. Past due loans declined by a similar amount.

Capital Levels Remain Healthy

F & M Bank Corp.'s loan growth over the past year has pushed the company's equity to assets ratio to 11.8% from 12.4% a year ago. At June 30th, the bank's Tier 1 capital ratio stood at a healthy 12.95% and all regulatory capital ratios remain in well-capitalized territory. We expect the bank's healthy capital levels to support growth for the foreseeable future.

Loan Growth Picks Up in the Second Quarter

Over the past year, loans held for investment increased by \$33.2 million, or 6.2%, which includes the \$9.1 million increase in the second quarter alone. The second quarter growth rate was a bit higher than what we have seen in recent quarters, so it seems that the bank took advantage of the stronger market conditions. Looking forward to the second half of the year, we anticipate quarterly loan growth in the \$7.0-\$9.0 million range, fairly consistent with what F & M Bank Corp. has delivered recently.

As F & M Bank Corp.'s newer branches and the Dealer Finance division mature over the next six to twelve months, we would not be surprised if management began to look for other avenues for growth. The most likely sources of growth could come through the relatively lower risk options of hiring experienced lenders in new markets and setting up a loan production office or by acquiring branches from other banks. While less likely, we could see F & M look to acquire a smaller institution that is struggling with the low growth and higher regulatory cost environments. F & M Bank Corp. has traditionally made conservative growth investments, so we would only expect a deal that made clear sense and come in low on the risk spectrum.

Net Interest Margin Stays Strong

F & M Bank Corp.'s net interest margin remains at the high end of the industry and continues to underpin the company's strong earnings. The margin has ticked lower by a few basis points in recent quarters, but we expect it to remain in the 4.30%-4.40% range during the second half of the year. That said, the longer interest rates stay at rock-bottom levels the harder it will be for F & M Bank Corp. and other banks to maintain yields on assets (loans and securities) as new investments are likely to be priced lower than maturing investments. For the second quarter, the margin came in at 4.37% compared to 4.39% in the first quarter and 4.46% a year ago.

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