

March 12, 2009

Dear Shareholder:

2008 was a difficult year in banking but a disastrous year in other parts of the financial services industry. We think that this environment is one where Sonabank can take advantage of its strengths and prosper amidst the wreckage of the financial services industry as we knew it. Let us tell you why.

Four elements caused the perfect storm which wrecked our financial system.

First, the catastrophic failure of sub-prime lending. This is so sad. It was an activity that shouldn't have been engaged in between consenting adults. The problem is that it has killed investment banking for a generation.

Second, the fact that securities are accounted for differently from other assets. Our accountants refer to it as "...the existence of the mixed-attribute reporting model..." That is a delicate way of saying that there are different ways of accounting for similar assets. Loans are accounted for differently from securities. In practice it has been a disaster. We'll try to condense several hundred pages of accounting literature into a few sentences: For banks, "fair market" valuation of their securities has become sacrosanct in the accounting rules. It is a religion. For securities held in "available for sale" declines in "fair market" value are deducted from tangible book value through "other comprehensive income". Not so for securities "held to maturity" but banks have to show declines in "fair market value" in their SEC reports. Under certain circumstances, which keep changing, banks must mark down securities to "fair market" value through Other than Temporary Impairments (OTTI) to income. Accounting for loans is quite different.

All of this is intellectually appealing but fairly harmless until the markets stop functioning which is what has happened in the past six months. Then it's catastrophic. The "mark to market" valuations become meaningless when there are no longer any market makers as described below.

Let us hypothesize that all securities are toxic because of the accounting. Let's put aside accounting dogmas and use a little common sense. We'll focus on one pristine high quality security. (We don't own this one.) GSMS 2005-GG4 AABA is a commercial mortgage backed security rated triple A by all three rating agencies **today**. As a point of reference there are only six corporate issuers rated triple A by Moodys and Standard and Poors. So GG4-AABA, which we'll call it, is in fairly lofty company.

So what is it? It's part of a \$4 billion security put together by Goldman Sachs in 2005. The GG4-AABA tranche is one of the most senior tranches. If you were a bank and you bought it in 2005 when it was originally issued you bought it at around par (100) to yield maybe 40 basis points over the Treasury curve. You were obsessively conservative. At issue the underlying loans had a loan to value of 71.9% and a debt service coverage ratio of 1.533 and you held a very senior tranche. You had a yield of 4.68%. Sounds super? It was.

Fast forward to the end of January 2009. Today the ratios are better. The underlying loans have an LTV of 70.6% and a debt service coverage ratio of 1.711. (We love loans with those ratios.) It's still triple triple A rated and interest rates are down.



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How good is that? The only problem is that you could have bought it at the end of January at a dollar price of 85 to yield just under 10%. If you had bought \$10 million and put it in Available for Sale in 2005 you now have a hole in your tangible book value of \$1.5 million and you want to vomit. This is the highest rated most pristine security I could find. If you're a bank you never want to buy another security.

If this security were a loan our hypothetical bank would be happy as a clam.

Third, fear and uncertainty after the U.S. Treasury's decision to be the ultimate arbiter of survival in the financial services industry.

The Economist put it well: "...the Bush administration and the Fed had nothing resembling a consistent strategy. They crushed Fannie's and Freddie's stockholders. They saved Citigroup's. Ad hocery is costly: it keeps private capital on the sidelines for fear of being wiped out in the next Saturday night rescue." We would add that they saved Bear Stearns since it was too big to fail but allowed Lehman Brothers, which was bigger, to fail. There was simply no way anyone could know which financial institutions were ultimately going to be thrown under the bus by the U.S. Treasury and which were not. It was simply too risky in this environment to lend money to other financial institutions or equally importantly to buy securities where the market making functions of the investment banks had completely ceased. This led to a virtual meltdown in the entire financial sector.

The banks which survived the meltdown, which was not of their making, have been accused by the politicians of "hoarding" cash. Of course we hoarded cash. It was an incredibly uncertain time and we wanted to remain solvent.

But we never stopped lending. We know our business customers, warts and all, and we continued throughout the crisis to lend to them. That is our business.

Fourth, the investment banks have simply stopped making meaningful markets in the securities they sold to the commercial banks and to corporations and wealthy individuals. They have stopped because they are choked with mispriced inventory, or they have failed (Lehman Brothers) or have been taken over and reined in (Bear Stearns and Merrill) or have ceased their market making activities because they've had to become bank holding companies (Goldman Sachs and Morgan Stanley) and are in the process of figuring out what their business models will be going forward.

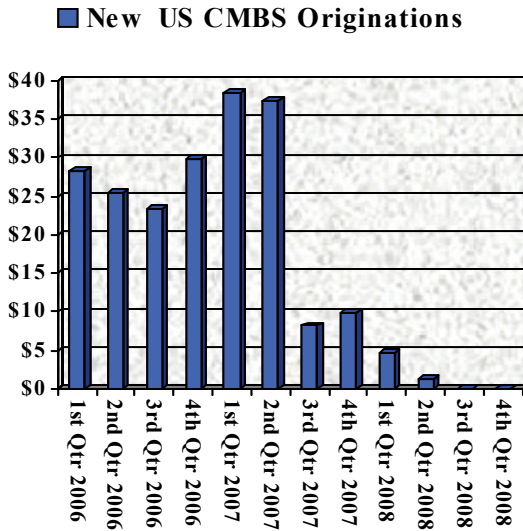
All of the discussion of the problem of reaching a fair market value for the "toxic" securities is a result of the fact that the investment banks are out of commission. Many of the "toxic" assets are still performing in accordance with their contractual obligations and expectations— some of them are truly "toxic," but many of them are "toxic" only because the investment banks do not really make markets in them anymore.

The original TARP was a desperate attempt to prop up the prices of the assets which had been securitized by the investment banks to save the commercial banks. As far as we know, they never did anything except perhaps to hire lawyers and consultants and a custodian. Fortunately perhaps, Gordon Brown, Britain's Prime Minister, who had been Chancellor of the Exchequer, figured out how to address the problem and the TARP morphed for better or worse into a bank bailout. The "toxic" assets were forgotten only to be partially addressed in the second Citibank bailout.

After very careful consideration, we issued a press release on December 4th, to the effect that we would not participate in the bank bailout version of the TARP. We also opted out of the TLGP. We didn't see what it would do for us and as with the TARP, we couldn't know, given Section 5.3 of the standard document required to be executed by the bank participants in the TARP, what strings would be attached. As of January 24, 2009, we understand that 1,600 financial institutions had sought to participate in the TARP and only 350 had been approved. We're ecstatic that we were not among the applicants.

In 1980, the banking system provided over 40% of the credit in the U.S. economy. Today it's around 20%. However, in the past year much of the institutional structure which provided credit outside the banking system has been damaged or destroyed.

- Over the past decade a huge volume of high quality commercial mortgages were packaged into commercial mortgage backed securities at incredibly low yields and without guarantees. The security in the example on the previous page was originated in 2005. During the first half of 2007, quarterly CMBS originations were running between the low \$20 billions to over \$35 billion. Now look at the graph below:

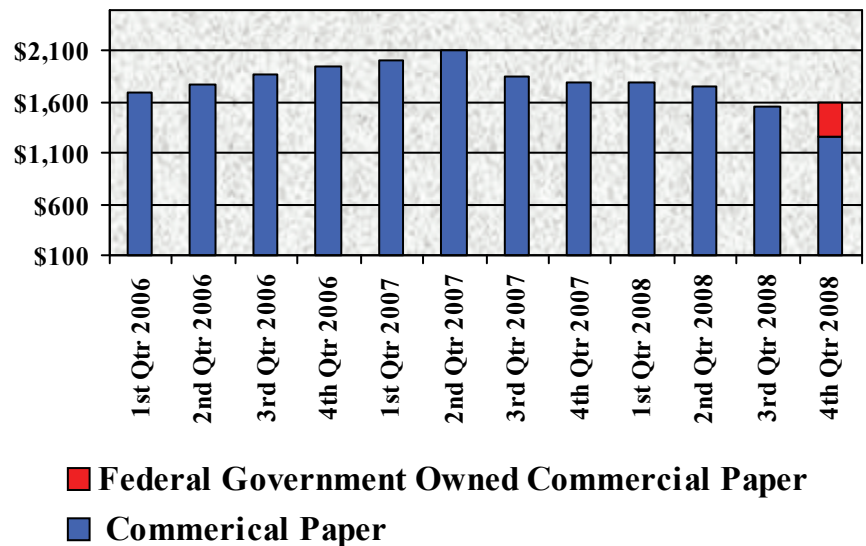


Originations of CMBS plummeted beginning in the third quarter of 2007. Extraordinarily, in the third and fourth quarter of 2008 there were no originations of CMBS securities. None. How well do you think that market is trading?

The point is that similar graphs for car loans, credit card loans and private label residential mortgage backed securities look much the same. The whole market for securitization is crippled.

- The commercial paper market has been a competitor for bank loans with the big banks for three or four decades. It peaked at the end of the second quarter of 2007 at about \$2.1 trillion. It was wounded by the SIV's a year ago. It was wounded again by Lehman and other defaults since then.

Commercial paper outstandings have declined every quarter since 2nd quarter of 2007. But what is more extraordinary is that since the Federal Reserve program was established on October 7, 2008 to save the commercial paper market, the Fed owned around 20% of all the commercial paper outstanding by the end of 2008. The enormity of this is that the Fed never owned a single dollar of commercial paper until October 2008. None. More significantly, excluding the commercial paper owned by the Fed, outstandings have declined to pre-2006 levels. If it hadn't been for Fed intervention, the market would have collapsed with unimaginable consequences for the U.S. economy. It's scary how close it came.



- Several of the Reserve Fund's money market funds were frozen on September 17, 2008 after their Primary Fund "broke the buck". 120 days later, 60% of the Reserve Fund's Government Fund were still frozen. If that doesn't damage the money market funds going forward, nothing will.
- Lehman Brothers and its affiliates were big construction and development lenders. We know of hedge funds who are lenders on large real estate projects. The Icelandic banks were big development lenders. Its funny today. But it was ridiculous for these now defunct institutions to be competing with bank lenders in these markets. These distortions are over.

All this marks the beginning of the reintermediation - the return of lending and deposit activity from the shadow banking system to the commercial banks. Everything which left the commercial banks has to come back now that it has no place to go. Over the next couple of years the commercial banks should see better terms and much better pricing now that the silly season is over. We've already seen some of it. The terms available on high quality commercial real estate loans are much better.

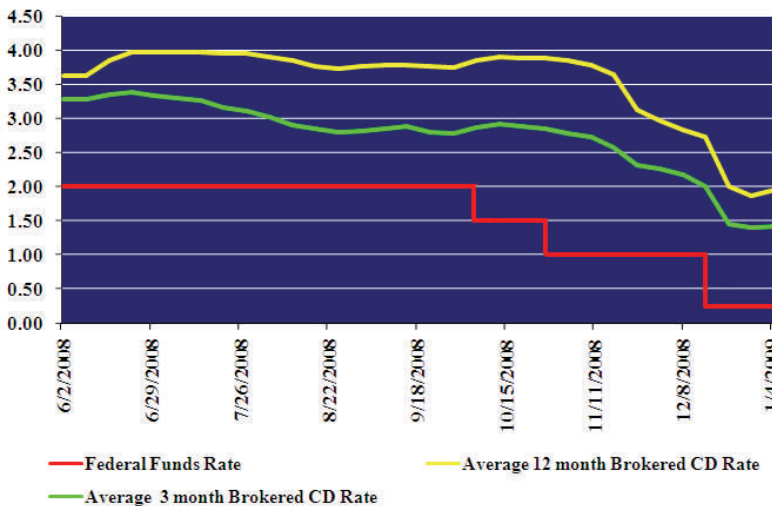
This means that over time bank profitability should improve. It's not going to be easy. The lock step march of the Prime rate, over which the small commercial banks have no control, from 3% over something reasonable to 3% over just over zero has created profound pricing anomalies which will take several years to correct. The bank across the street from our offices had a banner advertising home equity lines of credit (HELOCs) at 1% under prime which is now 2.25%. Some weeks ago they were running a CD special at 5%. Talk about upside down?

The HELOCs aren't a big deal for us since almost all of the ones we have were acquired in the 1st Service acquisition. All but a few have floors. On new and maturing C&I loans we're setting floors significantly above the current Prime rate.

We're a big player in the SBA lending market. The secondary market for the guaranteed portions of SBA loans has largely dried up. The permissible margin over Prime in an SBA loan agreement maxes out at 2.75% over prime or at 6% given today's Prime rate. That doesn't sound like a lot. But remember that the yield on the ten year Treasury is around 2.4%. And it's fixed. The yield on the guaranteed portion of an SBA loan will float upward with Prime. It can't decline a lot. In an environment where we'll see deficits of over a trillion dollars a year for the next several years, which would you rather own?

On the liability side we're finally starting to see some relief. Our most recent rate survey shows Wachovia (now Wells Fargo) paying 1% for a 12 month CD in one of our markets. They were paying over 4% just over two months ago. Brokered CD rates, which are a bellwether for the rest of the CD market were stubbornly high during the worst of the credit crisis, were way down by year-end.

Fed Funds Rate vs. Brokered CD Rate



We can't, nor can anyone else, know how all this will play out. The Treasury, the Fed, the FDIC and potentially Congress are changing the rules every day. The only thing we can do is to be true to our mission. We're a small and middle-market lender. We'll take our lumps in that market but we understand it. It's our business.

We are unique among the Virginia community banks in that, although we are under four years old, our core team of over 25 people, has been together for over a decade. We're profitable, well capitalized and lean. We're ready to pick through the wreckage of the financial services business and move ahead.

We're ready to come out of the bunker with cautious optimism.

Georgia S. Derrico
Chairman & CEO

R. Roderick Porter
President

Forward-Looking Statements

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