Zacks Small-Cap Research

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Chesapeake Financial Shares, Inc. (CPKF - OTCQB)

CPKF: Third Quarter Results Better Than Anticipated

Current Recommendation	**Neutral**
Prior Recommendation	Outperform
Date of Last Change	01/09/2014
Current Price (12/19/14)	$15.50
Twelve-Month Target Price	**$16.00**

OUTLOOK

CPKF's third quarter net earnings rose $0.2 million year over year, or 12%, to $1.7 million, while 2014's third quarter diluted EPS grew by $0.04, or 11%, to $0.42 from $0.38 posted a year ago. All per share data in this report have been adjusted for a 5-for-6 stock split, paid to shareholders in mid-October 2014. This was better than our estimate, which had called for a $0.1 million increase in net earnings to $1.6 million (off by $0.1 million) and a $0.02 rise in diluted EPS to $0.40 (off by $0.02). The primary reasons for the difference between reported results and our estimate was that net revenues were $1.0 million greater than $9.4 million we had projected, largely due to a sharper-than-expected increase in other income, partly offset by total noninterest that was $0.7 million more than we had estimated as other expense came in $0.4 million higher than we had expected. In addition, the effective tax rate of 26.3% was much greater than our 22.0% estimate, which decreased the bottom line by $0.2 million more than we anticipated. In July, CPKF declared a 6-for-5 stock split, while maintaining the quarterly dividend at $0.135 ($0.1125 after the split). Notably, CPKF was cited by SNL Financial as one of only 20 banks in the country (and 2 in Virginia) to increase dividends at least 2% per year and at least a cumulative 30% over the past five years. In August, CPKF announced that for the seventh consecutive year, Chesapeake Bank had made the American Banker magazine listing of the "Top 200 Community Banks" in the United States, ranking #28 out of 6,000 banks. We are currently reviewing our estimates and will issue a more comprehensive report when detailed financial information becomes available within the next few weeks.

SUMMARY DATA

52-Week High	**$16.04**
52-Week Low	**$14.08**
One-Year Return (%)	**6.24**
Beta	**0.12**
Average Daily Volume (sh)	**3,108**
Shares Outstanding (mil)	**4**
Market Capitalization ($mil)	**$61**
Short Interest Ratio (days)	**N/A**
Institutional Ownership (%)	**0**
Insider Ownership (%)	**40**
Annual Cash Dividend	**$0.45**
Dividend Yield (%)	**2.90**
5-Yr. Historical Growth Rates	
Net Revenue (%)	**4.4**
Earnings Per Share (%)	**8.3**
Dividend (%)	**8.6**
P/E using TTM EPS	**10.2**
P/E using 2014 Estimate	**10.3**
P/E using 2015 Estimate	**9.8**
Zacks Rank	**3**

Risk Level	**Average**
Type of Stock	**Small-Value**
Industry	**Banks-Southeast**
Zacks Rank in Industry	**16 of 69**

ZACKS ESTIMATES

Net Revenue
(in millions of $)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2012	9.0 A	9.4 A	10.1 A	9.6 A	38.1 A
2013	9.6 A	10.0 A	9.7 A	9.7 A	39.0 A
2014	9.0 A	9.7 A	10.4 A	9.0 E	37.1 E
2015					38.3 E

Earnings per Share*
(EPS is operating earnings before nonrecurring items)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2012	0.47 A	0.52 A	0.62 A	0.33 A	1.94 A
2013	0.53 A	0.46 A	0.38 A	0.30 A	1.66 A
2014	0.32 A	0.48 A	0.42 A	0.30 E	1.50 E
2015					1.58 E

Quarterly EPS may not add to total due to changes in shares outstanding.
* Per share data have been adjusted for a 5-for-6 stock split, paid to shareholders in mid-October 2014.

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THIRD QUARTER

CPKF's third quarter net earnings rose $0.2 million year over year, or 12%, to $1.7 million, while 2014's third quarter diluted EPS grew by $0.04, or 11%, to $0.42 from $0.38 posted a year ago. All per share data in this report have been adjusted for a 5-for-6 stock split, paid to shareholders in mid-October 2014.

This was better than our estimate, which had called for a $0.1 million increase in net earnings to $1.6 million (off by $0.1 million) and a $0.02 rise in diluted EPS to $0.40 (off by $0.02).

The primary reasons for the difference between reported results and our estimate was that net revenues were $1.0 million more than $9.4 million we had expected, consisting of noninterest income that was $0.7 million higher than our projection, largely due to a sharper-than-expected increase in other income (higher by about $0.9 million), which was partially offset by OREO expense that was $0.2 million more than we had projected, and net interest income that was $0.3 million greater than our estimate.

On the other hand, total noninterest expense of $8.0 million was also $0.7 million more than we had projected, which consisted of three items: (1) compensation expense of $3.8 million that was $0.2 million larger than our $3.6 million estimate; (2) merchant card expense of $0.7 million that was $0.1 million more than the $0.6 million we had projected; and (3) other expense of $2.4 million that came in $0.4 million more than we had expected.

Finally, the effective tax rate of 26.3% was much greater than our 22.0% estimate, which decreased the bottom line by $0.2 million more than we anticipated. In combination, these factors produced net income that was $0.1 million better than our projection.

The major reasons for the third quarter's $0.2 million gain versus the prior-year quarter were a $0.7 million increase in noninterest income (mostly due to a $0.9 million jump in other miscellaneous income) that was partly offset by a $0.3 million rise in noninterest expense (primarily the result of a $0.5 million climb in other miscellaneous expense) and a 26.3% effective tax rate, which was almost 500 basis points higher than the 21.4% posted last year, thereby depleting net income by $0.2 million more than a year ago.

Net interest income was flat year over year at $5.9 million ($0.3 million higher than our $5.6 million estimate), as an estimated 3% increase in average interest-earning assets partly offset a net interest margin that we estimate was lower than the 4.61% earned in the year-ago quarter.

Noninterest income surged $0.7 million, or 20%, year over year to $4.5 million ($0.7 million higher than our estimate), as other miscellaneous income more than doubled to $1.8 million.

Total noninterest expense rose $0.7 million, or 5%, to $8.0 million ($0.7 million higher than our estimate), largely the result of a $0.5 million, or 28%, jump in other miscellaneous expense to $2.4 million.

The loan loss provision rose by $50,000 to $150,000 from $100,000 in the year-ago quarter and was the same as our estimate. Loan loss reserves increased $0.1 million from $6.4 million (1.69% of loans) at the end of the second quarter to $6.5 million (1.67% of loans) at September 30, 2014, and were above the $6.1 million (1.62% of loans) in the year-ago quarter.

As to other asset quality measures, CPKF recorded a net charge-offs of $51,000 in the third quarter. This compares to net charge-offs of $225,000 in the year-ago quarter and of $243,000 in 2014's second quarter.

Gross loans outstanding increased $12 million, or about 3%, year over year, and rose $9 million, or 2%, sequentially to $390 million.

CPKF posted an 9.9% ROE and 1.03% ROA for the third quarter of 2014, compared to 9.9 % and 0.93%, respectively, in the prior-year quarter.

On July 1, Ms. Rebecca A. Foster became Chief Financial Officer of CPKF and all subsidiaries, replacing John H. Hunt, II, who became an Executive Vice President and Business Development Officer for Chesapeake Investment Group. Ms. Foster has been with CPKF for 19 years and held previous positions of Internal Auditor, Money Desk Manager and Investment Officer as well as Assistant Corporate Secretary. She has been in her current role of Investment Officer for the past 11 years and is already chair of the Asset/Liability Committee for Chesapeake Bank.

At their July 18, 2014 meeting, the Chesapeake Financial Shares Board of Directors declared a 6-for-5 stock split to shareholders of record on October 1, 2014, paid in mid-October 2014. At the same time, the Board approved a $0.135 per share dividend, payable on or about September 15, 2014 to shareholders of record September 1, 2014.

In 2013, CPKF hiked its quarterly dividend by 13% to $0.135 per share from $0.12 per share, following two dividend increases in 2012 totalling 20%. The total 2013 dividend payment of $0.51 represents a 13% rise over 2012's payment of $0.45. Notably, CPKF has increased the annual dividend payment every year for the past twenty-three years since 1991.

This feat was recently recognized by SNL Financial in a report that cited CPKF as one of only 20 banks in the country (and only two in Virginia) to increase dividends by at least 2% per year and at least a cumulative 30% over the past five years. The company recorded cumulative dividend growth of 51.1% over the 2008-2013 period.

On August 4, 2014, CPKF announced that for the seventh consecutive year, Chesapeake Bank had made the American Banker magazine (formerly US Banker magazine) listing of the "Top 200 Community Banks" in the United States. The bank ranked at #28 in the nation out of approximately 6,000 community banks in the study, up from #148, when CPKF first broke into the rankings in 2008. The ranking is based on a three-year average of return on average equity (ROAE), which for CPKF was14.07%.

We are currently reviewing our estimates and will issue a more comprehensive report when detailed financial information becomes available within the next few weeks.

OVERVIEW

Chesapeake Financial Shares, Inc. (CPKF or the Company) is a financial holding company headquartered in Kilmarnock, Virginia, with $658 million in total assets at September 30, 2014. CPKF is predominantly a small business lender with 12 branch offices that serve customers in the eastern region of Virginia between the Potomac and James Rivers. These offices are located in Kilmarnock, Lively, Irvington, Mathews, Hayes, and Gloucester, with five branches in Williamsburg. In addition, CPKF opened a commercial loan production office in Richmond, Virginia in 2011. CPKF, which began as Lancaster National Bank on April 13, 1900, has a long history and strong ties with the communities it serves.

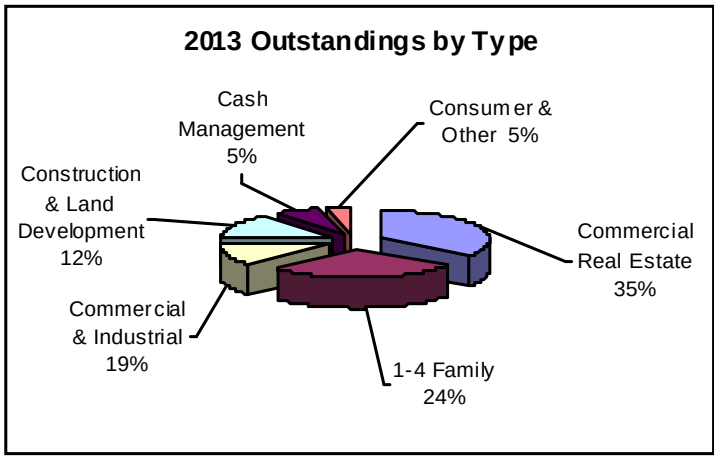
Operations are carried on through Chesapeake Bank, a state-chartered bank as well as Federal Reserve and FDIC member bank, and Chesapeake Investment Group, Inc. (CIG), an independent wealth management firm that manages about $313 million in assets (at 2013 yearend) through its subsidiaries involved in asset management (CIG is a registered investment adviser), brokerage, and trust services. Other activities of the Company include Chesapeake Payment Systems, Cash Flow program, Clear Sky accounts, and its secondary market mortgage banking operation.

Chesapeake Payment Systems offers merchant processing services such as credit card and debit card processing, electronic benefits transfers, and loyalty and gift card processing to companies involved in travel, entertainment, restaurant, hospitality, retail, mail order, and e-commerce. At yearend 2013, Chesapeake Payment Systems had 571 merchants in its system and processed over $132 million in merchant card transactions. In addition, Chesapeake Payment Systems has also partnered with four independent sales organizations (ISOs) to expand its processing footprint.

The Cash Flow program, which provides an attractive financing option to growing businesses, involves the purchase of the client company's accounts receivables. The Cash Flow program is currently offered in the Eastern half of the United States and had 79 customers at the end of 2013.

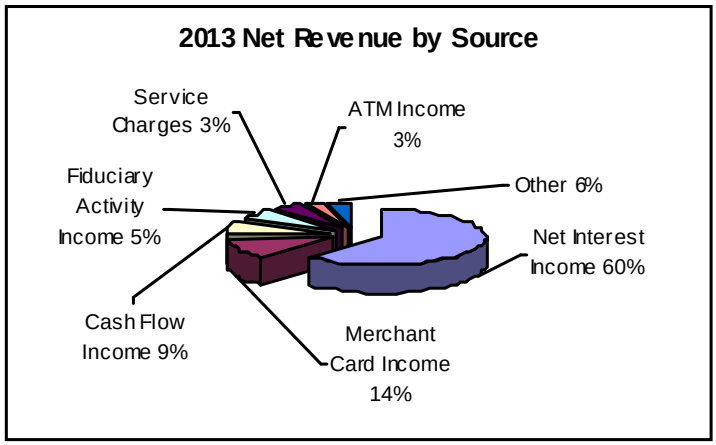
Clear Sky accounts, which offer internet-based retail deposit services for checking and saving accounts and certificates of deposit (CDs), expands CPKF's retail deposit base geographically. At December 31, 2013, Clear Sky deposits totalled $38 million, with customers in all 50 states.

Through Chesapeake's secondary market mortgage banking operation, the Company services a $225 million loan portfolio (as of December 31, 2013) of residential mortgage loans for Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac), for which it earns a 25 basis-point fee (approximately $562,500 annually) on the outstanding loan portfolio balance. Additionally, CPKF earns a pare-off fee for residential mortgage loans that are originated and closed with FHLMC, which added $964,000 to revenues in 2013 (both types of fees are included in other noninterest income in the Company's financial statements).



The lending portfolio is dominated by real estate loans, as shown in the chart at left. At December 31, 2013, the lending book consisted of commercial real estate (accounting for 35% of total gross outstandings), 1-4 family (24%), commercial and industrial (19%), construction and land development (12%), cash flow (5%), and consumer and other (5%). A majority of loans are secured, usually by real estate, inventory, accounts receivable, equipment, machinery, or corporate assets.

At December 31, 2013, the liquidity portfolio, which consists of cash, short-term investments, federal funds sold, and US agency mortgage obligations, represented about 14% of total assets and 18% of the securities portfolio. In addition, the available-for-sale portfolio includes municipal and private label mortgage securities, which accounted for 65% and 17%, respectively, of the total. Core deposits represented 82% of total deposits at December 31, 2013, with certificates of deposit larger than $100,000 at 18%.



In 2013, net interest income contributed 60% of net revenue, with a significant 40% coming from noninterest income sources. Major contributors to noninterest income include merchant card income (14% of net revenues), cash flow income (9%), income from fiduciary activities (5%), service charges on deposit accounts (3%), and ATM income (3%).

VALUATION

CPKF stock is up 3.3% year to date, a worse performance than the small-cap bank industry's median price increase of 10.0% and the 12.0% gain for the S&P 500, as shown in the following table.

At its current price, CPKF is trading at a discount to the industry median P/E of 25% in 2015, based upon our CPKF EPS estimate for 2015. This is below the average 51% P/E discount for CPKF, based upon 5-year historical P/E averages. Applying the historical discount of 51% to our 2015 EPS estimate results in a price of about $10.00.

Turning to Price/Tangible Book Value, CPKF is valued at 0.92X versus the industry median of 1.22X. This represents a 25% discount, well below the average historical premium of 20% for CPKF since mid-2008. Applying the historical premium of 20% to our estimated book value for CPKF twelve months out results in a price of approximately $22.00.

While we recognize that CPKF is still undervalued particularly on a book value basis, we believe that there is no immediate catalyst to drive the stock price higher over the near term, especially in view of what we imagine will be a tough 2014.

Accordingly, we have chosen the $16.00 midpoint of the wide range of values based upon CPKF's 2015 P/E of $10.00 and Price/Tangible Book Value of $22.00 as our new target price.

Industry Comparables - Small-cap Banks

		Price / Earnings Ratios					Return on Equity		Return on Assets		
	Pr Chg YTD	TTM* EPS	2014E	2015E	5-Yr Avg	Price/ Book	TTM*	5-Yr Avg	TTM*	5-Yr Avg	Div Yld
Chesapeake Finc'l	**3.3**	**10.2**	**10.3**	**9.8**	**7.3**	**0.92**	**21.4**	**14.5**	**2.12**	**1.17**	**2.9**
S&P 500	12.0	19.0	17.6	16.5	15.8	5.2	23.4	-----	8.9	-----	1.9
Median	**10.0**	**13.7**	**15.1**	**13.1**	**15.0**	**1.22**	**8.5**	**5.9**	**0.83**	**0.49**	**1.5**
Average	12.5	20.4	21.5	14.8	15.5	1.2	8.2	3.8	0.8	0.5	1.5
High	73.7	258.5	155.1	46.8	30.2	2.0	21.4	14.5	2.1	1.8	4.7
Low	(10.8)	7.4	8.8	8.5	6.5	0.6	(11.0)	(63.1)	(1.1)	(1.2)	-----

*Trailing twelve months

Chesapeake Financial Shares, Inc.

Income Statement and Balance Sheet

(Dollars in millions, except per share data)

Summary Financial Data	12/09	12/10	12/11	12/12	12/13	12/14E	12/15E
Net interest income	18.9	21.8	22.8	23.1	23.3	22.6	23.0
Non-interest income	14.1	13.8	13.7	15.0	15.7	14.5	15.3
Total net revenue	33.0	35.6	36.5	38.1	39.0	37.1	38.3
Loan loss provision	0.9	2.5	1.2	0.6	1.1	0.6	0.4
Non-interest expense	25.9	26.2	26.4	27.8	29.8	29.0	29.8
Income taxes & other	1.4	1.5	1.9	2.0	1.5	1.5	1.8
Zacks adjusted income before NRI	4.8	5.4	7.0	7.7	6.6	6.0	6.3
GAAP net income	4.8	5.4	7.0	7.7	7.4	6.0	6.3
Diluted EPS before NRI	1.23	1.41	1.80	1.94	1.66	1.50	1.58
Reported EPS	1.23	1.41	1.80	1.94	1.84	1.50	1.58
Dividends per share	0.29	0.30	0.33	0.38	0.43	0.45	0.45
Liquid assets	57.8	73.2	97.9	92.1	89.9	70.6	71.8
Outstandings, gross	391.3	382.3	373.1	397.6	401.0	406.6	418.9
Total assets	586.7	607.7	638.0	667.7	661.8	668.2	695.3
Core deposits	370.0	396.2	430.4	459.0	467.2	471.8	490.9
Purchased funds	131.3	127.2	113.3	118.4	105.3	93.9	95.4
Long-term debt	47.4	40.0	39.6	26.0	25.9	25.0	25.0
Shareholders' equity	35.3	41.1	51.2	60.9	61.8	68.9	73.4
Profitability							
Return on avg assets	0.84%	0.90%	1.13%	1.19%	1.01%	0.90%	0.92%
Return on avg equity	13.14%	13.55%	15.31%	14.87%	10.74%	9.01%	8.86%
Net interest margin	4.10%	4.40%	4.70%	4.60%	4.60%	4.43%	4.35%
Loan loss provision % avg assets	0.16%	0.41%	0.19%	0.09%	0.17%	0.09%	0.06%
Noninterest income % avg assets	2.45%	2.30%	2.21%	2.33%	2.40%	2.18%	2.25%
Noninterest expense % avg assets	4.51%	4.34%	4.27%	4.32%	4.55%	4.37%	4.37%
Preprovision pretax income % avg assets	1.24%	1.57%	1.62%	1.60%	1.41%	1.22%	1.24%
Tangible efficiency ratio	77%	73%	71%	71%	75%	77%	77%
Payout ratio	24%	21%	18%	19%	23%	30%	28%
Asset Quality							
Net charge-offs % avg outstandings	0.34%	0.48%	0.22%	0.18%	0.29%	0.14%	0.19%
Allowance % outstandings	1.59%	1.90%	2.01%	1.88%	1.75%	1.89%	2.00%
NPAs % loans + OREO	1.20%	3.91%	4.48%	4.93%	5.20%	4.26%	3.82%
Allowance % NPAs	131%	48%	44%	32%	30%	44%	52%
Liquidity & Funding							
Liquid assets % purchased funds	44%	58%	86%	78%	85%	75%	75%
Core deposits % outstandings	95%	104%	115%	115%	117%	116%	117%
Liquid assets % assets	10%	12%	15%	14%	14%	11%	10%
Outstandings % assets	67%	63%	58%	60%	61%	61%	60%
Capital Adequacy							
Total equity % assets	6.01%	6.76%	8.03%	9.12%	9.34%	10.31%	10.56%
Tangible equity % assets	6.01%	6.76%	8.03%	9.12%	9.34%	10.31%	10.56%
Tier 1 capital ratio	10.10%	12.07%	12.20%	13.55%	14.23%		
Total capital ratio	11.70%	13.54%	13.40%	14.80%	15.48%		
Parent Company Statistics							
Interest coverage	0.8X	2.6X	2.1X	4.4X	9.2X	7.5X	7.5X
Interest & dividend coverage	0.4X	1.1X	0.9X	1.5X	1.5X	1.4X	1.4X
Short-term debt coverage	Lge	Lge	Lge	Lge	Lge	Lge	Lge
Total debt coverage	0.8X	0.8X	0.8X	0.9X	1.0X	1.5X	2.0X
Double leverage	142.1%	134.7%	127.2%	121.7%	119.7%	116.1%	117.5%

Chesapeake Financial Shares, Inc.

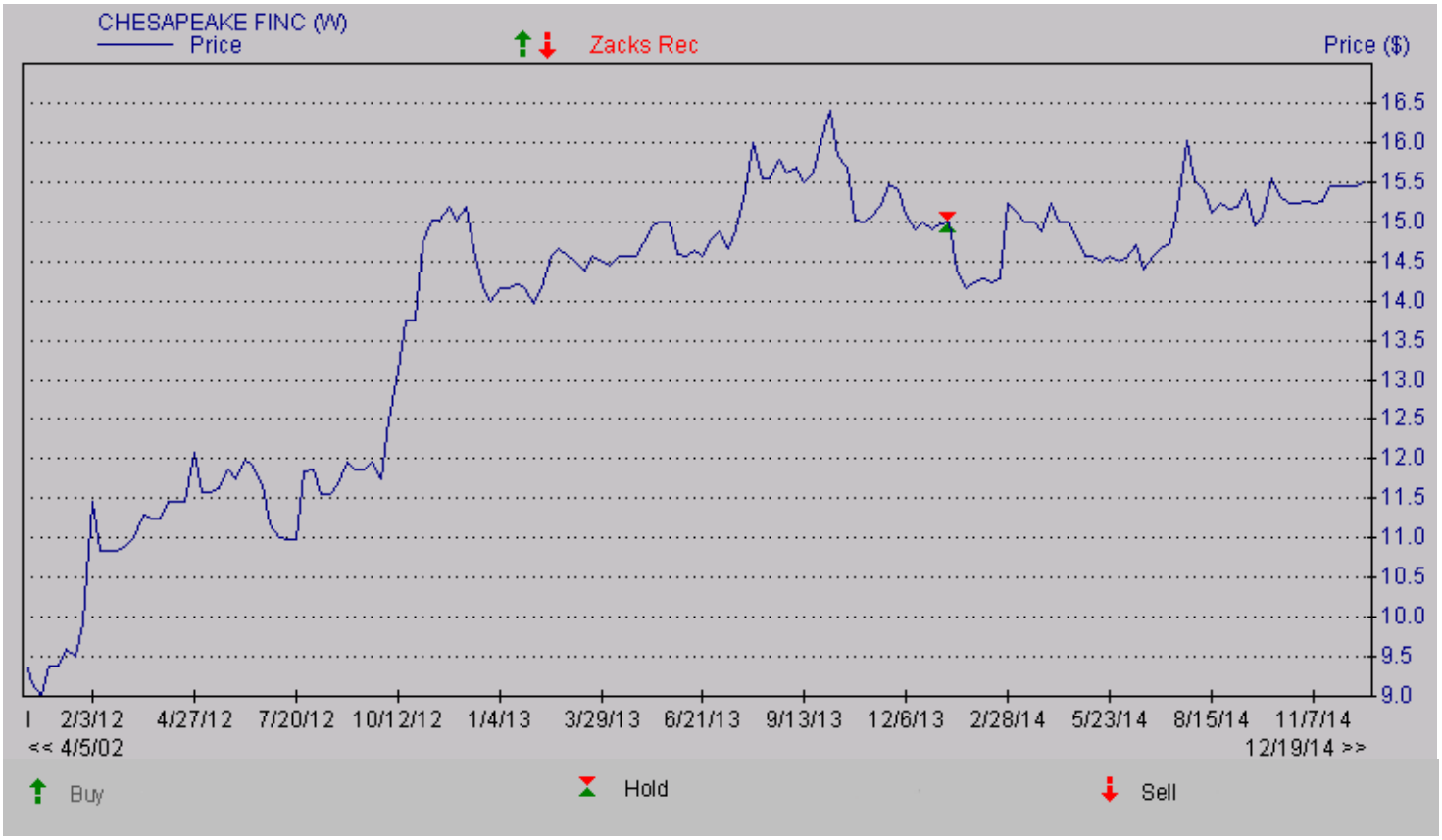
Income Statement and Balance Sheet

(Dollars in millions, except per share data)

	2013				2014			
Summary Financial Data	**Q1 A**	**Q2 A**	**Q3 A**	**Q4 A**	**Q1 A**	**Q2 A**	**Q3 P**	**Q4 E**
Net interest income	5.8	5.8	5.8	5.9	5.6	5.7	5.9	5.7
Non-interest income	3.8	4.2	3.9	3.8	3.4	4.0	4.5	3.3
Total net revenue	9.6	10.0	9.7	9.7	9.0	9.7	10.4	9.0
Loan loss provision	0.1	0.7	0.1	0.3	0.2	0.2	0.2	0.2
Non-interest expense	6.8	7.1	7.7	8.2	7.2	7.2	8.0	7.3
Income taxes & other	0.6	0.4	0.4	(0.0)	0.4	0.4	0.5	0.3
Zacks adjusted income before NRI	2.1	1.8	1.5	1.2	1.3	1.9	1.7	1.2
GAAP net income	2.1	2.5	1.5	1.2	1.3	1.9	1.7	1.2
Diluted EPS before NRI	0.53	0.46	0.38	0.30	0.32	0.48	0.42	0.30
Reported EPS	0.53	0.64	0.38	0.30	0.32	0.48	0.42	0.30
Dividends per share	0.10	0.10	0.11	0.11	0.11	0.11	0.11	0.11
Liquid assets	67.0	58.8	75.2	89.9	90.1	70.1	59.5	70.6
Outstandings, gross	395.7	404.5	407.1	401.0	404.7	400.6	409.8	406.6
Total assets	643.5	643.0	658.6	661.8	669.2	655.0	658.0	668.2
Core deposits	453.2	455.6	473.6	467.2	480.4	462.5	468.3	471.8
Purchased funds	98.9	96.2	93.3	105.4	95.2	93.1	93.1	93.9
Long-term debt	26.5	26.4	26.2	25.9	26.0	25.9	20.7	25.0
Shareholders' equity	61.9	60.7	61.4	61.8	64.5	67.0	68.9	68.9
Profitability								
Return on avg assets*	1.29%	1.13%	0.93%	0.73%	0.78%	1.15%	1.03%	0.71%
Return on avg equity *	13.72%	11.86%	9.91%	7.81%	8.26%	11.56%	9.94%	6.94%
Net interest margin*	4.54%	4.56%	4.61%	4.61%	4.46%	4.48%		4.40%
Loan loss provision % avg assets*	0.06%	0.40%	0.06%	0.17%	0.09%	0.09%	0.09%	0.09%
Noninterest income % avg assets*	2.29%	2.63%	2.37%	2.33%	2.06%	2.39%	2.76%	1.98%
Noninterest expense % avg assets*	4.12%	4.41%	4.71%	4.99%	4.32%	4.35%	4.85%	4.40%
Preprovision pretax inc.% avg assets*	1.71%	1.82%	1.25%	0.89%	1.10%	1.47%	1.49%	1.01%
Tangible efficiency ratio	70%	71%	75%	84%	80%	74%	76%	79%
Payout ratio	19%	16%	30%	37%	35%	23%	27%	38%
Asset Quality								
Net charge-offs % avg outstandings*	0.64%	0.21%	0.22%	0.09%	(0.07)%	0.24%		0.20%
Allowance % outstandings	1.77%	1.81%	1.85%	1.75%	1.83%	1.87%		1.89%
NPAs % loans + OREO	5.25%	3.66%	4.11%	5.20%	5.09%	4.50%		4.26%
Allowance % NPAs	28%	49%	45%	30%	31%	35%		44%
Liquidity & Funding								
Liquid assets % purchased funds	68%	61%	81%	85%	95%	75%	64%	75%
Core deposits % outstandings	115%	113%	116%	116%	119%	115%	114%	116%
Liquid assets % assets	10%	9%	11%	14%	13%	11%	9%	11%
Outstandings % assets	61%	63%	62%	61%	60%	61%	62%	61%
Capital Adequacy								
Total equity % assets	9.63%	9.43%	9.32%	9.34%	9.64%	10.23%	10.47%	10.31%
Tangible equity % assets	9.63%	9.43%	9.32%	9.34%	9.64%	10.23%	10.47%	10.31%
Tier 1 capital ratio	13.70%	13.74%	13.92%	14.23%	14.41%	14.84%		
Total capital ratio	14.94%	14.99%	15.17%	15.48%	15.66%	16.09%		

*Annualized.

HISTORICAL ZACKS RECOMMENDATIONS



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