Zacks Small-Cap Research

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Chesapeake Financial Shares, Inc. (CPKF - OTC)

CPKF: Record First Quarter Net Earnings

Current Recommendation	**Outperform**
Prior Recommendation	Neutral
Date of Last Change	05/26/2011
Current Price (05/01/12)	$14.00
Twelve-Month Target Price	**$17.50**

OUTLOOK

Chesapeake Financial Shares, Inc. (CPKF) reported that record first quarter net earnings jumped 21% year over year to $1.8 million and diluted EPS climbed 20% to $0.57. Sequential net income and diluted EPS advanced 16% and 15%, respectively, from the fourth quarter of 2011. The primary reasons for 2012's outperformance versus 2011's first quarter were a $0.44 million, or 75%, slide in the provision for loan losses to $0.15 million, and a drop in the effective tax rate to to 21.9% from 24.4%. Compared to our projections, net income was about $60,000, or $0.02 per diluted share, below our $1.9 million, or $0.59 per share, estimates. This primarily reflected asset management fees that were a bit lower and compensation expense that was modestly higher than our estimates. Net interest income inched up 0.3% year over year to $5.9 million (the same as our estimate), due to improvement in the net interest margin, while noninterest income advanced $0.4 million, or 15%, year over year to $3.1 million, largely reflecting a $0.3 million combined positive swing in securities losses and net losses on other real estate owned. CPKF recently raised its quarterly dividend by 10% to $0.11 from $0.10 and has increased its dividend payment annually for the past twenty years. 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	**$14.50**
52-Week Low	**$10.80**
One-Year Return (%)	**16.50**
Beta	**0.17**
Average Daily Volume (sh)	**1,061**
Shares Outstanding (mil)	**3**
Market Capitalization ($mil)	**$45**
Short Interest Ratio (days)	**N/A**
Institutional Ownership (%)	**0**
Insider Ownership (%)	**40**
Annual Cash Dividend	**$0.44**
Dividend Yield (%)	**3.14**
5-Yr. Historical Growth Rates	
Net Revenue (%)	**7.1**
Earnings Per Share (%)	**14.1**
Dividend (%)	**8.2**
P/E using TTM EPS	**6.2**
P/E using 2011 Actual	**6.4**
P/E using 2012 Estimate	**N/A**
Zacks Rank	**2**

Risk Level	**Average**
Type of Stock	**Small-Value**
Industry	**Banks-Southeast**
Zacks Rank in Industry	**10 of 70**

ZACKS ESTIMATES

Net Revenue
(in millions of $)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2009	7.5 A	8.0 A	8.6 A	8.9 A	33.0 A
2010	8.2 A	8.6 A	10.1 A	9.1 A	36.1 A
2011	8.8 A	9.4 A	9.2 A	9.1 A	36.5 A
2012	9.0 E	9.2 E	9.5 E	9.6 E	37.3 E

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

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2009	0.28 A	0.34 A	0.44 A	0.38 A	1.48 A
2010	0.35 A	0.40 A	0.59 A	0.31 A	1.69 A
2011	0.47 A	0.63 A	0.56 A	0.49 A	2.16 A
2012	0.57 A	0.56 E	0.59 E	0.46 E	2.20 E

Quarterly EPS may not add to total due to changes in shares outstanding.

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FIRST QUARTER RESULTS

CPKF reported that record first quarter net earnings jumped 21% year over year to $1.8 million and diluted EPS climbed 20% to $0.57. Sequential net income and diluted EPS advanced 16% and 15%, respectively, from the fourth quarter of 2011. The primary reasons for 2012's outperformance versus 2011's first quarter were a $0.44 million, or 75%, slide in the provision for loan losses to $0.15 million, and a drop in the effective tax rate to to 21.9% from 24.4%

Compared to our projections, net income was about $60,000, or $0.02 per diluted share, below our $1.9 million, or $0.59 per share, estimates. This primarily reflected asset management fees that were a bit lower and compensation expense that was modestly higher than our estimates.

Net interest income inched up 0.3% year over year to $5.9 million (the same as our estimate), due to improvement in the net interest margin. Loans and receivables outstanding decreased about 2% year over year due to weak loan demand.

Noninterest income advanced $0.4 million, or 15%, year over year to $3.1 million, largely reflecting a $0.3 million combined positive swing in securities losses and net losses on other real estate owned to a loss of $0.43 million in 2012 from a loss of $0.77 million in the year-ago quarter. Excluding these items, noninterest income was up 2% as strong growth in merchant card income and other noninterest income (up 7% and 36%, respectively) was offset by a 22% fall in cash flow income, reflecting a decline in receivables outstanding as CPKF clients secured more traditional bank financing at other financial institutions, and an 11% decrease in service charges on deposit accounts, primarily reflecting lower customer usage and secondarily changes in federal regulations.

Total noninterest expense increased $0.5 million, or about 9%, year over year to $6.4 million (the same as our estimate), as compensation expense climbed 13% and other noninterest expense rose about 3 ½%.

The loan loss provision decreased 75% to $0.15 million (versus our $0.20 million estimate), due to better asset quality. The Company's 30-day and over delinquencies were 1.64% of total loans, a 32% decrease from March 31, 2011. CPKF modestly decreased its loan loss reserves to $6.5 million (1.84% of loans) from $6.7 million (1.87% of loans) at the end of the comparable year-ago quarter, though it was higher than the $6.46 million (1.81% of loans) posted at the end of the previous quarter.

As to other asset quality measures, CPKF charged off $73,000 of loans in the first quarter. This is about the same as the level a year ago and compares to net charge-offs of $0.9 million for full-year 2011. Gross loans outstanding dropped about $0.8 million, less than 1%, sequentially to $355 million and $3.5 million from the comparable prior-year quarter, reflecting continued weak loan demand.

CPKF posted a 13.9% ROE and 1.15% ROA for the first quarter of 2012, compared to 14.4% and 1.01%, respectively, in the prior-year quarter.

On April 20, 2012, CPKF announced a $0.11 quarterly dividend, payable on or before June 15, 2012 to shareholders of record as of June 1, 2012. Earlier in the year, CPKF hiked the dividend 10% from the $0.10 quarterly rate.

In other news, Chesapeake Investment Group increased its assets under management by 3% sequentially to $311 million at March 31, 2012. In addition, John M. Sadler became President of Chesapeake Trust Company, a subsidiary of Chesapeake Investment Group, on May 1, replacing Gregory V. Powell, who retired on April 30, 2012. Sadler came on board on a part-time basis on April 2.

We note that US Banker ranked CPKF 20th (up from 32nd about a year ago) out of all banks nationally with less than $2 billion in total assets, which includes approximately 6,000 banks, and #1 of all banks in

Virginia. This ranking was based upon three-year average returns on equity, which for Chesapeake Financial was 13.40%. The Company has steadily risen through the rankings in the past four years, reflecting its solid financial performance during this difficult banking environment.

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 bank holding company headquartered in Kilmarnock, Virginia, with $641 million in total assets at March 31, 2012. CPKF is predominantly a small business lender with 11 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 four branches in Williamsburg. CPKF, which began as Lancaster National Bank on April 13, 1900, has a long history and strong ties with the communities it serves.

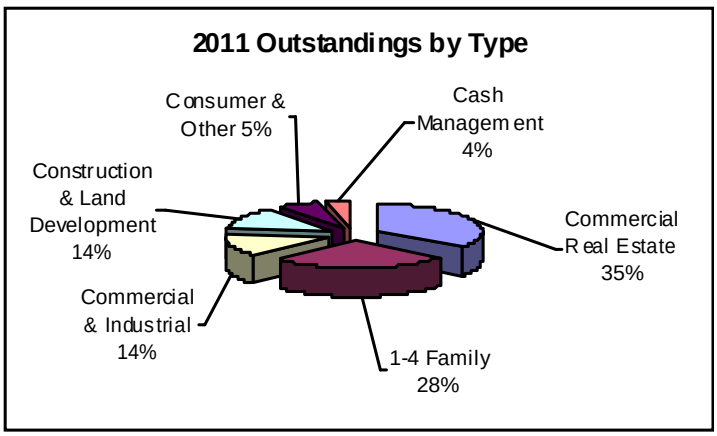
Operations are carried on through Chesapeake Bank, a state-chartered bank as well as Federal Reserve and FDIC member bank, and Chesapeake Investment Group, Inc. (CIG), an independent wealth management firm that manages about $301 million in assets (at 2011 yearend) through its subsidiaries involved in 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 2011, Chesapeake Payment Systems had 632 merchants in its system and processed over $124 million in merchant card transactions.

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 has approximately 63 customers.

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, 2011, Clear Sky deposits totalled $51 million, with customers in all 50 states.

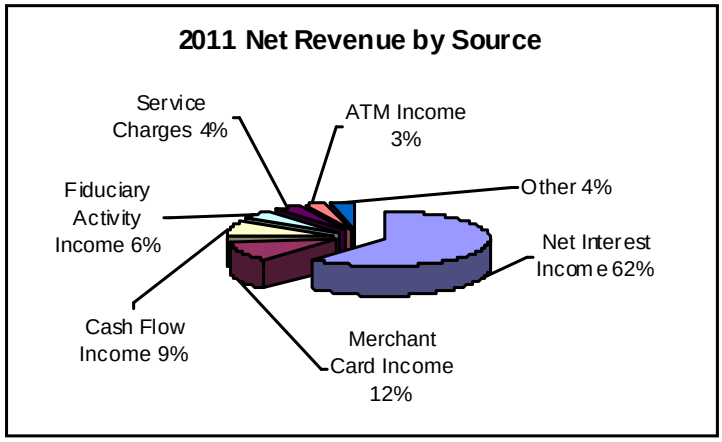
Through Chesapeake's secondary market mortgage banking operation, the Company services a $177 million loan portfolio (as of December 31, 2011) of residential mortgage loans for Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac), for which it earns a 25 basis-point fee (approximately $440,000 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 $474,000 to revenues in 2011 (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, 2011, the lending book consisted of commercial real estate (accounting for 35% of total gross outstandings), 1-4 family (28%),

commercial and industrial (14%), construction and land development (14%), consumer and other (5%), and cash flow (4%). A majority of loans are secured, usually by real estate, inventory, accounts receivable, equipment, machinery, or corporate assets.

The liquidity portfolio, consisting of cash, short-term investments, federal funds sold, and US agency mortgage obligations, represent about 15% of total assets and 32% of the securities portfolio. In addition, the available-for-sale portfolio includes municipal and private label mortgage securities, which currently account for 53% and 15%, respectively, of the total. Core deposits represented 79% of total deposits at December 31, 2011, with certificates of deposit larger than $100,000 at 21%.



In 2011, net interest income contributed 62% of net revenue, with a significant 38% coming from noninterest income sources. Major contributors to noninterest income include merchant card income (12% of net revenues), cash flow income (9%), income from fiduciary activities (6%), service charges on deposit accounts (4%), and ATM income (3%).

VALUATION

CPKF stock has risen 24.4% year to date and has outperformed the S&P 500's 11.8% advance by a wide margin, though it has modestly underperformed the industry's median price increase of 26.2%, as shown in the following table. At its current price, CPKF is trading at a discount to the industry median P/E of 44% in 2012 (versus 45% at the time of our last report on March 27, 2012), based upon our CPKF EPS estimate for 2012. This is in excess of the average 43% P/E discount for CPKF, based upon 5-year historical P/E averages. Applying the historical discount of 43% to our 2012 EPS estimate results in a price of about $14.50.

Turning to Price/Tangible Book Value, CPKF is valued at 0.89X versus the industry median of 0.89X. This represents a 0% premium, well below the average historical premium of 14% for CPKF since the end of 2005. We believe a higher premium is justified given CPKF's strong performance throughout the financial crisis, its strong profitability measures, and its solid dividend yield. Applying the historical premium of 14% to our estimated book value for CPKF twelve months out results in a price of approximately $20.50.

Taking the midpoint of the $14.50-20.50 stock price range determined above results in a target price of roughly $17.50 and compares to CPKF's current stock price of $14.00, indicating a 25% gain. When combined with the dividend yield, this represents a total return of about 28%, well above our expectations for gains in the broader market index over the next year. Therefore, we are maintaining our recommendation on CPKF at Outperform.

Industry Comparables- Small-cap Banks

	Pr Chg YTD	Price / Earnings Ratios TTM* EPS	2012E	2013E	5-Yr Avg	Price/ Book	Return on Equity TTM*	5-Yr Avg	Return on Assets TTM*	5-Yr Avg	Div Yld
Chesapeake Finc'l	**24.4**	**7.5**	**6.4**		**9.0**	**0.89**	**14.6**	**14.2**	**1.12**	**0.93**	**3.1**
S&P 500	11.8	14.6	13.6	12.6	17.1	-----	32.4	-----	10.5	-----	2.0
Median	**26.2**	**11.7**	**11.4**	**10.7**	**15.7**	**0.89**	**8.4**	**4.2**	**0.78**	**0.30**	**0.3**
Average	26.8	16.7	12.5	10.9	20.1	0.9	(0.8)	1.8	0.5	0.3	1.4
High	84.4	61.8	25.3	19.8	41.6	1.7	18.5	11.4	1.8	2.3	7.1
Low	(50.3)	6.2	6.8	7.0	11.5	0.0	(268.3)	(37.6)	(3.6)	(2.2)	-----

*Trailing twelve months

Chesapeake Financial Shares, Inc.

Income Statement and Balance Sheet

(Dollars in millions, except per share data)

Summary Financial Data	12/06	12/07	12/08	12/09	12/10	12/11	12/12 E
Net interest income	14.3	14.5	16.5	18.9	21.8	22.8	23.6
Non-interest income	11.6	13.5	15.0	14.1	13.8	13.7	13.7
Total net revenue	25.9	28.0	31.5	33.0	35.6	36.5	37.3
Loan loss provision	0.8	0.2	0.4	0.9	2.5	1.2	0.8
Non-interest expense	19.6	21.8	25.0	25.9	26.2	26.4	27.3
Income taxes & other	1.5	1.7	1.5	1.4	1.5	1.9	2.0
Zacks adjusted income before NRI	4.0	4.3	4.6	4.8	5.4	7.0	7.2
GAAP net income	4.0	4.3	4.6	4.8	5.4	7.0	7.2
Diluted EPS before NRI	1.12	1.24	1.34	1.48	1.69	2.16	2.20
Reported EPS	1.12	1.24	1.34	1.48	1.69	2.16	2.20
Dividends per share	0.27	0.29	0.34	0.35	0.36	0.40	0.44
Liquid assets	52.9	58.4	45.4	57.8	73.2	97.9	101.8
Outstandings, gross	319.4	361.6	396.2	391.3	382.3	373.1	388.2
Total assets	418.1	483.0	538.0	586.7	607.7	638.0	663.9
Core deposits	295.2	308.8	317.0	370.0	396.2	430.4	447.9
Purchased funds	73.7	80.0	115.9	126.7	121.7	113.3	117.9
Long-term debt	11.6	44.4	65.5	47.4	40.0	39.6	40.0
Shareholders' equity	31.0	33.7	30.6	35.3	41.1	51.2	56.2
Profitability							
Return on avg assets	0.98%	0.97%	0.89%	0.84%	0.90%	1.13%	1.10%
Return on avg equity	13.58%	13.68%	13.51%	13.14%	13.03%	15.31%	13.34%
Net interest margin	4.20%	4.10%	4.00%	4.10%	4.40%	4.70%	4.68%
Loan loss provision % avg assets	0.21%	0.04%	0.08%	0.16%	0.41%	0.19%	0.12%
Noninterest income % avg assets	2.88%	3.01%	2.91%	2.45%	2.28%	2.21%	2.10%
Noninterest expense % avg assets	4.86%	4.87%	4.84%	4.51%	4.31%	4.27%	4.19%
Preprovision pretax income % avg assets	1.54%	1.39%	1.26%	1.24%	1.56%	1.62%	1.54%
Tangible efficiency ratio	76%	78%	79%	78%	73%	71%	72%
Payout ratio	24%	23%	25%	24%	21%	18%	20%
Asset Quality							
Net charge-offs % avg outstandings	0.28%	0.04%	0.27%	0.34%	0.48%	0.22%	0.18%
Allowance % outstandings	1.55%	1.50%	1.43%	1.59%	1.90%	2.01%	2.00%
NPAs % loans + OREO	1.00%	0.61%	0.35%	1.20%	2.00%	4.48%	4.04%
Allowance % NPAs	154%	245%	411%	131%	94%	44%	49%
Liquidity & Funding							
Liquid assets % purchased funds	72%	73%	39%	46%	60%	86%	86%
Core deposits % outstandings	92%	85%	80%	95%	104%	115%	115%
Liquid assets % assets	13%	12%	8%	10%	12%	15%	15%
Outstandings % assets	76%	75%	74%	67%	63%	58%	58%
Capital Adequacy							
Total equity % assets	7.41%	6.97%	5.68%	6.01%	6.76%	8.03%	8.47%
Tangible equity % assets	7.41%	6.97%	5.68%	6.01%	6.76%	8.03%	8.47%
Tier 1 capital ratio	11.10%	10.80%	10.60%	10.10%	12.07%	12.20%	
Total capital ratio	12.50%	15.50%	12.50%	11.70%	13.54%	13.40%	
Parent Company Statistics							
Interest coverage	0.8X	0.4X	0.6X	0.8X	2.6X	2.1X	1.0X
Interest & dividend coverage	0.5X	0.3X	0.3X	0.4X	1.1X	0.9X	0.4X
Short-term debt coverage	Lge	Lge	Lge	Lge	Lge	Lge	Lge
Total debt coverage	1.0X	1.0X	0.9X	0.8X	0.8X	0.8X	1.2X
Double leverage	127.3%	133.2%	139.8%	142.1%	134.7%	127.2%	128.7%

Chesapeake Financial Shares, Inc.

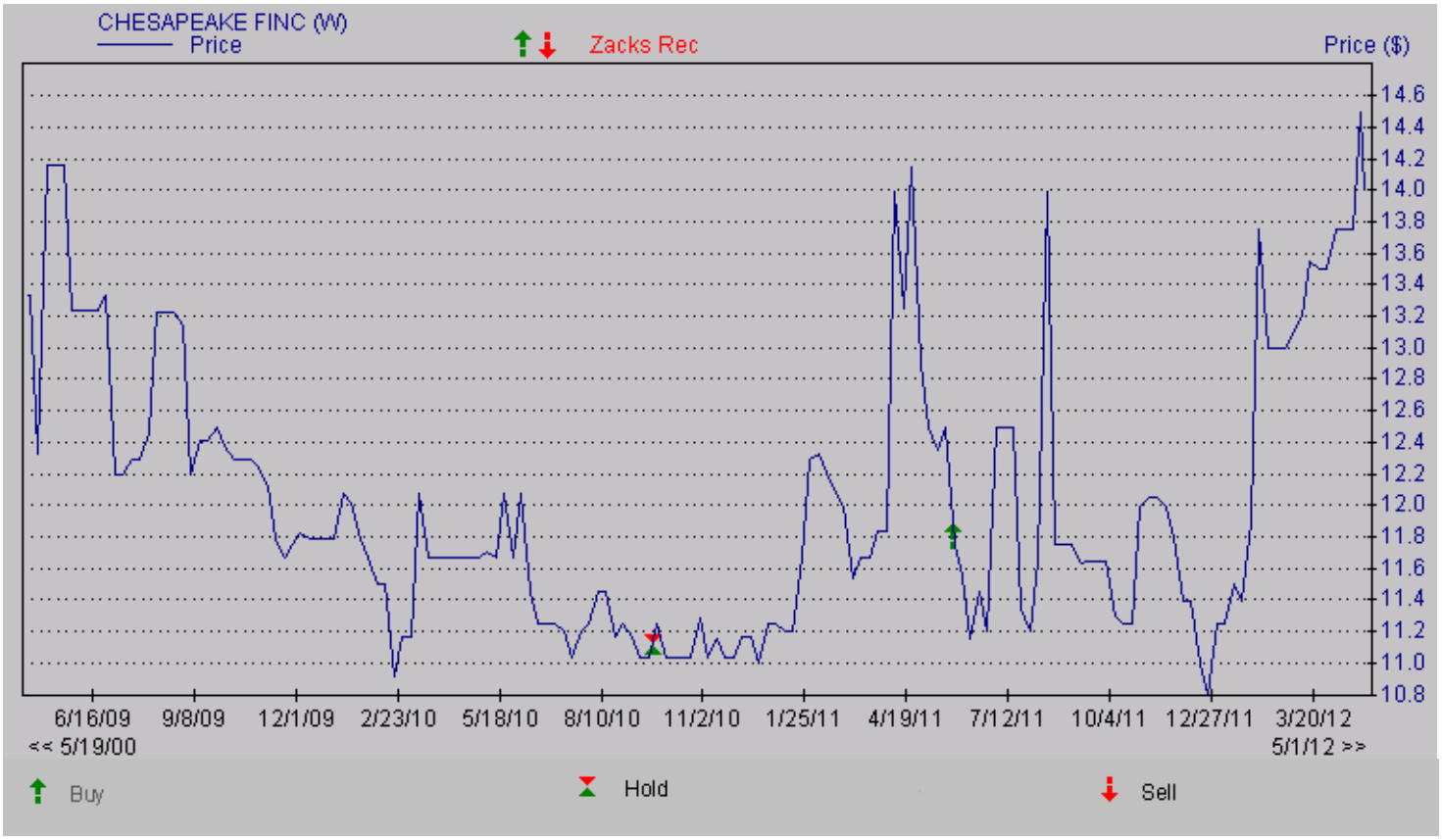
Income Statement and Balance Sheet

(Dollars in millions, except per share data)

	2011				2012			
Summary Financial Data	**Q1 A**	**Q2 A**	**Q3 A**	**Q4 A**	**Q1 P**	**Q2 E**	**Q3 E**	**Q4 E**
Net interest income	5.8	5.4	5.7	5.9	5.9	5.9	5.9	5.9
Non-interest income	3.0	4.0	3.5	3.2	3.1	3.3	3.6	3.7
Total net revenue	8.9	9.4	9.2	9.1	9.0	9.2	9.5	9.6
Loan loss provision	0.6	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Non-interest expense	6.2	6.5	6.6	7.2	6.4	6.7	6.8	7.4
Income taxes & other	0.5	0.6	0.6	0.1	0.6	0.5	0.6	0.5
Zacks adjusted income before NRI	1.5	2.1	1.8	1.6	1.8	1.8	1.9	1.5
GAAP net income	1.5	2.1	1.8	1.6	1.8	1.8	1.9	1.5
Diluted EPS before NRI	0.47	0.63	0.56	0.49	0.57	0.56	0.59	0.46
Reported EPS	0.47	0.63	0.56	0.49	0.57	0.56	0.59	0.46
Dividends per share	0.10	0.10	0.10	0.10	0.11	0.11	0.11	0.11
Liquid assets	68.9	88.4	99.8	97.9	93.2	99.8	100.8	101.8
Outstandings, gross	376.8	376.5	372.9	373.1		380.6	384.4	388.2
Total assets	602.7	619.6	631.5	638.0	640.7	650.8	657.3	663.9
Core deposits	397.2	415.3	422.9	430.4	427.5	439.1	443.5	447.9
Purchased funds	115.8	112.5	112.5	113.3	115.8	115.5	116.7	117.9
Long-term debt	40.0	39.9	39.8	39.6	37.1	40.0	40.0	40.0
Shareholders' equity	43.6	46.6	50.4	51.2	55.0	53.7	55.1	56.2
Profitability								
Return on avg assets*	1.01%	1.35%	1.16%	1.00%	1.15%	1.13%	1.17%	0.92%
Return on avg equity *	14.40%	18.28%	14.91%	12.49%	13.88%	13.79%	14.12%	10.87%
Net interest margin*	4.68%	4.33%	4.56%	4.77%		4.70%	4.65%	4.65%
Loan loss provision % avg assets*	0.39%	0.13%	0.13%	0.13%		0.12%	0.12%	0.12%
Noninterest income % avg assets*	1.99%	2.65%	2.25%	2.00%	1.93%	2.03%	2.19%	2.22%
Noninterest expense % avg assets*	4.13%	4.26%	4.20%	4.54%	4.02%	4.11%	4.16%	4.49%
Preprovision pretax inc.% avg assets*	1.72%	1.92%	1.66%	1.22%		1.57%	1.63%	1.29%
Tangible efficiency ratio	71%	69%	72%	75%	69%	71%	70%	76%
Payout ratio	20%	16%	18%	20%	19%	20%	19%	24%
Asset Quality								
Net charge-offs % avg outstandings*	0.01%	0.44%	-----	0.41%		0.16%	0.16%	0.18%
Allowance % outstandings	2.11%	2.06%	2.12%	2.01%		2.00%	2.00%	2.00%
NPAs % loans + OREO	1.92%	2.38%	2.28%	4.48%		4.28%	4.15%	4.04%
Allowance % NPAs	92%	85%	92%	44%		46%	48%	49%
Liquidity & Funding								
Liquid assets % purchased funds	60%	79%	89%	86%	80%	86%	86%	86%
Core deposits % outstandings	105%	110%	113%	115%		115%	115%	115%
Liquid assets % assets	11%	14%	16%	15%	15%	15%	15%	15%
Outstandings % assets	63%	61%	59%	58%		58%	58%	58%
Capital Adequacy								
Total equity % assets	7.24%	7.52%	7.98%	8.03%	8.58%	8.26%	8.38%	8.47%
Tangible equity % assets	7.24%	7.52%	7.98%	8.03%	8.58%	8.26%	8.38%	8.47%
Tier 1 capital ratio	12.39%	12.04%	12.09%	12.20%				
Total capital ratio	13.76%	13.30%	13.34%	13.40%				

*Annualized.

HISTORICAL ZACKS RECOMMENDATIONS



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