Zacks Small-Cap Research

April 20, 2011
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Chesapeake Financial Shares, Inc. (CPKF - OTC)

CPKF: First Quarter Results – Neutral

Current Recommendation	**Neutral**
Prior Recommendation	N/A
Date of Last Change	09/21/2010
Current Price (04/19/11)	$14.15
Six- Month Target Price	**$12.30***

*Under review

OUTLOOK

CPKF reported a strong first quarter, with diluted EPS rising 34.5% to $0.47 from $0.35, a penny short of our first quarter estimate of $0.48. (All per share data in this report have been adjusted for a 6-for-5 stock split that took place earlier this month.) This occurred despite a 144% year-over-year increase in the loan loss provision to $0.6 million as CPKF strengthened loan loss reserves and was mainly the result of 12.5% growth in net interest income to $5.8 million and tight control over operating expenses, which fell 2% year over year and 9% sequentially to $6.2 million. In addition, the effective tax rate was 2.5 points lower in 2011's first quarter than in the comparable 2010 period. CPKF has taken a number of steps to increase returns to shareholders, including two recent dividend hikes totalling almost 9% and a stock split. The Company just raised the quarterly dividend rate by 4.3% to $0.10 from $0.096, which follows a 4.5% dividend increase in March. In addition, the Company had a 6-for-5 stock split that occurred earlier this month. Following these events, CPKF shares surged 20% and are now trading at a 52-week high and well in excess of our target price. We are currently reviewing our target price and estimates and will issue a more comprehensive report when detailed financial information becomes available in the next few weeks.

SUMMARY DATA

52-Week High	**$14.15**
52-Week Low	**$10.89**
One-Year Return (%)	**25.75**
Beta	**0.12**
Average Daily Volume (sh)	**291**
Shares Outstanding (mil)	**3**
Market Capitalization ($mil)	**$46**
Short Interest Ratio (days)	**N/A**
Institutional Ownership (%)	**0**
Insider Ownership (%)	**40**
Annual Cash Dividend	**$0.38**
Dividend Yield (%)	**2.71**
5-Yr. Historical Growth Rates	
Net Revenue (%)	**8.1**
Earnings Per Share (%)	**10.5**
Dividend (%)	**7.2**
P/E using TTM EPS	**8.0**
P/E using 2010 Actual	**8.4**
P/E using 2011 Estimate	**7.5**
Zacks Rank	**2**

Risk Level	**Average**
Type of Stock	**Small-Value**
Industry	**Banks-Southeast**
Zacks Rank in Industry	**6 of 79**

ZACKS ESTIMATES

Net Revenue

(in millions of $)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2008	7.6 A	8.0 A	8.0 A	7.9 A	31.5 A
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	8.9 A	9.0 E*	9.2 E*	9.0 E*	36.1 E*

Earnings per Share

(EPS is operating earnings before nonrecurring items)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2008	0.29 A	0.41 A	0.32 A	0.32 A	1.34 A
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	0.49 E*	0.55 E*	0.35 E*	1.88 E*

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

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FIRST QUARTER RESULTS

CPKF reported strong 2011 first quarter net earnings of $1.5 million, up 31% from the $1.2 million reported in the year-ago quarter, while diluted EPS increased 34.5% to $0.47 from $0.35, with the better EPS performance reflecting share buybacks. This compares to our first quarter estimate of $0.48.(All per share data in this report have been adjusted for a 6-for-5 stock split that occurred earlier this month.)

There were a number of variances from our estimate. On the positive side, net interest income was $5.8 million, higher than our $5.3 million estimate, due to a sharp 30% decline in interest expense that we had not been anticipating, and an effective income tax rate of 24% that was lower than our 28% estimate. This was offset by an increased loan loss provision of $0.6 million, versus our $0.3 million estimate, and larger other-than-temporary impairment losses on securities of $0.4 million, which compares to our $0.1 million loss estimate.

Net interest income rose 12.5% to $5.8 million from $5.2 million in the comparable prior-year period, reflecting a higher net interest margin on reduced interest costs. Noninterest income was flat year over year at $3.0 million. Strong growth in ATM, merchant card, and other income were offset by higher losses from securities sales and OREO expense.

Noninterest expense fell 2% year over year, as the Company maintained tight control over operating expenses that lead to a 7-point improvement in the efficiency ratio, which dropped to 71% from 78% in the year-ago quarter.

The loan loss provision more than doubled to $0.6 million from $0.2 million in the first quarter of last year, as the Company continued to strenthen loan loss reserves. CPKF increased its loan loss reserves to $6.7 million (1.87% of loans) from $6.1 million (1.69% of loans) at the end of 2010's fourth quarter and $5.3 million at the end of the comparable year-ago quarter (1.44% of loans).

As to other asset quality measures, CPKF charged off $7,000 of loans in the first quarter. This compares to net charge-offs of $94,000 of loans in the prior-year period and of $1.5 million for full-year 2010. Gross loans outstanding dropped about $4 million, or 1%, sequentially to $362 million and $9 million from the comparable prior-year quarter, reflecting continued weak loan demand.

CPKF posted a 14.4% ROE and 1.01% ROA for the first quarter of 2011, compared to 12.9% and 0.78%, respectively, in the prior-year quarter.

CPKF has taken a number of steps to increase returns to shareholders, including two recent dividend hikes totalling almost 9% and a stock split. The Company just raised the quarterly dividend rate by 4.3% to $0.10 from $0.096, which follows a 4.5% dividend increase in March. In addition, the Company had a 6-for-5 stock split that occurred earlier this month.

Following these events, CPKF shares surged 20% in the past two weeks and are now trading at a 52-week high and well in excess of our target price.

We are currently reviewing our target price and earnings 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 $603 million in total assets at March 31, 2011. 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 $312 million in assets (as of the end of the first quarter) 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.

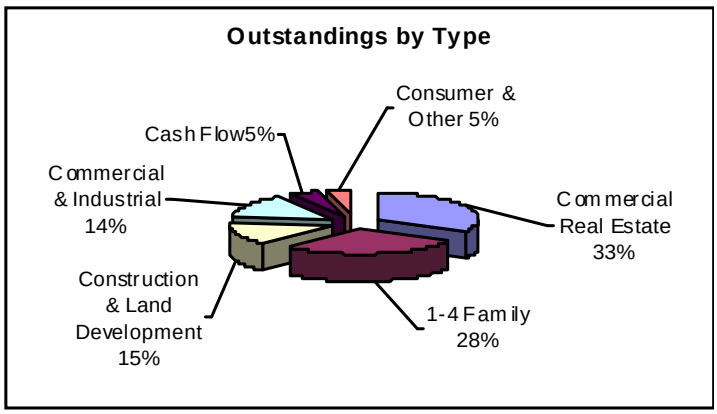
Chesapeake Payment Systems offers merchant processing services such as credit card and debit card processing, electronic benefits transfers, and loyalty and gift card processing to companies involved in travel, entertainment, restaurant, hospitality, retail, mail order, and e-commerce. At yearend 2010, Chesapeake Payment Systems had 678 merchants in its system and processed over $125 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 80 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 2010 yearend, Clear Sky deposits totalled $50 million, with customers in all 50 states.

Through Chesapeake's secondary market mortgage banking operation, the Company services a $169 million loan portfolio of residential mortgage loans for Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac), for which it earns a 25 basis-point fee (approximately $425,000 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 $550,000 to revenues in 2010 (both types of fees are included in other noninterest income in the Company's financial statements).

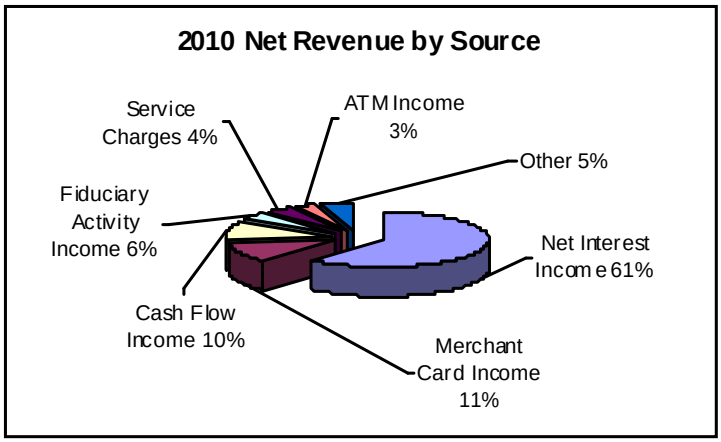
The lending portfolio is dominated by real estate loans, as shown in the chart below. At December 31, 2010, the lending book consisted of commercial real estate (accounting for 33% of total gross outstandings), 1-4 family (28%), construction and land development (15%), commercial and industrial (14%), 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.



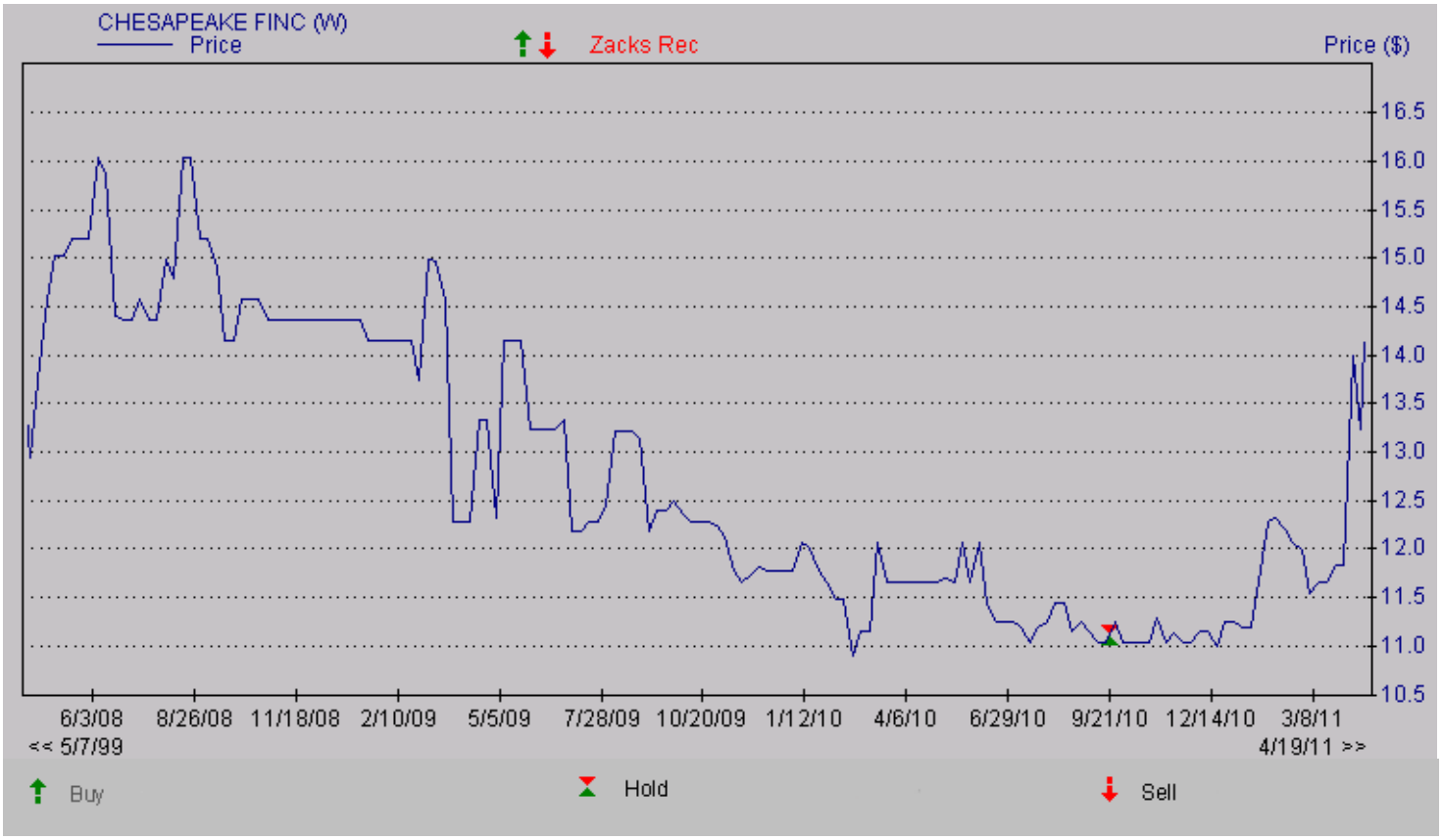
The liquidity portfolio, consisting of cash, short-term investments, federal funds sold, resale agreements, trading account assets, US Treasuries, and US agency mortgage obligations, represent about 12% of total assets and 31% of the securities portfolio. In addition, the available-for-sale portfolio includes municipal and private label mortgage securities, which currently

account for 47% and 22%, respectively, of the total. Core deposits represented 77% of total deposits at December 31, 2010, with certificates of deposit larger than $100,000 at 23%.

In 2010, net interest income contributed 61% of net revenue, with a significant 39% coming from noninterest income sources. Major contributors to noninterest income include merchant card income (11% of net revenues), cash flow income (10%), income from fiduciary activities (6%), service charges on deposit accounts (4%), and ATM income (3%).



HISTORICAL ZACKS RECOMMENDATIONS



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