Zacks Equity Research

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Chesapeake Financial Shares, Inc. (CPKF - OTC)

CPKF: Fourth Quarter Results – Neutral

Current Recommendation	**Neutral**
Prior Recommendation	N/A
Date of Last Change	09/21/2010
Current Price (01/27/11)	$14.75
Six- Month Target Price	**$15.50**

OUTLOOK

We are maintaining our Neutral rating on Chesapeake Financial Shares, Inc. (CPKF). CPKF reported 2010 fourth quarter diluted EPS of $0.38, down 17% from $0.45 posted in the year-ago quarter, and compares to our estimate of $0.49. We believe this was a creditable performance, given the difficult economic environment. There were several variances from our estimate. The loan loss provision was $0.9 million, higher than our $0.6 million estimate, and other expenses were $2.5 million versus our estimate of $1.8 million, primarily the result of one-time write-downs of other real estate owned. This was partially offset by a $0.1 million income tax credit compared to our estimate of $0.5 million in income taxes, as CPKF reversed prior income tax overaccruals. Net interest income was flat year over year at $5.5 million, and noninterest income rose 8% to $3.7 million. This was due to a 25% jump in merchant card income to $1.1 million on higher processing volumes and a 54% decline in securities losses to $0.1 million, which were partially offset by a 20% slide in services charges on deposit accounts, hurt by changes in federal regulations, and a 16% drop in cash flow income, the result of reduced lending volumes. The loan loss provision more than doubled to $0.9 million from $0.4 million a year ago, as CPKF continued to strengthen loan loss reserves, which grew to $6.1 million (1.69% of loans) from $5.2 million at yearend 2009 (1.41% of loans). Notably, CPKF just raised its quarterly dividend by 4.5% to $0.115 from $0.11. We are currently reviewing our estimates and will issue a more comprehensive report when detailed financial information becomes available.

SUMMARY DATA

52-Week High	**$14.75**
52-Week Low	**$12.50**
One-Year Return (%)	**10.26**
Beta	**0.11**
Average Daily Volume (sh)	**233**
Shares Outstanding (mil)	**3**
Market Capitalization ($mil)	**$40**
Short Interest Ratio (days)	**N/A**
Institutional Ownership (%)	**0**
Insider Ownership (%)	**40**
Annual Cash Dividend	**$0.46**
Dividend Yield (%)	**3.12**
5-Yr. Historical Growth Rates	
Net Revenue (%)	**8.6**
Earnings Per Share (%)	**10.9**
Dividend (%)	**7.6**
P/E using TTM EPS	**7.3**
P/E using 2010 Estimate	**7.3**
P/E using 2011 Estimate	**6.6**
Zacks Rank	**3**

Risk Level	**Average**
Type of Stock	**Small-Value**
Industry	**Banks-Southeast**
Zacks Rank in Industry	**51 of 86**

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					37.1 E*

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

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2008	0.34 A	0.49 A	0.38 A	0.39 A	1.60 A
2009	0.33 A	0.41 A	0.53 A	0.45 A	1.77 A
2010	0.42 A	0.48 A	0.71 A	0.38 A	2.03 A
2011					2.25 E*

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

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FOURTH QUARTER RESULTS

CPKF reported 2010 fourth quarter net earnings of $1.0 million, down 20% from the $1.3 million reported in the year-ago quarter, while diluted EPS decreased 17% to $0.38 from $0.45, with the better EPS performance reflecting share buybacks. This compares to our fourth quarter estimate of $0.49.

There were a number of variances from our estimate. On the negative side, the loan loss provision was $0.9 million, higher than our estimate of $0.6 million, and other expenses were $2.5 million versus our estimate of $1.8 million, primarily the result of one-time write-downs of other real estate owned. This was partially offset by a $0.1 million income tax credit compared to our estimate of $0.5 million in income taxes, as CPKF reversed previous income tax overaccruals in the prior three quarters.

Net interest income was flat year over year at $5.5 million, and noninterest income rose 8% to $3.7 million. This was due to a 25% jump in merchant card income to $1.1 million on higher processing volumes and a 54% decline in securities losses to $0.1 million, which were partially offset by a 20% slide in services charges on deposit accounts, hurt by changes in federal regulations, and a 16% drop in cash flow income, the result of reduced lending volumes.

Noninterest expense rose 3% year over year, largely due to a significant increase in other expenses that were partly offset by declines in other line items. The efficiency ratio was flat at 80%.

The loan loss provision more than doubled to $0.9 million from $0.4 million in the fourth quarter of last year, as the Company continued to strenthen loan loss reserves. CPKF increased its loan loss reserves to $6.1 million (1.69% of loans) from $5.6 million (1.54% of loans) at the end of 2010's third quarter and $5.2 million at yearend 2009 (1.41% of loans).

As to other asset quality measures, CPKF charged off $0.4 million of loans in the fourth quarter, resulting in a 0.45% charge-off ratio for the loan portfolio. This compares to net charge-offs of $0.4 million for full-year 2009 and $0.1 million for all of 2008. Gross loans outstanding dropped about $4 million, or 1%, sequentially to $362 million and $3 million from the end of 2009, reflecting continued weak loan demand.

CPKF posted a 9.7% ROE and 0.67% ROA for the fourth quarter of 2010, compared to 14.2% and 0.87%, respectively, in the prior-year quarter.

Notably, CPKF just raised its quarterly dividend by 4.5% to $0.115 from $0.11, payable on March 15, 2011 to shareholders of record on March 1, 2011. This means CPKF is on track to increase its annual dividend payment every year since 1992.

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 $608 million in total assets at December 31, 2010. 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 $302 million in assets 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.

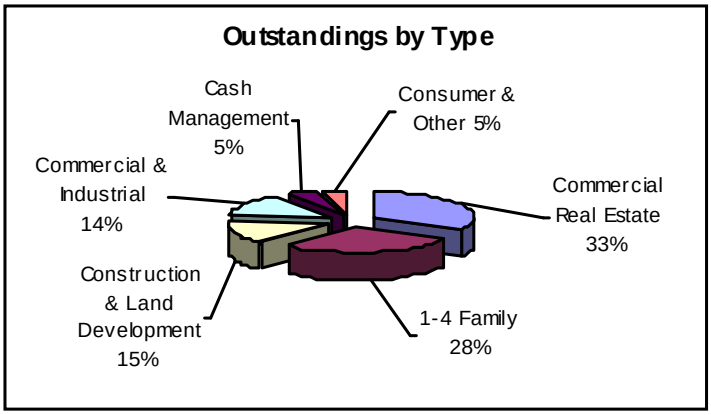
Chesapeake Payment Systems offers merchant processing services such as credit card and debit card processing, electronic benefits transfers, and loyalty and gift card processing to companies involved in travel, entertainment, restaurant, hospitality, retail, mail order, and e-commerce. At yearend 2010, 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.

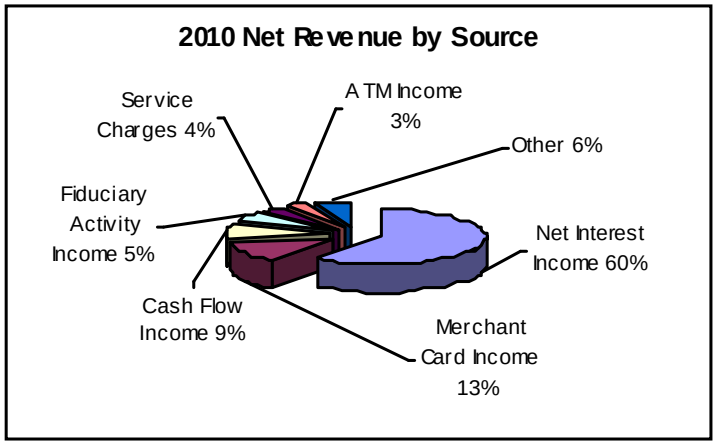
Clear Sky accounts, which offer internet-based retail deposit services for checking and saving accounts and certificates of deposit (CDs), expands CPKF's retail deposit base geographically. At 2010 yearend, Clear Sky deposits totalled $50 million, with customers in all 50 states.

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 at the left. 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 management (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 60% of net revenue, with a significant 40% coming from noninterest income sources. Major contributors to noninterest income include merchant card income (13% of net revenues), cash flow income

(9%), income from fiduciary activities (5%), service charges on deposit accounts (4%), and ATM income (3%).

VALUATION

CPKF stock has outperformed the industry, with a year-to-date price gain of 9.3% compared to a median increase of 3.3% for banks in the Zacks small-cap index, as shown in the following table. At its current price, CPKF is trading at a discount to the industry median P/E of 54% in 2011, based upon our CPKF EPS estimate. This is far in excess of the average 36% P/E discount for CPKF, based upon 5-year historical P/E averages.

Turning to Price/Tangible Book Value, which is the valuation favored by most investors at present, CPKF is valued at 0.95X versus the industry median of 0.73X. This represents a 31% premium versus an average historical premium of 18% for CPKF since the end of 2005. We believe this excess premium is justified given CPKF's strong performance throughout the financial crisis, as well as our expectations for continued growth in EPS in 2011, its strong profitability measures, and its solid dividend yield.

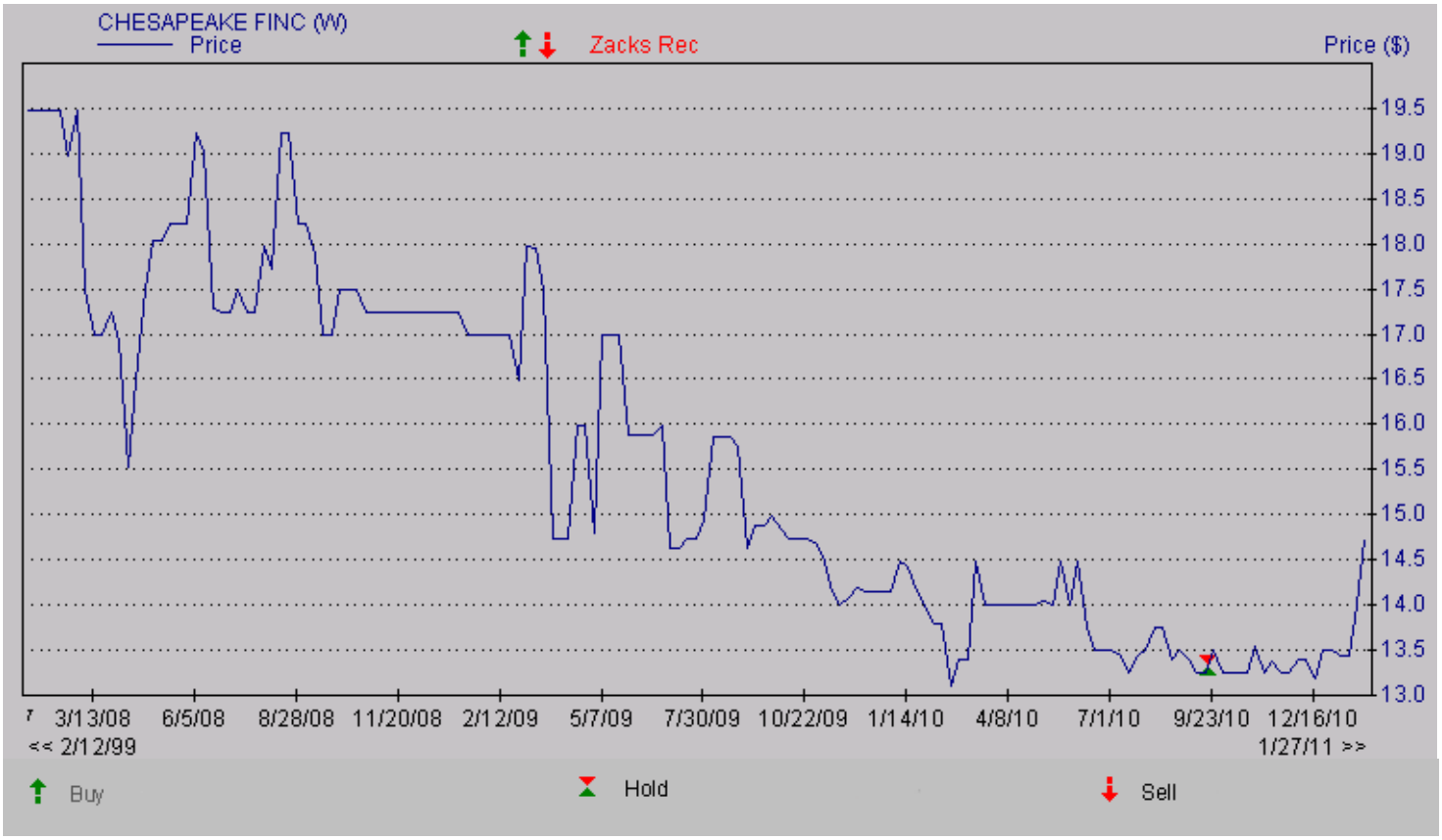
Applying the 0.95X ratio to our estimated book value for CPKF six months out results in a price target of approximately $15.50. Combined with the dividend yield, this represents a total return of about 6%, roughly in line with our expectations for broader U.S. equity market gains during this period. Therefore, we recommend a Neutral on CPKF shares.

Industry Comparables- Small-cap Banks

		Price / Earnings Ratios					Return on Equity		Return on Assets		
	Pr Chg YTD	TTM* EPS	2011E	2012E	5-Yr Avg	Price/ Book	TTM*	5-Yr Avg	TTM*	5-Yr Avg	Div Yld
Chesapeake Finc'l	**9.3**	**7.1**	**6.6**		**10.0**	**1.0**	**14.9**	**13.9**	**0.95**	**0.91**	**3.0**
S&P 500	3.3	22.9	14.0	13.2	18.4	3.6	21.9	-----	8.8	-----	1.9
Median	**2.9**	**15.8**	**14.5**	**12.8**	**15.6**	**0.7260**	**3.5**	**4.8**	**0.24**	**0.40**	**-----**
Average	5.8	19.5	19.0	13.8	19.2	0.7	(8.0)	2.4	(0.12)	0.39	1.3
High	51.3	44.4	88.8	32.5	44.7	1.6	15.2	16.1	2.03	2.61	7.1
Low	(12.1)	6.5	6.7	6.0	10.3	0.1	(226.9)	(27.4)	(5.13)	(1.53)	-----

*Trailing twelve months

HISTORICAL ZACKS RECOMMENDATIONS



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