Zacks Small-Cap Research

November 7, 2013
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Chesapeake Financial Shares, Inc. (CPKF - OTC)

CPKF: Third Quarter EPS Declines from Record EPS a Year Ago

Current Recommendation	**Outperform**
Prior Recommendation	Neutral
Date of Last Change	05/26/2011
Current Price (11/06/13)	$18.00
Twelve-Month Target Price	**$24.50**

OUTLOOK

CPKF's third quarter net earnings fell 38% to $1.5 million, while 2013's third quarter diluted EPS slumped 39% to $0.45 from the record $0.74 posted in 2012's third quarter. Admittedly, this was a bit disappointing to us, though we had never expected this year's third quarter to top last year's when CPKF achieved record earnings. In fact, CPKF's third quarter diluted EPS of $0.45 was $0.20, or 31%, below our $0.65 estimate, largely due to higher-than-expected expenses. There were some positives in the quarter. The Company reported $2 million of sequential loan growth, a provision for credit losses that was $50,000 below our $150,000 estimate, net interest income that was $0.1 million better than the $5.7 million we had projected, and growth in merchant card and cash flow income that each came in $0.1 million-plus higher than we had expected. Still, this was more than offset by noninterest expense that was $0.7 million higher than we had anticipated. Furthermore, combined losses from the sales of securities and OREO were $0.4 million worse than our estimate. On the positive side, CPKF recently hiked its quarterly dividend by 13% to $0.135 per share from $0.12 per share, which follows two dividend increases totalling 20% in 2012. Notably, CPKF has increased the annual dividend payment every year for the past twenty-two years since 1991. In December, CPKF completed a tender offer to repurchase $1.5 million of company stock (about 2% of outstanding shares) at $18.50 per share. We note that American Banker ranked CPKF 17th out of all banks nationally with less than $2 billion in total assets, which includes roughly 6,000 banks, and #2 of all banks in Virginia.

SUMMARY DATA

52-Week High	**$19.97**
52-Week Low	**$16.76**
One-Year Return (%)	**2.72**
Beta	**0.05**
Average Daily Volume (sh)	**1,408**
Shares Outstanding (mil)	**3**
Market Capitalization ($mil)	**$59**
Short Interest Ratio (days)	**N/A**
Institutional Ownership (%)	**0**
Insider Ownership (%)	**40**
Annual Cash Dividend	**$0.54**
Dividend Yield (%)	**3.00**
5-Yr. Historical Growth Rates	
Net Revenue (%)	**9.6**
Earnings Per Share (%)	**13.3**
Dividend (%)	**9.1**
P/E using TTM EPS	**8.9**
P/E using 2013 Estimate	**7.6**
P/E using 2014 Estimate	**7.1**
Zacks Rank	**4**

Risk Level	**Average**
Type of Stock	**Small-Value**
Industry	**Banks-Southeast**
Zacks Rank in Industry	**55 of 64**

ZACKS ESTIMATES

Net Revenue
(in millions of $)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2011	8.8 A	9.4 A	9.2 A	9.1 A	36.5 A
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 E	39.1 E
2014					39.7 E

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

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2011	0.47 A	0.63 A	0.56 A	0.49 A	2.16 A
2012	0.57 A	0.62 A	0.74 A	0.39 A	2.32 A
2013	0.63 A	0.55 A	0.45 A	0.54 E	2.36 E
2014					2.52 E

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

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THIRD QUARTER

CPKF's third quarter net earnings fell 38% to $1.5 million, while 2013's third quarter diluted EPS slumped 39% to $0.45 from the record $0.74 posted in 2012's third quarter. Admittedly, this was a bit disappointing to us, though we had never expected this year's third quarter to top last year's when the Company achieved record net earnings and EPS.

In fact, CPKF's third quarter diluted EPS of $0.45 was $0.20, or 31%, below our $0.65 estimate, largely due to higher-than-expected expenses. There were some positives in the quarter. The Company reported $2 million of sequential loan growth, a provision for credit losses that was $50,000 below our $150,000 estimate, net interest income that was $0.1 million better than the $5.7 million we had projected, and growth in merchant card and cash flow income that each came in $0.1 million-plus higher than we had expected.

Still, this was more than offset by noninterest expense that was $0.7 million worse than we had anticipated. Specifically, total compensation expense was $0.1 million larger than our estimate, while cash flow, ATM, and other expense were each $0.2 million more than we had expected. Furthermore, combined losses from the sales of securities and OREO were $0.4 million worse than our estimate

Relative to the year-ago quarter, net income tumbled $1.0 million, or 38%, from last year's's $2.5 million and diluted EPS slid $0.29, or 39%, from the $0.74 posted in the third quarter of 2012.

The primary reasons for the third quarter's decline versus the prior-year quarter were: (1) a $0.4 million negative swing in the combined gain/loss from the sales of securities and OREO to a loss of $0.5 million from a loss of $0.1 million; (2) a $0.2 million, or 26%, decrease in income from fiduciary activities to $0.5 million; (3) a $0.3 million, or 10%, increase in compensation expense to $3.8 million; and (4) a $0.5 million, or 16%, rise other noninterest expense to $3.8 million due to growth in merchant card, cash flow, and other expenses. This was partly offset by: (1) a $0.1 million, or 2%, climb in net interest income to $5.8 million; (2) a $50,000 drop in the loan loss provision to $100,000 from $150,000; and (3) income taxes that dipped $0.3 million to $0.4 million due to lower taxable income.

Compared to our projections, net income was $0.6 million, or $0.20 per diluted share, below our $2.1 million, or $0.65 per share, estimate, respectively. This primarily reflected combined gains from the sales of securities and OREO that were $0.4 million worse than our estimate and total noninterest expense that was $0.7 million higher than we had expected partially offset line items that came in better than our projections, including net interest income ($0.1 million), total noninterest income ($0.2 million), the loan loss provision ($50,000) and income taxes ($0.2 million).

Net interest income grew 2% year over year to $5.8 million ($0.1 million above our estimate), as slight growth in average interest-earning assets combined with a net interest margin that we estimate was higher than the 4.50% earned in the year-ago quarter.

Noninterest income slid $0.5 million, or 12%, year over year to $3.9 million ($0.3 million below our projection), primarily the result of a loss on the sale of securities of $0.5 million ($0.4 million greater than our estimate) and a $0.2 million ($0.2 million below our estimate) dip in income from fiduciary activities to $0.5 million.

Total noninterest expense increased $0.9 million, or about 13%, year over year to $7.7 million ($0.7 million higher than our estimate), largely due to a $0.3 million, or 10%, increase in compensation expense to $3.8 million and a $0.5 million, or 16%, rise in other noninterest expense to $3.8 million due to growth in merchant card, cash flow, and other expenses.

The loan loss provision decreased 33% to $0.1 million (below our $0.15 million estimate). Loan loss reserves fell $0.1 million from $6.2 million (1.66% of loans) at the end of the second quarter to $6.1

million (1.62% of loans) at September 30, 2013, and were below the $6.3 million (1.73% of loans) in the year-ago quarter.

As to other asset quality measures, CPKF charged off $225,000 of loans in the third quarter. This is $118,000 less than the $343,000 charged off in the year-ago quarter and compares to net charge-offs of $235,000 in 2013's second quarter and $709,000 for full-year 2012. CEO Jeff Szyperski noted that nonperforming assets increased to 3.49% of total assets at the end of the third quarter driven by several commercial lending relationships, but that no losses are expected as a result.

Gross loans outstanding increased $11 million, or about 5%, year over year and $2 million, or 1%, sequentially to $378 million.

CPKF posted an 9.9% ROE and 0.93% ROA for the third quarter of 2013, compared to 16.6% and 1.55%, respectively, in the prior-year quarter.

On July 19, 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-two years since 1991.

On October 29, 2012, CPKF announced a tender offer to repurchase up to $1.5 million of company stock at a price of $18.50 per share for shareholders of record (a 12% premium to the $16.50 share price at that time) as of October 25, 2012, with shares tendered by the close of business on December 10, 2012. As the entire $1.5 million was repurchased, this reduced shares outstanding by 2% and increased annual diluted EPS by a penny.

We note that American Banker recently ranked CPKF 17th (down one notch from 16th a year ago) out of all banks nationally with less than $2 billion in total assets, which includes approximately 6,000 banks, and #2 of all banks in Virginia. This ranking was based upon three-year average returns on equity, which for Chesapeake Financial was 14.10%. The Company has steadily risen through the rankings in the past five 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 financial holding company headquartered in Kilmarnock, Virginia, with $659 million in total assets at September 30, 2013. 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. CPKF, which began as Lancaster National Bank on April 13, 1900, has a long history and strong ties with the communities it serves. In addition, CPKF opened a commercial loan production office in Richmond, Virginia in mid-August 2011.

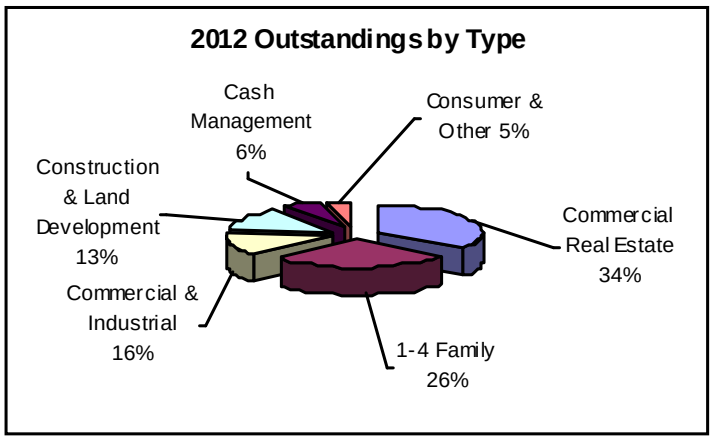
Operations are carried on through Chesapeake Bank, a state-chartered bank as well as Federal Reserve and FDIC member bank, and Chesapeake Investment Group, Inc. (CIG), an independent wealth management firm that manages about $330 million in assets (at 2012 yearend) through its subsidiaries involved in 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 2012, Chesapeake Payment Systems had 607 merchants in its system and processed over $133 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 76 customers at the end of 2012.

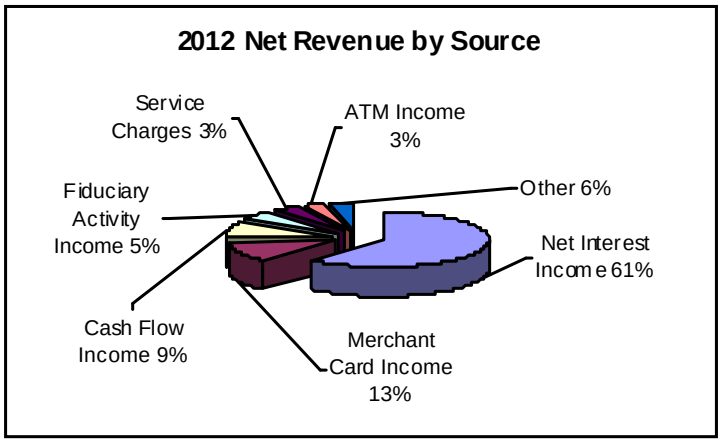
Clear Sky accounts, which offer internet-based retail deposit services for checking and saving accounts and certificates of deposit (CDs), expands CPKF's retail deposit base geographically. At December 31, 2012, Clear Sky deposits totalled $44 million, with customers in all 50 states.

Through Chesapeake's secondary market mortgage banking operation, the Company services a $207 million loan portfolio (as of December 31, 2012) of residential mortgage loans for Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac), for which it earns a 25 basis-point fee (approximately $520,000 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 $952,000 to revenues in 2012 (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, 2012, the lending book consisted of commercial real estate (accounting for 34% of total gross outstandings), 1-4 family (26%), commercial and industrial (16%), construction and land development (13%), cash flow (6%), 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, 2012, 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 21% of the securities portfolio. In addition, the available-for-sale portfolio includes municipal and private label mortgage securities, which accounted for 64% and 15%, respectively, of the total. Core deposits represented 81% of total deposits at December 31, 2012, with certificates of deposit larger than $100,000 at 19%.



In 2012, 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 (13% 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 has risen 7.1% year to date, below the small-cap bank industry's median price increase of 29.1%, as shown in the following table, as well as the 24.1% gain for the S&P 500. We note that CPKF's share price surged 49.3% last year in 2012 compared to a 13.4% increase for the S&P 500.

At its current price, CPKF is trading at a discount to the industry median P/E of 48% in 2014, based upon our most recent CPKF EPS estimate for 2014. This is below the average 55% P/E discount for CPKF, based upon 5-year historical P/E averages. Applying the historical discount of 55% to our 2014 EPS estimate results in a price of about $15.50.

Turning to Price/Tangible Book Value, CPKF is valued at 0.98X versus the industry median of 1.15X. This represents a 15% discount, well below the average historical premium of 19% for CPKF since the end of 2005. Applying the historical premium of 19% to our estimated book value for CPKF twelve months out results in a price of approximately $25.00.

At a minimum, we believe that CPKF should be trading in line with the industry's 1.15X Price/Tangible Book Value, given CPKF's strong performance throughout the financial crisis, its superior profitability measures, and its above-average yield on the dividend, which was just increased 13%. Applying this metric to our estimated book value for CPKF twelve months out results in a price of roughly $24.50.

With $24.50 as our target price (versus CPKF's $18.00 current market price) and a 3.0% dividend yield, this indicates a total return of 39%, 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

		Price / Earnings Ratios					Return on Equity		Return on Assets		
	Pr Chg YTD	TTM* EPS	2013E	2014E	5-Yr Avg	Price/ Book	TTM*	5-Yr Avg	TTM*	5-Yr Avg	Div Yld
Chesapeake Finc'l	**7.1**	**8.9**	**7.6**	**7.1**	**7.4**	**0.98**	**13.8**	**14.3**	**1.30**	**1.01**	**3.0**
S&P 500	24.1	18.0	16.3	15.2	16.6	4.9	27.0	-----	8.6	-----	2.0
Median	**29.1**	**12.7**	**13.6**	**13.6**	**16.4**	**1.15**	**8.7**	**4.3**	**0.89**	**0.41**	**1.1**
Average	34.8	17.8	14.2	14.6	24.6	1.1	9.1	2.0	0.9	0.3	1.2
High	103.9	154.5	27.1	31.6	100.5	1.8	33.6	14.3	3.9	2.0	4.4
Low	(19.3)	4.6	4.7	7.1	6.4	0.6	(3.2)	(77.0)	(0.4)	(2.3)	-----

*Trailing twelve months

Chesapeake Financial Shares, Inc.

Income Statement and Balance Sheet

(Dollars in millions, except per share data)

Summary Financial Data	12/08	12/09	12/10	12/11	12/12	12/13E	12/14E
Net interest income	16.5	18.9	21.8	22.8	23.1	23.1	23.7
Non-interest income	15.0	14.1	13.8	13.7	15.0	16.0	16.0
Total net revenue	31.5	33.0	35.6	36.5	38.1	39.1	39.7
Loan loss provision	0.4	0.9	2.5	1.2	0.6	1.1	0.6
Non-interest expense	25.0	25.9	26.2	26.4	27.8	28.0	28.3
Income taxes & other	1.5	1.4	1.5	1.9	2.0	2.1	2.4
Zacks adjusted income before NRI	4.6	4.8	5.4	7.0	7.7	7.9	8.4
GAAP net income	4.6	4.8	5.4	7.0	7.7	8.6	8.4
Diluted EPS before NRI	1.34	1.48	1.69	2.16	2.32	2.36	2.52
Reported EPS	1.34	1.48	1.69	2.16	2.32	2.58	2.52
Dividends per share	0.34	0.35	0.36	0.40	0.45	0.51	0.54
Liquid assets	45.4	57.8	73.2	97.9	92.1	60.0	60.9
Outstandings, gross	396.2	391.3	382.3	373.1	397.6	407.7	424.3
Total assets	538.0	586.7	607.7	638.0	667.7	648.1	674.4
Core deposits	317.0	370.0	396.2	430.4	459.0	459.5	478.2
Purchased funds	121.9	131.3	127.2	113.3	118.4	96.7	98.3
Long-term debt	65.5	47.4	40.0	39.6	26.0	25.0	25.0
Shareholders' equity	30.6	35.3	41.1	51.2	60.9	63.7	70.3
Profitability							
Return on avg assets	0.89%	0.84%	0.90%	1.13%	1.19%	1.21%	1.27%
Return on avg equity	13.51%	13.14%	13.55%	15.31%	14.87%	12.71%	12.53%
Net interest margin	4.00%	4.10%	4.40%	4.70%	4.60%	4.50%	4.45%
Loan loss provision % avg assets	0.08%	0.16%	0.41%	0.19%	0.09%	0.16%	0.09%
Noninterest income % avg assets	2.91%	2.45%	2.30%	2.21%	2.33%	2.48%	2.41%
Noninterest expense % avg assets	4.84%	4.51%	4.34%	4.27%	4.32%	4.33%	4.28%
Preprovision pretax income % avg assets	1.26%	1.24%	1.57%	1.62%	1.60%	1.71%	1.72%
Tangible efficiency ratio	80%	77%	73%	71%	71%	71%	71%
Payout ratio	25%	24%	21%	18%	19%	20%	21%
Asset Quality							
Net charge-offs % avg outstandings	0.27%	0.34%	0.48%	0.22%	0.18%	0.29%	0.16%
Allowance % outstandings	1.43%	1.59%	1.90%	2.01%	1.88%	1.83%	1.81%
NPAs % loans + OREO	0.35%	1.20%	3.91%	4.48%	4.93%	3.45%	3.01%
Allowance % NPAs	411%	131%	48%	44%	32%	53%	59%
Liquidity & Funding							
Liquid assets % purchased funds	37%	44%	58%	86%	78%	62%	62%
Core deposits % outstandings	80%	95%	104%	115%	115%	113%	113%
Liquid assets % assets	8%	10%	12%	15%	14%	9%	9%
Outstandings % assets	74%	67%	63%	58%	60%	63%	63%
Capital Adequacy							
Total equity % assets	5.68%	6.01%	6.76%	8.03%	9.12%	9.83%	10.42%
Tangible equity % assets	5.68%	6.01%	6.76%	8.03%	9.12%	9.83%	10.42%
Tier 1 capital ratio	10.60%	10.10%	12.07%	12.20%	13.55%		
Total capital ratio	12.50%	11.70%	13.54%	13.40%	14.80%		
Parent Company Statistics							
Interest coverage	0.6X	0.8X	2.6X	2.1X	4.4X	2.0X	2.0X
Interest & dividend coverage	0.3X	0.4X	1.1X	0.9X	1.5X	0.7X	0.7X
Short-term debt coverage	Lge	Lge	Lge	Lge	Lge	Lge	Lge
Total debt coverage	0.9X	0.8X	0.8X	0.8X	0.9X	1.5X	1.9X
Double leverage	139.8%	142.1%	134.7%	127.2%	121.7%	129.9%	129.6%

Chesapeake Financial Shares, Inc.

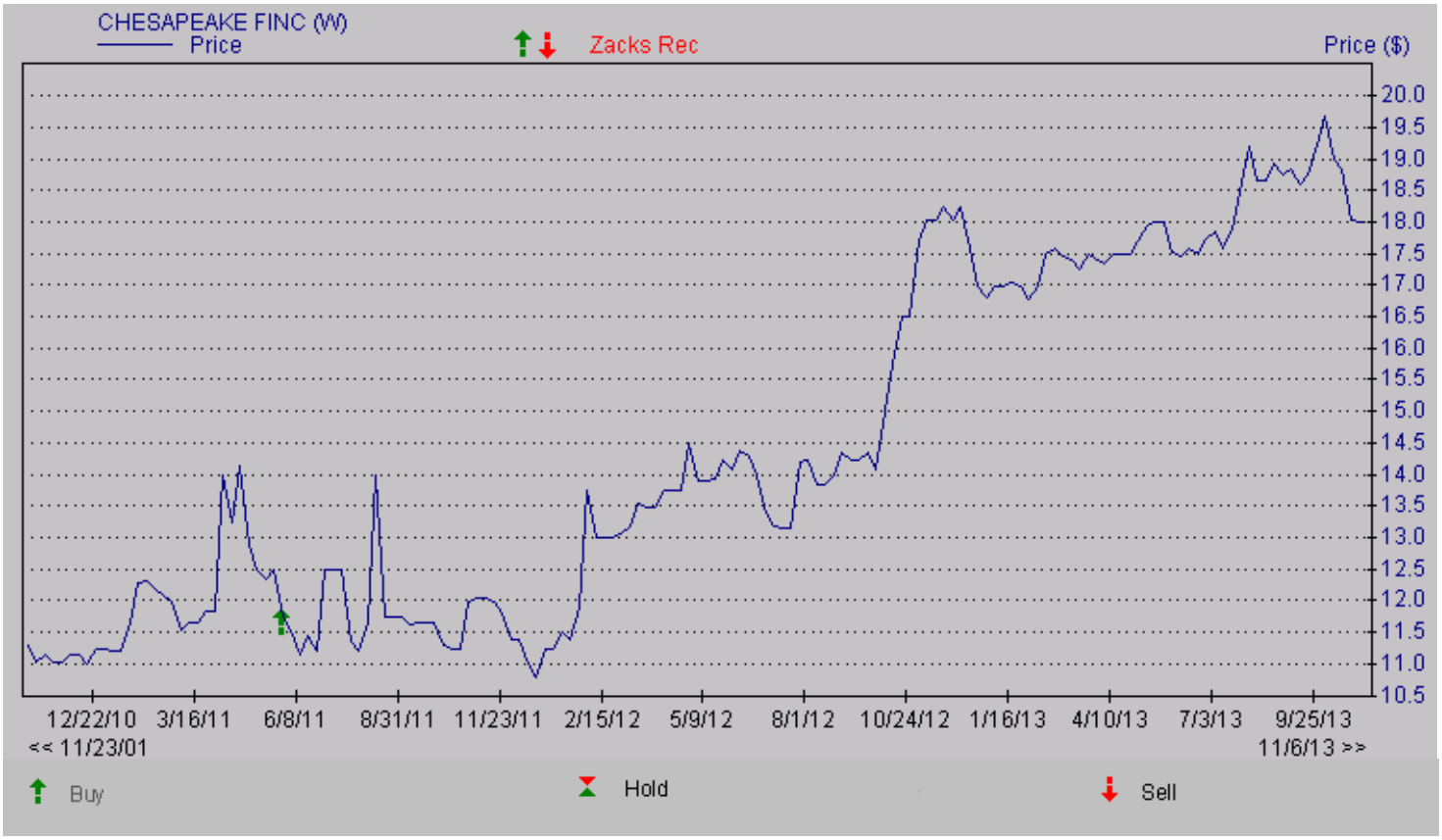
Income Statement and Balance Sheet

(Dollars in millions, except per share data)

	2012				2013			
Summary Financial Data	**Q1 A**	**Q2 A**	**Q3 A**	**Q4 A**	**Q1 A**	**Q2 A**	**Q3 P**	**Q4 E**
Net interest income	5.9	5.7	5.7	5.7	5.8	5.8	5.8	5.8
Non-interest income	3.1	3.7	4.4	3.9	3.8	4.2	3.9	3.9
Total net revenue	9.0	9.4	10.1	9.6	9.6	10.0	9.7	9.7
Loan loss provision	0.2	0.2	0.2	0.2	0.1	0.7	0.1	0.2
Non-interest expense	6.4	6.6	6.8	7.9	6.8	7.1	7.7	7.2
Income taxes & other	0.6	0.5	0.6	0.2	0.6	0.4	0.4	0.5
Zacks adjusted income before NRI	1.8	2.1	2.5	1.3	2.1	1.8	1.5	1.8
GAAP net income	1.8	2.1	2.5	1.3	2.1	2.5	1.5	1.8
Diluted EPS before NRI	0.57	0.62	0.74	0.39	0.64	0.55	0.45	0.54
Reported EPS	0.57	0.62	0.74	0.39	0.64	0.76	0.45	0.54
Dividends per share	0.11	0.11	0.11	0.12	0.12	0.12	0.14	0.14
Liquid assets	99.0	85.3	74.5	92.1	67.0	58.8	78.3	60.0
Outstandings, gross	372.3	379.5	386.9	397.6	395.7	404.5	406.8	407.7
Total assets	640.7	635.4	633.9	667.7	643.5	643.0	658.6	648.1
Core deposits	432.9	424.9	422.5	459.0	453.8	455.9	470.9	459.5
Purchased funds	122.9	122.5	119.9	118.4	98.2	96.0	96.0	96.7
Long-term debt	27.1	26.9	26.8	26.0	26.5	26.4	26.2	25.0
Shareholders' equity	55.0	57.4	60.8	60.9	61.9	60.7	61.4	63.7
Profitability								
Return on avg assets*	1.15%	1.29%	1.55%	0.81%	1.29%	1.13%	0.93%	1.10%
Return on avg equity *	13.88%	14.61%	16.63%	8.70%	13.72%	11.86%	9.91%	11.31%
Net interest margin*	4.67%	4.53%	4.50%	4.49%	4.54%	4.56%		4.45%
Loan loss provision % avg assets*	0.09%	0.09%	0.09%	0.09%	0.06%	0.40%	0.06%	0.09%
Noninterest income % avg assets*	1.93%	2.28%	2.75%	2.37%	2.33%	2.63%	2.37%	2.41%
Noninterest expense % avg assets*	4.02%	4.13%	4.28%	4.85%	4.16%	4.41%	4.71%	4.48%
Preprovision pretax inc.% avg assets*	1.57%	1.74%	2.09%	1.04%	1.71%	1.82%	1.25%	1.51%
Tangible efficiency ratio	69%	69%	67%	80%	70%	71%	75%	74%
Payout ratio	19%	18%	15%	30%	19%	16%	30%	25%
Asset Quality								
Net charge-offs % avg outstandings*	0.08%	0.17%	0.35%	0.14%	0.64%	0.23%		0.15%
Allowance % outstandings	2.04%	2.00%	1.92%	1.88%	1.77%	1.81%		1.83%
NPAs % loans + OREO	4.20%	4.11%	4.39%	4.93%	5.25%	3.66%		3.45%
Allowance % NPAs	48%	48%	43%	32%	28%	49%		53%
Liquidity & Funding								
Liquid assets % purchased funds	81%	70%	62%	78%	68%	61%	82%	62%
Core deposits % outstandings	116%	112%	109%	115%	115%	113%	116%	113%
Liquid assets % assets	15%	13%	12%	14%	10%	9%	12%	9%
Outstandings % assets	58%	60%	61%	60%	61%	63%	62%	63%
Capital Adequacy								
Total equity % assets	8.58%	9.03%	9.59%	9.12%	9.63%	9.43%	9.32%	9.83%
Tangible equity % assets	8.58%	9.03%	9.59%	9.12%	9.63%	9.43%	9.32%	9.83%
Tier 1 capital ratio	13.20%	13.38%	13.81%	13.55%	13.70%	13.74%		
Total capital ratio	14.45%	14.63%	15.06%	14.80%	14.94%	14.99%		

*Annualized.

HISTORICAL ZACKS RECOMMENDATIONS



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