Zacks Equity Research

October 7, 2010
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Chesapeake Financial Shares, Inc. (CPKF - OTC)

CPKF: Initiating Coverage – Neutral

Current Recommendation	**Neutral**
Prior Recommendation	N/A
Date of Last Change	09/21/2010
Current Price (10/06/10)	$13.25
Six- Month Target Price	**$14.00**

OUTLOOK

We are initiating coverage on Chesapeake Financial Shares, Inc. (CPKF) with a Neutral rating. CPKF has done an exceptional job navigating the treacherous financial landscape that has characterized the past few years, with EPS growing throughout this period. While asset quality has weakened this year, it still remains satisfactory. The balance sheet continues strong. Going forward, we estimate that diluted EPS will increase 3% to $1.82 in 2010 and an additional 5% to $1.92 in 2011. Turning to valuation, CPKF is valued at 0.9X versus the industry median of 0.6X, based upon price/tangible book value. This represents a 67% premium versus an average historical premium of about 19% for CPKF since the end of 2005. We believe this premium is justified given CPKF's strong performance throughout the financial crisis, as well as our expectations for continued growth in EPS over 2010-2011, its strong profitability measures, and its solid dividend yield. With these positives already incorporated into the share price, we expect the stock to perform in line with the overall market over the next six months; hence our Neutral rating on CPKF shares.

SUMMARY DATA

52-Week High	**$14.85**
52-Week Low	**$12.50**
One-Year Return (%)	**-6.85**
Beta	**0.09**
Average Daily Volume (sh)	**359**
Shares Outstanding (mil)	**3**
Market Capitalization ($mil)	**$36**
Short Interest Ratio (days)	**N/A**
Institutional Ownership (%)	**0**
Insider Ownership (%)	**40**
Annual Cash Dividend	**$0.44**
Dividend Yield (%)	**3.32**
5-Yr. Historical Growth Rates	
Net Revenue (%)	**8.2**
Earnings Per Share (%)	**8.6**
Dividend (%)	**8.4**
P/E using TTM EPS	**7.0**
P/E using 2010 Estimate	**7.3**
P/E using 2011 Estimate	**6.9**
Zacks Rank	**N/A**

Risk Level	**Average**
Type of Stock	**Small-Value**
Industry	**Banks-Southeast**
Zacks Rank in Industry	**N/A**

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	9.1 E	9.0 E	34.9 E
2011					36.0 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	0.59 E	0.33 E	1.82 E
2011					1.92 E

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

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OVERVIEW

Chesapeake Financial Shares, Inc. (CPKF or the Company) is a bank holding company headquartered in Kilmarnock, Virginia, with $604 million in total assets at June 30, 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 $285 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.

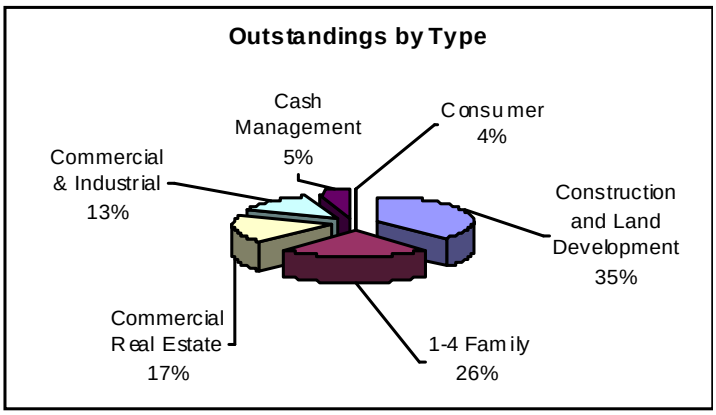
Chesapeake Payment Systems offers merchant processing services such as credit card and debit card processing, electronic benefits transfers, and loyalty and gift card processing to companies involved in travel, entertainment, restaurant, hospitality, retail, mail order, and e-commerce. At yearend 2009, Chesapeake Payment Systems had over 700 merchants in its system and processed over $115 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.

Through Chesapeake's secondary market mortgage banking operation, the Company services a $155 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 $375,000 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 $620,000 to revenues in 2009 (both types of fees are included in other noninterest income in the Company's financial statements).

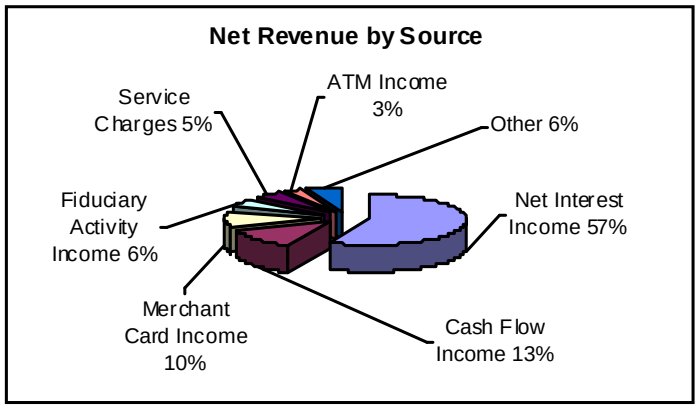
The lending portfolio is dominated by real estate loans, as shown in the chart at the left. At June 30, 2010, the lending book consisted of construction and land development (accounting for 35% of total gross outstandings), 1-4 family (26%), commercial real estate (17%), commercial and industrial (13%), cash management (5%), and consumer (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, resale agreements, trading account assets, US Treasuries, and US agency mortgage obligations, has declined on a relative basis, and is now about 12% of total assets. This was due to CPKF's shift in the available-for-sale securities portfolio into higher yielding municipal and private label mortgage securities, which currently account for approximately 11% and 7% of total assets, respectively

(versus 7% and 0%, respectively, in 2005). Core deposits represented 77% of total deposits at June 30, 2010, with certificates of deposit larger than $100,000 at 23%.

In 2009, net interest income contributed 57% of net revenue, with a large 43% coming from noninterest income sources. Significant contributors to noninterest income include cash flow income (13% of net revenues), merchant card income (10%), income from fiduciary activities (6%), service charges on deposit accounts (5%) and ATM income (3%).



STRATEGY AND FINANCIAL GOALS

CPKF's strategy in recent years has been focussed on increasing diversification of earnings sources, in addition to emphasizing its core strength in business lending. Some of these new operations have been related to and stem from CPKF's ability to promote a higher level of service to its business customers. For example, Chesapeake Payment Systems, which CPKF started in 1996, leverages the Company's business experience into technology-related merchant payment systems. The Cash Flow program, begun in 1994, grew out of the need to provide additional sources of financing to companies for which credit lines or traditional loans did not make sense.

Others have their roots in long-established operations. Chesapeake Investment Group grew out of the bank's trust operations, and now additionally provides brokerage and asset management services. Clear Sky accounts are a 2009 expansion of the bank's deposit-gathering activities into a solely internet-based retail operation, which CPKF views and runs as an independent branch, and now account for about $50 million of total deposits.

Finally, the Company is involved in various insurance activities through minority ownership positions (usually about 2-3%) in several different businesses, from which it receives a share of commissions. These include: (1) Bankers Insurance, LLC, a full-service, independent insurance agency headquartered in Richmond, Virginia, that provides property and casualty and life and health insurance to both individuals and businesses; (2) Bankers Title, LLC, a full service lender-owned title insurance agency serving the Commonwealth of Virginia; and (3) Provider Trust, which provides trust services for burials and funerals (and has about $77 million of assets under management).

The driving force behind the success of these diversification efforts has been the Company's good strategic planning and its ability to execute these plans effectively. CPKF meets annually to determine short-term goals, as well as long-term strategy. These meetings include senior management and the Board of Directors or middle management (in alternate years) so that a broad range of opinions is factored into determining direction. Not surprisingly, CPKF is not interested in making acquisitions, favoring the de novo start-ups that have characterized its recent history.

Financial goals are reasonable and clear-cut, meaning the Company will not take undue risk to achieve its target ratios, which include: (1) maintaining capital adequacy ratios that are considered well-capitalized at both the bank and bank holding company levels under the FDIC's risk-rating system (the Company's ratios exceed the well-capitalized level by a wide margin); (2) maintaining the dividend payout ratio at 20-25% of net earnings (since 2005, the annual payout ratio has been in the 23-25% range); (3) generating long-term loan and deposit growth of 6-8% annually (compound annual growth since 2005 of

7% in loans and of 9% in deposits); and (4) generating a return on equity of 13% (annual ROE has been over 13% since 2005).

In this regard, it should be noted that Chesapeake Financial has recently been ranked as one of the most profitable banks in the US among smaller banks. According to US Banker, CPKF ranked 32nd out of all banks with less than $2 billion in total assets, which includes approximately 6,000 banks. This ranking was based upon three-year average returns on equity, which for Chesapeake Financial was 13.44% through mid-year 2010. The Company has steadily risen though the rankings in the past three years, reflecting its solid financial performance during this period of global financial markets distress.

LOANS AND ASSET QUALITY

CPKF's loan portfolio has a concentration in construction and land development, accounting for 35% of gross outstandings at June 30, 2010, as shown in the table below. (In 2010, about $80 million of loans, or one-fifth of Companywide outstandings, were reclassified to construction and land development loans from commercial and industrial loans. This may mean that data from years prior to 2010 are not strictly comparable.) The bank is currently in compliance with FDIC guidelines, which call for greater FDIC scrutiny under certain circumstances, including CRE loans in excess of 300% of capital and construction and land development loans in excess of 100% of capital. Included in the mortgage loan category are approximately $3 ½ million of loan participations, largely purchased from customers involved in CPKF's Cash Flow program. The rest of the loan portfolio includes 1-4 family mortgage loans (25% of gross outstandings), commercial real estate (17%), commercial and industrial (13%), cash management receivables (5%), and consumer (4%).

	Amount (Dollars in Millions)				% of Companywide Outstandings			
Type of Loan	2007	2008	2009	6/30/10	2007	2008	2009	6/30/10
Construction and land development	$71.9	$66.5	$58.2	$136.7	20%	17%	15%	35%
1-4 family	90.3	101.9	99.7	98.2	25	26	26	26
Commercial real estate	96.7	76.1	67.7	65.9	27	19	17	17
Total mortgage loans	258.9	244.5	225.6	300.8	72	62	58	78
Commercial and industrial loans	57.3	101.8	123.0	50.7	16	26	31	13
Consumer loans	16.8	16.8	16.2	15.6	5	4	4	4
Other loans	0.7	0.5	1.0	0.8	0	0	0	0
Total gross loans	333.7	363.6	365.8	367.9	92	92	93	95
Cash management receivables	27.9	32.6	25.5	20.5	8	8	7	5
Companywide gross outstandings	$361.6	$396.2	$391.3	$388.4	100%	100%	100%	100%

As shown in the table above, construction and land development loans have grown from 20% of the lending portfolio at yearend 2007 to 35% at the end of the second quarter in 2010, largely due to the reclassification of loans that occurred in 2010's second quarter (first quarter results were restated to conform to this reclassification). Of total construction and land development loans of $136.7 million at the end of June, about one-fifth are 1-4 family residential construction loans, with the balance representing a wide variety commercial construction projects.

As to 1-4 family mortgage loans, which have been relatively stable at about 25% of gross outstandings, these are about evenly split between home equity lines of credit (48% of the $98.2 million total

outstandings at June 30, 2010) and first mortgages (47%). In addition, CPKF has a small portfolio (5%) of 1-4 family loans that are second mortgages.

Rounding out the mortgage loan category are commercial real estate (CRE) outstandings of $65.4 million at the end of 2010's second quarter, which have fallen from about 27% of gross outstandings to 17% currently, reflecting weakened demand. Positively, all of the CRE loans are secured by owner-occupied properties, which should enhance credit quality performance vis-à-vis loans secured by investor-owned properties.

In total, real estate mortgage loans account for about-three fourths of gross outstandings, a little more than the 72% at the end of 2007. While we have concerns about the commercial real estate market, we note that Virginia's economy is holding up better than the national average. Moreover, the Virginia economy tends to be a bit more stable than many areas of the country, in part due to its close proximity to Washington, D.C. Indeed, the unemployment rate in Virginia is about 7.0% compared to 9.6% nationally, and the markets in which CPKF operate are generally performing in line with the state.

Commercial and industrial loans, which fell to 13% of outstandings at June 30, 2010 from 16% at 2007 yearend, include loans that are secured by inventory, accounts receivable, equipment, machinery, and other corporate assets and may contain a personal guarantee from the owner of the borrowing business.

Cash management receivables, which have declined to about 5% of total outstandings from 8% in 2007 due to weak demand, represent receivables stemming from the Company's Cash Flow program. Under this program, CPKF purchases accounts receivable from client companies for a fixed discount fee. Unlike factoring, CPKF does not primarily rely on the credit quality of the receivables purchased, but has recourse to the client company. Furthermore, CPKF's interface is limited to the client company and does not involve interaction with customers of the client company.

Finally, the Company has a small consumer loan portfolio (accounting 4% of total outstandings), largely consisting of revolving credit plans and other types of consumer installment lending.

The Company employs a thorough loan underwriting and approval process, in addition to following guidelines established by regulatory authorities, such as FNMA/FHLMC restrictions on residential loans and the $8.5-million limit on single-risk concentration limits established by the FDIC. Since loan officers have a relatively low lending authority limit ($100,000 maximum), most loans must be approved by the credit committee. The credit committee includes the chief executive officer, the executive vice president in charge of lending, the senior credit officer, and five commercial loan officers.

Loans and leases are placed on nonaccrual status when a loan is delinquent for 90 days or more or when it is specifically determined to be impaired. A loan is considered impaired when it is probable that collection of contractual payments of principal and interest seem unlikely due to deterioration of the financial condition of the borrower.

As shown in the following table, the level of nonaccrual loans and receivables, as measured in dollar amounts and as a percentage of loans, continues to rise, reflecting prolonged economic weakness in the US and deterioration of the commercial and residential real estate markets. Thus, nonperforming loans and receivables climbed to $8.2 million at the end of the second quarter from $1.1 million at yearend 2007. As a percentage of Companywide outstandings, nonaccrual loans and receivables jumped to 2.11% from 0.30% over the same period.

Nonperforming assets, which include nonaccrual loans and receivables as well as foreclosed and repossessed assets, have more than quintupled, rising from $2.2 million at the end of 2007 to $11.2 million at the June 30, 2010, or from 0.61% of gross outstandings and other real estate owned (OREO) to 2.87% at June 2010 quarterend, largely due to rising nonaccrual loans and receivables. Foreclosed and repossessed assets were $3.0 million at June 30, 2010, up from $1.1 million at yearend 2007. Excluded

from the data are $5.8 million of restructured loans currently in compliance with modified terms, which the Company recorded in 2010's second quarter.

Not surprisingly, the weakest loan categories are primarily concentrated in the real estate markets and include commercial real estate (4.18% nonaccrual loan ratio at June 30, 2010), construction and land development (1.62%), and 1-4 family (1.24%).

Nonaccrual loans hurt the Company in a couple of ways. First, net interest income and the net interest margin are lower than they otherwise would be, as the Company can no longer accrue interest on these loans. Second, nonaccrual loans and leases are indicators of potential future losses in the loan portfolio. As nonaccrual loans rise, the Company must increase loan loss provisions charged against revenues in the income statement, thereby reducing net income and earnings per share.

	Amount (Dollars in Millions)				Nonaccruals % Outstandings			
Nonaccruals by Category	**2007**	**2008**	**2009**	**2Q'10**	**2007**	**2008**	**2009**	**2Q'10**
All mortgage loans	$0.6	$0.1	$1.3	$6.2	0.23%	0.04%	0.55%	2.06%
Commercial and industrial loans	0.2	0.0	0.0	1.9	0.30	-----	-----	N/A
Consumer loans	0.0	0.0	0.0	0.1	0.36	0.18	0.20	0.70
Total nonaccrual loans	0.8	0.1	1.3	N/A	0.25	0.04	0.35	N/A
Cash management receivables	0.3	0.1	1.0	N/A	0.92	0.07	4.03	N/A
Companywide nonaccruals	$1.1	$0.2	$2.3	$8.2	0.30%	0.04%	0.59%	2.11%
Companywide nonperforming assets	$2.2	$1.4	$4.7	$11.2	0.61%	0.35%	1.20%	2.87%

Net charge-offs (gross charge-offs less recoveries) are another important indicator of asset quality. Loans are charged off when management determines that a loan balance is uncollectible. As shown in the table below, net charge-offs as a % of average outstandings are relatively low, especially when compared with other community banks. This reflects the fact that almost all of CPKF's lending portfolio is secured, usually by real estate, inventory, accounts receivable, equipment, machinery, or corporate assets. That said, net charge-offs on the cash management receivables portfolio has increased rather sharply in 2008-2009 to the 3% level, largely due to the worsening financial position of CPKF's client companies.

	Amount (Dollars in Millions)				Net Charge-offs % Avg Outstandings			
Net Charge-offs by Category	**2007**	**2008**	**2009**	**1H'10**	**2007**	**2008**	**2009**	**1H'10**
All mortgage loans	$-----	$(0.1)	$0.2	$0.1	-----	(0.04)%	0.09%	0.07%
Commercial and industrial loans	0.1	(0.0)	0.2	0.0	0.12	(0.04)	0.18	-----
Consumer loans	0.0	0.2	0.0	(0.0)	0.29	1.24	0.27	(0.10)
Total loan net-charge-offs	0.1	0.1	0.4	0.1	0.04	0.02	0.12	0.05%
Cash management receivables	0.0	0.9	0.9	(0.0)	0.10	3.18	2.99	(0.02)
Companywide net charge-offs	$0.1	$1.0	$1.3	$0.1	0.04%	0.27%	0.33%	0.05%

The loan loss allowance, which is a valuation account applied against the loan portfolio on the balance sheet, is established by the Company at a level that it deems sufficient to cover future losses in the loan book. The allowance for loan losses is increased by the provision for loan losses as charged against revenues in the income statement and decreased by net charge-offs. Net charge-offs and loan loss

provisions are cyclical in nature, usually rising in the fourth quarter as the Company completes it yearend review and declining in the first quarter, as shown in the following table.

CPKF uses a number of factors to establish the appropriate level of loan loss allowance, including historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral, and prevailing economic conditions.

The allowance includes two components: allocated and general. For the allocated component, which relates to loans that are classified as impaired, an allowance is established when the discounted cash flows (or collateral value) of the impaired loan are less than the carrying value of the loan. The general component covers nonclassified loans and is based upon historical charge-offs and default rates, derived from CPKF's loss experience by loan type. Other adjustments may be made to the allowance based upon factors that are not reflected in the historical loss or risk rating data.

CPKF has been strengthening the loss allowance over the last few years due to weakening asset quality, as reflected in the higher level of nonperforming assets. Thus, the Companywide loss allowance was 1.73% of outstandings at the end of June 2010 compared to 1.59% at yearend 2009 and 1.43% at December 31, 2008. As can be seen in the table following, the loss allowance for the cash management portfolio is much higher than the allowance for loans. This reflects the higher loss content inherent in the cash management portfolio, as demonstrated by its larger charge-off rates.

As is typical during periods of economic weakness, the loss allowance as measured against nonperforming assets continued to decline, falling to 60% of nonperforming assets at June quarterend from 131% at yearend 2009, and 411% at December 31, 2008, as increases in nonaccrual loans and receivables and OREO outpaced gains in the Companywide loss allowance.

	2008				2009				2010	
Amount ($ in Millions)	**Q1 A**	**Q2 A**	**Q3 A**	**Q4 A**	**Q1 A**	**Q2 A**	**Q3 A**	**Q4 A**	**Q1 A**	**Q2 A**
Beginning loan loss allowance	4.4	4.5	4.5	4.7	4.7	4.8	4.8	5.0	5.2	5.3
Loan loss provision	0.1	0.0	0.2	0.1	0.2	0.1	0.2	0.4	0.2	0.2
Less: Loan net charge-offs	(0.0)	0.0	0.0	0.1	0.1	0.1	0.0	0.2	0.1	(0.0)
Ending loan loss allowance	4.5	4.5	4.7	4.7	4.8	4.8	5.0	5.2	5.3	5.5
					-			-		
Beginning cash management loss allow.	1.1	1.5	1.5	1.7	1.0	1.0	1.1	1.2	1.1	1.1
Cash management provision	0.4	-----	0.3	0.2	0.0	0.1	0.2	0.6	0.1	0.1
Less: cash management net charge-offs	(0.0)	(0.0)	0.1	0.9	-----	-----	0.1	0.7	(0.0)	(0.0)
Ending cash management loss allowance	1.5	1.5	1.7	1.0	1.0	1.1	1.2	1.1	1.1	1.2
Loss allowance % loans	1.33%	1.27%	1.32%	1.30%	1.32%	1.34%	1.38%	1.41%	1.44%	1.49%
Loss allowance % cash mgmt receivables	4.97%	4.17%	4.81%	2.93%	3.94%	3.95%	4.26%	4.13%	3.94%	3.95%
Companywide allowance % outstandings	1.62%	1.54%	1.63%	1.43%	1.50%	1.53%	1.59%	1.59%	1.65%	1.73%
Companywide allowance % NPAs	192%	234%	366%	411%	392%	229%	136%	131%	67%	60%

LIQUIDITY AND FUNDING

The Company has two primary sources of liquidity that can be used during periods of economic stress: on balance-sheet liquidity and off-balance-sheet liquidity, such as secured and unsecured lines of credit. Importantly, CPKF has been beefing up both types of liquidity since the 2008 financial crisis.

At June 30, 2010, liquid assets (consisting of cash, short-term investments, federal funds sold, resale agreements, trading account assets, US Treasuries, and US agency mortgage obligations) were $73.1 million, accounting for 12% of total assets. As measured against purchased funds (composed of confidence-sensitive financing, such as foreign deposits, deposits greater than $100,000, trading account liabilities, commercial paper, current maturities of long-term debt, federal funds purchased, and repurchase agreements), liquid assets represented 61% of purchased funds at the end of 2010's second quarter.

Until 2009, CPKF's liquid assets had been on a declining trend since reaching a 2007 yearend annual peak of 73% of purchased funds, before falling to 39% at the end of 2008 and rising to 61% at June 30, 2010. This largely reflected a shift of the available-for-sale securities portfolio into higher yielding municipal (on a taxable-equivalent basis) and private-label mortgage securities, away from US agency mortgage obligations, in line with the Company's strategy of managing the securities portfolio for total return. As shown in the table below, municipal securities increased to 42% of total available-for-sale securities at June 30, 2010 from 26% at yearend 2007, while US agency securities declined to 31% from 55% and private-label mortgage securities rose to 27% from 19% over the same period.

These changes in the investment portfolio boosted the Company's net interest margin. But, this came at the cost of reducing the credit quality of the available-for-sale securities portfolio, as the Company replaced higher quality (AAA-rated) US agency mortgage securities with lower quality municipal and private-label mortgage securities.

As to the credit quality of the municipal securities portfolio, these obligations are largely rated at AA- to AAA, primarily reflecting the fact that these bonds are insured by various third party bond insurers. In addition, a small portion is not rated as ratings have been withdrawn and another small portion is rated at BBB+ to A. The credit quality of private-label mortgage securities portfolio is mixed; at June 30, 2010, about one-half of the portfolio is below investment grade and the other half is invested in investment-grade securities.

Reflecting the reduction in credit quality of the available-for-sale securities portfolio, the Company began taking other-than-temporary impairment charges on its securities portfolio in 2009. In 2009, CPKF recognized impairment charges on its private-label mortgage securities of $0.9 million and took another $0.9 million charge to earnings in 2010's first half.

	Amount (Dollars in Millions)				% of Available-for Sale Securities			
Type of Security	**2007**	**2008**	**2009**	**6/30/10**	**2007**	**2008**	**2009**	**6/30/10**
Municipal securities	$21.1	$33.2	$54.2	$63.9	26%	36%	38%	42%
US agency securities	43.4	28.5	44.6	46.7	55	31	31	31
Private-label mortgage securities	15.1	29.9	44.1	40.8	19	33	31	27
Total available-for-sale securities	$79.6	$91.6	$142.9	$151.4	100%	100%	100%	100%
Liquid assets % assets	12%	8%	10%	12%				
Liquid assets % purchased funds	73%	39%	46%	61%				
Core deposits % outstandings	85%	80%	95%	101%				

On the funding side, the majority of funding comes from the Company's deposit base. CPKF has significantly ramped up its deposit funding operations through the mid-2009 addition of Clear Sky accounts to its deposit-gathering capabilities. Clear Sky accounts offer internet-based retail deposit services for checking and saving accounts and certificates of deposit (CDs). These are attractive to the Company for several reasons: (1) it diversifies and expands CPKF's deposit base; (2) operating costs are minimal compared to those for traditional deposits, where the Company maintains a physical presence (e.g., a branch office or ATM); and (3) these deposits are attractively priced relative to the rest of the Company's deposits.

As shown in the table above, core deposits, which equal total deposits less foreign deposits and certificates of deposit over $100,000, have been increasing over the last few years and now cover over 100% of loans. This reflects both the addition of the Clear Sky accounts and a modest 2% contraction in the Company's lending portfolio since the end of 2008.

As is true for banks generally, the Company has benefitted from increases in FDIC guarantee limits. Through December 31, 2012, deposits held in noninterest-bearing transaction accounts will be fully insured, regardless of the amount in the account, at all FDIC-insured institutions, and the deposit insurance coverage limit for interest-bearing accounts has been permanently raised to $250,000 per depositor from $100,000.

In addition to deposits, the Company finances its operations with purchased funds (consisting of confidence-sensitive financing, such as foreign deposits, deposits greater than $100,000, trading account liabilities, commercial paper, current maturities of long-term debt, federal funds purchased, and repurchase agreements) and long-term debt. Purchased funds have been rising steadily since yearend 2005, increasing from $52.7 million at December 31, 2005 to $126.7 million at the end of 2009, before shrinking modestly to $119.9 million at June 30, 2010. These funds have largely been used for expansion of the municipal and private-label mortgage securities portfolios, which have grown to 18% of total assets at June 30, 2010 from 7% at December 31, 2005.

This expansion, in turn, had contributed to reduced on balance-sheet liquidity, as a greater proportion of assets was financed with less stable purchased funds. This is demonstrated by a decline in the liquid assets % purchased funds ratio, which tumbled from 73% at yearend 2007 to a trough of 39% at the end of 2008. Positively, this ratio rose to 46% at yearend 2009 and jumped to 61% at June 30, 2010, as the Company took steps to improve its on balance-sheet liquidity profile.

As to off balance-sheet liquidity, CPKF has a $44.0 million FHLB line of credit, with advances on the credit line collateralized by certain loans and securities. At June 30, 2010, FHLB advances under this line were $33.0 million. FHLB advances carry 1.00-4.76% interest rates, have maturities ranging from 11/29/10 through 7/3/18, and are subject to prepayment fees if repaid prior to maturity. Importantly, the Company can increase its secured line of credit with the FHLB to the equivalent of 20% of assets, or roughly $120 million currently, from $44.0 million at June 30, 2010, provided CPKF puts up additional collateral (e.g., 1-4 family residential loans, home equity loans, and AAA-rated mortgage securities) to support these credit lines.

Moreover, CPKF has $33.0 million of unsecured overnight lines of credit with correspondent banks and a $5.0 million short-term line of credit secured by CPKF stock, of which $1.5 million was drawn at June 30, 2010. While the $33.0 million in unsecured lines may not be available to CPKF during an economic crisis, these could be readily supplanted by increasing the amount of the secured credit line with the FHLB.

As to long-term debt, the Company has one major long-term debt issues outstanding: $15.5 million of junior subordinated notes due on October 1, 2037 that were issued with proceeds from the sale of a similar amount of trust preferred securities, which count toward up to 25% of Tier 1 capital and the balance as Tier 2 capital. In addition, the Company has several smaller debt issues, totalling $2.0 million. CPKF has no debt outstanding under the Debt Guarantee Program, in which the US government

guaranteed senior unsecured debt issued during the period from October 14, 2008 through June 30, 2009. Furthermore, Chesapeake Financial did not receive any TARP funds.

The five-year debt maturity schedule is manageable, with debt maturities of $10.1 million in 2010, $5.6 million in 2011, $0.1 million in 2012, $12.6 million in 2013, and $0.1 million in 2014. The maturity schedule for CDs is heavily weighted toward 2010 with maturities of $176.2 million, and remaining maturities of $28.4 million in 2011, $92.6 million in 2012, $0.6 million in 2013, and $2.3 million in 2014.

CPKF attempts to match maturities of assets and liabilities in order to minimize interest-rate risk through the use of a sophisticated computer model that tracks the cash flows associated with every single asset and liability on its balance sheet. These are carefully monitored, with interest rates and terms of new loans and deposits adjusted to mitigate CFPK's overall interest-rate risk profile. Importantly, the Company does not employ derivatives in its asset/liability risk management.

Though CPKF attempts to remain interest-rate neutral, we note that CPKF's balance sheet is currently liability sensitive over the near term. This means that a greater portion of liabilities reprice or mature within the next year as compared to assets. Given recent low interest rates and expectations for this to continue over the short term, this is having the continuing effect of boosting net interest margins. However, any rapid rise in interest rates (which is currently not expected), would have the opposite effect, squeezing net interest margins.

CAPITAL ADEQUACY AND DIVIDENDS

CPKF and its subsidiary bank are considered well capitalized, the highest rating possible under the FDIC's four-risk category rating system, as shown in the following table. Under the FDIC's risk-based capital guidelines, different categories of assets (including certain off-balance sheet items) are assigned different risk weights, based on the credit risk of the asset. These risk-weighted assets are added together to derive the risk weight of the entire asset base and then measured against Tier 1 and Total capital to determine capital adequacy. Total capital is the sum of Tier 1 and Tier 2 capital, with Tier 2 capital being limited to 100% of Tier 1 capital. Tier 1 capital includes common stockholders' equity, any perpetual preferred stock, qualifying trust preferred securities, and minority interests in unconsolidated subsidiaries. Tier 2 capital includes any perpetual preferred stock and trust preferred securities not included in Tier 1 capital, subordinated debt, specific maturing capital instruments, and the allowance for loan and lease losses (limited to 1.25% of risk-weighted assets).

At June 30, 2010	CPKF	Chesapeake Bank	FDIC- Well Capitalized
Total capital ratio	12.23%	11.96%	≥10%
Tier 1 capital ratio	10.61%	10.71%	≥6%
Tier 1 leverage ratio*	8.69%	8.74%	≥5%

*Tier 1 capital to average assets

CPKF capital adequacy ratios had been on a deteriorating trend, with the Tier 1 capital ratio falling from 11.00% at yearend 2005 to 10.10% at the end of 2009 and the Total capital ratio slumping from 12.50% to 11.70% over the same period, as gains in risk-weighted assets outpaced growth in capital levels, in part due to common share repurchases. The Company has purchased $6.3 million of common stock since the end of 2004, and has authorized an additional $0.2 million in buybacks for 2010. This reflects management's philosophy of providing value to shareholders when such purchases are accretive to earnings per share.

The declining trend in capital ratios reversed course in 2010, with capital ratios increasing by roughly 50 basis points. The Tier 1 ratio rose to 10.61% and the Total capital ratio increased to 12.23%, due to a small decline in risk-weighted assets combined with growth in retained earnings, and are now approaching levels last seen in 2005. We view this positively and believe the Company's capital adequacy ratios are satisfactory. Moreover, by our admittedly very rough estimate and based upon current definitions of core Tier 1 capital and risk-weighted assets (which we understand are to be tightened up), CPKF's core Tier 1 capital ratio already exceeds the 7% threshold set by Basel III.

Looking at the Parent Company alone, the Parent employs a high amount of double leverage (defined as the Parent's investments in subsidiaries divided by total stockholders' equity), which is an important indicator of a Parent Company's debt burden and financial flexibility, measuring the degree to which subsidiary banks' equity capital is being financed with Parent Company debt. At CPKF, the double leverage ratio was 142% at December 31, 2009, compared to a more typical ratio of 105-120% for regional banks. Furthermore, double leverage has increased from 125% in 2005 to its current level as the Parent has added long-term debt to its balance sheet to finance long-term growth and repurchase common shares, reducing its common equity.

In addition, liquidity at the Parent Company is somewhat weak as it holds only $0.3 million of cash. While this combined with dividend income the Parent receives from subsidiaries ($1.3 million in 2009, up from $1.2 million in 2007-2008) is sufficient to cover immediate cash needs of roughly $1 million of interest payments on debt obligations, it still results in subpar interest coverage, which was only 0.8X in 2009. However, the Parent's financial position improves dramatically when including potential dividend payments from subsidiaries. Cash dividends of $13.7 million could be upstreamed from the subsidiary bank to its Parent without prior regulatory approval as of December 31, 2009 and are sufficient to retire about 75% of the Parent's entire debt burden right now, even though these obligations mature many years from now. From a practical perspective, it is unlikely the Parent would do so because this would leave the subsidiary bank too thinly capitalized. Furthermore, regulators can restrict bank dividend payments under adverse conditions, which means that these funds might not be available to the Parent Company when they are likely to be needed most.

CPKF has increased its annual dividend payment every year since 1992. The quarterly dividend was recently boosted 5% from $0.105 per share to $0.11 per share, paid on September 15, 2010 to shareholders of record as of September 1, 2010. The Company maintained the dividend throughout the recent financial turmoil, as a demonstration of good faith in its financial strength and future prospects.

EARNING POWER AND PROFITABILITY

The majority of the Company's net revenue stream derives from net interest income, which typically accounts for about 52-59% of total net revenues. Net interest income is determined by multiplying the amount of average interest-earning assets on the balance sheet, including loans and receivables (typically around three-fourths of total assets for CPKF, though this has fallen to about two-thirds since yearend 2008), securities (usually about 16-17%, though this has increased to about 25% since the end of 2008), and short-term investments, and the net interest margin. The net interest margin measures the difference between interest the Company earns on its assets and the interest it must pay on its liabilities, which include deposits, purchased funds, and long-term debt, expressed as a percentage of average total assets.

Net interest income has been rising over the last few years, growing at a compound annual growth rate of 7.4% since yearend 2005, largely the result of gains in the interest-earning asset base since the net interest margin has been somewhat flat over the last few years at about 4.00-4.10%. (We note that these data exclude the cash flow business. Including cash flow accounts, the net interest margin would be some 50-60 basis points higher.)

However, since mid 2009, the net interest margin has grown rather dramatically, rising about 40-50 basis points to 4.40-4.50% from 4.00-4.10%, for a couple of reasons. First, deposit and funding costs have dropped more than yields on the lending and securities portfolios over this period. Second, as is typical for the banking industry as a whole, the Company has shifted its balance sheet from an interest-rate neutral position to a liability-sensitive position, to take advantage of current very low deposit and funding costs.

Moreover, the Company has been very successful in growing its noninterest income stream, which typically accounts for more than 40% of net revenue (this has temporarily shrunk to about 36-37% of net revenue due to impairment losses on the private label mortgage securities portfolio). Furthermore, the sources of noninterest income are well-diversified, as shown in the following table. The largest contributors to noninterest income are cash flow income (generating about 11-12% of net revenue), merchant card income (10-11%), income from fiduciary activities (5-6%), services charges on deposit accounts (5-6%), and ATM income (3%), as shown in the following table.

In addition, securities gains and losses are included in noninterest income. While the Company has traditionally posted small gains on securities' sales, this has turned into losses beginning in 2009's second quarter, when the Company began recognizing other-than-temporary impairment (OTTI) losses on its private-label mortgage securities portfolio. The company recorded $0.9 million of OTTI charges in full-year 2009 and an additional $0.9 million in 2010's first half.

	Amount (Dollars in Millions)							Percentage of Net Revenue						
						2010							2010	
Noninterest Income	**2005**	**2006**	**2007**	**2008**	**2009**	**1Q**	**2Q**	**2005**	**2006**	**2007**	**2008**	**2009**	**1Q**	**2Q**
Fiduciary income	$1.3	$1.6	$1.8	$2.0	$2.0	$0.5	$0.5	5.5%	6.2%	6.6%	6.3%	6.2%	5.6%	6.0%
Service charges on deposits	1.1	1.4	1.9	1.8	1.7	0.4	0.4	4.4	5.5	6.7	5.8	5.2	4.9	4.9
Net gain (loss) on OREO	0.0	0.0	(0.2)	0.0	(0.0)	0.0	0.0	0.0	0.1	(0.6)	0.0	(0.2)	0.0	0.0
Securities gains (losses)- net	0.1	0.1	0.1	0.1	(0.4)	(0.3)	(0.6)	0.5	0.3	0.3	0.3	(1.2)	(3.3)	(6.9)
Merchant card income	2.2	2.5	3.0	3.1	3.5	0.8	1.0	9.1	9.7	10.8	9.8	10.5	10.0	11.2
ATM income	0.6	0.7	0.8	0.8	0.9	0.2	0.3	2.5	2.8	2.8	2.7	2.7	2.8	3.1
Cash flow income	3.0	2.9	4.3	5.0	4.1	0.9	0.9	12.3	11.2	15.3	16.0	12.5	10.6	10.7
Other income	1.6	2.4	1.8	2.2	2.3	0.5	0.6	6.7	9.1	6.2	6.8	6.9	6.1	7.3
Total noninterest income	$9.9	$11.6	$13.5	$15.0	$14.1	$3.0	$3.1	41.0%	44.9%	48.1%	47.7%	42.6%	36.7%	36.3%

In total, noninterest income has grown at a 9.3% compound annual growth rate (CAGR) since 2005, and has contributed to an 8.2% CAGR for total net revenue. This is about one percentage point below the 9.2% CAGR of noninterest expense, which has been inflated by costs associated with weaker asset quality (provisions for losses on cash management accounts) and increased FDIC insurance premiums, stemming from the financial crisis in the US. Excluding these items, noninterest expense would have grown at a compound annual rate of 7.7%, or about 50 basis points lower than that for total net revenues.

Of particular note is the large jump in FDIC insurance premiums, which were nominal until 2009, when the FDIC enacted new regulations calling for increased premiums to replenish FDIC coffers. Thus, FDIC premiums rose from to $848,000 in 2009 (2.6% of net revenue) from $275,000 in 2008 (0.9%) and $43,000 in 2007 (0.2%).

Moreover, loss provisions for the cash management receivables portfolio experienced a 45.7% CAGR, jumping from $0.3 million in 2005 to $1.0 million in 2009, much higher than the growth in cash management receivables outstanding, which increased at an 8.7% compound annual rate.

The above-average losses in the cash management portfolio reflect its inherently weaker credit quality vis-à-vis the loan portfolio, as well as a declining receivables base, which has been hurt by anemic loan demand due to the weak economy. We note, however, that while the loss content is larger for cash management accounts, this is somewhat offset by the significantly higher net interest margins CPKF earns on these receivables.

On the flip side of the coin, the provision for loan losses has decreased at a 2.5% compound annual rate, falling from $1.0 million in 2005 to $0.9 million in 2009.

In total, these factors have contributed to steadily rising net income, which has increased at a 7.1% compound annual rate to $4.8 million in 2009 from $3.7 million in 2005. Diluted earnings per share have climbed at an even faster pace, at 9.6% compounded annually, to $1.77 in 2009 from $1.23 in 2005, reflecting additionally the a decline in average shares outstanding due to common share repurchases.

As to profitability, return on average equity (ROE) is relatively strong and has been stable in the 13-14% range since 2005, aided by good earnings growth, even in the face of significant economic weakness over the past couple of years, and common stock buybacks. These positive trends continued in 2010's first and second quarters.

	Amount (Dollars in Millions)							Percentage of Net Revenue						
						2010							2010	
Noninterest Expense	**2005**	**2006**	**2007**	**2008**	**2009**	**1Q**	**2Q**	**2005**	**2006**	**2007**	**2008**	**2009**	**1Q**	**2Q**
Salaries	$6.9	$7.9	$8.7	$9.7	$9.8	$2.3	$2.5	28.7%	30.6%	31.1%	30.9%	29.6%	28.4%	28.2%
Employee benefits	2.1	2.0	2.1	2.4	2.4	0.7	0.7	8.8	7.9	7.5	7.8	7.4	8.7	8.4
Occupancy expense	2.1	2.3	2.6	3.0	3.2	0.7	0.8	8.9	8.8	9.3	9.4	9.7	8.8	9.0
Merchant card expense	1.7	1.9	2.2	2.3	2.5	0.8	0.7	7.0	7.4	8.0	7.4	7.7	9.2	8.3
ATM expense	0.5	0.5	0.6	0.5	0.6	0.1	0.2	2.0	1.9	2.0	1.6	1.7	1.6	1.8
Cash flow expense	0.9	0.5	0.7	1.1	1.0	0.1	0.1	3.6	2.0	2.4	3.4	3.0	1.0	1.4
Cash flow loss provision	0.3	0.2	0.5	0.9	1.0	0.1	0.1	1.2	0.8	1.6	2.7	2.9	1.0	1.4
Other expenses	3.7	4.3	4.4	5.1	5.4	1.6	1.6	15.2	16.5	15.9	16.1	16.4	19.0	18.7
Total noninterest expense	$18.2	$19.6	$21.8	$25.0	$25.9	$6.4	$6.7	75.4%	75.9%	77.8%	79.3%	78.4%	77.7%	77.2%

RECENT NEWS

CPKF reported 2010 second quarter net earnings of $1.3 million, up 15% from the $1.2 million reported in the year-ago quarter, while diluted EPS increased 17% to $0.48 from $0.41, with the larger gain reflecting share buybacks. This was primarily driven by a significant gain in net interest income, partly offset by higher credit costs (loan loss provision and cash flow loss provision), increased securities losses (which rose to $0.6 million from $0.2 million), and rising employee benefit costs (up 10.5% year over year) and merchant card expense (up 19.9%).

Net interest income increased 21.8% year over year, aided by a 44 basis-point gain in the net interest margin to 4.53% from 4.09% and a 10.3% rise in average interest-earning assets to $516 million on higher average securities (average outstandings were essentially flat). The net interest margin benefitted from funding costs that fell more than loan yields and a shift in the funding the balance sheet to lower cost deposits (from Clear Sky accounts) and purchased funds.

The loan loss provision deteriorated, rising 50.0% year over year to $0.2 million from $0.1 million and the cash flow loss provision jumped 36.3%, reflecting weaker asset quality.

Asset quality measures deteriorated, with nonperforming assets increasing year over year to 2.87% of loans plus OREO from 0.66% at June 30, 2009 and 1.20% from yearend 2009, reflecting a 332% year-over year increase in nonperforming assets to $11.2 million at the 2010 second quarterend from $2.6 million at the end of the year-ago quarter and a 137% jump from $4.7 million at yearend 2009. The loan loss allowance as a percent of nonperforming assets also dropped--to 60% at the end of the quarter from 229% at the end of March 2009. This was the result of higher nonperforming assets, as the loan and receivables loss allowance actually increased to $6.7 million, or 1.73% of outstandings, from $6.0 million, or 1.53% of outstandings.

Total noninterest expense was held in check despite higher employee, merchant card, and cash flow provision expenses, growing only 6.3% to $6.7 million, below the 8.5% gain in net revenues, which were hurt by the jump in securities losses. This lead to a 160 basis-point improvement in the efficiency ratio (noninterest expense as a % of net revenues), which decreased to 77.2% from 78.8% in the year-ago quarter.

The Company's capital adequacy improved, and the Tier 1 capital ratio rose to 10.61% at the end of 2010's second quarter from 10.46% at the end of the comparable period in 2009, while the Total capital ratio decreased slightly to 12.23% from 12.29%. This reflected growth in retained earnings and an increased amount of junior subordinated debt counted as Tier 1 capital, partly offset by a 5.7% gain in risk-weighted assets.

CPKF posted a 14.2% ROE and 0.88% ROA for the second quarter of 2010, compared to 16.3% and 0.80%, respectively, in the prior-year quarter.

MANAGEMENT, INSIDER TRADING, AND OWNERSHIP

Below is a list of top management of Chesapeake Financial Shares, Inc., as provided by the Company.

Douglas D. Monroe, Jr., Vice Chairman of the Board of Directors and past Chairman and CEO of Chesapeake Financial Shares. Served on the Board of Directors of the Federal Reserve Bank of Richmond; former member of the Board of Directors and President of the Virginia Bankers Association; former Vice Chairman of the Community Bankers Division of the American Bankers Association; former member of the Board of Directors of the Corporation for American Banking; founding member of the Board of Directors of Rappahannock Westminster-Canterbury; former Chairman of the Board of Rappahannock General Hospital; founding member of the Board of Trustees for Chesapeake Academy in lrvington; Co-founder and President of Virginia Quality Life. Graduate of Washington and Lee University, Lexington, Virginia with a BS degree and Purdue University, Lafayette, Indiana with a MS degree in Economics. Served as a Lieutenant in the U.S. Navy on active duty from 1955-1959.

Jeffrey M, Szyperski, Chairman, CEO & President and member of the Boards of Directors of Chesapeake Financial Shares, lnc. And Chesapeake Bank; Chairman & CEO and member of the Board of Directors of Chesapeake lnvestment Group; former Senior Manager for KPMG Peat Marwick in Raleigh, North Carolina; member of the Board of Directors and Executive Committee of the Virginia Bankers Association; member of VBA Management Services, lnc. and Bankers lnsurance Boards of Directors; former member of the Board of Directors of VBA Bankers lnvestments Group; member of the American Bankers Association Membership Council; member of the Board of Trustees of the Graduate School of Banking at Louisiana State University; member of the Board of Advisors of Connect Rappahannock; member of the Lancaster County lndustrial Development Authority; member of the Chesapeake Academy Finance Committee and past Chairman and past member of Board of Trustees; member of the Board of Trustees of Chesapeake Pharmacy; past Chairman and member of the Board of

Trustees of Rappahannock Westminster-Canterbury, lnc.; past member of the Board of Advisors of Christopher Newport University Joseph W. Luter, lll School of Business. Graduate of the University of North Carolina at Chapel Hill; graduate of the Graduate School of Banking at Louisiana State University; Former CPA with KPMG Peat Marwick; Certified Financial Planner designation.

John H. Hunt, II, Executive Vice President, Chief Financial Officer and Corporate Secretary for CFS and Chesapeake Bank; past member and Chair of the Virginia Bankers Association Operations Committee; past president of the National Liberty Users Group, a national software group representing approximately 300 banks; current President and past Treasurer of the Foundation for Historic Christ Church; Chairman of the Board of Directors of Northern Neck lnsurance Company; past Trustee and Treasurer of the Lancaster Public Library; portfolio manager of the company's fixed income securities.
Graduate of Virginia Polytechnic lnstitute, BS, General Busíness; Darden School Executive Program, University of Virginia.

Marshall N. Warner, Executive Vice President and Senior Loan Officer of Chesapeake Bank. Member of Chesapeake's Asset/Liability Committee and serves as Senior Economic Advisor; Past Chairman of the Board of Directors, Greater Williamsburg Chamber and Tourism Alliance; Chairman of the Finance Committee; Williamsburg Landing Board of Directors; Finance Division Chair, United Way Campaign Committee; Director Economic Development Authority for James City County; and served as a Captain in the U.S. Army and was awarded the Army Commendation Medal. Graduate of Rider College, Lawrenceville, New Jersey; major in Finance and minor in Accounting.

John K. O' Shaughnessy, Executive Vice President and Senior Credit Officer of Chesapeake Bank responsible for all lending and retail functions In the Northern Neck and Mathews markets; former Vice President and area manager of Signet Bank; member of Chesapeake Bank Asset and Liability Committee and Chesapeake Trust Company Board of Directors; Member of the Board of Directors and past Chairman of the Board of Rappahannock-Westminster Canterbury in lrvington, VA; Treasurer of the Steamboat Era Museum, lrvington, Va. Graduate of West Virginia University, BS in Finance; Consumer Bankers School of Bank Management at the University of Virginia.

J. Mark Monroe, President, Chesapeake lnvestment Group; senior officer responsible for asset management services; investment officer, asset management and trust department, Fidelity lnvestments, Boston, Massachusetts; manager, Preneed Trust and Provider Trust, Chesapeake Bank, Raleigh, North Carolina; Past President of Chesapeake Academy Foundation Board; Association for lnvestment Management and Research (AIMR) Member. 17 years of investment management experience. Graduate of North Carolina State University, BS degree in Statistics, BS degree in Economics; Level lll candidate for Chartered Financial Analyst (CFA) designation; Series 65 Securities License.

Gregory V. Powell, J.D., Managing Director, Chesapeake lnvestment Group and President, Chesapeake Trust Company; Chesapeake lnvestment Group, lnvestment Committee; member of Maryland & DC Bar Association; Former partner Furey, Doolan & Abell in Chevy Chase, MD; Former officer Barristers of Washington, DC; Former Chairman of the Board, Rappahannock Westminster Canterbury Foundation; Former Foreign Service Officer, US Department of State; Lecturer Overseas Briefing Center Department of State, and at U.S. Embassies Abroad. Graduate of Providence College, B.A. English Literature; Duke University School of Law, J.D. and Johns Hopkins School of Advanced lnternational Studies, Masters in lnternational Affairs.

Trudy M. Quinto, Managing Director and President of Chesapeake lnvestment Services, Chesapeake lnvestment Group. Member of Chesapeake lnvestment Group's lnvestment Committee. Securities registrations and insurance licenses include Series 7, 63, and 65, registrations and Life and Health lnsurance and Variable Annuities licenses. Retirement and 401k Specialist. Former Board Member of Gloucester County Chamber of Commerce; Former Chairperson for Chesapeake Bay Conference Gloucester Rotary; Member of Gloucester and Yorktown Chamber of Commerce. 18 years of client risk and investment management experience. Chartered Financial Consultant designation.

Dianne Hall, Senior Vice President and Chief Operations Officer of Chesapeake Bank. Dianne has over 30 years of banking experience with Chesapeake Bank. She is a graduate of VBA School of Bank Management and the VBA Leadership Institute. She currently serves as Chairman of the Bankers Title, LLC.

Patricia Lewis, Vice President and Director of Human Resources. Patricia has over 30 years of banking experience with Chesapeake Bank. She currently holds the Senior Professional in Human Resources Certification and is currently enrolled in the Virginia Bankers Association's Executive Leadership Institute. She is also the Chair of the Virginia Bankers Association's Human Resource Training Officer Committee.

Paula Milsted, Assistant Vice President and Director of Marketing. Paula has fifteen years of bank experience ranging from customer service representative to marketing research manager. In 2002, Mrs. Milsted joined Chesapeake Bank as their business development officer for the Northern Neck and Mathews regions. She holds a Masters degree in Business Administration from Indiana University of Pennsylvania and a B.S. degree in Marketing Management from Grove City College, Pennsylvania. Paula completed the American Bankers Association's School of Bank Marketing and Management and, subsequently, earned her Certified Financial Marketing Professional designation.

Institutional holders own 0% of outstanding shares, while insiders own roughly 40% of the Company's total shares outstanding.

PEER COMPARISONS

Peer comparisons for Chesapeake Financial Shares for the quarter ending June 30, 2010 are shown in the table below. Several items are noteworthy. First, CPKF's profitability measures are among the highest for the group—its ROE is far superior to those of any of its peers, while its ROA is second only to that of Union First Market Bankshares. This partly reflects CPKF's higher degree of leverage. Second, CPKF's capital adequacy metrics are generally worse than those for the bank holding companies listed on this table (with the exception of Eastern Virginia Bankshares), as demonstrated by its Tier 1 capital ratio of 10.61% and Tier 1 leverage ratio of 8.69%, with its next nearest competitor, Union First Market Bankshares, posting ratios of 12.51% and 10.24%, respectively. This means that CPKF has a smaller cushion of protection during periods of adversity. Finally, CPKF's asset quality measures are generally in the middle of the peer group listed below, though its net charge-off ratio and loss reserves appear a bit stronger than those of its peers. This may partly reflect distortions caused the fact that CPKF typically records most of its loan charge-offs in the fourth quarter.

Quarter Ending June 30, 2010	**Chesapeake Financial Shares CPKF**	Eastern Virginia Bankshares EVBS	Middleburg Financial Corporation MBRG	Towne Bank TOWN	Union First Market Bankshares UBSH
Total outstandings (millions)	**$388.4**	$844.1	$716.7	$2,762.1	$2,894.4
Total assets (millions)	**$604.3**	$1,099.8	$1,061.4	$3,732.7	$3,874.2
Net income (loss) (millions)	**$1.3**	$(6.3)	$1.5	$4.5	$8.7
ROE*	**14.16%**	(30.63)%	2.85%	5.67%	8.41%
ROA*	**0.88%**	(2.30)%	0.28%	0.74%	0.91%
Net interest margin*	**4.53%**	3.65%	3.67%	3.66%	4.65%
Efficiency ratio	**77%**	73%	82%	66%	68%
Net charge-offs (recoveries) % avg outstandings*	**0.00%**	2.83%	0.15%	(0.90)%	0.57%
Nonperforming assts % outstandings +OREO	**2.87%**	4.91%	3.68%	2.07%	2.71%
Loss allowance % outstandings	**1.73%**	2.37%	1.54%	1.34%	1.20%
Tier 1 capital ratio	**10.61%**	11.20%	13.33%	12.81%	12.51%
Tier 1 leverage ratio	**8.69%**	8.30%	10.58%	10.86%	10.24%

* Annualized

PROJECTIONS

Our annual and quarterly projections are shown on pages 20 and 21, respectively. We are estimating diluted EPS of $1.82 in 2010, an increase of 3% over 2009's $1.77, and of $1.92 in 2011, a 5% gain over our 2010 estimate. Key highlights include:

- A net interest margin of 4.50% for the balance of 2010 the same as that achieved in 2010's second quarter, as the Company continues to benefit from lower deposit and purchased funds costs. In 2011, we expect a modest narrowing in the net interest margin due to expected increases in the general level of interest rates.
- Resumption of growth in noninterest income in 2011 as securities impairment provisions moderate, though this will be partly offset by expected weakness in service charges on deposit accounts, hurt by a change in federal regulations, and income from cash flow accounts, as these receivables continue to run off.
- An increase in the loan loss provision from $0.9 million in 2009 to $1.0 million in 2010 and $1.1 million in 2011. This will be offset by a decrease in the loss provision for cash management receivables from $1.0 million in 2009 to $0.7 million in 2010 and $0.5 million in 2011
- A 2% decline in loan and receivables outstanding in 2010, followed by a 5% gain in 2011.
- Continuing, though slowing, asset quality deterioration throughout 2010, with modest improvement expected in 2011.
- Moderate improvement in the efficiency ratio, falling to 77.7% in 2010 and 77.2% in 2011 from 78.4% in 2009.
- No change in the recently increased $0.11 quarterly dividend through 2011, nor further stock buybacks in 2011, though we expect the Company to complete the $186,000 share repurchases for 2010 that was recently authorized by the Board of Directors. We believe CPKF will use retained earnings to support future loan growth. The Company's internal rate of growth, based upon median values for ROE and dividend payout over the last five years, is 10 ½%. This is about 80 basis points below the 11.3% compound annual growth in assets over the 2005-2009 period. Long-term asset growth in excess of this 10 ½% rate will result in higher leverage.

Major risks include:

- A halt in the recovery in the US, which would depress loan and receivables demand and hurt asset quality.
- Greater-than-expected asset quality deterioration due to weaker-than-expected real estate markets.
- Reliance on confidence-sensitive purchased funds.
- Political risk, including increased regulation.

VALUATION

CPKF stock has underperformed the industry, with a year-to-date price decline of 6.4% compared to a median increase of 3.0% for banks in the Zacks small-cap index, as shown in the following table. At its current price, CPKF is trading at discounts to the industry median P/E of 50% in 2010 and 43% in 2011, based upon our CPKF EPS estimates. This is far in excess of the average 25% P/E discount for CPKF, based upon 5-year historical P/E averages.

Turning to Price/Tangible Book Value, CPKF is valued at 0.9X versus the industry median of 0.6X. This represents a 67% premium versus an average historical premium of about 19% for CPKF since the end of 2005. We believe this premium is justified given CPKF's strong performance throughout the financial crisis, as well as our expectations for continued growth in EPS over 2010-2011, its strong profitability measures, and its solid dividend yield. With these positives already incorporated into the share price, we expect the stock to perform in line with the overall market over the next six months. 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	2010E	2011E	5-Yr Avg	Price/ Book	TTM*	5-Yr Avg	TTM*	5-Yr Avg	Div Yld
Chesapeake Finc'l	**(6.4)**	**7.0**	**7.3**	**6.9**	**11.7**	**0.9**	**13.9**	**13.8**	**0.88**	**0.91**	**3.3**
S&P 500	4.0	20.4	14.5	12.6	18.1	3.6	22.1	-----	9.4	-----	2.0
Median	**3.0**	**15.4**	**15.1**	**12.2**	**15.6**	**0.6**	**1.4**	**5.0**	**0.12**	**0.46**	**-----**
Average	11.1	34.6	27.6	14.0	19.0	0.7	(9.4)	3.4	(0.20)	0.45	1.3
High	338.7	302.0	203.8	36.7	43.1	1.6	14.1	16.4	2.40	2.70	5.6
Low	(59.4)	6.5	6.3	5.2	10.5	0.2	(142.1)	(23.0)	(5.67)	(1.38)	-----

*Trailing twelve months

Chesapeake Financial Shares, Inc.

Income Statement and Balance Sheet

(Dollars in millions, except per share data)

Summary Financial Data	12/05	12/06	12/07	12/08	12/09	12/10 E	12/11 E
Net interest income	14.2	14.3	14.5	16.5	18.9	21.7	22.0
Non-interest income	9.9	11.6	13.5	15.0	14.1	13.2	14.0
Total net revenue	24.1	25.9	28.0	31.5	33.0	34.9	36.0
Loan loss provision	1.0	0.8	0.2	0.4	0.9	1.0	1.1
Non-interest expense	18.2	19.6	21.8	25.0	25.9	27.2	27.7
Income taxes & other	1.2	1.5	1.7	1.5	1.4	1.7	1.8
Zacks adjusted income before NRI	3.7	4.0	4.3	4.6	4.8	5.0	5.3
GAAP net income	3.7	4.0	4.3	4.6	4.8	5.0	5.3
Diluted EPS before NRI	1.23	1.34	1.49	1.60	1.77	1.82	1.92
Reported EPS	1.23	1.34	1.49	1.60	1.77	1.82	1.92
Dividends per share	0.30	0.32	0.35	0.41	0.42	0.43	0.44
Liquid assets	37.2	52.9	58.4	45.4	57.8	75.6	78.7
Outstandings, gross	299.9	319.4	361.6	396.2	391.3	384.3	403.9
Total assets	382.7	418.1	483.0	538.0	586.7	605.5	630.1
Core deposits	275.9	295.2	308.8	317.0	370.0	393.3	409.6
Purchased funds	52.7	73.7	80.0	115.9	126.7	120.0	120.0
Long-term debt	16.7	11.6	44.4	65.5	47.4	40.0	45.0
Shareholders' equity	28.6	31.0	33.7	30.6	35.3	40.2	44.2
Profitability							
Return on avg assets	0.98%	0.98%	0.97%	0.89%	0.84%	0.83%	0.85%
Return on avg equity	13.69%	13.58%	13.68%	13.51%	13.14%	13.11%	12.48%
Net interest margin	4.80%	4.20%	4.10%	4.00%	4.10%	4.47%	4.35%
Loan loss provision % avg assets	0.26%	0.21%	0.04%	0.08%	0.16%	0.16%	0.18%
Noninterest income % avg assets	2.62%	2.88%	3.01%	2.91%	2.45%	2.18%	2.26%
Noninterest expense % avg assets	4.83%	4.86%	4.87%	4.84%	4.51%	4.50%	4.49%
Preprovision pretax income % avg assets	1.57%	1.54%	1.39%	1.26%	1.24%	1.29%	1.33%
Tangible efficiency ratio	75%	76%	78%	79%	78%	78%	77%
Payout ratio	25%	24%	23%	25%	24%	24%	23%
Asset Quality							
Net charge-offs % avg outstandings	0.15%	0.28%	0.04%	0.27%	0.34%	0.33%	0.30%
Allowance % outstandings	1.60%	1.55%	1.50%	1.43%	1.59%	1.72%	1.74%
NPAs % loans + OREO	1.42%	1.00%	0.61%	0.35%	1.20%	3.41%	2.76%
Allowance % NPAs	113%	154%	245%	411%	131%	50%	63%
Liquidity & Funding							
Liquid assets % purchased funds	71%	72%	73%	39%	46%	63%	66%
Core deposits % outstandings	92%	92%	85%	80%	95%	102%	101%
Liquid assets % assets	10%	13%	12%	8%	10%	12%	12%
Outstandings % assets	78%	76%	75%	74%	67%	63%	64%
Capital Adequacy							
Total equity % assets	7.47%	7.41%	6.97%	5.68%	6.01%	6.63%	7.02%
Tangible equity % assets	7.47%	7.41%	6.97%	5.68%	6.01%	6.63%	7.02%
Tier 1 capital ratio	10.98%	11.10%	10.80%	10.60%	10.10%		
Total capital ratio	12.45%	12.50%	15.50%	12.50%	11.70%		
Parent Company Statistics							
Interest coverage	1.1X	0.8X	0.4X	0.6X	0.8X	1.0X	1.0X
Interest & dividend coverage	0.9X	0.5X	0.3X	0.3X	0.4X	0.5X	0.5X
Short-term debt coverage	Lge	Lge	Lge	Lge	Lge	Lge	Lge
Total debt coverage	1.0X	1.0X	1.0X	0.9X	0.8X	1.0X	1.3X
Double leverage	124.5%	127.3%	133.2%	139.8%	142.1%	137.3%	136.6%

Chesapeake Financial Shares, Inc.

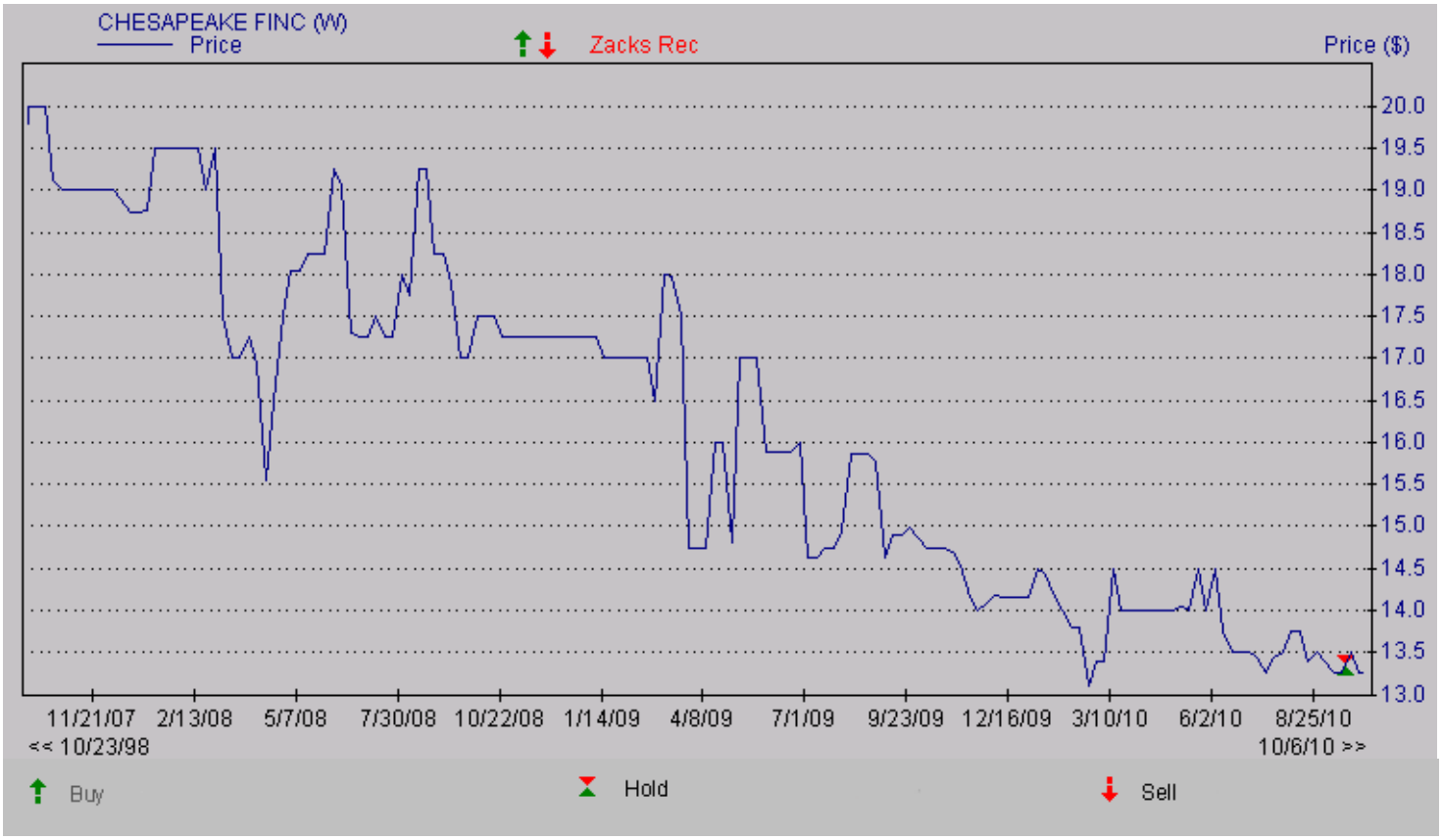
Income Statement and Balance Sheet

(Dollars in millions, except per share data)

	2009				2010			
Summary Financial Data	**Q1 A**	**Q2 A**	**Q3 A**	**Q4 A**	**Q1 A**	**Q2 E**	**Q3 E**	**Q4 E**
Net interest income	3.9	4.6	5.1	5.5	5.2	5.5	5.5	5.6
Non-interest income	3.6	3.4	3.6	3.4	3.0	3.1	3.6	3.4
Total net revenue	7.5	8.0	8.7	8.9	8.2	8.7	9.1	9.0
Loan loss provision	0.2	0.1	0.3	0.4	0.2	0.2	0.2	0.4
Non-interest expense	6.1	6.3	6.4	7.1	6.4	6.7	6.8	7.3
Income taxes & other	0.3	0.4	0.5	0.1	0.4	0.4	0.5	0.4
Zacks adjusted income before NRI	0.9	1.2	1.5	1.3	1.2	1.3	1.6	0.9
GAAP net income	0.9	1.2	1.5	1.3	1.2	1.3	1.6	0.9
Diluted EPS before NRI	0.33	0.41	0.53	0.45	0.42	0.48	0.59	0.33
Reported EPS	0.33	0.41	0.53	0.45	0.42	0.48	0.59	0.33
Dividends per share	0.10	0.10	0.10	0.10	0.10	0.10	0.11	0.11
Liquid assets	105.2	52.9	53.6	57.8	74.9	73.1	73.8	75.6
Outstandings, gross	387.5	389.2	395.2	391.3	391.5	388.4	388.2	384.3
Total assets	598.2	563.5	580.3	586.7	608.5	604.3	604.9	605.5
Core deposits	384.0	358.8	375.4	370.0	388.6	391.9	392.9	393.3
Purchased funds	116.4	114.2	108.4	126.7	125.4	119.9	120.0	120.0
Long-term debt	52.6	52.5	53.7	47.4	44.5	41.4	40.0	40.0
Shareholders' equity	27.1	29.7	35.6	35.3	36.9	38.2	39.6	40.2
Profitability								
Return on avg assets*	0.66%	0.80%	1.04%	0.87%	0.78%	0.88%	1.07%	0.59%
Return on avg equity *	12.93%	16.33	18.15	14.24%	12.87	14.16	16.60	8.95%
Net interest margin*	3.59%	4.09%	4.44%	4.71%	4.36%	4.53%	4.50%	4.50%
Loan loss provision % avg assets*	0.11%	0.07%	0.17%	0.27%	0.16%	0.10%	0.13%	0.26%
Noninterest income % avg assets*	2.54%	2.37%	2.53%	2.33%	2.02%	2.07%	2.38%	2.27%
Noninterest expense % avg assets*	4.29%	4.32%	4.46%	4.88%	4.27%	4.40%	4.47%	4.85%
Preprovision pretax inc.% avg assets*	1.00%	1.16%	1.59%	1.20%	1.23%	1.30%	1.58%	1.06%
Tangible efficiency ratio	81%	79%	74%	80%	78%	77%	74%	82%
Payout ratio	32%	25%	20%	23%	25%	22%	19%	34%
Asset Quality								
Net charge-offs % avg outstandings*	0.11%	0.04%	0.17%	1.02%	0.10%	(0.00)	-----	1.24%
Allowance % outstandings	1.50%	1.53%	1.59%	1.59%	1.65%	1.73%	1.82%	1.72%
NPAs % loans + OREO	0.38%	0.66%	1.17%	1.20%	2.46%	2.87%	3.12%	3.41%
Allowance % NPAs	392%	229%	136%	131%	67%	60%	58%	50%
Liquidity & Funding								
Liquid assets % purchased funds	90%	46%	49%	46%	60%	61%	61%	63%
Core deposits % outstandings	99%	92%	95%	95%	99%	101%	101%	102%
Liquid assets % assets	18%	9%	9%	10%	12%	12%	12%	12%
Outstandings % assets	65%	69%	68%	67%	64%	64%	64%	63%
Capital Adequacy								
Total equity % assets	4.53%	5.27%	6.14%	6.01%	6.07%	6.33%	6.54%	6.63%
Tangible equity % assets	4.53%	5.27%	6.14%	6.01%	6.07%	6.33%	6.54%	6.63%
Tier 1 capital ratio	10.27%	10.46	10.44	10.06%	10.19	10.61		
Total capital ratio	12.14%	12.29	12.19	11.73%	11.87	12.23		

*Annualized.

HISTORICAL ZACKS RECOMMENDATIONS



DISCLOSURES

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