

Chesapeake Financial Shares, Inc. (CPKF - OTC)

CPKF: Third Quarter Results – Neutral

OUTLOOK

We are maintaining our Neutral rating on Chesapeake Financial Shares, Inc. (CPKF). CPKF reported third quarter diluted EPS of \$0.71, a 33% increase from the \$0.53 posted a year ago. This compares to our third quarter estimate of \$0.59, with the outperformance primarily reflecting stronger cost controls than anticipated, as total noninterest expense declined 2% year over year and 6.5% sequentially to \$6.2 million. Net interest income increased 12% year over year to \$5.6 million, and noninterest income jumped 23% to \$4.5 million, largely the result of a \$0.9 million positive swing in securities gains/losses to a \$0.65 million gain in 2010's third quarter from a \$0.25 million loss in the prior-year quarter. This was offset by a corresponding \$0.9 million increase in the loan loss provision to \$1.2 million. Though CPKF charged off \$1.0 million of loans in the third quarter, the Company increased its loan loss reserves to \$5.6 million (1.54% of loans) at the end of 2010's third quarter from \$5.5 million at June 30, 2010 (1.49% of loans) and \$5.2 million at yearend 2009 (1.41% of loans). Nonperforming loans declined, falling to 2.71% of total loans at September 30, 2010 from 3.04% at the end of June 2010. We are currently reviewing our estimates and will issue a more comprehensive report when detailed financial information becomes available within the next few weeks.

Current Recommendation	Neutral
Prior Recommendation	N/A
Date of Last Change	09/21/2010
 Current Price (10/19/10)	 \$13.25
Six- Month Target Price	\$14.00

SUMMARY DATA

52-Week High	\$14.75
52-Week Low	\$12.50
One-Year Return (%)	-6.85
Beta	0.09
Average Daily Volume (sh)	175

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	6.4
P/E using 2010 Estimate	7.3
P/E using 2011 Estimate	6.9

Zacks Rank	3
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Risk Level	Average
Type of Stock	Small-Value
Industry	Banks-Southeast
Zacks Rank in Industry	39 of 83

ZACKS ESTIMATES

Net Revenue (in millions of \$)

	Q1	Q2	Q3	Q4	Year
	(Mar)	(Jun)	(Sep)	(Dec)	(Dec)
2008	7.6 A	8.0 A	8.0 A	7.9 A	31.5 A
2009	7.5 A	8.0 A	8.6 A	8.9 A	33.0 A
2010	8.2 A	8.6 A	10.1 A	9.0 E*	34.9 E*
2011					36.0 E*

Earnings per Share

(EPS is operating earnings before nonrecurring items)

	Q1	Q2	Q3	Q4	Year
	(Mar)	(Jun)	(Sep)	(Dec)	(Dec)
2008	0.34 A	0.49 A	0.38 A	0.39 A	1.60 A
2009	0.33 A	0.41 A	0.53 A	0.45 A	1.77 A
2010	0.42 A	0.48 A	0.71 A	0.33 E*	1.82 E*
2011					1.92 E*

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

* Under review.

THIRD QUARTER RESULTS

CPKF reported 2010 third quarter net earnings of \$1.9 million, up 31% from the \$1.5 million reported in the year-ago quarter, while diluted EPS increased 33% to \$0.71 from \$0.53, with the larger gain reflecting share buybacks. This compares to our third quarter estimate of \$0.59, with the outperformance primarily reflecting stronger cost controls than anticipated, as total noninterest expense declined 2% year over year and 6.5% sequentially to \$6.2 million due to reduced employee benefits (down 15% year over year), occupancy (a decrease of 21%), and cash flow rexpense (a decline of 83%).

Net interest income increased 12% year over year to \$5.6 million, and noninterest income jumped 23% to \$4.5 million, largely the result of a \$0.9 million positive swing in securities gains/losses to a \$0.65 million gain in 2010's third quarter from a \$0.25 million loss in the prior-year quarter. This was offset by a corresponding \$0.9 million increase in the loan loss provision to \$1.2 million.

The efficiency ratio improved dramatically, dropping to 61.9% from 73.7% a year ago, aided both by higher net revenues (up 16.5% year over year) and lower noninterest expense.

As to asset quality, CPKF charged off \$1.0 million of loans in the third quarter, resulting in a 1.10% charge-off ratio for the loan portfolio. This compares to net charge-offs of \$0.4 million for full-year 2009 and \$0.1 million for all of 2008. Despite this higher level of charge-offs, the Company increased its loan loss reserves to \$5.6 million (1.54% of loans) at the end of 2010's third quarter from \$5.5 million at June 30, 2010 (1.49% of loans) and \$5.2 million at yearend 2009 (1.41% of loans).

Nonperforming loans declined, falling to 2.71% of total loans at September 30, 2010 from 3.04% at the end of June 2010. Gross loans outstanding dropped about \$1 million sequentially to \$367 million, but rose \$1 million from the end of 2009.

CPKF posted a 19.3% ROE and 1.29% ROA for the third quarter of 2010, compared to 18.2% and 1.04%, respectively, in the prior-year quarter.

In other news, the Company noted a 28% year-to-date gain through the end of the third quarter in assets under management at Chesapeake Investment Group, principally due to the addition of new business (though rising stock and bond markets helped somewhat). In addition, Chesapeake Payment Systems added some new companies to its system, which will add to revenues and earnings going forward.

CPKF announced a quarterly dividend of \$0.11, payable on December 15, 2010 to shareholders of record on December 1, 2010.

We are currently reviewing our estimates and will issue a more comprehensive report when detailed financial information becomes available within the next few weeks.

OVERVIEW

Chesapeake Financial Shares, Inc. (CPKF or the Company) is a bank holding company headquartered in Kilmarnock, Virginia, with \$605 million in total assets at September 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 \$365 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.

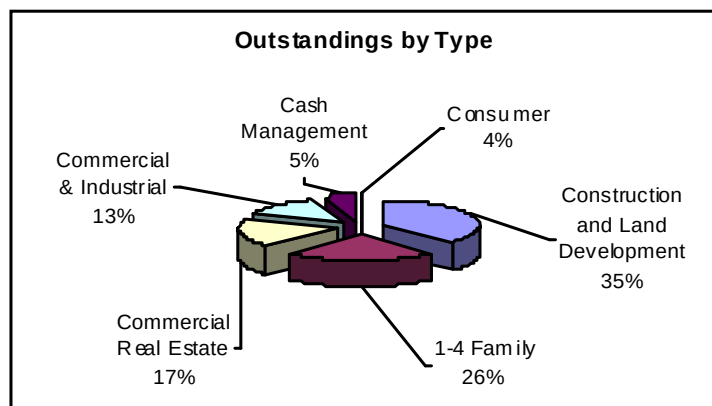
Chesapeake Payment Systems offers merchant processing services such as credit card and debit card processing, electronic benefits transfers, and loyalty and gift card processing to companies involved in travel, entertainment, restaurant, hospitality, retail, mail order, and e-commerce. At yearend 2009, 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).

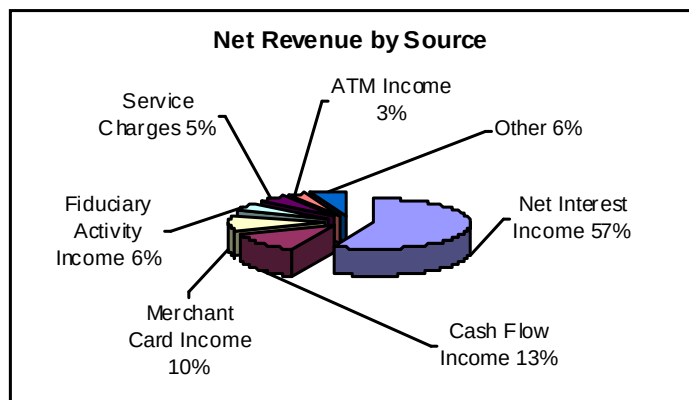
The lending portfolio is dominated by real estate loans, as shown in the chart at the left. At June 30, 2010, the lending book consisted of construction and land development (accounting for 35% of total gross outstandings), 1-4 family (26%), commercial real estate (17%), commercial and industrial (13%), cash management (5%), and consumer (4%). A majority of loans are secured, usually by real estate, inventory, accounts receivable, equipment, machinery, or corporate assets.



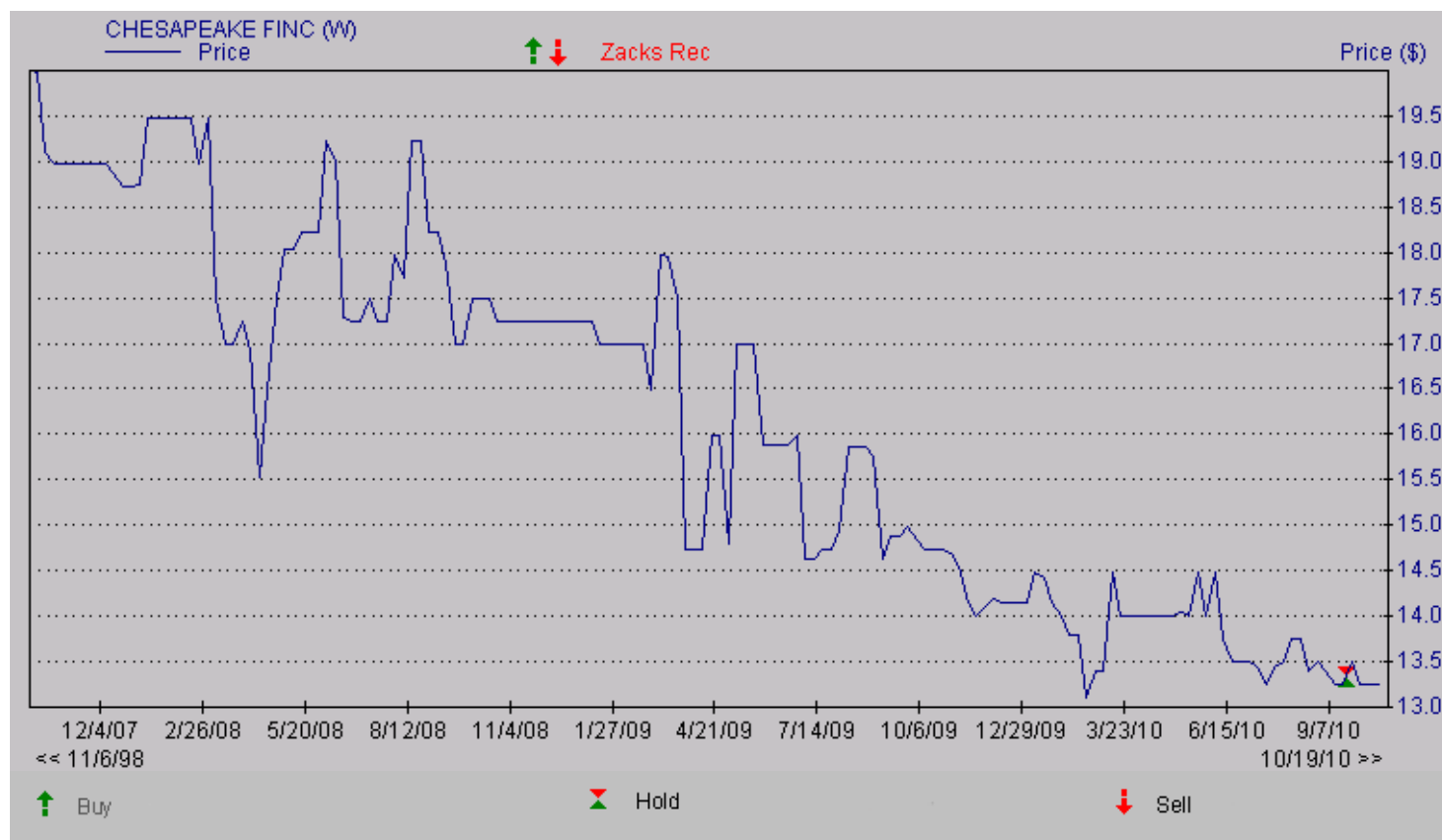
The liquidity portfolio, consisting of cash, short-term investments, federal funds sold, resale agreements, trading account assets, US Treasuries, and US agency mortgage

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%).



HISTORICAL ZACKS RECOMMENDATIONS



DISCLOSURES

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