Zacks Small-Cap Research

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Chesapeake Financial Shares, Inc. (CPKF - OTC)

CPKF: Second Quarter Results – Outperform

Current Recommendation	**Outperform**
Prior Recommendation	Neutral
Date of Last Change	05/26/2011
Current Price (07/18/11)	$12.50
Six- Month Target Price	**$13.75**

OUTLOOK

We are maintaining our outperform recommendation on Chesapeake Financial Shares, Inc. (CPKF). CPKF reported solid 2011 second quarter net earnings of $2.1 million, up 55% from the $1.3 million reported in the year-ago quarter, while diluted EPS increased 57% to $0.63 from $0.40, with the better EPS performance reflecting share buybacks. Our second quarter diluted EPS estimate was $0.49. The primary reason for this improvement was a $1.1 million positive swing in securities gains and losses to a gain of $0.5 million in 2011 from a loss of $0.6 million in the year-ago quarter. That said, CPKF surprised on the upside in a number of key fee income categories, including income from fiduciary activities ($0.5 million versus our estimate of $0.45 million), merchant card income ($1.06 million versus our $0.9 million estimate), and cash flow income ($0.95 million compared to our $0.85 million estimate as CPKF experienced cash flow asset growth for the first time since the third quarter of 2009). Moreover, the Company has taken a number of steps to increase returns to shareholders, including two recent dividend hikes totalling 9% and a stock split, and we don't believe this has been reflected in the share price. We are reviewing our estimates and will issue a more comprehensive report when detailed financial information becomes available within the next few weeks.

SUMMARY DATA

52-Week High	**$14.15**
52-Week Low	**$10.89**
One-Year Return (%)	**16.84**
Beta	**0.13**
Average Daily Volume (sh)	**951**
Shares Outstanding (mil)	**3**
Market Capitalization ($mil)	**$41**
Short Interest Ratio (days)	**N/A**
Institutional Ownership (%)	**0**
Insider Ownership (%)	**40**
Annual Cash Dividend	**$0.40**
Dividend Yield (%)	**3.20**
5-Yr. Historical Growth Rates	
Net Revenue (%)	**8.1**
Earnings Per Share (%)	**10.5**
Dividend (%)	**7.2**
P/E using TTM EPS	**6.3**
P/E using 2011 Estimate	**6.9**
P/E using 2012 Estimate	**6.6**
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)
2009	7.5 A	8.0 A	8.6 A	8.9 A	33.0 A
2010	8.2 A	8.6 A	10.1 A	9.1 A	36.1 A
2011	8.9 A	9.4 A	8.9 E	8.9 E	35.4 E
2012					36.1 E

Earnings per Share

(EPS is operating earnings before nonrecurring items)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2009	0.28 A	0.34 A	0.44 A	0.38 A	1.48 A
2010	0.35 A	0.40 A	0.59 A	0.31 A	1.69 A
2011	0.47 A	0.63 A	0.52 E	0.32 E	1.80 E
2012					1.90 E

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

SECOND QUARTER RESULTS

CPKF reported solid 2011 second quarter net earnings of $2.1 million, up 55% from the $1.3 million reported in the year-ago quarter, while diluted EPS increased 57% to $0.63 from $0.40, with the better EPS performance reflecting share buybacks. Our second quarter diluted EPS estimate was $0.49. The primary reason for this improvement was a $1.1 million positve swing in securities gains and losses to a gain of $0.5 million in 2011 from a loss of $0.6 million in the year-ago quarter. This compares to our estimate of a $0.1 milllion loss for 2011's second quarter.

That said, CPKF surprised on the upside in a number of key fee income categories, including income from fiduciary activities ($0.5 million versus our estimate of $0.45 million), merchant card income ($1.06 million versus our $0.9 million estimate), and cash flow income ($0.95 million compared to our $0.85 million estimate as the Company experienced cash flow asset growth for the first time since the third quarter of 2009).

Net interest income fell 2% year over year and 8% sequentially to $5.4 million (versus our $5.6 million estimate), largely reflecting a decline in average outstandings, as loans and receivables decreased more than 3% year over year and 1% sequentially due to weak loan demand. We also estimate that the net interest margin fell slightly from a near cycle peak of 4.68% that occurred in 2011's first quarter.

Noninterest income jumped 32% year over year to $4.1 million, primarily due to a $1.1 million positve swing in securities gains and losses to a gain of $0.5 million in 2011 from a loss of $0.6 million in the year-ago quarter. Excluding this item, noninterest income was down 2% as strong growth in ATM and merchant card income (up 9% and 8%, respectively) was offset by losses from OREO expense and a 19% decline in service charges on deposit accounts as the Company continues to experience the negative impact of changes in federal regulations, along with the rest of the industry.

Noninterest expense fell 1% year over year to $6.5 million (the same as our estimate), as the Company maintained tight control over operating expenses that lead to an 8-point improvement in the efficiency ratio, which dropped to 69% from 77% in the year-ago quarter.

The loan loss provision increased 33% to $0.2 million, as the Company continued to strenthen loan loss reserves. CPKF increased its loan loss reserves to $6.5 million (1.83% of loans) from $5.5 million (1.49% of loans) at the end of the comparable year-ago quarter, though there was modest deterioration on a sequential basis from the $6.7 million (1.87% of loans) at the end of the previous quarter.

As to other asset quality measures, CPKF charged off $412,000 of loans in the second quarter. This compares to net recoveries of loan losses of $2,000 in the prior-year quarter and of net charge-offs of $1.5 million for full-year 2010. Gross loans outstanding dropped about $4 million, or 1%, sequentially to $355 million and almost $13 million from the comparable prior-year quarter, reflecting continued weak loan demand.

CPKF posted a 18.3% ROE and 1.35% ROA for the second quarter of 2011, compared to 14.2% and 0.88%, respectively, in the prior-year quarter.

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

We note that US Banker ranked CPKF 20th (up from 32nd about a year ago) out of all banks nationally with less than $2 billion in total assets, which includes approximately 6,000 banks, and #1 of all banks in Virginia. This ranking was based upon three-year average returns on equity, which for Chesapeake

Financial was 13.40%. The Company has steadily risen through the rankings in the past four years, reflecting its solid financial performance during this difficult banking environment.

More recently, Jeffrey M. Szyperski, Chairman, President & CEO, Chesapeake Bank, has been named Chairman-Elect of the Virginia Bankers Association. As Chairman-Elect, he is slated to become the Association's Chairman in 2011.

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

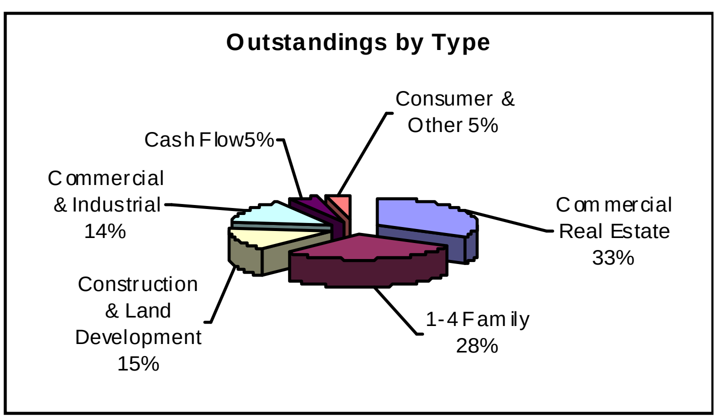
OVERVIEW

Chesapeake Financial Shares, Inc. (CPKF or the Company) is a bank holding company headquartered in Kilmarnock, Virginia, with $620 million in total assets at June 30, 2011. CPKF is predominantly a small business lender with 11 branch offices that serve customers in the eastern region of Virginia between the Potomac and James Rivers. These offices are located in Kilmarnock, Lively, Irvington, Mathews, Hayes, and Gloucester, with four branches in Williamsburg. CPKF, which began as Lancaster National Bank on April 13, 1900, has a long history and strong ties with the communities it serves.

Operations are carried on through Chesapeake Bank, a state-chartered bank as well as Federal Reserve and FDIC member bank, and Chesapeake Investment Group, Inc. (CIG), an independent wealth management firm that manages about $312 million in assets (as of the end of the first quarter) through its subsidiaries involved in asset management (CIG is a registered investment adviser), brokerage, and trust services. Other activities of the Company include Chesapeake Payment Systems, Cash Flow program, Clear Sky accounts, and its secondary market mortgage banking operation.

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

The Cash Flow program, which provides an attractive financing option to growing businesses, involves the purchase of the client company's accounts receivables. The Cash Flow program is currently offered in the Eastern half of the United States and has approximately 80 customers.

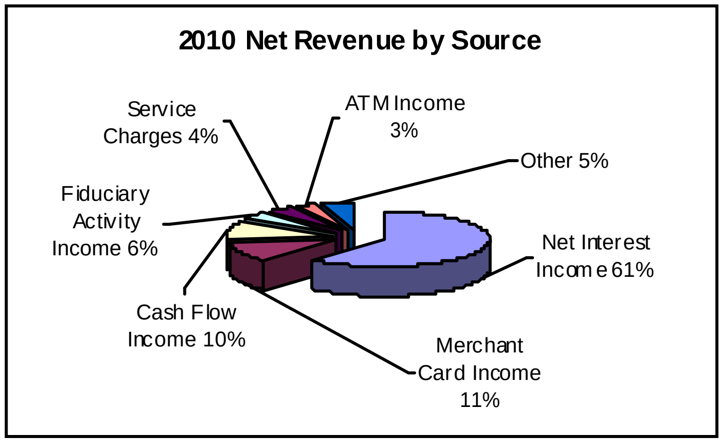


Clear Sky accounts, which offer internet-based retail deposit services for checking and saving accounts and certificates of deposit (CDs), expands CPKF's retail deposit base geographically. At 2010 yearend, Clear Sky deposits totalled $50 million, with customers in all 50 states.

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

The lending portfolio is dominated by real estate loans, as shown in the chart above. At March 31, 2011, the lending book consisted of commercial real estate (accounting for 33% of total gross outstandings), 1-4 family (28%), construction and land development (15%), commercial and industrial (14%), cash flow (5%), and consumer and other (5%). A majority of loans are secured, usually by real estate, inventory, accounts receivable, equipment, machinery, or corporate assets.

The liquidity portfolio, consisting of cash, short-term investments, federal funds sold, US Treasuries, and US agency mortgage obligations, represent about 11% of total assets and 32% of the securities portfolio. In addition, the available-for-sale portfolio includes municipal and private label mortgage securities, which currently account for 48% and 20%, respectively, of the total. Core deposits represented 77% of total deposits at March 31, 2011, with certificates of deposit larger than $100,000 at 23%.



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

VALUATION

CPKF stock has outperformed the industry, with a year-to-date price gain of 11.1% compared to a median increase of 6.1% for banks in the Zacks small-cap bank index, as shown in the following table. At its current price, CPKF is trading at a discount to the industry median P/E of 49% in 2011 and of 45% in 2012, based upon our CPKF EPS estimates. This is in excess of the average 43% P/E discount for CPKF, based upon 5-year historical P/E averages.

Turning to Price/Book Value, which is the valuation favored by most investors at present, CPKF is valued at 0.93X versus the industry median of 0.72X. This represents a 29 ½% premium, a bit above the average historical premium of 26 ½% 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 in 2011 and 2012, its strong profitability measures, and its solid dividend yield.

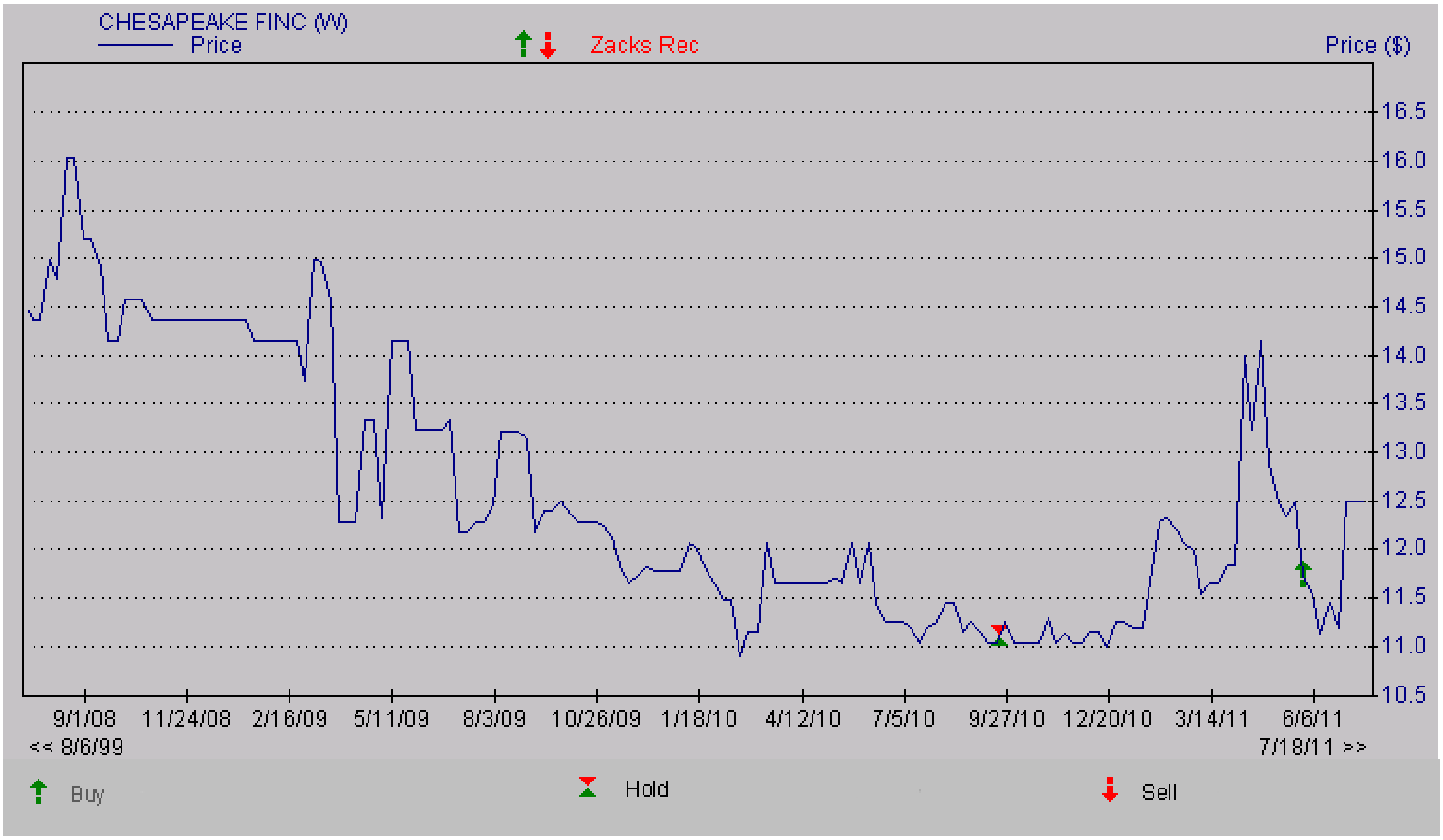
Applying the 0.93X ratio to our estimated book value for CPKF six months out results in a price target of approximately $13.75. Combined with the dividend yield, this represents a total return of 11 ½%, well above our expectations for gains in the broader market index over the next six months. Therefore, 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	2011E	2012E	5-Yr Avg	Price/ Book	TTM*	5-Yr Avg	TTM*	5-Yr Avg	Div Yld
Chesapeake Finc'l	**11.1**	**6.3**	**6.9**	**6.6**	**9.6**	**0.93**	**18.3**	**14.0**	**1.35**	**0.91**	**3.2**
S&P 500	3.8	17.8	13.6	12.6	18.0	3.8	22.4	-----	9.4	-----	2.0
Median	**6.1**	**15.8**	**13.6**	**11.9**	**16.8**	**0.72**	**5.3**	**4.2**	**0.40**	**0.33**	**-----**
Average	7.1	16.9	16.5	32.0	20.5	0.7	1.1	2.7	0.25	0.33	1.5
High	70.8	36.5	41.0	500.0	44.1	1.4	15.5	13.8	2.19	2.48	6.3
Low	(29.7)	6.2	5.8	6.7	12.2	0.3	(53.4)	(32.2)	(2.82)	(1.82)	-----

*Trailing twelve months

HISTORICAL ZACKS RECOMMENDATIONS



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