Zacks Small-Cap Research
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Chesapeake Financial Shares, Inc. (CPKF - OTC)

CPKF: Third Quarter Results – Outperform

Current Recommendation	**Outperform**
Prior Recommendation	Neutral
Date of Last Change	05/26/2011
Current Price (10/27/11)	$12.25
Twelve-Month Target Price	**$14.50**

OUTLOOK

We are maintaining our Outperform recommendation and $14.50 target price on Chesapeake Financial Shares, Inc. (CPKF). CPKF reported 2011 third quarter net earnings of $1.8 million, or $0.56 per diluted share, $0.04 better than our $0.52 diluted EPS estimate. This outperformance primarily reflected positive variances in both net interest income and other noninterest expense relative to our third quarter estimates, partially offset by a larger-than-expected loan loss provision. Compared to the year-ago quarter, net income dropped 7% from $1.9 million and diluted EPS fell by 5% from $0.59, with the better EPS performance reflecting share buybacks. The primary reason for 2011's slippage versus 2010's third quarter was a $0.3 million, or 10.8%, increase in total compensation costs to $3.3 million, partly offset by a lower effective tax rate that declined to 24.4% from 26.9%. CPKF just announced it was maintaining its $0.10 quarterly dividend, payable on or before December 15, 2011 to shareholders of record as of December 1, 2011. Earlier in the year, CPKF hiked the dividend 9% (4.3% in April and 4.5% in March) and had a 6-for-5 stock split that occurred in April. 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	$10.89
One-Year Return (%)	12.56
Beta	0.13
Average Daily Volume (sh)	208
Shares Outstanding (mil)	3
Market Capitalization ($mil)	$40
Short Interest Ratio (days)	N/A
Institutional Ownership (%)	0
Insider Ownership (%)	40
Annual Cash Dividend	$0.40
Dividend Yield (%)	3.27
5-Yr. Historical Growth Rates	
Net Revenue (%)	8.1
Earnings Per Share (%)	10.5
Dividend (%)	7.2
P/E using TTM EPS	6.2
P/E using 2011 Estimate	6.3
P/E using 2012 Estimate	6.0
Zacks Rank	3

Risk Level	Average
Type of Stock	Small-Value
Industry	Banks-Southeast
Zacks Rank in Industry	36 of 76

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	9.2 A	9.1 E	36.4 E
2012					37.1 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	0.56 A	0.32 E	1.94 E
2012					2.05 E

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

THIRD QUARTER RESULTS

CPKF reported 2011 third quarter net earnings of $1.8 million, or $0.56 per diluted share, $0.04 better than our $0.52 diluted EPS estimate. This outperformance primarily reflected positive variances in both net interest income and other noninterest expense relative to our third quarter estimates, partially offset by a larger-than-expected loan loss provision.

Compared to the year-ago quarter, net income dropped 7% from $1.9 million and diluted EPS fell by 5% from $0.59, with the better EPS performance reflecting share buybacks. The primary reason for 2011's slippage versus 2010's third quarter was a $0.3 million, or 10.8%, increase in total compensation costs to $3.3 million, partly offset by a lower effective tax rate that declined to 24.4% from 26.9%.

Net interest income inched up 0.5% year over year and 5% sequentially to $5.6 million (versus our $5.5 million estimate), due to improvement in the net interest margin from the 4.33% that occurred in 2011's second quarter. Loans and receivables outstanding decreased more than 3% year over year and 0.6% sequentially due to weak loan demand.

Noninterest income plunged $1.0 million, or 23%, year over year to $3.5 million, largely reflecting a $0.9 million negative swing in securities gains and losses to a loss of $0.2 million in 2011 from a gain of $0.7 million in the year-ago quarter. Excluding this item, noninterest income was only down 4% as strong growth in ATM and merchant card income (up 6% and 8%, respectively) was offset by losses from OREO expense, a 6% fall in cash flow income, a 10% drop in other noninterest income, and an 11% 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.

Total noninterest expense rose $0.3 million, or 4%, year over year to $6.6 million (compared to our $6.7 million estimate), as the Company maintained tight control over noncompensation operating expenses.

The loan loss provision decreased 83% to $0.2 million (versus our $0.1 million estimate), as the Company reverted to normal reserve strengthening compared to the outsized $1.2 million provision taken in the year-ago quarter. CPKF increased its loan loss reserves to $6.7 million (1.89% of loans) from $5.6 million (1.54% of loans) at the end of the comparable year-ago quarter, though it was level with the $6.5 million (1.89% of loans) at the end of the previous quarter.

As to other asset quality measures, CPKF charged off $58,000 of loans in the third quarter. This compares to net charge-offs of $1.0 million in the prior-year quarter and of net charge-offs of $1.5 million for full-year 2010. Gross loans outstanding dropped about $3 million, or almost 1%, sequentially to $352 million and $14.5 million from the comparable prior-year quarter, reflecting continued weak loan demand.

CPKF posted a 14.9% ROE and 1.16% ROA for the third quarter of 2011, compared to 19.3% and 1.29%, respectively, in the prior-year quarter.

On October 25, 2011, CPKF announced it was maintaining its $0.10 quarterly dividend, payable on or before December 15, 2011 to shareholders of record as of December 1, 2011. Earlier in the year, CPKF hiked the dividend 9% (4.3% in April and 4.5% in March) and had a 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.

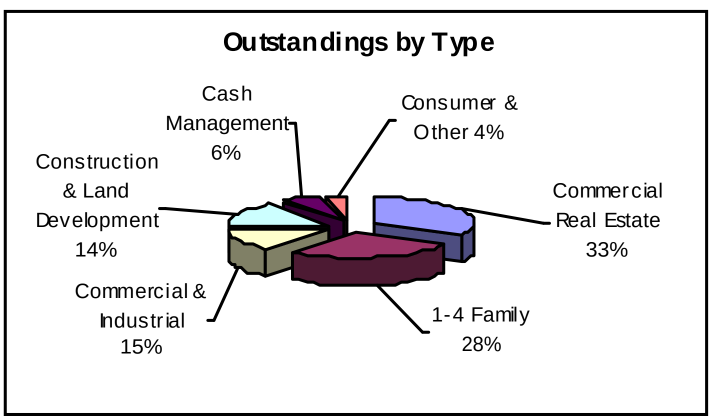
We are currently reviewing our estimates and will issue a more comprehensive report when detailed financial information becomes available within the next few weeks.

OVERVIEW

Chesapeake Financial Shares, Inc. (CPKF or the Company) is a bank holding company headquartered in Kilmarnock, Virginia, with $631 million in total assets at September 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 $319 million in assets (as of the end of the second 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.

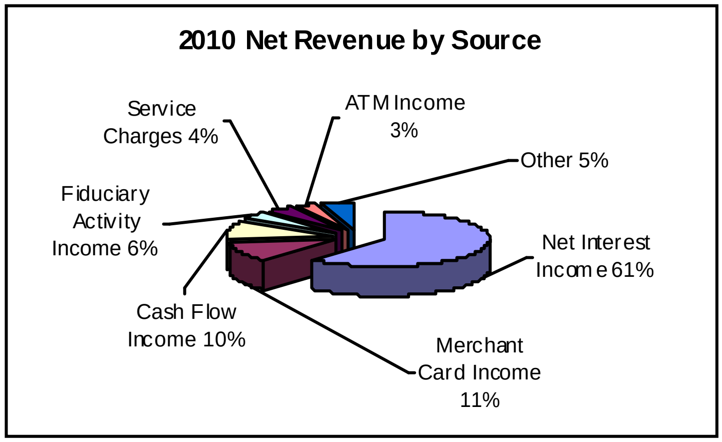


Clear Sky accounts, which offer internet-based retail deposit services for checking and saving accounts and certificates of deposit (CDs), expands CPKF's retail deposit base geographically. At 2010 yearend, Clear Sky deposits totalled $50 million, with customers in all 50 states.

Through Chesapeake's secondary market mortgage banking operation, the Company services a $176 million loan portfolio (as of June 30, 2011) 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 June 30, 2011, the lending book consisted of commercial real estate (accounting for 33% of total gross outstandings), 1-4 family (28%), commercial and industrial (15%), construction and land development (14%), cash flow (6%), and consumer and other (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, US Treasuries, and US agency mortgage obligations, represent about 14% of total assets and 35% of the securities portfolio. In addition, the available-for-sale portfolio includes municipal and private label mortgage securities, which currently account for 46% and 19%, respectively, of the total. Core deposits represented 79% of total deposits at June 30, 2011, with certificates of deposit larger than $100,000 at 21%.



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 8.9% compared to no gain or loss for banks in the Zacks small-cap bank index, as shown in the following table. At its current price, CPKF is trading at discounts to the industry median P/E of 49% in 2011 (versus 54% at the time of our last report on August 2, 2011) and of 44% in 2012 (compared to 47% at August 2, 2011), 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/Tangible Book Value, CPKF is valued at 0.85X versus the industry median of 0.76X. This represents a 12% premium, well below the average historical premium of 23% for CPKF since the end of 2005. We believe a higher 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.

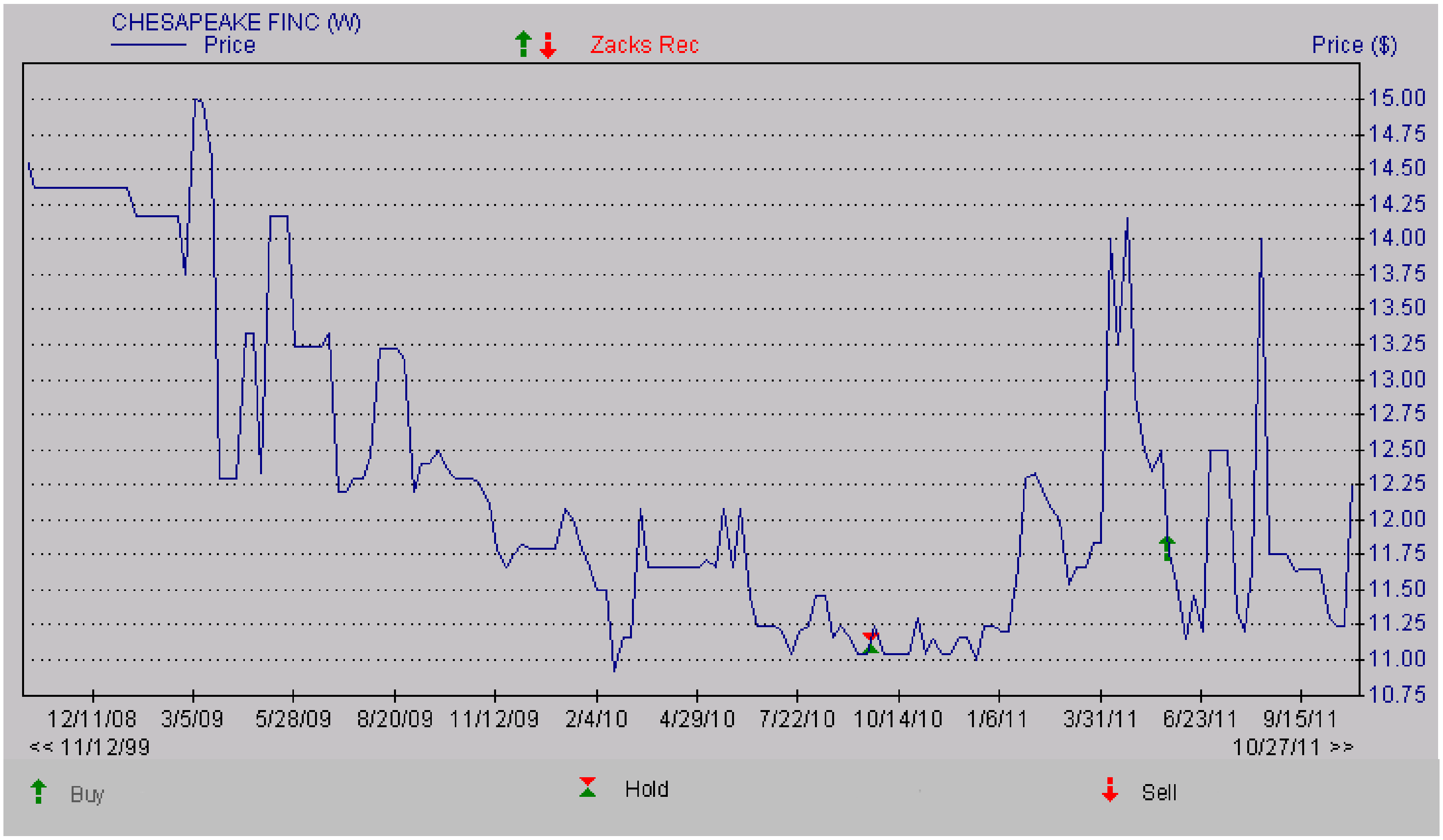
Applying the historical premium of 23% to our estimated book value for CPKF twelve months out results in a price target of approximately $14.50. Combined with the dividend yield, this represents a total return of almost 22%, well above our expectations for gains in the broader market index over the next year. Therefore, we are maintaining our recommendation on CPKF at Outperform.

Industry Comparables- Small-cap Banks

	Pr Chg YTD	Price / Earnings Ratios: TTM* EPS	2011E	2012E	5-Yr Avg	Price/ Book	Return on Equity: TTM*	5-Yr Avg	Return on Assets: TTM*	5-Yr Avg	Div Yld
Chesapeake Finc'l	**8.9**	**6.2**	**6.3**	**6.0**	**9.4**	**0.85**	**14.3**	**14.1**	**1.04**	**0.91**	**3.3**
S&P 500	2.1	17.5	13.3	12.4	18.0	3.8	28.8	-----	10.8	-----	2.0
Median	**(0.0)**	**12.4**	**12.4**	**10.8**	**16.4**	**0.76**	**5.9**	**4.3**	**0.50**	**0.34**	**0.4**
Average	2.5	13.1	13.3	22.4	19.9	0.7	4.4	2.6	0.51	0.32	1.4
High	61.2	25.0	33.6	264.3	42.9	1.5	21.2	12.8	2.21	2.41	6.1
Low	(55.2)	4.8	4.6	5.4	12.0	0.2	(51.6)	(32.9)	(1.73)	(1.88)	-----

*Trailing twelve months

HISTORICAL ZACKS RECOMMENDATIONS



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