Zacks Small-Cap Research

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Chesapeake Financial Shares, Inc. (CPKF - OTC)

CPKF: Fourth Quarter EPS Up 57% and Dividend Raised 10% - Outperform

Current Recommendation	**Outperform**
Prior Recommendation	Neutral
Date of Last Change	05/26/2011
Current Price (01/24/12)	$11.90
Twelve-Month Target Price	**$14.75**

OUTLOOK

Chesapeake Financial Shares, Inc. (CPKF) reported 2011 fourth quarter net earnings of $1.6 million, or $0.49 per diluted share, up 57% from the $1.0 million, or $0.31 per diluted share posted in the year-ago quarter, and compares to our $0.33 estimate. There were a number of variances from our estimate, including a $0.2 million loan loss provision that was $0.3 million better than our estimate of $0.5 million and an 8.9% effective tax rate that was lower than our 24.4% estimate. On the negative side, CPKF recorded a net loss on the sale of securities of $455,000 (compared to our $50,000 estimate), reducing noninterest income to $3.2 million (versus our $3.5 million estimate). Net interest income rose 9% year over year to $6.0 million, while noninterest expense rose 5% year over year to $7.2 million, largely reflecting a 19% gain in total compensation costs, partly offset by a 14% slide in other noninterest expense. The efficiency ratio was flat at roughly 79%. For the year, CPKF earned $7.0 million, or $2.16 per diluted share, up 28% from the $5.4 million, or $1.69 per diluted share, posted in 2010. This year-over-year gain primarily stemmed from a 5% rise in net interest income to $22.8 million on a higher net interest margin (average loans were flat) and a 52% decline in the loan loss provision. The effective tax rate in 2011 was 21.4%, a bit lower than 2010's 22.0%. CPKF just raised its quarterly dividend by 10% to $0.11 from $0.10 and has increased its dividend payment annually for the past twenty years. We are currently 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	**$10.80**
One-Year Return (%)	**0.17**
Beta	**0.13**
Average Daily Volume (sh)	**1,063**
Shares Outstanding (mil)	**3**
Market Capitalization ($mil)	**$39**
Short Interest Ratio (days)	**N/A**
Institutional Ownership (%)	**0**
Insider Ownership (%)	**40**
Annual Cash Dividend	**$0.44**
Dividend Yield (%)	**3.70**
5-Yr. Historical Growth Rates	
Net Revenue (%)	**7.1**
Earnings Per Share (%)	**14.1**
Dividend (%)	**8.2**
P/E using TTM EPS	**5.5**
P/E using 2011 Actual	**5.5**
P/E using 2012 Estimate	**5.7**
Zacks Rank	**3**

Risk Level	**Average**
Type of Stock	**Small-Value**
Industry	**Banks-Southeast**
Zacks Rank in Industry	**50 of 72**

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	8.8 A	9.4 A	9.2 A	9.1 A	36.5 A
2012					37.4 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	0.49 A	2.16 A
2012					2.10 E

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

FOURTH QUARTER RESULTS

CPKF reported 2011 fourth quarter net earnings of $1.6 million, or $0.49 per diluted share, up 57% from the $1.0 million, or $0.31 per diluted share posted in the year-ago quarter. This compares to our fourth quarter estimate of $0.33.

There were a number of variances from our estimate. On the positive side, the loan loss provision was $0.2 million, $0.3 million lower than our estimate of $0.5 million, and the effective tax rate was 8.9% versus our estimate of 24.4%. Negatively, CPKF recorded a net loss on the sale of securities of $455,000 (compared to our $50,000 estimate), reducing noninterest income to $3.2 million (versus our $3.5 million estimate).

Net interest income rose 9% year over year to $6.0 million, and noninterest income fell 1% to $3.2 million. This was due to a 16% drop in cash flow income to $726,000, the result of reduced lending volumes, and a 300% incease in the net loss on securities sales to $455,000, partially offset by an 8% advance in merchant card income to $1.2 million on higher processing volumes and a 74% decline in net losses from other real estate owned to $86,000.

Noninterest expense rose 5% year over year to $7.2 million, largely reflecting a 19% gain in total compensation costs, partly offset by a 14% slide in other noninterest expense. The efficiency ratio was flat at roughly 79%.

The loan loss provision was slashed by 78%, dropping to $0.2 million from $0.9 million in the fourth quarter of last year, as the Company continued to strenthen loan loss reserves. CPKF increased its loan loss reserves to $6.5 million (1.81% of loans) from $6.1 million (1.69% of loans) at the end of 2010.

As to other asset quality measures, CPKF charged off $0.4 million of loans in the fourth quarter, resulting in a 0.45% charge-off ratio for the loan portfolio. This compares to net charge-offs of $0.4 million in the comparable quarter a year ago, $0.9 million for full-year 2011, and $1.5 million for all of 2010. Gross loans outstanding inched up about $4 million, or 1%, sequentially to $356 million, but fell $6 million year over year from the end of 2010, reflecting continued weak loan demand. Total delinquencies 30 days and over decreased during this same period by 42% to 1.25% of total loans.

CPKF posted a 12.5% ROE and 1.00% ROA for the fourth quarter of 2011, compared to 9.7% and 0.67%, respectively, in the prior-year quarter.

For the year, CPKF earned $7.0 million, or $2.16 per diluted share, up 28% from the $5.4 million, or $1.69 per diluted share, posted in 2010. This year-over-year gain primarily stemmed from a 5% rise in net interest income to $22.8 million on a higher net interest margin (average loans were flat) and a 52% decline in the loan loss provision to $1.2 million. The effective tax rate in 2011 was 21.4%, a bit lower than 2010's 22.0%. For full-year 2011, CPKF posted a 16.7% ROE and 1.15% ROA, compared to 13.0% and 0.90%, respectively, in the prior year.

Importantly, CPKF just raised its quarterly dividend by 10% to $0.11 from $0.10, payable on March 15, 2012 to shareholders of record on March 1, 2012. This means CPKF has increased its dividend payment annually for the past twenty years since 1992.

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 of the Virginia Bankers Association.

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

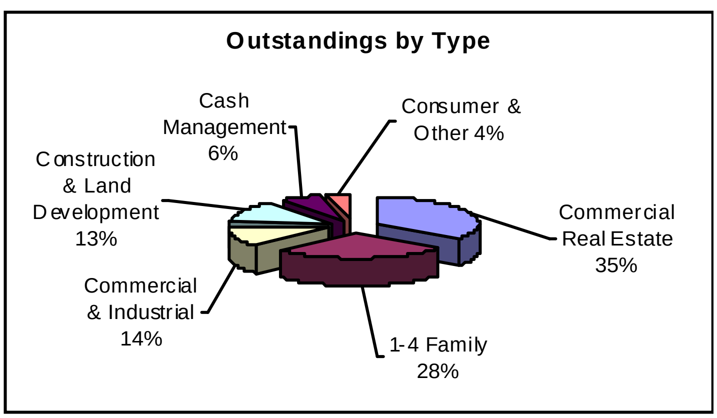
OVERVIEW

Chesapeake Financial Shares, Inc. (CPKF or the Company) is a bank holding company headquartered in Kilmarnock, Virginia, with $638 million in total assets at December 31, 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 $306 million in assets (as of the end of the third 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.

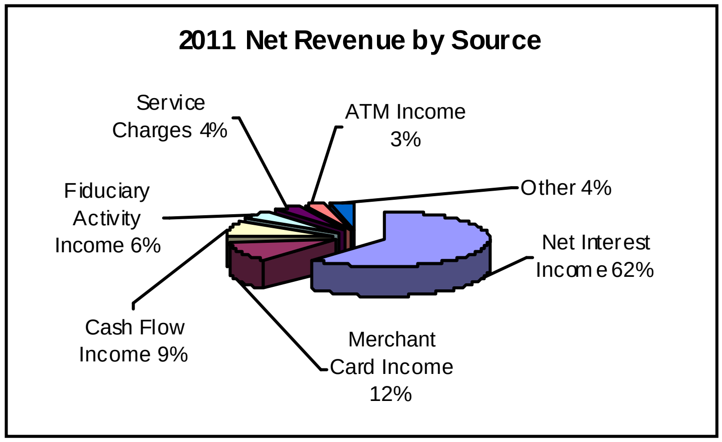


Clear Sky accounts, which offer internet-based retail deposit services for checking and saving accounts and certificates of deposit (CDs), expands CPKF's retail deposit base geographically. At September 30, 2011, Clear Sky deposits totalled $50 million, with customers in all 50 states.

Through Chesapeake's secondary market mortgage banking operation, the Company services a $175 million loan portfolio (as of September 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 September 30, 2011, the lending book consisted of commercial real estate (accounting for 35% of total gross outstandings), 1-4 family (28%), commercial and industrial (14%), construction and land development (13%), 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, and US agency mortgage obligations, represent about 16% of total assets and 34% of the securities portfolio. In addition, the available-for-sale portfolio includes municipal and private label mortgage securities, which currently account for 48% and 18%, respectively, of the total. Core deposits represented 79% of total deposits at September 30, 2011, with certificates of deposit larger than $100,000 at 21%.



In 2011, net interest income contributed 62% of net revenue, with a significant 38% coming from noninterest income sources. Major contributors to noninterest income include merchant card income (12% of net revenues), cash flow income (9%), 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 5.8% compared to a 5.1% gain 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 58% in 2011 (versus 48% at the time of our last report on November 22, 2011) and of 49% in 2012 (compared to 44% November 22, 2011), based upon our current CPKF EPS estimate for 2012. This is in excess of the average 42% P/E discount for CPKF, based upon 5-year historical P/E averages. Applying the historical discount of 42% to our 2012 EPS estimate results in a price of about $14.00.

Turning to Price/Tangible Book Value, CPKF is valued at 0.76X versus the industry median of 0.76X. This represents a 0% premium, well below the average historical premium of 20% for CPKF since the end of 2005. We believe a higher premium is justified given CPKF’s strong performance throughout the financial crisis, its strong profitability measures, and its solid dividend yield. Applying the historical premium of 20% to our estimated book value for CPKF twelve months out results in a price of approximately $15.50.

Taking the midpoint of the $14.00-15.50 stock price range determined above results in a target price of $14.75 and compares to CPKF’s current stock price of $11.90, indicating a 24% gain. When combined with the dividend yield, this represents a total return of almost 28%, 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	TTM* EPS	Price / Earnings Ratios 2012E	2013E	5-Yr Avg	Price/ Book	Return on Equity TTM*	5-Yr Avg	Return on Assets TTM*	5-Yr Avg	Div Yld
Chesapeake Finc'l	**5.8**	**5.5**	**5.7**		**9.2**	**0.76**	**16.7**	**14.2**	**1.15**	**0.92**	**3.7**
S&P 500	4.5	13.9	12.8	12.3	17.3	3.9	23.5	-----	9.1	-----	2.2
Median	**5.1**	**13.1**	**11.1**	**9.9**	**15.9**	**0.76**	**6.2**	**4.0**	**0.59**	**0.32**	**0.4**
Average	9.1	19.6	10.7	9.7	20.6	0.7	4.7	2.2	0.57	0.30	1.5
High	111.9	111.3	16.7	13.9	41.8	1.5	23.2	11.9	2.31	2.35	7.0
Low	(6.8)	6.2	4.8	4.4	12.0	0.1	(71.8)	(35.2)	(1.81)	(2.04)	-----

*Trailing twelve months

Chesapeake Financial Shares, Inc.

Income Statement and Balance Sheet

(Dollars in millions, except per share data)

Summary Financial Data	**12/06**	**12/07**	**12/08**	**12/09**	**12/10**	**12/11 P**	**12/12 E**
Net interest income	14.3	14.5	16.5	18.9	21.8	22.8	22.9
Non-interest income	11.6	13.5	15.0	14.1	13.8	13.7	14.5
Total net revenue	25.9	28.0	31.5	33.0	35.6	36.5	37.4
Loan loss provision	0.8	0.2	0.4	0.9	2.5	1.2	1.2
Non-interest expense	19.6	21.8	25.0	25.9	26.2	26.4	27.2
Income taxes & other	1.5	1.7	1.5	1.4	1.5	1.9	2.1
Zacks adjusted income before NRI	4.0	4.3	4.6	4.8	5.4	7.0	6.9
GAAP net income	4.0	4.3	4.6	4.8	5.4	7.0	6.9
Diluted EPS before NRI	1.12	1.24	1.34	1.48	1.69	2.16	2.10
Reported EPS	1.12	1.24	1.34	1.48	1.69	2.16	2.10
Dividends per share	0.27	0.29	0.34	0.35	0.36	0.40	0.40
Liquid assets	52.9	58.4	45.4	57.8	73.2	99.7	104.9
Outstandings, gross	319.4	361.6	396.2	391.3	382.3	373.2	391.9
Total assets	418.1	483.0	538.0	586.7	607.7	638.0	663.7
Core deposits	295.2	308.8	317.0	370.0	396.2	431.1	444.4
Purchased funds	73.7	80.0	115.9	126.7	121.7	112.5	116.5
Long-term debt	11.6	44.4	65.5	47.4	40.0	37.2	40.0
Shareholders' equity	31.0	33.7	30.6	35.3	41.1	51.2	55.7
Profitability							
Return on avg assets	0.98%	0.97%	0.89%	0.84%	0.90%	1.15%	1.05%
Return on avg equity	13.58%	13.68%	13.51%	13.14%	13.03%	16.70%	12.86%
Net interest margin	4.20%	4.10%	4.00%	4.10%	4.40%		4.45%
Loan loss provision % avg assets	0.21%	0.04%	0.08%	0.16%	0.41%	0.20%	0.18%
Noninterest income % avg assets	2.88%	3.01%	2.91%	2.45%	2.28%	2.26%	2.23%
Noninterest expense % avg assets	4.86%	4.87%	4.84%	4.51%	4.31%	4.36%	4.18%
Preprovision pretax income % avg assets	1.54%	1.39%	1.26%	1.24%	1.56%	1.66%	1.57%
Tangible efficiency ratio	76%	78%	79%	78%	73%	72%	73%
Payout ratio	24%	23%	25%	24%	21%	18%	19%
Asset Quality							
Net charge-offs % avg outstandings	0.28%	0.04%	0.27%	0.34%	0.48%		0.31%
Allowance % outstandings	1.55%	1.50%	1.43%	1.59%	1.90%		2.09%
NPAs % loans + OREO	1.00%	0.61%	0.35%	1.20%	2.00%		1.92%
Allowance % NPAs	154%	245%	411%	131%	94%		108%
Liquidity & Funding							
Liquid assets % purchased funds	72%	73%	39%	46%	60%	89%	90%
Core deposits % outstandings	92%	85%	80%	95%	104%	115%	113%
Liquid assets % assets	13%	12%	8%	10%	12%	16%	16%
Outstandings % assets	76%	75%	74%	67%	63%	59%	59%
Capital Adequacy							
Total equity % assets	7.41%	6.97%	5.68%	6.01%	6.76%	8.03%	8.39%
Tangible equity % assets	7.41%	6.97%	5.68%	6.01%	6.76%	8.03%	8.39%
Tier 1 capital ratio	11.10%	10.80%	10.60%	10.10%	12.07%		
Total capital ratio	12.50%	15.50%	12.50%	11.70%	13.54%		
Parent Company Statistics							
Interest coverage	0.8X	0.4X	0.6X	0.8X	2.6X		1.0X
Interest & dividend coverage	0.5X	0.3X	0.3X	0.4X	1.1X		0.4X
Short-term debt coverage	Lge	Lge	Lge	Lge	Lge		Lge
Total debt coverage	1.0X	1.0X	0.9X	0.8X	0.8X		1.4X
Double leverage	127.3%	133.2%	139.8%	142.1%	134.7%		123.4%

Chesapeake Financial Shares, Inc.

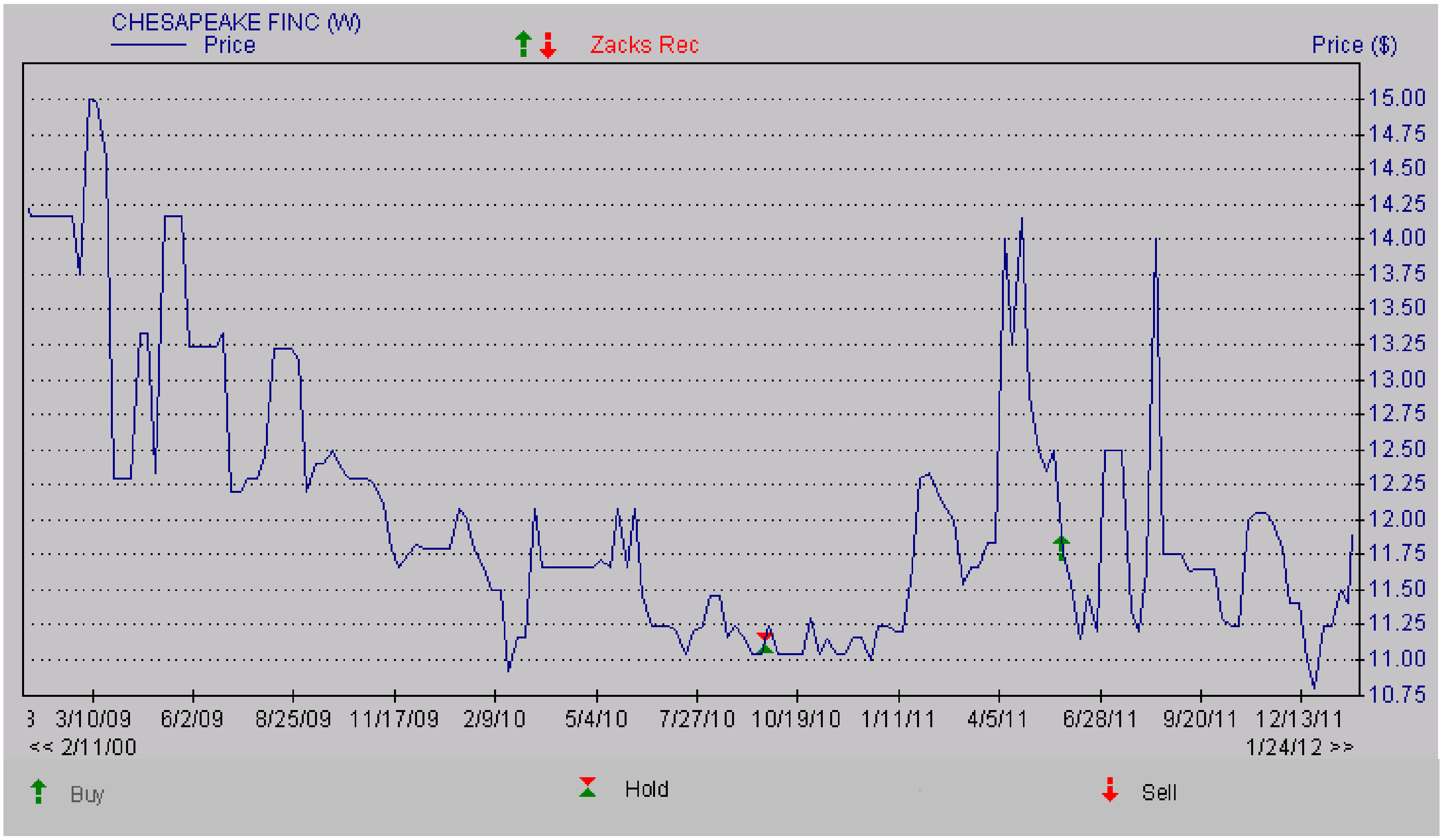
Income Statement and Balance Sheet

(Dollars in millions, except per share data)

	2010				2011			
Summary Financial Data	**Q1 A**	**Q2 A**	**Q3 A**	**Q4 A**	**Q1 A**	**Q2 A**	**Q3 A**	**Q4 P**
Net interest income	5.2	5.5	5.6	5.5	5.8	5.4	5.7	6.0
Non-interest income	3.0	3.1	4.6	3.2	3.0	4.0	3.5	3.2
Total net revenue	8.2	8.6	10.2	8.7	8.9	9.4	9.2	9.1
Loan loss provision	0.2	0.2	1.2	0.9	0.6	0.2	0.2	0.2
Non-interest expense	6.4	6.6	6.3	6.9	6.2	6.5	6.6	7.2
Income taxes & other	0.4	0.5	0.8	(0.1)	0.5	0.6	0.6	0.2
Zacks adjusted income before NRI	1.2	1.3	1.9	1.0	1.5	2.1	1.8	1.6
GAAP net income	1.2	1.3	1.9	1.0	1.5	2.1	1.8	1.6
Diluted EPS before NRI	0.42	0.48	0.71	0.38	0.47	0.63	0.56	0.49
Reported EPS	0.42	0.48	0.71	0.38	0.47	0.63	0.56	0.49
Dividends per share	0.10	0.10	0.11	0.11	0.10	0.10	0.10	0.10
Liquid assets	74.9	73.1	69.2	73.2	68.9	88.4	99.8	99.7
Outstandings, gross	391.5	388.4	387.3	382.3	376.8	376.5	372.9	373.2
Total assets	608.5	604.3	605.1	607.7	602.7	619.6	631.5	638.0
Core deposits	388.6	391.9	390.1	396.2	397.2	415.3	422.9	431.1
Purchased funds	125.4	119.9	117.9	121.7	115.8	112.5	112.5	112.5
Long-term debt	44.5	41.4	40.5	40.0	40.0	39.9	39.8	37.2
Shareholders' equity	36.9	38.2	42.4	41.1	43.6	46.6	50.4	51.2
Profitability								
Return on avg assets*	0.78%	0.88%	1.29%	0.67%	1.01%	1.35%	1.16%	1.00%
Return on avg equity *	12.87%	14.16%	19.29%	9.68%	14.40%	18.28%	14.91%	12.49%
Net interest margin*	4.36%	4.53%	4.54%	4.42%	4.68%	4.33%	4.56%	
Loan loss provision % avg assets*	0.16%	0.10%	0.78%	0.60%	0.39%	0.13%	0.13%	0.13%
Noninterest income % avg assets*	2.02%	2.02%	3.00%	2.13%	1.99%	2.65%	2.25%	2.00%
Noninterest expense % avg assets*	4.27%	4.35%	4.17%	4.54%	4.13%	4.26%	4.20%	4.54%
Preprovision pretax inc.% avg assets*	1.23%	1.30%	2.54%	1.20%	1.72%	1.92%	1.66%	1.22%
Tangible efficiency ratio	78%	77%	62%	79%	71%	69%	72%	79%
Payout ratio	25%	22%	16%	29%	20%	16%	18%	20%
Asset Quality								
Net charge-offs % avg outstandings*	0.10%	(0.00)%	1.25%	0.59%	0.01%	0.44%	-----	
Allowance % outstandings	1.65%	1.73%	1.74%	1.90%	2.11%	2.06%	2.12%	
NPAs % loans + OREO	2.46%	2.87%	2.32%	2.00%	1.92%	2.38%	2.28%	
Allowance % NPAs	67%	60%	74%	94%	92%	85%	92%	
Liquidity & Funding								
Liquid assets % purchased funds	60%	61%	59%	60%	60%	79%	89%	89%
Core deposits % outstandings	99%	101%	101%	104%	105%	110%	113%	115%
Liquid assets % assets	12%	12%	11%	12%	11%	14%	16%	16%
Outstandings % assets	64%	64%	64%	63%	63%	61%	59%	59%
Capital Adequacy								
Total equity % assets	6.07%	6.33%	7.01%	6.76%	7.24%	7.52%	7.98%	8.03%
Tangible equity % assets	6.07%	6.33%	7.01%	6.76%	7.24%	7.52%	7.98%	8.03%
Tier 1 capital ratio	10.19%	10.61%	11.58%	12.07%	12.39%	12.04%	12.09%	
Total capital ratio	11.87%	12.23%	13.11%	13.54%	13.76%	13.30%	13.34%	

*Annualized.

HISTORICAL ZACKS RECOMMENDATIONS



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