Zacks Small-Cap Research

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Chesapeake Financial Shares, Inc. (CPKF - OTC)

CPKF: Good Second Quarter Prompts 13% Dividend Increase

Current Recommendation	**Outperform**
Prior Recommendation	Neutral
Date of Last Change	05/26/2011
Current Price (07/30/13)	$18.49
Twelve-Month Target Price	**$22.50**

OUTLOOK

CPKF reported second quarter diluted EPS of $0.76 that was $0.08, or 12%, better than our $0.68 estimate, as the Company recognized $1.06 million in gains from the sale of securities, which was partly offset by a $0.65 million loan loss provision and a higher effective tax rate. Relative to the year-ago quarter, net earnings climbed 23% to $2.5 million, while 2013's second quarter diluted EPS advanced 23% from the $0.62 posted in 2012's second quarter. Sequential net income jumped 20% from first quarter's $2.1 million and diluted EPS also gained 20% from the $0.63 posted in the first quarter of 2013. The primary reasons for the second quarter's gain versus the first quarter were: (1) a $1.1 million positive swing in the combined gain/loss from the sales of securities and OREO to a gain of $1.0 million from a loss of $0.1 million in the first quarter; (2) a $0.55 million jump in the loan loss provision to $650,000 from $100,000; and (3) a 220 basis-point bump-up in the effective tax rate to 24.2% from 22.0%. On July 19, 2013, CPKF hiked its quarterly dividend by 13% to $0.135 per share from $0.12 per share, which follows two dividend increases totaling 20% in 2012. Notably, CPKF has increased the annual dividend payment every year for the past twenty-one years since 1991. In December, CPKF completed a tender offer to repurchase $1.5 million of company stock (about 2% of outstanding shares) at $18.50 per share. We note that American Banker ranked CPKF 17th out of all banks nationally with less than $2 billion in total assets, which includes roughly 6,000 banks, and #2 of all banks in Virginia.

SUMMARY DATA

52-Week High	**$18.70**
52-Week Low	**$13.80**
One-Year Return (%)	**34.57**
Beta	**0.10**
Average Daily Volume (sh)	**991**
Shares Outstanding (mil)	**3**
Market Capitalization ($mil)	**$61**
Short Interest Ratio (days)	**N/A**
Institutional Ownership (%)	**0**
Insider Ownership (%)	**40**
Annual Cash Dividend	**$0.54**
Dividend Yield (%)	**2.92**
5-Yr. Historical Growth Rates	
Net Revenue (%)	**9.6**
Earnings Per Share (%)	**13.3**
Dividend (%)	**9.1**
P/E using TTM EPS	**7.3**
P/E using 2013 Estimate	**7.4**
P/E using 2014 Estimate	**7.3**
Zacks Rank	**1**

Risk Level	**Average**
Type of Stock	**Small-Value**
Industry	**Banks-Southeast**
Zacks Rank in Industry	**10 of 62**

ZACKS ESTIMATES

Net Revenue
(in millions of $)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2011	8.8 A	9.4 A	9.2 A	9.1 A	36.5 A
2012	9.0 A	9.4 A	10.1 A	9.6 A	38.1 A
2013	9.6 A	11.1 A	10.0 E	9.6 E	39.2 E
2014					39.8 A

Earnings per Share
(EPS is operating earnings before nonrecurring items)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2011	0.47 A	0.63 A	0.56 A	0.49 A	2.16 A
2012	0.57 A	0.62 A	0.74 A	0.39 A	2.32 A
2013	0.63 A	0.76 A	0.68 E	0.51 E	2.50 E
2014					2.55 A

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

SECOND QUARTER

CPKF reported second quarter diluted EPS of $0.76 that was $0.08, or 12%, better than our $0.68 estimate, as the Company recognized $1.06 million in gains from the sale of securities, which was partly offset by a $0.65 million loan loss provision and a higher effective tax rate.

Relative to the year-ago quarter, net earnings climbed 23% to $2.5 million, while 2013's second quarter diluted EPS advanced 23% from the $0.62 posted in 2012's second quarter.

Sequential net income jumped 20% from first quarter's $2.1 million and diluted EPS also gained 20% from the $0.63 posted in the first quarter of 2013. The primary reasons for the second quarter's gain versus the first quarter were: (1) a $1.1 million positive swing in the combined gain/loss from the sales of securities and OREO to a gain of $1.0 million from a loss of $0.1 million in the first quarter; (2) a $0.55 million jump in the loan loss provision to $650,000 from $100,000; and (3) a 220 basis-point bump-up in the effective tax rate to 24.2% from 22.0%.

Compared to our projections, net income was $0.3 million, or $0.08 per diluted share, above our $2.2 million, or $0.68 per share, estimate, respectively. This primarily reflected combined gains from the sales of securities and OREO that were $1.0 million above our estimate partially offset a loan loss provision and income taxes that came in $0.5 million and $0.2 million, respectively, higher than our projections.

Net interest income grew 1% year over year to $5.8 million ($0.1 million lower than our estimate), as 6 ½% growth in loans and receivables outstanding was partially offset by a net interest margin that we estimate was below the 4.53% earned in the year-ago quarter.

Noninterest income advanced $1.6 million, or 45%, year over year to $5.3 million ($1.1 million above our projection), primarily the result of a large gain on the sale of securities ($1.1 million greater than our estimate) and solid growth in merchant card income (up $0.1 million, or 9%) as the Company added new clients, cash flow income (up $0.1 million or 15%) due to product line expansion, and miscellaneous income (up almost $0.2 million, or 18%) reflecting strong growth in mortgage banking.

Total noninterest expense increased $0.5 million, or about 8%, year over year to $7.1 million ($0.1 million higher than our estimate), largely reflecting a $0.2 million, or 6%, gain in salary expense, a $0.2 million, or 12%, rise in miscellaneous expense, and a $0.1 million advance in cash flow expense.

The loan loss provision climbed 333% to $0.65 million (well above our $0.15 estimate), as CPKF stengthened loan loss reseves. Loan loss reserves rose $0.4 million from $5.8 million (1.56% of loans) at the end of the first quarter to $6.2 million (1.66% of loans) at June 30, 2013, though this level was below the $6.5 million (1.82%) in the year-ago quarter.

As to other asset quality measures, CPKF charged off $215,000 of loans in the second quarter. This is $55,000 larger than the $160,000 charged off in the year-ago quarter and compares to net charge-offs of $634,000 in 2013's first quarter and $709,000 for full-year 2012. CEO Jeff Szyperski noted that total delinquencies 30 days and over improved, decreasing to 1.914% of total loans at the end of the second quarter compared to 2.149% at March 30, 2013 and 3.031% at December 31, 2012.

Gross loans outstanding increased $16 million, or about 5%, year over year and $3 ½ million, or 1%, sequentially to $376 million.

CPKF posted an 16.5% ROE and 1.57% ROA for the second quarter of 2013, compared to 14.6% and 1.29%, respectively, in the prior-year quarter.

On July 19, 2013, CPKF hiked its quarterly dividend by 13% to $0.135 per share from $0.12 per share, payable on September 15, 2013 to shareholders of record on September 1, 2013. CPKF increased the quarterly dividend twice in 2012, by $0.02 or 20%. Notably, CPKF has increased the annual dividend payment every year for the past twenty-one years since 1991.

On October 29, 2012, CPKF announced a tender offer to repurchase up to $1.5 million of company stock at a price of $18.50 per share for shareholders of record (a 12% premium to the $16.50 share price at that time) as of October 25, 2012, with shares tendered by the close of business on December 10, 2012. As the entire $1.5 million was repurchased, this reduced shares outstanding by 2% and increased annual diluted EPS by a penny.

We note that American Banker recently ranked CPKF 17th (down one notch from 16th a year ago) out of all banks nationally with less than $2 billion in total assets, which includes approximately 6,000 banks, and #2 of all banks in Virginia. This ranking was based upon three-year average returns on equity, which for Chesapeake Financial was 14.10%. The Company has steadily risen through the rankings in the past five years, reflecting its solid financial performance during this difficult banking environment.

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 $643 million in total assets at June 30, 2013. CPKF is predominantly a small business lender with 12 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 five 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. In addition, CPKF opened a commercial loan production office in Richmond, Virginia in mid-August 2011.

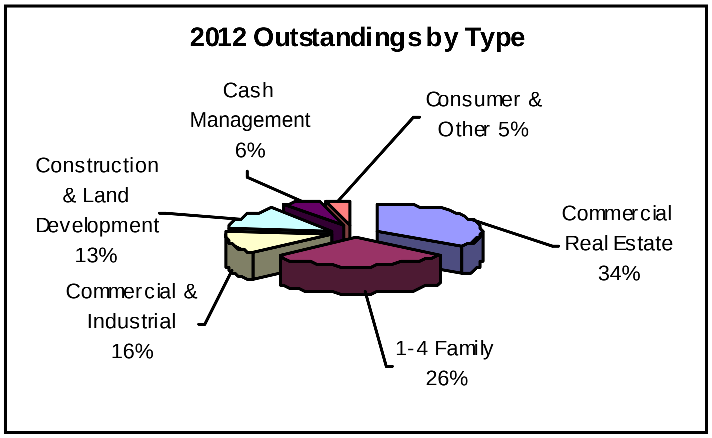
Operations are carried on through Chesapeake Bank, a state-chartered bank as well as Federal Reserve and FDIC member bank, and Chesapeake Investment Group, Inc. (CIG), an independent wealth management firm that manages about $330 million in assets (at 2012 yearend) through its subsidiaries involved in 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 2012, Chesapeake Payment Systems had 607 merchants in its system and processed over $133 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 had 76 customers at the end of 2012.

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 December 31, 2012, Clear Sky deposits totalled $44 million, with customers in all 50 states.

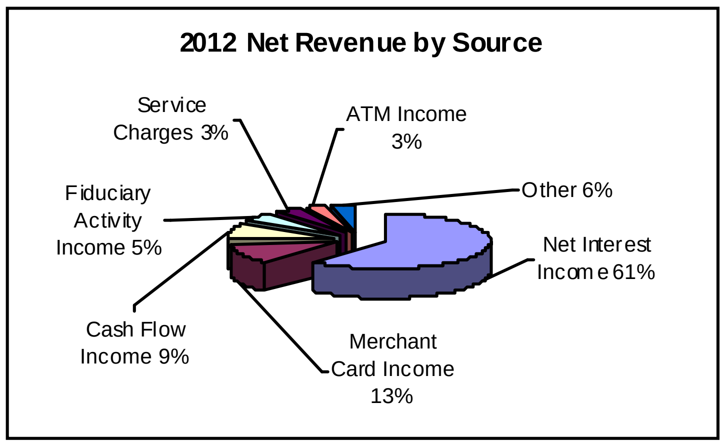
Through Chesapeake's secondary market mortgage banking operation, the Company services a $207 million loan portfolio (as of December 31, 2012) of residential mortgage loans for Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac), for which it earns a 25 basis-point fee (approximately $520,000 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 $952,000 to revenues in 2012 (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 left. At December 31, 2012, the lending book consisted of commercial real estate (accounting for 34% of total gross outstandings), 1-4 family (26%), commercial and industrial (16%), construction and land development (13%), cash flow (6%), and consumer and other (5%). A majority of loans are secured, usually by real estate, inventory, accounts receivable, equipment, machinery, or corporate assets.

At December 31, 2012, the liquidity portfolio, which consists of cash, short-term investments, federal funds sold, and US agency mortgage obligations, represented about 14% of total assets and 21% of the securities portfolio. In addition, the available-for-sale portfolio includes municipal and private label mortgage securities, which accounted for 64% and 15%, respectively, of the total. Core deposits represented 81% of total deposits at December 31, 2012, with certificates of deposit larger than $100,000 at 19%.

In 2012, 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 (13% of net revenues), cash flow income (9%), income from fiduciary activities (5%), service charges on deposit accounts (3%), and ATM income (3%).



VALUATION

CPKF stock has risen 10.1% year to date, below the small-cap bank industry's median price increase of 26.4%, as shown in the following table, as well as the 18.2% gain for the S&P 500. We note that the share price surged 49.3% last year in 2012 compared to 13.4% for the S&P 500.

At its current price, CPKF is trading at a discount to the industry median P/E of 43% in 2014, based upon our most recent CPKF EPS estimate for 2014. This is below the average 52% P/E discount for CPKF, based upon 5-year historical P/E averages. Applying the historical discount of 52% to our 2014 EPS estimate results in a price of about $15.50.

Turning to Price/Tangible Book Value, CPKF is valued at 0.98X versus the industry median of 1.10X. This represents an 11% discount, well below the average historical premium of 19% for CPKF since the end of 2005. Applying the historical premium of 19% to our estimated book value for CPKF twelve months out results in a price of approximately $25.25.

At a minimum, we believe that CPKF should be trading in line with the industry's 1.10X Price/Tangible Book Value, given CPKF's strong performance throughout the financial crisis, its superior profitability measures, and its above-average yield on the dividend, which was just increased 13%. Applying this metric to our estimated book value for CPKF twelve months out results in a price of roughly $22.50.

With $22.50 as our target price (versus CPKF's $18.49 current market price) and a 2.9% dividend yield, this indicates a total return of over 24%, 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

		Price / Earnings Ratios					Return on Equity		Return on Assets		
	Pr Chg YTD	TTM* EPS	2013E	2014E	5-Yr Avg	Price/ Book	TTM*	5-Yr Avg	TTM*	5-Yr Avg	Div Yld
Chesapeake Finc'l	**10.1**	**7.3**	**7.4**	**7.3**	**7.7**	**0.98**	**13.7**	**14.3**	**1.31**	**0.97**	**2.9**
S&P 500	18.2	17.4	15.6	14.7	16.6	4.3	26.4	-----	9.0	-----	2.0
Median	**26.4**	**13.9**	**13.6**	**12.7**	**16.1**	**1.10**	**7.7**	**4.0**	**0.74**	**0.35**	**1.0**
Average	29.4	17.1	14.1	13.6	24.1	1.1	7.5	1.7	0.7	0.3	1.2
High	97.9	45.1	29.3	26.4	104.5	2.1	14.2	14.3	1.5	2.0	4.7
Low	(2.5)	7.6	7.4	7.3	6.4	0.5	(1.6)	(78.5)	(0.1)	(2.4)	-----

*Trailing twelve months

PROJECTED INCOME STATEMENT & BALANCE SHEET - ANNUAL

Chesapeake Financial Shares, Inc.

Income Statement and Balance Sheet

(Dollars in millions, except per share data)

Summary Financial Data	**12/08**	**12/09**	**12/10**	**12/11**	**12/12**	**12/13E**	**12/14E**
Net interest income	16.5	18.9	21.8	22.8	23.1	23.6	24.0
Non-interest income	15.0	14.1	13.8	13.7	15.0	15.7	15.8
Total net revenue	31.5	33.0	35.6	36.5	38.1	39.3	39.8
Loan loss provision	0.4	0.9	2.5	1.2	0.6	0.6	0.6
Non-interest expense	25.0	25.9	26.2	26.4	27.8	28.0	28.2
Income taxes & other	1.5	1.4	1.5	1.9	2.0	2.4	2.4
Zacks adjusted income before NRI	4.6	4.8	5.4	7.0	7.7	8.3	8.6
GAAP net income	4.6	4.8	5.4	7.0	7.7	8.3	8.6
Diluted EPS before NRI	1.34	1.48	1.69	2.16	2.32	2.50	2.55
Reported EPS	1.34	1.48	1.69	2.16	2.32	2.50	2.55
Dividends per share	0.34	0.35	0.36	0.40	0.45	0.48	0.48
Liquid assets	45.4	57.8	73.2	97.9	92.1	69.1	71.9
Outstandings, gross	396.2	391.3	382.3	373.1	397.6	407.6	424.2
Total assets	538.0	586.7	607.7	638.0	667.7	663.0	689.9
Core deposits	317.0	370.0	396.2	430.4	459.0	467.5	486.5
Purchased funds	121.9	131.3	127.2	113.3	118.4	99.7	101.7
Long-term debt	65.5	47.4	40.0	39.6	26.0	25.0	25.0
Shareholders' equity	30.6	35.3	41.1	51.2	60.9	66.9	73.9
Profitability							
Return on avg assets	0.89%	0.84%	0.90%	1.13%	1.19%	1.27%	1.27%
Return on avg equity	13.51%	13.14%	13.55%	15.31%	14.87%	13.02%	12.15%
Net interest margin	4.00%	4.10%	4.40%	4.70%	4.60%	4.51%	4.40%
Loan loss provision % avg assets	0.08%	0.16%	0.41%	0.19%	0.09%	0.08%	0.09%
Noninterest income % avg assets	2.91%	2.45%	2.30%	2.21%	2.33%	2.38%	2.33%
Noninterest expense % avg assets	4.84%	4.51%	4.34%	4.27%	4.32%	4.28%	4.17%
Preprovision pretax income % avg assets	1.26%	1.24%	1.57%	1.62%	1.60%	1.71%	1.71%
Tangible efficiency ratio	80%	77%	73%	71%	71%	71%	71%
Payout ratio	25%	24%	21%	18%	19%	19%	19%
Asset Quality							
Net charge-offs % avg outstandings	0.27%	0.34%	0.48%	0.22%	0.18%	0.27%	0.16%
Allowance % outstandings	1.43%	1.59%	1.90%	2.01%	1.88%	1.77%	1.74%
NPAs % loans + OREO	0.35%	1.20%	3.91%	4.48%	4.93%	4.85%	4.36%
Allowance % NPAs	411%	131%	48%	44%	32%	36%	40%
Liquidity & Funding							
Liquid assets % purchased funds	37%	44%	58%	86%	78%	69%	71%
Core deposits % outstandings	80%	95%	104%	115%	115%	115%	115%
Liquid assets % assets	8%	10%	12%	15%	14%	10%	10%
Outstandings % assets	74%	67%	63%	58%	60%	61%	61%
Capital Adequacy							
Total equity % assets	5.68%	6.01%	6.76%	8.03%	9.12%	10.10%	10.71%
Tangible equity % assets	5.68%	6.01%	6.76%	8.03%	9.12%	10.10%	10.71%
Tier 1 capital ratio	10.60%	10.10%	12.07%	12.20%	13.55%		
Total capital ratio	12.50%	11.70%	13.54%	13.40%	14.80%		
Parent Company Statistics							
Interest coverage	0.6X	0.8X	2.6X	2.1X	4.4X	2.0X	2.0X
Interest & dividend coverage	0.3X	0.4X	1.1X	0.9X	1.5X	0.8X	0.8X
Short-term debt coverage	Lge	Lge	Lge	Lge	Lge	Lge	Lge
Total debt coverage	0.9X	0.8X	0.8X	0.8X	0.9X	1.4X	1.9X
Double leverage	139.8%	142.1%	134.7%	127.2%	121.7%	123.2%	123.2%

PROJECTED INCOME STATEMENT & BALANCE SHEET - QUARTERLY

Chesapeake Financial Shares, Inc.

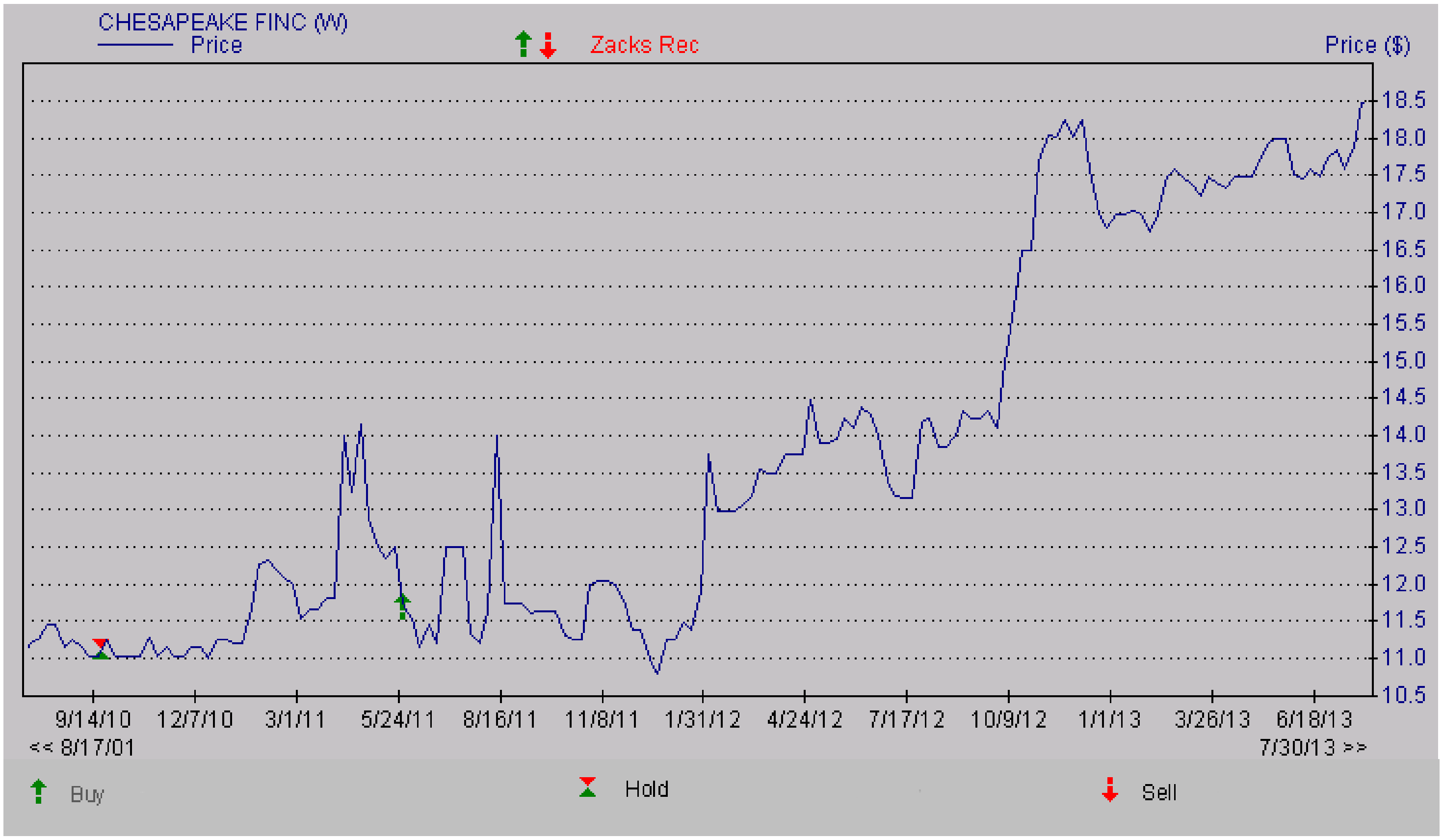
Income Statement and Balance Sheet

(Dollars in millions, except per share data)

	2012				2013			
Summary Financial Data	**Q1 A**	**Q2 A**	**Q3 A**	**Q4 A**	**Q1 A**	**Q2 P**	**Q3 E**	**Q4 E**
Net interest income	5.9	5.7	5.7	5.7	5.8	5.8	5.9	6.0
Non-interest income	3.1	3.7	4.4	3.9	3.8	5.3	4.1	3.6
Total net revenue	9.0	9.4	10.1	9.6	9.6	11.1	10.0	9.6
Loan loss provision	0.2	0.2	0.2	0.2	0.1	0.7	0.2	0.2
Non-interest expense	6.4	6.6	6.8	7.9	6.8	7.1	7.0	7.2
Income taxes & other	0.6	0.5	0.6	0.2	0.6	0.8	0.6	0.5
Zacks adjusted income before NRI	1.8	2.1	2.5	1.3	2.1	2.5	2.2	1.7
GAAP net income	1.8	2.1	2.5	1.3	2.1	2.5	2.2	1.7
Diluted EPS before NRI	0.57	0.62	0.74	0.39	0.64	0.76	0.68	0.51
Reported EPS	0.57	0.62	0.74	0.39	0.64	0.76	0.68	0.51
Dividends per share	0.11	0.11	0.11	0.12	0.12	0.12	0.12	0.12
Liquid assets	99.0	85.3	74.5	92.1	67.0	64.9	68.4	69.1
Outstandings, gross	372.3	379.5	386.9	397.6	395.7	404.4	403.6	407.6
Total assets	640.7	635.4	633.9	667.7	643.5	643.0	656.5	663.0
Core deposits	432.9	424.9	422.5	459.0	453.8	453.6	462.9	467.5
Purchased funds	122.9	122.5	119.9	118.4	98.2	98.2	99.2	99.7
Long-term debt	27.1	26.9	26.8	26.0	26.5	26.4	25.0	25.0
Shareholders' equity	55.0	57.4	60.8	60.9	61.9	60.7	65.6	66.9
Profitability								
Return on avg assets*	1.15%	1.29%	1.55%	0.81%	1.29%	1.57%	1.38%	1.03%
Return on avg equity *	13.88%	14.61%	16.63%	8.70%	13.72%	16.52%	13.91%	10.28%
Net interest margin*	4.67%	4.53%	4.50%	4.49%	4.54%	----	4.50%	4.50%
Loan loss provision % avg assets*	0.09%	0.09%	0.09%	0.09%	0.06%	0.40%	0.09%	0.09%
Noninterest income % avg assets*	1.93%	2.28%	2.75%	2.37%	2.33%	3.28%	2.49%	2.19%
Noninterest expense % avg assets*	4.02%	4.13%	4.28%	4.85%	4.16%	4.41%	4.26%	4.39%
Preprovision pretax inc.% avg assets*	1.57%	1.74%	2.09%	1.04%	1.71%	2.48%	1.85%	1.42%
Tangible efficiency ratio	69%	69%	67%	80%	70%	71%	69%	75%
Payout ratio	19%	18%	15%	30%	19%	16%	18%	23%
Asset Quality								
Net charge-offs % avg outstandings*	0.08%	0.17%	0.35%	0.14%	0.64%	-----	0.15%	0.15%
Allowance % outstandings	2.04%	2.00%	1.92%	1.88%	1.77%	-----	1.77%	1.77%
NPAs % loans + OREO	4.20%	4.11%	4.39%	4.93%	5.25%	-----	4.99%	4.85%
Allowance % NPAs	48%	48%	43%	32%	28%	-----	35%	36%
Liquidity & Funding								
Liquid assets % purchased funds	81%	70%	62%	78%	68%	66%	69%	69%
Core deposits % outstandings	116%	112%	109%	115%	115%	112%	115%	115%
Liquid assets % assets	15%	13%	12%	14%	10%	10%	10%	10%
Outstandings % assets	58%	60%	61%	60%	61%	63%	61%	61%
Capital Adequacy								
Total equity % assets	8.58%	9.03%	9.59%	9.12%	9.63%	9.43%	10.00%	10.10%
Tangible equity % assets	8.58%	9.03%	9.59%	9.12%	9.63%	9.43%	10.00%	10.10%
Tier 1 capital ratio	13.20%	13.38%	13.81%	13.55%	13.70%			
Total capital ratio	14.45%	14.63%	15.06%	14.80%	14.94%			

*Annualized.

HISTORICAL ZACKS RECOMMENDATIONS



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