Zacks Small-Cap Research

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Chesapeake Financial Shares, Inc. (CPKF - OTCQB)

CPKF: Fourth Quarter Hit by Higher Loss Provision and Noninterest Expense

Current Recommendation	**Neutral**
Prior Recommendation	Outperform
Date of Last Change	01/09/2014
Current Price (03/05/14)	$18.29
Twelve-Month Target Price	**$18.75**

OUTLOOK

CPKF's fourth quarter net earnings fell 9% to $1.2 million, while 2013's fourth quarter diluted EPS slumped by $0.03, or 9%, to $0.36 from $0.39 posted in 2012's fourth quarter. We had been expecting a better quarter and had estimated that the Company would earn $0.47 per diluted share, roughly on par with the third quarter's $0.45, but $0.11 more than CPKF actually posted. While our net revenue estimate was right on target at $9.7 million, we were wrong in a number of areas. First, the provision for loan losses was $283,000, about $183,000 more than the $100,000 we had anticipated. Second, total noninterest expense was $8.2 million, about $0.6 million higher than our $7.6 million projection, with total compensation coming in $0.5 million lower and other expense coming in $0.9 million higher than we had expected. Finally on the positive side, CPKF posted a $19,000 income tax credit versus our estimate of $438,000 in income tax expense. In 2013, CPKF hiked its quarterly dividend by 13% to $0.135 per share from $0.12 per share, following two dividend increases in 2012 totalling 20%. The total 2013 dividend payment of $0.51 represents a 13% rise over 2012's payment of $0.45. Notably, CPKF has increased the annual dividend payment every year for the past twenty-three years since 1991. This feat was recently recognized by SNL Financial in a report that cited CPKF as one of only 20 banks in the country (and only two in Virginia) to increase dividends by at least 2% per year and at least a cumulative 30% over the past five years. The company recorded cumulative dividend growth of 51.1% over the 2008-2013 period.

SUMMARY DATA

52-Week High	**$19.97**
52-Week Low	**$16.90**
One-Year Return (%)	**7.47**
Beta	**0.05**
Average Daily Volume (sh)	**1,063**
Shares Outstanding (mil)	**3**
Market Capitalization ($mil)	**$60**
Short Interest Ratio (days)	**N/A**
Institutional Ownership (%)	**0**
Insider Ownership (%)	**40**
Annual Cash Dividend	**$0.54**
Dividend Yield (%)	**2.95**
5-Yr. Historical Growth Rates	
Net Revenue (%)	**4.4**
Earnings Per Share (%)	**8.3**
Dividend (%)	**8.6**
P/E using TTM EPS	**9.2**
P/E using 2013 Actual	**9.2**
P/E using 2014 Estimate	**9.4**
Zacks Rank	**N/A**

Risk Level	**Average**
Type of Stock	**Small-Value**
Industry	**Banks-Southeast**
Zacks Rank in Industry	**61 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	10.0 A	9.7 A	9.7 A	39.0 A
2014					38.9 E

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	0.55 A	0.45 A	0.36 A	1.99 A
2014					1.95 E

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

FOURTH QUARTER

CPKF's fourth quarter net earnings fell 9% to $1.2 million, while 2013's fourth quarter diluted EPS slumped by $0.03, or 9%, to $0.36 from $0.39 posted in 2012's fourth quarter. We had been expecting a better quarter and had estimated that the Company would earn $0.47 per diluted share, roughly on par with the third quarter's $0.45, but $0.11 more than CPKF actually posted.

While our net revenue estimate was right on target at $9.7 million, we were wrong in a number of areas. First, the provision for loan losses was $283,000, about $183,000 more than the $100,000 we had anticipated. Second, total noninterest expense was $8.2 million, about $0.6 million higher than our $7.6 million projection, with total compensation coming in $0.5 million lower and other expense coming in $0.9 million higher than we had expected. Finally on the positive side, CPKF posted a $19,000 income tax credit versus our estimate of $438,000 in income tax expense.

For the year, CPKF reported $7.4 million, or $2.21 per diluted share, down 4% from the $7.7 million, or $2.32 per diluted share, posted in 2012. This includes a one-time $1.06 million pretax gain on the sale of securities ($713,500 or $0.21 per share on an aftertax basis) in the second quarter. Excluding this item, net earnings were $6.6 million or $1.99 per share, down 14% from 2012. Primary contributors to this result were an almost doubling in the loan loss provision to $1.13 million from $0.6 million in the prior year and a $2.0 million, or 7%, rise in noninterest expense to $29.8 million, partially offset by a 3-point decline in the effective tax rate to 17.9% from 20.9%.

Relative to the year-ago quarter, net income tumbled $0.1 million, or 9%, from last year's's $1.3 million and diluted EPS slid $0.03, or 9%, from the $0.39 posted in the fourth quarter of 2012.

The major reasons for the fourth quarter's decline versus the prior-year quarter were: (1) a $0.2 million positive swing in the combined gain/loss from the sales of securities and OREO to a loss of $0.3 million from a loss of $0.5 million; (2) a $0.1 million, or 22%, increase in income from fiduciary activities to $0.6 million; (3) a $0.6 million, or 15%, decrease in compensation expense to $3.4 million; and (4) income taxes that dipped $0.2 million to a $19,000 tax credit. This was more than offset by: (1) a $0.1 million, or 89%, climb in the loan loss provision to $0.3 million; (2) a $0.4 million decrease in other income to $0.7 million from $1.1 million; (3) a more than doubling in cash flow expense to $0.4 million; and (4) a $0.5 million, or 24%, advance in other expense.

Net interest income grew 2% year over year to $5.9 million ($0.1 million above our estimate), as slight growth in average interest-earning assets combined with a net interest margin that we estimate was higher than the 4.49% earned in the year-ago quarter.

Noninterest income was flat year over year at $3.8 million ($0.1 million below our projection), as a $0.4 million decline in other income was offset by a $0.2 million positive swing in the combined gain/loss from the sales of securities and OREO and good growth in income from fiduciary activities (up $0.1 million, or 22%) and cash flow income (up $0.1 million, or 8%).

Total noninterest expense increased $0.3 million, or about 4%, year over year to $8.2 million ($0.6 million higher than our estimate), largely due to a $0.9 million, or 24%, increase in other noninterest expense primarily from growth in merchant card, ATM, cash flow, and other expenses partly offset by $0.6 million slide in compensation costs to $3.4 million.

The loan loss provision jumped 89% to $0.3 million (above our $0.1 million estimate). Loan loss reserves increased $0.2 million from $6.1 million (1.62% of loans) at the end of the third quarter to $6.3 million (1.66% of loans) at December 31, 2013, and were below the $6.4 million (1.69% of loans) in the year-ago quarter.

As to other asset quality measures, CPKF charged off $88,000 of loans in the fourth quarter. This is

$83,000 less than the $171,000 charged off in the year-ago quarter and compares to net charge-offs of $225,000 in 2013's third quarter and $1,179,000 for full-year 2013. CEO Jeff Szyperski noted that 30-day delinquencies increased to 4.93% of total loans at the end of the fourth quarter driven by a single credit, but that no losses are expected as a result.

Gross loans outstanding increased $5 million, or about 1 ½%, year over year and $3 million, or almost 1%, sequentially to $380 million.

CPKF posted a 7.8% ROE and 0.73% ROA for the fourth quarter of 2013, compared to 8.7% and 0.81%, respectively, in the prior-year quarter.

In 2013, CPKF hiked its quarterly dividend by 13% to $0.135 per share from $0.12 per share, following two dividend increases in 2012 totalling 20%. The total 2013 dividend payment of $0.51 represents a 13% rise over 2012's payment of $0.45. Notably, CPKF has increased the annual dividend payment every year for the past twenty-three years since 1991.

This feat was recently recognized by SNL Financial in a report that cited CPKF as one of only 20 banks in the country (and only two in Virginia) to increase dividends by at least 2% per year and at least a cumulative 30% over the past five years. The company recorded cumulative dividend growth of 51.1% over the 2008-2013 period.

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 financial holding company headquartered in Kilmarnock, Virginia, with $662 million in total assets at December 31, 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 2011.

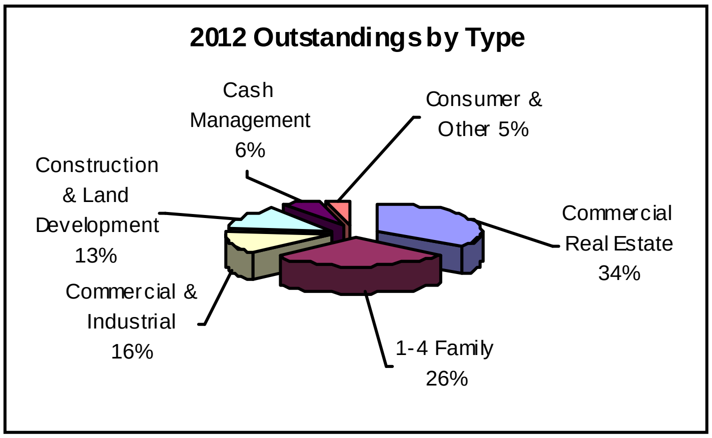
Operations are carried on through Chesapeake Bank, a state-chartered bank as well as Federal Reserve and FDIC member bank, and Chesapeake Investment Group, Inc. (CIG), an independent wealth management firm that manages about $330 million in assets (at 2012 yearend) through its subsidiaries involved in 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. In addition, Chesapeake Payment Systems has also partnered with four independent sales organizations (ISOs) to expand its processing footprint.

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.

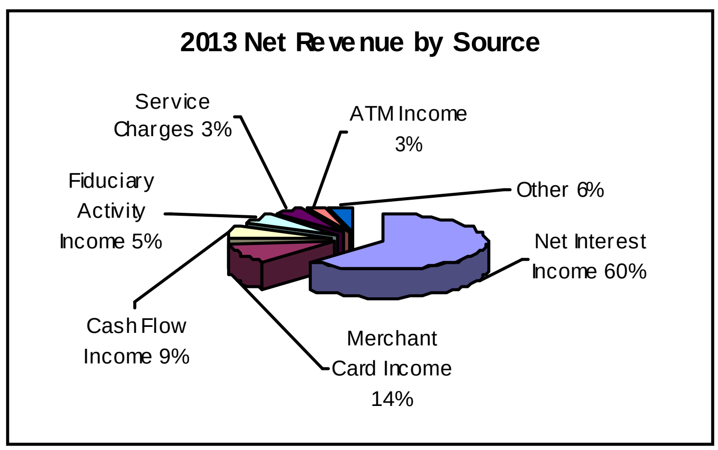
Clear Sky accounts, which offer internet-based retail deposit services for checking and saving accounts and certificates of deposit (CDs), expands CPKF's retail deposit base geographically. At December 31, 2012, Clear Sky deposits totalled $44 million, with customers in all 50 states.

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 2013, net interest income contributed 60% of net revenue, with a significant 40% coming from noninterest income sources. Major contributors to noninterest income include merchant card income (14% 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 is up 1.6% year to date, a moderately worse performance than the small-cap bank industry's median price increase of 4.1%, as shown in the following table, but better than the 1.4% gain for the S&P 500.

At its current price, CPKF is trading at a discount to the industry median P/E of 32% in 2014, based upon our most recent CPKF EPS estimate for 2014. This is below the average 56% P/E discount for CPKF, based upon 5-year historical P/E averages. Applying the historical discount of 56% to our 2014 EPS estimate results in a price of about $12.00.

Turning to Price/Tangible Book Value, CPKF is valued at 0.98X versus the industry median of 1.25X. This represents a 21% discount, well below the average historical premium of 26% for CPKF since the end of 2008. Applying the historical premium of 26% to our estimated book value for CPKF twelve months out results in a price of approximately $25.50.

While we recognize that CPKF is still undervalued particularly on a book value basis, we believe that there is no immediate catalyst to drive the stock price higher over the near term, especially in view of what we imagine will be a tough 2014.

Accordingly, we have chosen the $18.75 midpoint of the wide range of values based upon CPKF's 2014 P/E of $12.00 and Price/Tangible Book Value of $25.50 as our new target price.

Industry Comparables - Small-cap Banks

		Price / Earnings Ratios					Return on Equity		Return on Assets		
	Pr Chg YTD	TTM* EPS	2014E	2015E	5-Yr Avg	Price/ Book	TTM*	5-Yr Avg	TTM*	5-Yr Avg	Div Yld
Chesapeake Finc'l	**1.6**	**7.2**	**9.4**		**7.2**	**0.98**	**12.0**	**14.1**	**1.13**	**1.03**	**3.0**
S&P 500	1.4	18.3	16.0	15.0	16.7	4.5	24.3	-----	8.5	-----	2.0
Median	**4.1**	**13.6**	**13.9**	**13.0**	**16.4**	**1.25**	**9.1**	**4.8**	**0.88**	**0.43**	**1.3**
Average	6.3	18.6	15.6	13.3	23.7	1.2	9.2	2.5	0.9	0.3	1.4
High	37.6	204.5	35.8	23.0	93.0	2.3	29.5	14.1	3.7	2.0	4.2
Low	(12.1)	4.5	9.4	8.7	6.5	0.7	(7.0)	(69.8)	(0.8)	(1.7)	-----

*Trailing twelve months

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**	**12/13P**	**12/14E**
Net interest income	16.5	18.9	21.8	22.8	23.1	23.3	23.4
Non-interest income	15.0	14.1	13.8	13.7	15.0	15.7	15.5
Total net revenue	31.5	33.0	35.6	36.5	38.1	39.0	38.9
Loan loss provision	0.4	0.9	2.5	1.2	0.6	1.1	0.6
Non-interest expense	25.0	25.9	26.2	26.4	27.8	29.8	29.9
Income taxes & other	1.5	1.4	1.5	1.9	2.0	1.5	1.9
Zacks adjusted income before NRI	4.6	4.8	5.4	7.0	7.7	6.6	6.5
GAAP net income	4.6	4.8	5.4	7.0	7.7	7.4	6.5
Diluted EPS before NRI	1.34	1.48	1.69	2.16	2.32	1.99	1.95
Reported EPS	1.34	1.48	1.69	2.16	2.32	2.21	1.95
Dividends per share	0.34	0.35	0.36	0.40	0.45	0.51	0.54
Liquid assets	45.4	57.8	73.2	97.9	92.1	84.4	77.2
Outstandings, gross	396.2	391.3	382.3	373.1	397.6	401.7	421.2
Total assets	538.0	586.7	607.7	638.0	667.7	661.8	688.1
Core deposits	317.0	370.0	396.2	430.4	459.0	479.4	495.0
Purchased funds	121.9	131.3	127.2	113.3	118.4	93.0	94.9
Long-term debt	65.5	47.4	40.0	39.6	26.0	26.0	25.0
Shareholders' equity	30.6	35.3	41.1	51.2	60.9	61.8	67.2
Profitability							
Return on avg assets	0.89%	0.84%	0.90%	1.13%	1.19%	1.02%	0.97%
Return on avg equity	13.51%	13.14%	13.55%	15.31%	14.87%	10.82%	10.06%
Net interest margin	4.00%	4.10%	4.40%	4.70%	4.60%		4.45%
Loan loss provision % avg assets	0.08%	0.16%	0.41%	0.19%	0.09%	0.17%	0.09%
Noninterest income % avg assets	2.91%	2.45%	2.30%	2.21%	2.33%	2.41%	2.30%
Noninterest expense % avg assets	4.84%	4.51%	4.34%	4.27%	4.32%	4.56%	4.44%
Preprovision pretax income % avg assets	1.26%	1.24%	1.57%	1.62%	1.60%	1.41%	1.33%
Tangible efficiency ratio	80%	77%	73%	71%	71%	75%	77%
Payout ratio	25%	24%	21%	18%	19%	23%	28%
Asset Quality							
Net charge-offs % avg outstandings	0.27%	0.34%	0.48%	0.22%	0.18%		0.23%
Allowance % outstandings	1.43%	1.59%	1.90%	2.01%	1.88%		1.75%
NPAs % loans + OREO	0.35%	1.20%	3.91%	4.48%	4.93%		3.58%
Allowance % NPAs	411%	131%	48%	44%	32%		48%
Liquidity & Funding							
Liquid assets % purchased funds	37%	44%	58%	86%	78%	81%	81%
Core deposits % outstandings	80%	95%	104%	115%	115%	116%	118%
Liquid assets % assets	8%	10%	12%	15%	14%	11%	11%
Outstandings % assets	74%	67%	63%	58%	60%	62%	61%
Capital Adequacy							
Total equity % assets	5.68%	6.01%	6.76%	8.03%	9.12%	9.45%	9.77%
Tangible equity % assets	5.68%	6.01%	6.76%	8.03%	9.12%	9.45%	9.77%
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
Interest & dividend coverage	0.3X	0.4X	1.1X	0.9X	1.5X		0.7X
Short-term debt coverage	Lge	Lge	Lge	Lge	Lge		Lge
Total debt coverage	0.9X	0.8X	0.8X	0.8X	0.9X		1.8X
Double leverage	139.8%	142.1%	134.7%	127.2%	121.7%		131.5%

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 A**	**Q3 A**	**Q4 A**
Net interest income	5.9	5.7	5.7	5.7	5.8	5.8	5.8	5.9
Non-interest income	3.1	3.7	4.4	3.9	3.8	4.2	3.9	3.8
Total net revenue	9.0	9.4	10.1	9.6	9.6	10.0	9.7	9.7
Loan loss provision	0.2	0.2	0.2	0.2	0.1	0.7	0.1	0.3
Non-interest expense	6.4	6.6	6.8	7.9	6.8	7.1	7.7	8.2
Income taxes & other	0.6	0.5	0.6	0.2	0.6	0.4	0.4	(0.0)
Zacks adjusted income before NRI	1.8	2.1	2.5	1.3	2.1	1.8	1.5	1.2
GAAP net income	1.8	2.1	2.5	1.3	2.1	2.5	1.5	1.2
Diluted EPS before NRI	0.57	0.62	0.74	0.39	0.64	0.55	0.45	0.36
Reported EPS	0.57	0.62	0.74	0.39	0.64	0.76	0.45	0.36
Dividends per share	0.11	0.11	0.11	0.12	0.12	0.12	0.14	0.14
Liquid assets	99.0	85.3	74.5	92.1	67.0	58.8	75.2	84.4
Outstandings, gross	372.3	379.5	386.9	397.6	395.7	404.5	407.1	401.7
Total assets	640.7	635.4	633.9	667.7	643.5	643.0	658.6	661.8
Core deposits	432.9	424.9	422.5	459.0	453.8	455.9	473.8	479.4
Purchased funds	122.9	122.5	119.9	118.4	98.2	96.0	93.0	93.0
Long-term debt	27.1	26.9	26.8	26.0	26.5	26.4	26.2	26.0
Shareholders' equity	55.0	57.4	60.8	60.9	61.9	60.7	61.4	61.8
Profitability								
Return on avg assets*	1.15%	1.29%	1.55%	0.81%	1.29%	1.13%	0.93%	0.73%
Return on avg equity *	13.88%	14.61%	16.63%	8.70%	13.72%	11.86%	9.91%	7.81%
Net interest margin*	4.67%	4.53%	4.50%	4.49%	4.54%	4.56%	4.61%	
Loan loss provision % avg assets*	0.09%	0.09%	0.09%	0.09%	0.06%	0.40%	0.06%	0.17%
Noninterest income % avg assets*	1.93%	2.28%	2.75%	2.37%	2.33%	2.63%	2.37%	2.33%
Noninterest expense % avg assets*	4.02%	4.13%	4.28%	4.85%	4.16%	4.41%	4.71%	4.99%
Preprovision pretax inc.% avg assets*	1.57%	1.74%	2.09%	1.04%	1.71%	1.82%	1.25%	0.89%
Tangible efficiency ratio	69%	69%	67%	80%	70%	71%	75%	84%
Payout ratio	19%	18%	15%	30%	19%	16%	30%	38%
Asset Quality								
Net charge-offs % avg outstandings*	0.08%	0.17%	0.35%	0.14%	0.64%	0.23%	0.22%	
Allowance % outstandings	2.04%	2.00%	1.92%	1.88%	1.77%	1.81%	1.85%	
NPAs % loans + OREO	4.20%	4.11%	4.39%	4.93%	5.25%	3.66%	4.11%	
Allowance % NPAs	48%	48%	43%	32%	28%	49%	45%	
Liquidity & Funding								
Liquid assets % purchased funds	81%	70%	62%	78%	68%	61%	81%	81%
Core deposits % outstandings	116%	112%	109%	115%	115%	113%	116%	116%
Liquid assets % assets	15%	13%	12%	14%	10%	9%	11%	11%
Outstandings % assets	58%	60%	61%	60%	61%	63%	62%	62%
Capital Adequacy								
Total equity % assets	8.58%	9.03%	9.59%	9.12%	9.63%	9.43%	9.32%	9.45%
Tangible equity % assets	8.58%	9.03%	9.59%	9.12%	9.63%	9.43%	9.32%	9.45%
Tier 1 capital ratio	13.20%	13.38%	13.81%	13.55%	13.70%	13.74%	13.92%	
Total capital ratio	14.45%	14.63%	15.06%	14.80%	14.94%	14.99%	15.17%	

*Annualized.

HISTORICAL ZACKS RECOMMENDATIONS

DISCLOSURES

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