Zacks Small-Cap Research

May 21, 2014
Ann H. Heffron, CFA, CPA
312-265-9428
aheffron@zacks.com

scr.zacks.com
111 North Canal Street • Chicago, IL 60606

Chesapeake Financial Shares, Inc. (CPKF - OTCQB)

CPKF: First Quarter About As Expected

Current Recommendation	**Neutral**
Prior Recommendation	Outperform
Date of Last Change	01/09/2014
Current Price (05/20/14)	$17.50
Twelve-Month Target Price	**$17.75**

OUTLOOK

CPKF's first quarter net earnings fell $0.8 million, or 38%, to $1.3 million, while 2014's first quarter diluted EPS slumped by $0.24, or 39%, to $0.39 from $0.63 posted a year ago. This was only slightly worse than our estimate, which had called for a $0.7 million decline in net earnings to $1.4 million (off by $0.1 million) and a $0.21 drop in diluted EPS to $0.42 (off by $0.03). The primary reason for the difference between reported results and our estimate was that noninterest income fell about $0.1 million short of our projection. The major reasons for the first quarter's decline versus the prior-year quarter were: (1) a $0.2 million, or 15%, decline in merchant card income to $1.0 million as CPKF cut the number of independent sales organizations (ISOs) to four from five; (2) a $0.3 million, or 34%, slide in other income to $0.7 million, partly reflecting a drop in pare-off fees due to a slump in residential mortgage refinancings; and (3) a $0.3 million, or 20%, increase in other noninterest expense, partly due to higher legal fees associated with loan problems. 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	**$16.90**
One-Year Return (%)	**0.31**
Beta	**0.09**
Average Daily Volume (sh)	**937**
Shares Outstanding (mil)	**3**
Market Capitalization ($mil)	**$58**
Short Interest Ratio (days)	**N/A**
Institutional Ownership (%)	**0**
Insider Ownership (%)	**40**
Annual Cash Dividend	**$0.54**
Dividend Yield (%)	**3.09**
5-Yr. Historical Growth Rates	
Net Revenue (%)	**4.4**
Earnings Per Share (%)	**8.3**
Dividend (%)	**8.6**
P/E using TTM EPS	**10.0**
P/E using 2013 Actual	**8.8**
P/E using 2014 Estimate	**10.3**
Zacks Rank	**N/A**

Risk Level	**Average**
Type of Stock	**Small-Value**
Industry	**Banks-Southeast**
Zacks Rank in Industry	**62 of 63**

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	9.0A				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	0.39 A				1.70 E

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

FIRST QUARTER

CPKF's first quarter net earnings fell $0.8 million, or 38%, to $1.3 million, while 2014's first quarter diluted EPS slumped by $0.24, or 39%, to $0.39 from $0.63 posteda year ago. This was only slightly worse than our estimate, which had called for a $0.7 million decline in net earnings to $1.4 million (off by $0.1 million) and a $0.21 drop in diluted EPS to $0.42 (off by $0.03).

The primary reason for the difference between reported results and our estimate was that noninterest income fell about $0.1 million short of our projection due to a sharper-than-expected decline in other income (off by about $0.1 million).

The major reasons for the first quarter's decline versus the prior-year quarter were: (1) a $0.2 million, or 15%, decline in merchant card income to $1.0 million as CPKF cut the number of independent sales organizations (ISOs) to four from five; (2) a $0.3 million, or 34%, slide in other income to $0.7 million, partly reflecting a drop in pare-off fees due to a slump in residential mortgage refinancings; and (3) a $0.3 million, or 20%, increase in other noninterest expense, partly due to higher legal fees associated with loan problems.

Net interest income fell 4% year over year to $5.6 million (about the same as our estimate), as a slim decline in average interest-earning assets combined with a net interest margin that we estimate was lower than the 4.54% earned in the year-ago quarter.

Noninterest income dipped $0.3 million, or 7%, year over year to $3.4 million ($0.1 million below our projection), as a $0.3 million decline in other income and a $0.2 million fall in merchant card income was offset by a $0.1 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 24%).

Total noninterest expense increased $0.5 million, or about 8%, year over year to $7.2 million (about the same as our estimate), largely due to a $0.3 million increase in other noninterest expense, a $0.1 million, or 3%, rise in total compensation costs to $3.6 million, and a $0.1 million climb in cash flow expense to $0.15 million.

The loan loss provision jumped 50% year over year to $0.15 million (the same as our estimate). Loan loss reserves increased $0.2 million from $6.3 million (1.66% of loans) at the end of the fourth quarter to $6.5 million (1.71% of loans) at March 31, 2014, and were above the $5.8 million (1.56% of loans) in the year-ago quarter.

As to other asset quality measures, CPKF recorded a net recovery of $68,000 in the first quarter. This compares to net charge-offs of $634,000 in the year-ago quarter and $87,000 in 2013's fourth quarter.

Gross loans outstanding increased $11 million, or about 3%, year over year and $2 million, or almost 1%, sequentially to $383 million.

CPKF posted an 8.3% ROE and 0.78% ROA for the first quarter of 2014, compared to 13.7% and 1.29%, 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 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 $669 million in total assets at March 31, 2014. 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.

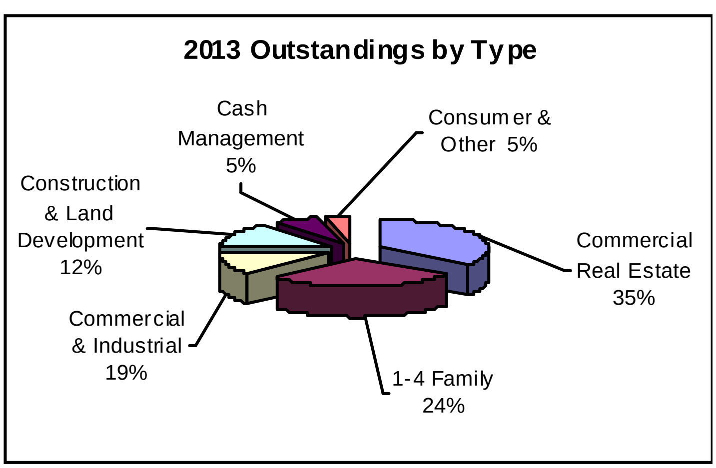
Operations are carried on through Chesapeake Bank, a state-chartered bank as well as Federal Reserve and FDIC member bank, and Chesapeake Investment Group, Inc. (CIG), an independent wealth management firm that manages about $313 million in assets (at 2013 yearend) through its subsidiaries involved in 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 2013, Chesapeake Payment Systems had 571 merchants in its system and processed over $132 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 79 customers at the end of 2013.

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, 2013, Clear Sky deposits totalled $38 million, with customers in all 50 states.

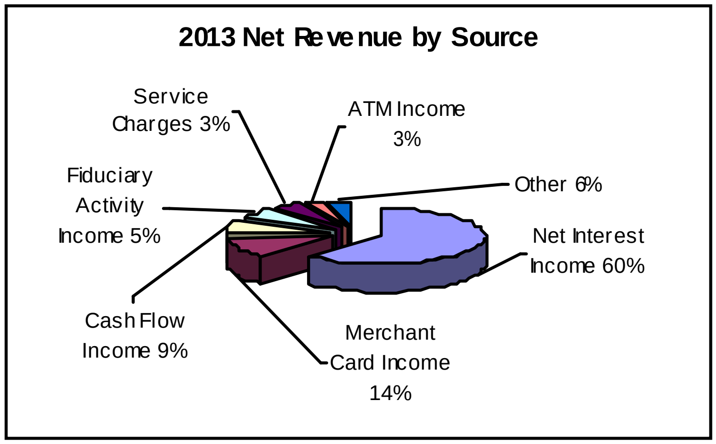
Through Chesapeake's secondary market mortgage banking operation, the Company services a $225 million loan portfolio (as of December 31, 2013) of residential mortgage loans for Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac), for which it earns a 25 basis-point fee (approximately $562,500 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 $964,000 to revenues in 2013 (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, 2013, the lending book consisted of commercial real estate (accounting for 35% of total gross outstandings), 1-4 family (24%), commercial and industrial (19%), construction and land development (12%), 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.

At December 31, 2013, 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 18% of the securities portfolio. In addition, the available-for-sale portfolio includes municipal and private label mortgage securities, which accounted for 65% and 17%, respectively, of the total. Core deposits represented 82% of total deposits at December 31, 2013, with certificates of deposit larger than $100,000 at 18%.



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 down 2.8% year to date, a moderately worse performance than the small-cap bank industry's median price increase of 3.5% and the 1.3% gain for the S&P 500, as shown in the following table.

At its current price, CPKF is trading at a discount to the industry median P/E of 21% in 2014, based upon our most recent CPKF EPS estimate for 2014. This is below the average 57% P/E discount for CPKF, based upon 5-year historical P/E averages. Applying the historical discount of 57% to our 2014 EPS estimate results in a price of about $9.50.

Turning to Price/Tangible Book Value, CPKF is valued at 0.93X versus the industry median of 1.18X. This represents a 21% discount, well below the average historical premium of 24% for CPKF since mid-2008. Applying the historical premium of 24% to our estimated book value for CPKF twelve months out results in a price of approximately $26.00.

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 $17.75 midpoint of the wide range of values based upon CPKF's 2014 P/E of $9.50 and Price/Tangible Book Value of $26.00 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	**(2.8)**	**8.8**	**10.3**		**7.2**	**0.93**	**12.0**	**14.0**	**1.13**	**1.04**	**3.1**
S&P 500	1.3	18.3	16.0	15.0	16.7	4.6	23.2	-----	8.4	-----	2.0
Median	**3.5**	**13.1**	**13.0**	**11.5**	**16.9**	**1.18**	**9.0**	**5.3**	**0.88**	**0.48**	**1.4**
Average	4.1	13.6	15.2	12.1	23.5	1.1	8.7	2.9	0.9	0.4	1.5
High	69.5	22.5	40.2	18.9	89.9	2.1	26.6	14.0	3.6	1.9	4.1
Low	(22.7)	4.0	8.9	8.1	6.6	0.7	(13.1)	(67.8)	(1.5)	(1.5)	-----

*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**	**12/13**	**12/14E**
Net interest income	16.5	18.9	21.8	22.8	23.1	23.3	22.9
Non-interest income	15.0	14.1	13.8	13.7	15.0	15.7	15.0
Total net revenue	31.5	33.0	35.6	36.5	38.1	39.0	37.9
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	30.0
Income taxes & other	1.5	1.4	1.5	1.9	2.0	1.5	1.6
Zacks adjusted income before NRI	4.6	4.8	5.4	7.0	7.7	6.6	5.7
GAAP net income	4.6	4.8	5.4	7.0	7.7	7.4	5.7
Diluted EPS before NRI	1.34	1.48	1.69	2.16	2.32	1.99	1.70
Reported EPS	1.34	1.48	1.69	2.16	2.32	2.21	1.70
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	89.9	91.3
Outstandings, gross	396.2	391.3	382.3	373.1	397.6	401.0	413.2
Total assets	538.0	586.7	607.7	638.0	667.7	661.8	688.6
Core deposits	317.0	370.0	396.2	430.4	459.0	467.2	486.1
Purchased funds	121.9	131.3	127.2	113.3	118.4	105.3	107.1
Long-term debt	65.5	47.4	40.0	39.6	26.0	25.9	25.0
Shareholders' equity	30.6	35.3	41.1	51.2	60.9	61.8	65.7
Profitability							
Return on avg assets	0.89%	0.84%	0.90%	1.13%	1.19%	1.01%	0.85%
Return on avg equity	13.51%	13.14%	13.55%	15.31%	14.87%	10.74%	8.98%
Net interest margin	4.00%	4.10%	4.40%	4.70%	4.60%	4.60%	4.40%
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%	2.40%	2.22%
Noninterest expense % avg assets	4.84%	4.51%	4.34%	4.27%	4.32%	4.55%	4.43%
Preprovision pretax income % avg assets	1.26%	1.24%	1.57%	1.62%	1.60%	1.41%	1.18%
Tangible efficiency ratio	80%	77%	73%	71%	71%	75%	78%
Payout ratio	25%	24%	21%	18%	19%	23%	32%
Asset Quality							
Net charge-offs % avg outstandings	0.27%	0.34%	0.48%	0.22%	0.18%	0.29%	0.20%
Allowance % outstandings	1.43%	1.59%	1.90%	2.01%	1.88%	1.75%	1.80%
NPAs % loans + OREO	0.35%	1.20%	3.91%	4.48%	4.93%	5.20%	4.74%
Allowance % NPAs	411%	131%	48%	44%	32%	30%	38%
Liquidity & Funding							
Liquid assets % purchased funds	37%	44%	58%	86%	78%	85%	85%
Core deposits % outstandings	80%	95%	104%	115%	115%	117%	118%
Liquid assets % assets	8%	10%	12%	15%	14%	14%	13%
Outstandings % assets	74%	67%	63%	58%	60%	61%	60%
Capital Adequacy							
Total equity % assets	5.68%	6.01%	6.76%	8.03%	9.12%	9.34%	9.55%
Tangible equity % assets	5.68%	6.01%	6.76%	8.03%	9.12%	9.34%	9.55%
Tier 1 capital ratio	10.60%	10.10%	12.07%	12.20%	13.55%	14.23%	
Total capital ratio	12.50%	11.70%	13.54%	13.40%	14.80%	15.48%	
Parent Company Statistics							
Interest coverage	0.6X	0.8X	2.6X	2.1X	4.4X	9.2X	7.5X
Interest & dividend coverage	0.3X	0.4X	1.1X	0.9X	1.5X	1.5X	1.4X
Short-term debt coverage	Lge	Lge	Lge	Lge	Lge	Lge	Lge
Total debt coverage	0.9X	0.8X	0.8X	0.8X	0.9X	1.0X	1.5X
Double leverage	139.8%	142.1%	134.7%	127.2%	121.7%	119.7%	121.3%

Chesapeake Financial Shares, Inc.

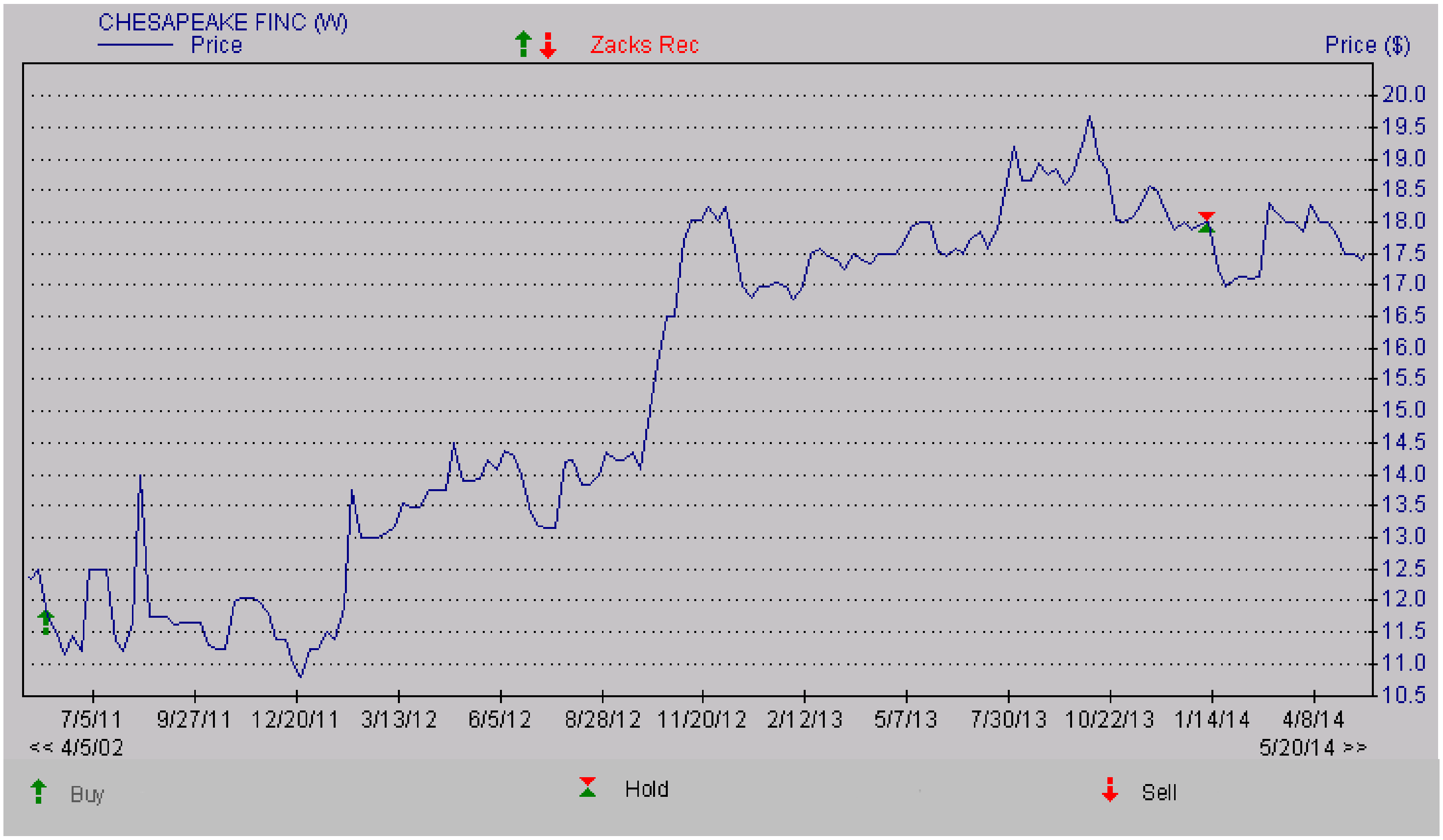
Income Statement and Balance Sheet

(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	89.9
Outstandings, gross	372.0	379.5	386.9	397.6	395.7	404.5	407.1	401.0
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	453.2	455.6	473.6	467.2
Purchased funds	122.9	122.5	119.9	118.4	98.9	96.2	93.3	105.4
Long-term debt	27.1	26.9	26.8	26.0	26.5	26.4	26.2	25.9
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%	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*	1.96%	2.28%	2.75%	2.37%	2.29%	2.63%	2.37%	2.33%
Noninterest expense % avg assets*	4.06%	4.13%	4.28%	4.85%	4.12%	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	70%	69%	67%	80%	70%	71%	75%	84%
Payout ratio	19%	18%	15%	30%	19%	16%	30%	37%
Asset Quality								
Net charge-offs % avg outstandings*	0.08%	0.17%	0.35%	0.14%	0.64%	0.21%	0.22%	0.09%
Allowance % outstandings	2.04%	2.00%	1.92%	1.88%	1.77%	1.81%	1.85%	1.75%
NPAs % loans + OREO	4.20%	4.11%	4.39%	4.93%	5.25%	3.66%	4.11%	5.20%
Allowance % NPAs	48%	48%	43%	32%	28%	49%	45%	30%
Liquidity & Funding								
Liquid assets % purchased funds	81%	70%	62%	78%	68%	61%	81%	85%
Core deposits % outstandings	116%	112%	109%	115%	115%	113%	116%	116%
Liquid assets % assets	15%	13%	12%	14%	10%	9%	11%	14%
Outstandings % assets	58%	60%	61%	60%	61%	63%	62%	61%
Capital Adequacy								
Total equity % assets	8.58%	9.03%	9.59%	9.12%	9.63%	9.43%	9.32%	9.34%
Tangible equity % assets	8.58%	9.03%	9.59%	9.12%	9.63%	9.43%	9.32%	9.34%
Tier 1 capital ratio	13.20%	13.38%	13.81%	13.55%	13.70%	13.74%	13.92%	14.23%
Total capital ratio	14.45%	14.63%	15.06%	14.80%	14.94%	14.99%	15.17%	15.48%

*Annualized.

HISTORICAL ZACKS RECOMMENDATIONS



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