Zacks Small-Cap Research

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Chesapeake Financial Shares, Inc. (CPKF - OTCQB)

CPKF: Excellent Growth in Merchant Card Processing Generates Higher-than-Expected Gains in Second Quarter Revenue and EPS

Current Recommendation	**Hold**
Prior Recommendation	Buy
Date of Last Change	01/09/2014
Current Price (08/24/15)	$16.68
Twelve-Month Target Price	**$17.25**

OUTLOOK

CPKF's second quarter net earnings rose $0.3 million year over year, or 16%, to $2.2 million, while 2015's second quarter diluted EPS grew by $0.06, or 12%, to $0.54 from $0.48 posted a year ago. (All per share data in this report have been adjusted for a 6-for-5 stock split, paid to shareholders in mid-October 2014.) This was higher than our estimate, which had called for a $0.2 million increase in net earnings to $2.1 million (off by $0.1 million) and a $0.02 rise in diluted EPS to $0.52 (off by $0.02).The primary reason for the difference between reported results and our estimate was that net revenues were $0.5 million more than the $10.1 million we had anticipated, largely due to merchant card income that was better than expected. This was partly offset by total noninterest expense of $7.8 million that was $0.3 million more than we had projected. CEO Jeffrey M. Szyperski noted that CPKF's asset quality improved year over year, with nonperforming assets decreasing to 3.32% of total loans at June 30, 2015 compared to 4.36% at June 30, 2014. On July 17, 2015, CPKF's Board of Directors approved a 6.7% increase in the quarterly dividend to $0.12 from $0.1125, payable on September 15, 2015 to shareholders of record on September 1, 2015. Notably, CPKF has increased the annual dividend payment every year for the past twenty-four years since 1991. In 2015 for the eighth consecutive year, Chesapeake Financial Shares, Inc. has been included in the American Banker magazine listing of the "Top 200 Community Banks" in the United States, ranking #34 out of about 6,000 community banks. We are currently reviewing our estimates and will issue a more comprehensive report when detailed financial information becomes available.

SUMMARY DATA

52-Week High	**$17.10**
52-Week Low	**$14.96**
One-Year Return (%)	**14.30**
Beta	**0.08**
Average Daily Volume (sh)	**1,301**
Shares Outstanding (mil)	**4**
Market Capitalization ($mil)	**$67**
Short Interest Ratio (days)	**N/A**
Institutional Ownership (%)	**0**
Insider Ownership (%)	**40**
Annual Cash Dividend	**$0.48**
Dividend Yield (%)	**2.88**
5-Yr. Historical Growth Rates	
Net Revenue (%)	**3.3**
Earnings Per Share (%)	**5.7**
Dividend (%)	**9.1**
P/E using TTM EPS	**10.1**
P/E using 2015 Estimate	**10.8**
P/E using 2016 Estimate	**10.4**
Zacks Rank	**3**

Risk Level	**Average**
Type of Stock	**Small-Value**
Industry	**Banks-Southeast**
Zacks Rank in Industry	**51 of 71**

ZACKS ESTIMATES

Net Revenue
(in millions of $)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2013	9.5 A	10.0 A	9.6 A	9.6 A	39.0 A
2014	9.0 A	9.6 A	9.3 A	9.7 A	37.7 A
2015	9.8 A	10.6 A	9.7 E	9.8 E	39.4 E
2016					40.4 E

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

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2013	0.53 A	0.46 A	0.38 A	0.30 A	1.66 A
2014	0.32 A	0.48 A	0.23 A	0.41 A	1.43 A
2015	0.47 A	0.54 A	0.30 E	0.26 E	1.55 E
2016					1.60 E

Quarterly EPS may not add to total due to changes in shares outstanding.
* Per share data have been adjusted for a 5-for-6 stock split, paid to shareholders in mid-October 2014.

SECOND QUARTER

CPKF's second quarter net earnings rose $0.3 million year over year, or 16%, to $2.2 million, while 2015's second quarter diluted EPS grew by $0.06, or 12%, to $0.54 from $0.48 posted a year ago. (All per share data in this report have been adjusted for a 6-for-5 stock split, paid to shareholders in mid-October 2014.)

This was higher than our estimate, which had called for a $0.2 million increase in net earnings to $2.1 million (off by $0.1 million) and a $0.02 rise in diluted EPS to $0.52 (off by $0.02).

The primary reason for the difference between reported results and our estimate was that net revenues were $0.5 million more than the $10.1 million we had anticipated, largely consisting of noninterest income that was $0.6 million higher than our projection (entirely due to merchant card income that was $0.6 million better than expected), partly offset by net interest income that was $0.1 million lower than our estimate.

On the other hand, total noninterest expense of $7.8 million was $0.3 million more than we had projected, primarily reflecting other miscellaneous expense that was $0.7 million more than anticipated (largely due to higher merchant card expense), which was partly offset by compensation expense that was $0.4 million below our estimate.

The major reasons for the second quarter's $0.3 million gain in net earnings versus the prior-year quarter were a $0.1 million increase in net interest income, a $0.1 million, or 52%, drop in the provision for loan losses, and a $0.9 million , or 22%, advance in noninterest income from higher merchant card income and securities gains, which were partly offset by a $0.6 million rise in total noninterest expense from greater merchant card expense.

Net interest income fell $0.1 million, or 1%, year over year in the second quarter to $5.8 million ($0.1 million below our $5.9 million estimate), as an estimated 6% increase in average interest-earning assets was partly offset by a net interest margin that we estimate was lower than the 4.48% earned in the year-ago quarter.

Noninterest income increased $0.9 million, or 22%, year over year to $4.8 million ($0.6 million greater than our $4.2 million projection), on the strength of higher net securities gains (up $0.3 million) and merchant card income (up $0.6 million).

Noninterest expense advanced $0.6 million, or 8%, to $7.8 million ($0.3 million more than the $7.4 million we had projected) from the prior-year quarter, largely reflecting noncompensation expense that was $0.8 million more than a year ago (largely due to higher merchant card expense), which was partly offset by compensation expense that was $0.2 million lower than that reported in the prior-year quarter.

The loan loss provision declined by $57,000 to $72,000 from $150,000 in the year-ago quarter and was the slighly higher than our $63,000 estimate. Loan loss reserves were flat at $6.2 million (1.57% of loans) compared with the first quarter (1.53% of loans), and were $0.3 million below the $6.5 million (1.69% of loans) in the year-ago quarter.

As to other asset quality measures, CPKF recorded net charge-offs of $66,000 in the second quarter. This compares to net charge-offs of $243,000 in the year-ago quarter and net charge-offs of $445,000 for the full year in 2014.

CEO Jeffrey M. Szyperski noted that CPKF's asset quality improved year over year, with nonperforming assets decreasing to 3.32% of total loans at June 30, 2015 compared to 4.36% at June 30, 2014.

Gross loans increased $12 million, or about 3%, year over year, and declined $9 million, or 2%, sequentially to $393 million.

CPKF posted a 12.5% ROE and 1.00% ROA for the second quarter of 2015, compared to 11.6% and 1.15%, respectively, in the prior-year quarter.

CPKF recently announced it will be opening a new branch for the first time in Richmond, Virginia in late summer 2015 as part of its long-term strategy emphasizing planned thoughtful expansion.The 7,500 square-foot location will house all of CPKF's Richmond area associates, from loan production to banking.

On July 17, 2015, CPKF's Board of Directors approved a 6.7% increase in the quarterly dividend to $0.12 from $0.1125, payable on September 15, 2015 to shareholders of record on September 1, 2015. Notably, CPKF has increased the annual dividend payment every year for the past twenty-four 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.

In 2015 for the eighth consecutive year, Chesapeake Financial Shares, Inc. has been included in the American Banker magazine (formerly US Banker magazine) listing of the "Top 200 Community Banks" in the United States. The bank ranked at #34 in the nation out of approximately 6,000 community banks in the study, up from #148, when CPKF first broke into the rankings in 2008. The ranking is based on a three-year average of return on average equity (ROAE), which for CPKF was12.64%.

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 $665 million in total assets at June 30, 2015. 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. In addition, CPKF opened a commercial loan production office in Richmond, Virginia in 2011. CPKF, which began as Lancaster National Bank on April 13, 1900, has a long history and strong ties with the communities it serves.

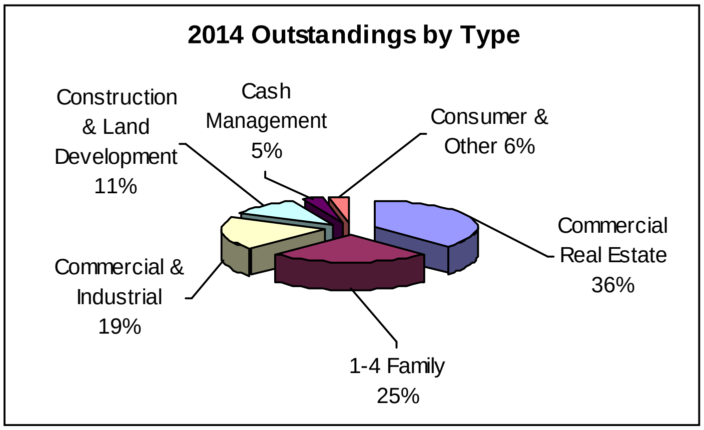
Operations are carried on through Chesapeake Bank, a state-chartered bank as well as Federal Reserve and FDIC member bank, and Chesapeake Investment Group, Inc. (CIG), an independent wealth management firm that manages about $356 million in assets (at 2014 yearend) through its subsidiaries involved in 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 2014, Chesapeake Payment Systems had 535 merchants in its system and processed over $129 million in merchant card transactions. In addition, Chesapeake Payment Systems has also partnered with three 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 77 customers at the end of 2014.

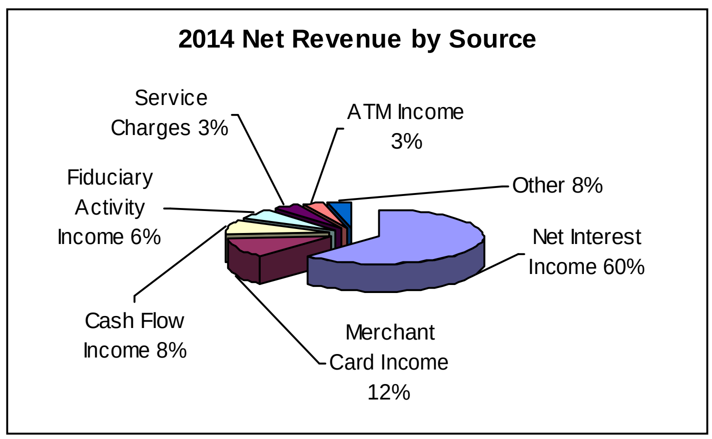
Clear Sky accounts, which offer internet-based retail deposit services for checking and saving accounts and certificates of deposit (CDs), expands CPKF's retail deposit base geographically. At December 31, 2014, Clear Sky deposits totalled $30 million, with customers in all 50 states.

Through Chesapeake's secondary market mortgage banking operation, the Company services a $219 million loan portfolio (as of December 31, 2014) of residential mortgage loans for Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac), for which it earns a 25 basis-point fee (approximately $560,000 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 $272,000 to revenues in 2014 (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, 2014, the lending book consisted of commercial real estate (accounting for 36% of total gross outstandings), 1-4 family (25%), commercial and industrial (19%), construction and land development (11%), cash flow (5%), and consumer and other (6%). A majority of loans are secured, usually by real estate, inventory, accounts receivable, equipment, machinery, or corporate assets.

At December 31, 2014, the liquidity portfolio, which consists of cash, short-term investments, federal funds sold, and US agency mortgage obligations, represented about 9% of total assets and 19% of the securities portfolio. In addition, the available-for-sale portfolio includes municipal and private label mortgage securities, which accounted for 64% and 17%, respectively, of the total. Core deposits represented 85% of total deposits at December 31, 2014, with certificates of deposit larger than $100,000 at 15%.



In 2014, 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 (12% of net revenues), cash flow income (8%), income from fiduciary activities (6%), service charges on deposit accounts (3%), and ATM income (3%).

VALUATION

CPKF stock is up 7.9% year to date, better than the 0.9% median gain for the small-cap bank industry, as well as the 8.0% price decline 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 10% in 2016, based upon our current CPKF EPS estimate for 2016. This is above the average 35% P/E discount for CPKF, based upon recent historical P/E averages. Applying the historical discount of 35% to our 2016 EPS estimate results in a price of about $12.00.

Turning to Price/Tangible Book Value, CPKF is valued at 0.90X versus the industry median of 1.23X. This represents a 26% discount, well below the average historical premium of 16% for CPKF since mid-2008. Applying the historical premium of 16% to our estimated book value for CPKF twelve months out results in a price of approximately $22.50.

While we recognize that CPKF is still undervalued particularly on a book value basis (CPKF's current book value is $18.15), we believe that there is no immediate catalyst to drive the stock price higher over the near term.

Accordingly, we have chosen the $17.25 midpoint of the wide range of values based upon CPKF's 2016 P/E of $12.00 and Price/Tangible Book Value of $22.50 as our new target price.

Industry Comparables - Small-cap Banks

		Price / Earnings Ratios					Return on Equity		Return on Assets		
	Pr Chg YTD	TTM* EPS	2015E	2016E	5-Yr Avg	Price/ Book	TTM*	5-Yr Avg	TTM*	5-Yr Avg	Div Yld
Chesapeake Finc'l	**7.9**	**10.1**	**10.8**	**10.4**	**8.3**	**0.90**	**11.5**	**15.1**	**1.24**	**1.33**	**2.9**
S&P 500	(8.0)	17.0	15.9	14.5	15.9	5.6	29.2	-----	8.7	-----	-----
Median	**0.9**	**13.8**	**13.4**	**11.5**	**12.9**	**1.23**	**8.9**	**6.5**	**0.92**	**0.59**	**2.1**
Average	2.1	16.0	20.2	13.4	15.0	1.1	8.3	5.6	0.8	0.6	1.9
High	23.5	69.2	141.4	37.2	27.9	2.0	15.1	15.1	1.4	1.7	4.9
Low	(19.1)	8.1	10.4	9.5	6.8	0.6	0.1	(36.5)	0.0	(0.6)	-----

*Trailing twelve months

Chesapeake Financial Shares, Inc.

Income Statement and Balance Sheet

(Dollars in millions, except per share data)

Summary Financial Data	**12/10**	**12/11**	**12/12**	**12/13**	**12/14**	**12/15E**	**12/16E**
Net interest income	21.8	22.8	23.1	23.3	23.1	23.8	24.3
Non-interest income	13.8	13.7	15.0	15.7	14.6	15.6	16.1
Total net revenue	35.6	36.5	38.1	39.0	37.7	39.4	40.4
Loan loss provision	2.5	1.2	0.6	1.1	0.6	0.3	0.3
Non-interest expense	26.2	26.4	27.8	29.8	30.5	31.4	32.0
Income taxes & other	1.5	1.9	2.0	1.5	0.8	1.4	1.6
Zacks adjusted income before NRI	5.4	7.0	7.7	6.6	5.8	6.3	6.5
GAAP net income	5.4	7.0	7.7	7.4	6.5	7.0	6.5
Diluted EPS before NRI	1.41	1.80	1.94	1.66	1.43	1.55	1.60
Reported EPS	1.41	1.80	1.94	1.84	1.62	1.73	1.60
Dividends per share	0.30	0.33	0.38	0.43	0.45	0.47	0.48
Liquid assets	73.2	97.9	92.1	89.9	62.8	51.8	52.6
Outstandings, gross	382.3	373.1	397.6	401.0	410.4	430.2	451.0
Total assets	607.7	638.0	667.7	661.8	663.2	683.2	711.0
Core deposits	396.2	430.4	459.0	467.2	480.5	496.6	516.8
Purchased funds	127.2	113.3	118.4	105.3	82.4	83.9	85.3
Long-term debt	40.0	39.6	26.0	25.9	20.6	19.0	19.0
Shareholders' equity	41.1	51.2	60.9	61.8	70.6	76.2	80.9
Profitability							
Return on avg assets	0.90%	1.13%	1.19%	1.01%	0.87%	0.94%	0.93%
Return on avg equity	13.55%	15.31%	14.87%	10.74%	9.14%	8.45%	8.26%
Net interest margin	4.40%	4.70%	4.60%	4.60%	4.60%	4.40%	4.30%
Loan loss provision % avg assets	0.41%	0.19%	0.09%	0.17%	0.09%	0.04%	0.04%
Noninterest income % avg assets	2.30%	2.21%	2.33%	2.40%	2.20%	2.33%	2.31%
Noninterest expense % avg assets	4.34%	4.27%	4.32%	4.55%	4.61%	4.68%	4.59%
Preprovision pretax income % avg assets	1.57%	1.62%	1.60%	1.41%	1.09%	1.19%	1.20%
Tangible efficiency ratio	73%	71%	71%	75%	81%	80%	79%
Payout ratio	21%	18%	19%	23%	28%	26%	28%
Asset Quality							
Net charge-offs % avg outstandings	0.48%	0.22%	0.18%	0.29%	0.14%	0.17%	0.14%
Allowance % outstandings	1.90%	2.01%	1.88%	1.75%	1.88%	1.74%	1.64%
NPAs % loans + OREO	3.91%	4.48%	4.93%	5.20%	4.20%	3.17%	2.72%
Allowance % NPAs	48%	44%	32%	30%	37%	55%	60%
Liquidity & Funding							
Liquid assets % purchased funds	58%	86%	78%	85%	76%	62%	62%
Core deposits % outstandings	104%	115%	115%	117%	117%	115%	115%
Liquid assets % assets	12%	15%	14%	14%	9%	8%	7%
Outstandings % assets	63%	58%	60%	61%	62%	63%	63%
Capital Adequacy							
Total equity % assets	6.76%	8.03%	9.12%	9.34%	10.65%	11.16%	11.38%
Tangible equity % assets	6.76%	8.03%	9.12%	9.34%	10.65%	11.16%	11.38%
Tier 1 capital ratio	12.07%	12.20%	13.55%	14.23%	14.69%		
Total capital ratio	13.54%	13.40%	14.80%	15.48%	15.94%		
Parent Company Statistics							
Interest coverage	2.6X	2.1X	4.4X	9.2X	27.3X	7.5X	7.5X
Interest & dividend coverage	1.1X	0.9X	1.5X	1.5X	3.7X	1.4X	1.3X
Short-term debt coverage	Lge	Lge	Lge	Lge	Lge	Lge	Lge
Total debt coverage	0.8X	0.8X	0.9X	1.0X	0.9X	0.9X	0.9X
Double leverage	134.7%	127.2%	121.7%	119.7%	109.3%	110.4%	112.1%

Chesapeake Financial Shares, Inc.

Income Statement and Balance Sheet

(Dollars in millions, except per share data)

	2014				2015			
Summary Financial Data	**Q1 A**	**Q2 A**	**Q3 A**	**Q4 A**	**Q1 A**	**Q2 P**	**Q3 E**	**Q4 E**
Net interest income	5.6	5.7	5.9	6.0	5.9	5.8	6.0	6.0
Non-interest income	3.4	4.0	3.4	3.7	3.9	4.8	3.7	3.8
Total net revenue	9.0	9.7	9.3	9.7	9.8	10.6	9.7	9.8
Loan loss provision	0.2	0.2	0.2	0.2	0.1	0.1	0.1	0.1
Non-interest expense	7.2	7.2	8.0	8.1	7.4	7.8	8.1	8.5
Income taxes & other	0.4	0.4	0.2	(0.2)	0.4	0.5	0.3	0.2
Zacks adjusted income before NRI	1.3	1.9	0.9	1.6	1.9	2.2	1.2	1.0
GAAP net income	1.3	1.9	1.7	1.6	2.6	2.2	1.2	1.0
Diluted EPS before NRI	0.32	0.48	0.23	0.41	0.48	0.54	0.30	0.26
Reported EPS	0.32	0.48	0.42	0.41	0.66	0.54	0.30	0.26
Dividends per share	0.11	0.11	0.11	0.11	0.11	0.11	0.12	0.12
Liquid assets	90.1	70.1	63.2	62.8	51.1	59.0	51.6	51.8
Outstandings, gross	404.7	400.6	409.4	410.4	420.6	414.5	427.0	430.2
Total assets	669.2	655.0	658.0	663.2	663.1	665.1	676.5	683.2
Core deposits	480.4	462.5	477.4	480.5	482.0	487.6	491.7	496.6
Purchased funds	95.2	93.1	84.0	82.4	82.9	82.9	83.6	83.9
Long-term debt	26.0	25.9	20.7	20.6	19.3	15.5	19.0	19.0
Shareholders' equity	64.5	67.0	68.9	70.6	73.2	72.9	75.6	76.2
Profitability								
Return on avg assets*	0.78%	1.15%	0.55%	0.99%	1.16%	1.00%	0.73%	0.61%
Return on avg equity *	8.26%	11.56%	5.35%	9.40%	10.67%	12.49%	6.50%	5.49%
Net interest margin*	4.46%	4.48%	4.55%	4.60%	4.41%	-----	4.40%	4.40%
Loan loss provision % avg assets*	0.09%	0.09%	0.09%	0.09%	0.04%	0.13%	0.04%	0.04%
Noninterest income % avg assets*	2.06%	2.39%	2.09%	2.28%	2.36%	2.00%	2.19%	2.25%
Noninterest expense % avg assets*	4.32%	4.35%	4.85%	4.93%	4.44%	4.54%	4.81%	5.01%
Preprovision pretax inc.% avg assets*	1.10%	1.47%	0.82%	0.97%	1.46%	1.22%	0.93%	0.79%
Tangible efficiency ratio	80%	74%	85%	84%	77%	75%	83%	86%
Payout ratio	35%	23%	27%	28%	17%	21%	37%	44%
Asset Quality								
Net charge-offs % avg outstandings*	(0.07)%	0.24%	0.05%	0.32%	0.27%	-----	0.14%	0.14%
Allowance % outstandings	1.83%	1.87%	1.89%	1.88%	1.80%	-----	1.76%	1.74%
NPAs % loans + OREO	5.09%	4.50%	3.90%	4.20%	3.48%	-----	3.28%	3.17%
Allowance % NPAs	31%	35%	41%	37%	42%	-----	53%	55%
Liquidity & Funding								
Liquid assets % purchased funds	95%	75%	75%	76%	62%	71%	62%	62%
Core deposits % outstandings	119%	115%	117%	117%	115%	118%	115%	115%
Liquid assets % assets	13%	11%	10%	9%	8%	9%	8%	8%
Outstandings % assets	60%	61%	62%	62%	63%	62%	63%	63%
Capital Adequacy								
Total equity % assets	9.64%	10.23%	10.47%	10.65%	11.05%	10.97%	11.18%	11.16%
Tangible equity % assets	9.64%	10.23%	10.47%	10.65%	11.05%	10.97%	11.18%	11.16%
Tier 1 capital ratio	14.41%	14.84%	14.22%	14.69%	13.85%			
Total capital ratio	15.66%	16.09%	15.47%	15.94%	15.10%			

*Annualized.

HISTORICAL ZACKS RECOMMENDATIONS

DISCLOSURES

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