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Chesapeake Financial Shares, Inc. (CPKF – OTCQB)

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Price: *	$ 17.70	**Diluted EPS**	**2014A: ***	$1.44	**P/E**	**2014A:**	12.3 x
52 Wk. Range:	$15.45 - $18.90	(FY: DEC)	**2015A:***	$1.46		**2015A:**	12.1 x
Div/Div Yld:	$0.48 /2.7%		**2016E:**	$1.65		**2016E:**	10.7 x
Shrs/Mkt Cap:	4.0 mm/ $71 mm	**Book Value:**		$18.92	**Price/Book Value:**		0.94 x

* 2014 EPS excludes $0.19 per share in gains on retirement of Trust Preferred Securities and security gains (net of impairments), while 2015 EPS excludes similar gains totaling $0.36 per share.

SYMBOL: CPKF

ASSETS: $679 MM

HQ: KILMARNOCK, VA

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4TH QUARTER HIGHLIGHTS:

EPS: $0.22 VS. $0.41

EARNINGS WERE AFFECTED BY PERSONNEL ADDITIONS, WHICH ADDED TO COMPENSATION COSTS

NET INTEREST INCOME INCREASED DUE TO GROWTH IN AVERAGE EARNING ASSETS

EARNINGS ALSO BENEFITTED FROM A DROP IN THE PROVISION FOR LOAN LOSSES

NONINTEREST INCOME, EXCLUDING NONRECURRING ITEMS, INCREASED 27%

Background

Chesapeake Financial Shares, Inc. is a one-bank holding company originally chartered in 1900 and is based in Kilmarnock, VA. As of December 31, 2015, the Company had $679 million in total assets. The holding company operates two subsidiaries, Chesapeake Bank and Chesapeake Investment Group, Inc. Chesapeake Bank is primarily a lender to small businesses. Personal and business products and services offered include checking, savings, CDs, mortgages, mobile and online banking, e-services comprising an internet branch, and a business cash management program. The Bank currently operates 13 branches; four in the Northern Neck, three in the Middle Peninsula, five in Williamsburg and one in Richmond. There is also a loan production office in Richmond. The Bank also offers merchant processing services for credit and debit card transactions. Chesapeake Investment Group is an independent wealth management firm with more than $340 million in assets which offers trust and estate management services. Chesapeake Financial Shares, Inc.'s stock trades on the over-the-counter market (OTCQB) under the symbol "CPKF." The Company's Chairman, President, and CEO, Jeffrey M. Szyperski, is a former Chairman of the Virginia Bankers Association and was appointed in 2014 to the ABA Board of Directors for a three-year term.

Fourth Quarter Earnings Affected By Higher Expansion Related Costs

Chesapeake Financial Shares reported fourth quarter earnings that were below our projections, though much of that shortfall was from expansion related costs. Moreover, the Company reported encouraging trends in a number of other key areas, one of those being loan growth, which picked up in the quarter. Also, the Merchant Card operation continues to report quite strong quarter over year-ago quarter comparisons, which reflects the progress this division is making in new client acquisition. Asset quality has been good as well, with the level of nonperforming assets dropping slightly from the linked third quarter and declining significantly from the level at the end of 2014. So all in all, we viewed it as a good quarter.

Net income for the fourth quarter of 2015 was $913,000, or $0.22 per diluted share, versus $1,640,000, or $0.41 per diluted share, in the year-ago quarter. We had been projecting earnings of $0.28 per share. One of the more encouraging aspects of the quarter was the linked quarter pick-up in net interest income. Although net interest income was up only about a percent from the year-ago quarter, it was up 4% from the level in the third quarter of 2015. Margins have been fairly flat to down slightly, though that has been more than offset by the growth in average earning assets. Earnings also benefitted from a modest drop in the provision for loan losses (it was $84,000 in 2015's fourth quarter, versus $150,000 in the year-ago quarter), reflecting the Bank's strong reserve position and improving asset quality. Comparisons were also encouraging in noninterest income, which (excluding net security related gains and losses) was up 27% to $4.8 million in 2015's fourth quarter from $3.8 million in the year-ago quarter. As was the case last quarter, most of that growth came from the Merchant Card Division. Core noninterest income in 2015's fourth quarter (primarily fiduciary, service charges, merchant card, Cash Flow and ATM income) accounted for roughly 45% of

NONINTEREST EXPENSE INCREASED 22%, PARTLY FROM PERSONNEL HIRES BUT ALSO FROM AN ADDITIONAL ONE-TIME CONTRIBUTION TO THE ESOP OF $250,000

Chesapeake's total revenues. We would also note that none of that was mortgage banking related, which tends to be fairly volatile. Finally, fourth quarter earnings were affected by the previously mentioned noninterest expense, which increased 22% to $9.9 million in the fourth quarter of 2015 from $8.2 million in the year-ago quarter. That increase came primarily from new hires, as well as an additional one-time contribution to the ESOP of $250,000.

TWELVE-MONTH HIGHLIGHTS:

EPS: $1.82 VS. $1.62

BOTH YEARS INCLUDED NONRECURRING GAINS

For the twelve months ended December 31, 2015, net income totaled $7,404,000, or $1.82 per diluted share, up from $6,534,000, or $1.62 per diluted share, in 2014. Included in both year's earnings were $1.1 million in gains (one in the third quarter of 2014 and one in the first quarter of 2015) from the retirement of Trust Preferred securities, as well as other net security gains. Net interest income was up 1%, while noninterest income, excluding nonrecurring items, was up 20% and noninterest expense increased 11% in 2015 relative to 2014.

Stock Performance Has Been Quite Impressive

In one of the Company's most recent press releases, it was noted that CPKF shares had a total return of roughly 107% over the past ten years. While that in itself is impressive, it is even more noteworthy if taken in context. After all, the period from early 2006 to early 2016 has been a very challenging period for banks. That is particularly apparent when we look at broader market bank indices, such as the KBW Bank Index (which shows a similar trend as other bank indices such as the NASDAQ Bank Index). As can be seen in the chart at the right, the KBW Bank Index lost nearly 80% of its value from early 2007 until early 2009, and has still not fully recovered from that drop. On the other hand, CPKF shares exhibited much less volatility/downside pressure, as well as having a much better long-term return. Over the ten year period we considered, CPKF's total return to shareholders was actually 111%. What is interesting is the breakdown of that return: of the 111%, 62% came from appreciation (the KBW Index *lost* 42% over the same period), while the other 49% came from the cash dividends. And speaking of dividends, we would note that 2016 marks the 24th consecutive year in which the Company has increased its cash dividend. Companies that are in the S&P 500 that increase the cash dividend for 25 consecutive years are generally regarded as "Dividend Aristocrats," and while Chesapeake is clearly not large enough to make it into the S&P 500, its dividend record certainly sets it apart within the community bank universe.

THE RETURN ON CPKF SHARES IN THE PAST TEN YEARS IS OVER 100%

THIS RATE OF RETURN GREATLY EXCEEDS THAT OF MOST BANK INDICES

ROUGHLY 60% OF THAT RETURN CAME FROM APPRECIATION, WHILE THE REST CAME FROM DIVIDENDS

CHESAPEAKE HAS INCREASED ITS DIVIDEND FOR 24 CONSECUTIVE YEARS



Asset Quality Continues to Improve

NPAS/ASSETS: 1.49%

RESERVES/LOANS: 1.33%

At December 31, 2015, Chesapeake had nonperforming assets of $10.1 million, or 1.49% of assets, down from $10.7, or 1.61% of assets, at September 30, 2015 and $11.1 million, or 1.68% of total assets, at December 31, 2014. NPAs consisted of $8.0 million in nonaccruing loans and $2.1 million in OREO. The allowance for loan losses totaled $5.5 million, or 1.33% of loans, at December 31, 2015, compared to $6.4 million, or 1.63% of loans, at the year-ago date.

Projections

EPS:
2014A: $1.44*
2015A: $1.46*
2016E: $1.65

To better reflect the operating earnings trends of the Company, we are showing the historical EPS net of several nonrecurring items, which includes $1.1 million gains on the repurchase of Trust Preferred securities in 2014 and 2015, as well as other net security gains and losses. For the year 2016, we are projecting net income of $6.8 million, or $1.65 per diluted share. These projections could vary considerably if economic or other conditions change.

*** EXCLUDES NONRECURRING GAINS OF $0.19 AND $0.36 PER SHARE IN 2014 AND 2015, RESPECTIVELY**

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