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Chesapeake Financial Shares, Inc. (CPKF – OTCQB)

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John A. Howard, CFA
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Price:	$ 18.11	**Diluted EPS**	**2014A: ***	$1.44	**P/E**	**2014A:**	12.6 x
52 Wk. Range:	$15.75 - $18.90	(FY: DEC)	**2015A:***	$1.46		**2015A:**	12.4 x
Div/Div Yld:	$0.48 /2.7%		**2016E:**	$1.75		**2016E:**	10.3 x
Shrs/Mkt Cap:	4.0 mm/ $73 mm	**Book Value:**		$19.34	**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: $693 MM

HQ: KILMARNOCK, VA

CONTACT:
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Background

Chesapeake Financial Shares, Inc. is a one-bank holding company originally chartered in 1900 and is based in Kilmarnock, VA. As of March 31, 2016, the Company had $693 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.

1ST QUARTER HIGHLIGHTS:

OPERATING EARNINGS WERE ACTUALLY BETTER THAN IMPLIED BY THE BOTTOM LINE NUMBERS

EPS: $0.48 VS. $0.65

THE YEAR-AGO EARNINGS INCLUDED A $1.1 MILLION GAIN ON THE RETIREMENT OF TRUST PREFERRED SECURITIES

IF WE ELIMINATE NONRECURRING ITEMS, PRETAX ADJUSTED INCOME WAS UP ABOUT 25%

First Quarter Results Were Excellent

Chesapeake Financial Shares reported first quarter results that were quite strong, and which were much better than implied by the bottom line comparisons. The earnings were also well above our projections, and while we are raising our EPS projection for the year, we believe the revised figures may still be on the conservative side. Moreover, the Bank continues to experience encouraging growth in the loan portfolio, which has been a stubborn challenge at many of the banks we follow. Asset quality has been holding up as well, which should keep the provision for loan losses relatively low. Given the strong returns on equity (ROAE was in the low double digits in the most recent quarter) and the fact that the stock is trading at a slight discount to book value, we believe the shares represent a compelling value from a long-term standpoint.

Net income for the first quarter of 2016 was $1,968,000, or $0.48 per diluted share, versus $2,644,000, or $0.65 per diluted share, in 2015's first quarter. We had projected earnings of $0.33 per share, so the results were well above our expectations. The year-ago quarter included several nonrecurring items. Those items included a $1.1 million gain from the retirement of $5 million in trust-preferred securities, as well as gains on security sales, net of impairment losses, of about $241,000. In contrast, earnings in 2016's first quarter included about $118,000 in net losses on the sale of securities. If we exclude these items and the provision for loan losses, we see that normalized pretax, pre-provision income was roughly $2.6 million in 2016's first quarter, up about 25% from the year-ago figure of $2.1 million.

First Quarter Results ($000s)	2015	2016
Pretax Income	3,341	2,405
Add Back:		
Provision	72	62
Security Losses (Gains)	(241)	118
Gain on Trust Pfd Repurch.	(1,100)	-
Pretax Inc. Bef. Unusual Items	2,072	2,585

NET INTEREST INCOME INCREASED 4% DUE TO SOLID GROWTH IN AVERAGE EARNING ASSETS

NONINTEREST INCOME, EXCLUDING NONRECURRING ITEMS, INCREASED 24%

NONINTEREST EXPENSE INCREASED 7%, THOUGH MUCH OF THAT WAS DUE TO HIGHER MERCHANT CARD DIVISION EXPENSES

BALANCE SHEET GROWTH WAS SOLID AS WELL

The strength in the operating results was fairly broad based. For example, net interest income, which benefited from growth in average earning assets, was $6,081,000 in 2016's first quarter, up 4% from $5,861,000 in the year-ago quarter, and was actually the highest it has been for any given quarter in the Company's history. Moreover, the provision for loan losses remained low (it actually declined slightly), allowing all of the improvement in net interest income to flow through to earnings. Core noninterest income was also quite strong. Excluding the previously mentioned $1.1 million gain and the net security related gains and losses, core noninterest income was $4.4 million in 2016's first quarter, an increase of 24% increase from $3.6 million in 2015's first quarter. While most of that growth came from the Merchant Card Division, strong comparisons were also reported in Cash Flow and ATM income. Finally, noninterest expense was $7.9 million in 2016's first quarter, an increase of 7% from the year-ago quarter, although most of that increase related to the growth in the Merchant Card Division. Balance sheet growth was good, with the new location in Richmond contributing to the increase in deposits and loans. Relative to the year-ago figures, total assets were up 4%, while gross loans were up 6% and deposits increased 3%. Total shareholders' equity was $77.6 million at March 31, 2016, or 11.2% of assets. As we have stated in previous reports, the strength of Chesapeake Financial's capital position provides it the flexibility to pursue a number of shareholder value enhancement strategies, such as boosting cash dividends (it has done so for 25 consecutive years) or initiating stock buybacks.

CHESAPEAKE FINANCIAL'S PROFITABILITY RATIOS ARE MUCH HIGHER THAN THOSE OF THE TYPICAL VIRGINIA BANK

NPAS TO ASSETS WERE HIGHER BUT THE RESERVE COVERAGE WAS SIMILAR

DESPITE THE SUPERIOR PERFORMANCE, CPKF'S SHARES ARE TRADING AT LOWER MULTIPLES AND HAVE A HIGHER DIVIDEND YIELD

Chesapeake Financial Continues to Outperform Peers

We have discussed in previous reports how Chesapeake Financial remains one of the best performing banks in Virginia. For example, the Company's profitability measures (such as ROAA and ROAE) are well above the median ratios for Virginia banks. Although its NPAs-to-assets ratio was higher, its reserve coverage was similar. Despite its superior performance, the shares are trading at a discount to Virginia peers based on earnings and book value. Finally, CPKF shares pay an annual cash dividend of $0.48 per share, which represents a 2.65% yield, well above that of the typical Virginia bank.

PEER GROUP COMPARISON: SBFC VS. VA PUBLIC BANKS

	ROAA MRQ	ROAE MRQ	NPAs/ Assets	Reserves/ Loans	Dividend Yield	Price/ EPS	Price/ Book Value
CPKF	1.15%	10.39%	1.31%	1.19%	2.65%	11.0x	0.94x
Peer Median	0.86%	7.81%	0.83%	1.19%	2.39%	15.7x	1.03x

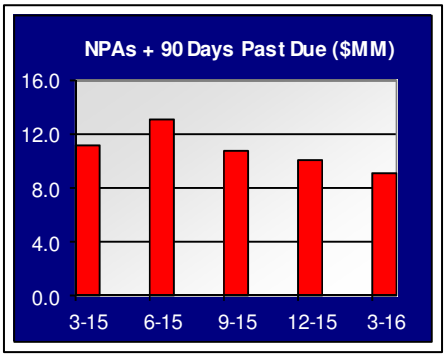
ASSET QUALITY HAS BEEN HOLDING UP WELL

NPAS/ASSETS: 1.31%

RESERVES/LOANS: 1.19%

Asset Quality Continues to Improve

Chesapeake Financial continues to make progress reducing its level of nonperforming assets. At March 31, 2016, Chesapeake had NPAs of $9.1 million, or 1.31% of assets, versus $10.1 million, or 1.49% of assets, at December 31, 2015 and $11.1 million, or 1.68% of total assets, at March 31, 2015, NPAs consisted of $7.2 million in nonaccruing loans and $1.8 million in OREO. The allowance for loan losses totaled $5.1 million, or 1.19% of loans, at March 31, 2016, compared to $6.2 million, or 1.53% of loans, at the year-ago date.



EPS:
2014A: $1.44*
2015A: $1.46*
2016E: $1.75

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

Projections Increased

Based on the strength of the first quarter results, we are increasing our projection for 2016 net income to $7.2 million, or $1.75 per diluted share. These projections could vary considerably if economic or other conditions change.

ADDITIONAL INFORMATION UPON REQUEST

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