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Chesapeake Financial Shares, Inc. (CPKF – OTCQB)

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John A. (Buddy) Howard, CFA
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Price:	\$ 20.50	Diluted EPS	2015A: *	\$ 1.46	P/E	2015A:	14.0 x
52 Wk. Range:	\$16.70 - \$22.44	(FY: DEC)	2016E:	\$ 1.75		2016E:	11.7 x
Div/Div Yld:	\$0.50 /2.4%		2017E:	\$ 1.86		2017E:	11.0 x
Shrs/Mkt Cap:	4.0 mm/ \$82 mm	Book Value:		\$20.10	Price/Book Value:		1.02 x

* 2015 EPS excludes \$0.36 per share in gains on retirement of Trust Preferred Securities and security gains (net of impairments).

Background

Chesapeake Financial Shares, Inc. is a one-bank holding company originally chartered in 1900 and is based in Kilmarnock, VA. As of September 30, 2016, the Company had \$719 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 14 branches; four in the Northern Neck, three in the Middle Peninsula, five in Williamsburg and two 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. He was also appointed in 2014 to the ABA Board of Directors for a three-year term and was recently elected to be Vice Chairman.

Third Quarter Results Were Slightly Below Expectations

Chesapeake Financial Shares reported third quarter results that were a touch below our estimates, mainly due to an increase in interest expense and higher noninterest expense, though some of that was due to expansion related costs. Although earnings were a touch short, we were pleased with many other aspects of the quarter, most notably the positive momentum in loans, which are benefitting from a stronger lending environment but also from the Bank's new presence in and around Richmond. Interestingly, it is often factors such as this – a bank's successful entry into an attractive new market – that leads to an accelerating stock price. While we believe Chesapeake Financial's strong stock performance (as discussed more fully on the back page) is partly the result of the Company's solid earnings and asset quality, we attribute a good bit of it to the broadening of its geographic market and the associated pick up in balance sheet growth.

In terms of specific results, net income in 2016's third quarter was \$1,780,000 or \$0.43 per diluted share, as compared to \$1,651,000, or \$0.40 per diluted share, in the year-ago quarter. The largest contributors to the increase were higher net interest income and noninterest income. Net interest income increased 5% to \$6,074,000 in 2016's third quarter from \$5,781,000 in the year-ago quarter, with average earning assets driving most of this increase. The growth in core (i.e., excluding security gains and net impairment losses) was even stronger, increasing 10% to \$5,661,000 in the third quarter of 2016 from \$5,150,000 in the year-ago quarter. As has been the case in the past several quarters, the expansion of the merchant card division fueled much of this growth. Moreover, in the most recent quarter, merchant card income accounted for roughly 47% of core noninterest income, and added more than \$900,000 of earnings to the Bank. (The Company breaks out the expenses for the Merchant

SYMBOL: CPKF

ASSETS: \$719 MM

HQ: KILMARNOCK, VA

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3RD QUARTER HIGHLIGHTS:

EPS: \$0.43 vs. \$0.40

**THE RESULTS WERE
SLIGHTLY BELOW TARGET
BUT THE QUARTER WAS
ENCOURAGING IN OTHER
RESPECTS**

**NET INTEREST INCOME WAS
UP 5%**

**CORE NONINTEREST INCOME
INCREASED 10%**

**MERCHANT CARD INCOME
GROWTH REMAINED QUITE
STRONG**

Card division, just as it does for Cash Flow and ATM expense). Noninterest expense increased 8% to \$9,812,000 from \$9,100,000 in the year-ago quarter (partly from higher merchant card volume), while the provision for loan losses was \$62,000, in 2016's third quarter, versus roughly \$12,000 in the year-ago quarter.

Nine months results were also commendable, although the year-ago results were affected by a \$1.1 million gain from the retirement of \$5 million in trust-preferred securities, as well as a large amount of security gains. Net income for the first nine months of 2016 was \$5,652,000 or \$1.38 per diluted share, compared to \$6,491,000, or \$1.59 per diluted share in the year-ago period. Pretax income before the provision, the \$1.1 million gain and net security gains (in both periods) was \$7,140,000 in the first nine months of 2016, up 10% from \$6,500,000 in the year-ago period. Net interest income and core noninterest income were up 5%, while noninterest expense increased 9% from the year-ago period. As was mentioned earlier, we were also encouraged by balance sheet growth, most notably in loans. From September 30, 2015 to September 30, 2016, gross loans increased an impressive 14%, while deposits grew 6% and total assets were up 8%. Clearly, the Company's growing presence in the Richmond area has been the source of a good deal of this growth. And thanks to the Company's solid return on equity (the annualized return on average equity in the most recent quarter was nearly 9%), the capital ratios are holding up well. Shareholders' equity at September 30, 2016 was \$81 million, or 11.2% of total assets.

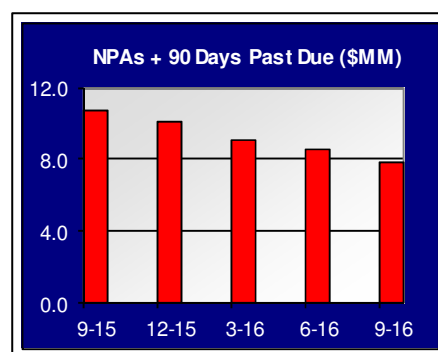
Long-Term Returns to CPKF Shareholders Have Been Impressive

Chesapeake Financial has done a great job building value for shareholders, as can be seen in the adjacent table. Over the past year, Chesapeake's stock is up 22%, while the KBW NASDAQ Bank stock index is actually down slightly over the same period. Chesapeake Financial's returns were also higher for the year-to-date, one-, five- and 10-year periods. Interestingly, CPKF shares held up quite well throughout the Great Recession, which accounts for its unusually strong performance relative to the broader index for the ten-year period. We would also note that these returns do not even include cash dividends that were paid over this period. Chesapeake Financial also paid three 20% (6-for-5) stock dividends over this period: one each in 2007, 2011 and 2014.

Through 10/28/16	Appreciation (Excl. Dividends) - %	
	CPKF	KBW NASDAQ Bank Index
Year-to-Date	18.2	2.0
One Year	22.2	(0.4)
Three Years	36.3	14.7
Five Years	105.0	78.2
Ten Years	84.0	(34.5)

Asset Quality Remains Good

Chesapeake's level of nonperforming assets continues to improve. At September 30, 2016, NPAs totaled \$7.8 million, or 1.09% of assets, versus \$8.5 million, or 1.21% of total assets, at June 30, 2016, and \$10.7, or 1.61% of assets, at September 30, 2015. NPAs were primarily nonaccrual loans (\$6.5 million) followed by OREO (\$1.3 million). The allowance for loan losses was \$4.8 million, or 1.07% of loans, at September 30, 2016, versus \$5.6 million, or 1.41% of loans, at September 30, 2015.



Projections Maintained

Based on the third quarter results, we are maintaining our projection for 2016 of net income of \$7.2 million, or \$1.75 per diluted share, and are introducing our earnings estimate for 2017 of \$7.6 million, or \$1.86 per diluted share. These projections could vary considerably if economic or other conditions change.

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NINE MONTHS HIGHLIGHTS:

RESULTS WERE AFFECTED BY A LARGE GAIN IN THE YEAR-AGO PERIOD

EPS: \$1.38 vs. \$1.59

PRETAX INCOME BEFORE THE PROVISION AND NONRECURRING GAINS WAS UP 10%

CHESAPEAKE FINANCIAL HAS INCREASED SHAREHOLDER VALUE OVER THE LONG AND SHORT TERM

ITS STOCK HELD UP RELATIVELY WELL IN THE GREAT RECESSION, WHICH IS ONE REASON IT HAS BUILT VALUE MORE SUCCESSFULLY THAN THE BROADER MARKETS

NPAS HAVE BEEN CONSISTENTLY DECLINING

NPAS/ASSETS: 1.09%

RESERVES/LOANS: 1.07%

EPS:
2015A: \$1.46*
2016E: \$1.75
2017E: \$1.86

* EXCLUDES NONRECURRING GAINS OF \$0.36 PER SHARE IN 2015