

Live Oak Bancshares, Inc.  
Form 10-Q  
May 12, 2016

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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549  
FORM 10-Q

ý Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the quarterly period ended March 31, 2016

or  
Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the transition period from to .

Commission file number: 001-37497

LIVE OAK BANCSHARES, INC.

(Exact name of registrant as specified in its charter)

North Carolina

(State or other jurisdiction of incorporation or organization) 26-4596286 (I.R.S. Employer Identification No.)

1741 Tiburon Drive

Wilmington, North Carolina

(Address of principal executive offices)

(910) 790-5867

(Registrant's telephone number, including area code)

28403 (Zip Code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES ý NO "

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). YES ý NO "

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See definitions of "large accelerated filer", "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large Accelerated Filer "

Accelerated Filer "

Non-accelerated Filer x (Do not check if smaller reporting company) Smaller Reporting Company "

Indicate by check mark whether registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). YES " NO ý

APPLICABLE ONLY TO CORPORATE ISSUERS:

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

As of May 11, 2016, there were 29,467,643 shares of the registrant's voting common stock outstanding and 4,723,530 shares of the registrant's non-voting common stock outstanding.

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## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements

## Live Oak Bancshares, Inc.

## Consolidated Balance Sheets

As of March 31, 2016 (unaudited) and December 31, 2015\*

(Dollars in thousands)

	March 31, 2016	December 31, 2015*
Assets		
Cash and due from banks	\$226,556	\$102,607
Certificates of deposit with other banks	9,000	10,250
Investment securities available-for-sale	55,674	53,762
Loans held for sale	537,293	480,619
Loans held for investment	313,633	279,969
Allowance for loan losses	(8,616	) (7,415
Net loans	305,017	272,554
Premises and equipment, net	61,839	62,653
Foreclosed assets	3,020	2,666
Servicing assets	47,377	44,230
Other assets	22,765	23,281
Total assets	\$1,268,541	\$1,052,622
Liabilities and Shareholders' Equity		
Liabilities		
Deposits:		
Noninterest-bearing	\$21,125	\$21,502
Interest-bearing	994,340	783,286
Total deposits	1,015,465	804,788
Long term borrowings	28,271	28,375
Other liabilities	20,372	19,971
Total liabilities	1,064,108	853,134
Shareholders' equity		
Preferred stock, no par value, 1,000,000 authorized, none issued or outstanding at March 31, 2016 and December 31, 2015	—	—
Class A common stock, no par value, 100,000,000 shares authorized, 29,460,348 and 29,449,369 shares issued and outstanding at March 31, 2016 and December 31, 2015, respectively	138,199	137,492
Class B common stock, no par value, 10,000,000 shares authorized, 4,723,530 shares issued and outstanding at March 31, 2016 and December 31, 2015	50,015	50,015
Retained earnings	16,147	12,140
Accumulated other comprehensive income (loss)	47	(192
Total shareholders' equity attributed to Live Oak Bancshares, Inc.	204,408	199,455
Noncontrolling interest	25	33
Total equity	204,433	199,488
Total liabilities and shareholders' equity	\$1,268,541	\$1,052,622

\* Derived from audited consolidated financial statements.

See Notes to Unaudited Consolidated Financial Statements



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Live Oak Bancshares, Inc.

Consolidated Statements of Income

For the three months ended March 31, 2016 and 2015 (unaudited)

(Dollars in thousands, except per share data)

	Three Months Ended March 31,	
	2016	2015
Interest income		
Loans and fees on loans	\$ 11,005	\$ 6,730
Investment securities, taxable	251	176
Other interest earning assets	138	66
Total interest income	11,394	6,972
Interest expense		
Deposits	2,444	1,476
Borrowings	241	441
Total interest expense	2,685	1,917
Net interest income	8,709	5,055
Provision for loan losses	1,433	1,077
Net interest income after provision for loan losses	7,276	3,978
Noninterest income		
Loan servicing revenue and revaluation	4,758	4,106
Net gains on sales of loans	16,425	15,461
Equity in loss of non-consolidated affiliates	—	(26 )
Gain on sale of investment in non-consolidated affiliate	—	3,782
Construction supervision fee income	630	216
Other noninterest income	619	516
Total noninterest income	22,432	24,055
Noninterest expense		
Salaries and employee benefits	12,993	8,355
Travel expense	1,846	1,476
Professional services expense	528	850
Advertising and marketing expense	963	1,008
Occupancy expense	1,193	481
Data processing expense	1,208	893
Equipment expense	551	443
Other loan origination and maintenance expense	574	477
Other expense	1,855	719
Total noninterest expense	21,711	14,702
Income before taxes	7,997	13,331
Income tax expense	3,314	5,278
Net income	4,683	8,053
Net loss attributable to noncontrolling interest	8	20
Net income attributable to Live Oak Bancshares, Inc.	\$ 4,691	\$ 8,073
Basic earnings per share	\$ 0.14	\$ 0.28
Diluted earnings per share	\$ 0.13	\$ 0.27

See Notes to Unaudited Consolidated Financial Statements



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Live Oak Bancshares, Inc.

Consolidated Statements of Comprehensive Income

For the three months ended March 31, 2016 and 2015 (unaudited)

(Dollars in thousands)

	Three Months Ended March 31,	
	2016	2015
Net income	\$4,683	\$8,053
Other comprehensive income before tax:		
Net unrealized gain on investment securities arising during the period	389	203
Reclassification adjustment for (gain) loss on sale of securities available-for-sale included in net income	—	—
Other comprehensive income before tax	389	203
Income tax expense	(150 )	(79 )
Other comprehensive income, net of tax	239	124
Total comprehensive income	\$4,922	\$8,177
See Notes to Unaudited Consolidated Financial Statements		

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Live Oak Bancshares, Inc.

Consolidated Statements of Changes in Shareholders' Equity

For the three months ended March 31, 2016 and 2015 (unaudited)

(Dollars in thousands)

	Common stock Shares			Retained earnings (accumulated deficit)	Accumulated other comprehensive income (loss)	Non- controlling interest	Total equity
	Class A	Class B	Amount				
Balance at December 31, 2014	23,896,400	4,723,530	\$98,672	\$ (6,943 )	\$ 85	\$ —	\$91,814
Net income (loss)	—	—	—	8,073	—	(20 )	8,053
Other comprehensive income	—	—	—	—	124	—	124
Consolidation of investment with non-controlling interest	—	—	—	—	—	35	35
Stock option exercises	3,679	—	16	—	—	—	16
Stock option based compensation expense	—	—	118	—	—	—	118
Restricted stock expense	—	—	8	—	—	—	8
Balance at March 31, 2015	23,900,079	4,723,530	\$98,814	\$ 1,130	\$ 209	\$ 15	\$100,168
Balance at December 31, 2015	29,449,369	4,723,530	\$187,507	\$ 12,140	\$ (192 )	\$ 33	\$199,488
Net income (loss)	—	—	—	4,691	—	(8 )	4,683
Other comprehensive income	—	—	—	—	239	—	239
Issuance of restricted stock	2,776	—	—	—	—	—	—
Stock option exercises	8,203	—	48	—	—	—	48
Stock option based compensation expense	—	—	592	—	—	—	592
Restricted stock expense	—	—	67	—	—	—	67
Dividends (distributions to shareholders)	—	—	—	(684 )	—	—	(684 )
Balance at March 31, 2016	29,460,348	4,723,530	\$188,214	\$ 16,147	\$ 47	\$ 25	\$204,433

See Notes to Unaudited Consolidated Financial Statements

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Live Oak Bancshares, Inc.  
 Consolidated Statements of Cash Flows  
 For the three months ended March 31, 2016 and 2015 (unaudited)  
 (Dollars in thousands)

	Three Months Ended March 31,	
	2016	2015
Cash flows from operating activities		
Net income	\$4,683	\$ 8,053
Adjustments to reconcile net income to net cash used by operating activities:		
Depreciation and amortization	1,065	433
Provision for loan losses	1,433	1,077
Amortization of premium on securities, net of accretion	30	15
Amortization (accretion) of discount on unguaranteed loans, net	146	319
Deferred tax expense	739	226
Originations of loans held for sale	(256,077)	(223,905)
Proceeds from sales of loans held for sale	172,638	180,991
Net gains on sale of loans held for sale	(16,425)	(15,461)
Net loss on sale of foreclosed assets	—	7
Net increase in servicing assets	(3,147 )	(3,458 )
Gain on sale of investment in non-consolidated affiliate	—	(3,782 )
Net loss on disposal of premises and equipment	—	3
Stock option based compensation expense	592	118
Restricted stock expense	67	8
Equity in loss of non-consolidated affiliates	—	26
Changes in assets and liabilities:		
Other assets	516	92
Other liabilities	(146 )	5,265
Net cash used by operating activities	(93,886)	(49,973)
Cash flows from investing activities		
Purchases of securities available-for-sale	(2,443 )	(1,900 )
Proceeds from sales, maturities, calls, and principal paydowns of securities available-for-sale	890	629
Proceeds from sale/collection of foreclosed assets	52	330
Maturities of certificates of deposit with other banks	1,250	—
Proceeds from sale of investment in non-consolidated affiliate	—	9,896
Net cash acquired in consolidation of equity method investment	—	319
Loan originations and principal collections, net	8,742	26,725
Purchases of premises and equipment, net	(251 )	(3,281 )
Net cash provided by investing activities	8,240	32,718
See Notes to Unaudited Consolidated Financial Statements		

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Live Oak Bancshares, Inc.

Consolidated Statements of Cash Flows (Continued)

For the three months ended March 31, 2016 and 2015 (unaudited)

(Dollars in thousands)

	Three Months Ended March 31,	
	2016	2015
Cash flows from financing activities		
Net increase in deposits	210,677	34,003
Proceeds from long term borrowings	—	8,468
Repayment of long term borrowings	(104 )	(107 )
Repayment of short term borrowings	—	(6,100 )
Stock option exercises	48	16
Shareholder dividend distributions	(1,026 )	(1,363 )
Net cash provided by financing activities	209,595	34,917
Net increase in cash and cash equivalents	123,949	17,662
Cash and cash equivalents, beginning	102,607	29,902
Cash and cash equivalents, ending	\$226,556	\$47,564
Supplemental disclosure of cash flow information		
Interest paid	\$2,690	\$1,915
Income tax	2,181	1,974
Supplemental disclosures of noncash operating, investing, and financing activities		
Unrealized holding gains on available-for-sale securities, net of taxes	\$239	\$124
Transfers from loans to foreclosed real estate and other repossessions	406	—
Transfers of loans accounted for as secured borrowing collateral to other assets	—	4,674
Dividends declared but not paid	—	169
Transfer of loans held for sale to loans held for investment	13,763	2,294
Transfer of loans held for investment to loans held for sale	752	1,370
Contingent consideration in acquisition of controlling interest in equity method of investment	—	170
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Live Oak Bancshares, Inc.

Notes to Unaudited Consolidated Financial Statements

Note 1. Basis of Presentation

Nature of Operations

Live Oak Bancshares, Inc. (the "Company" or "LOB") is a bank holding company headquartered in Wilmington, North Carolina incorporated under the laws of North Carolina in December 2008. The Company conducts business operations primarily through its commercial bank subsidiary, Live Oak Banking Company (the "Bank"). The Bank was established in May 2008 as a North Carolina-chartered commercial bank. The Bank specializes in providing lending services to small businesses nationwide in targeted industries. The Bank identifies and grows within credit-worthy industries through expertise within those industries. A significant portion of the loans originated by the Bank are guaranteed by the Small Business Administration ("SBA") under the 7(a) program. On July 23, 2015 the Company closed on its initial public offering. In 2010, the Bank formed Live Oak Number One, Inc., a wholly-owned subsidiary, to hold properties foreclosed on by the Bank.

During 2011, the Company formed Independence Aviation, LLC, a wholly-owned subsidiary, for the purpose of purchasing and operating aircraft used for business purposes of the Company. The net assets of Independence Aviation, LLC were transferred to the Company and the Bank effective December 31, 2015 resulting in its dissolution.

In addition to the Bank, the Company owns Live Oak Grove, LLC, opened in September 2015 for the purpose of providing Company employees and business visitors an on-site restaurant location, Government Loan Solutions, Inc. ("GLS"), a management and technology consulting firm that specializes in the settlement, accounting, and securitization processes for government guaranteed loans, including loans originated under the SBA 7(a) loan program and USDA-guaranteed loans, and 504 Fund Advisors, LLC ("504FA"), formed to serve as the investment adviser to the 504 Fund, a closed-end mutual fund organized to invest in SBA section 504 loans.

The Company acquired control over 504FA, previously carried as an equity method investment, on February 2, 2015 by increasing its ownership from 50.0% to 91.3%. The acquisition of an additional 41.3% of ownership occurred in exchange for contingent consideration estimated to total \$170 thousand. Transactions in the third quarter of 2015 and first quarter of 2016 increased the Company's ownership to 92.9%. With 7.1% of ownership remaining with a third party investor, amounts of earnings and equity in 504FA attributable to the third party investor are now disclosed in the Company's consolidated financial statements as related to a noncontrolling interest.

The Company earns revenue primarily from the sale of SBA-guaranteed loans. This income is comprised of net gains on the sale of loans, revenues on the servicing of sold loans and valuation of loan servicing rights. Net interest income is another contributor to earnings. Offsetting these revenues are the cost of funding sources, provision for loan losses, any costs related to foreclosed assets and other operating costs such as salaries and employee benefits, travel, professional services, advertising and marketing and tax expense.

General

In the opinion of management, all adjustments necessary for a fair presentation of the financial position and results of operations for the periods presented have been included, and all intercompany transactions have been eliminated in consolidation. Results of operations for the three months ended March 31, 2016 are not necessarily indicative of the results of operations that may be expected for the year ending December 31, 2016. The consolidated balance sheet as of December 31, 2015 has been derived from the audited consolidated financial statements contained in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2015, filed with the Securities Exchange Commission on March 14, 2016 (SEC File No. 001-37497) (the "2015 Annual Report"). A summary description of the significant accounting policies followed by the Company is set forth in Note 1 of the Notes to Consolidated Financial Statements in the Company's 2015 Annual Report. These unaudited interim consolidated financial statements should be read in conjunction with the consolidated financial statements and footnotes in the Company's 2015 Annual Report.

The preparation of financial statements in conformity with United States generally accepted accounting principles, or GAAP, requires management to make estimates and assumptions that affect reported amounts of assets and liabilities

and the reported amounts of revenues and expenses during the reporting period. Actual results could differ significantly from those estimates.

Amounts in all tables in the Notes to Unaudited Consolidated Financial Statements have been presented in thousands, except percentage, time period, stock option, share and per share data or where otherwise indicated.

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Live Oak Bancshares, Inc.

Notes to Unaudited Consolidated Financial Statements

**Business Segments**

Management has determined that the Company has one significant operating segment, which is providing a lending platform for small businesses nationwide. In determining the appropriateness of segment definition, the Company considers the materiality of a potential segment, the components of the business about which financial information is available, and components for which management regularly evaluates relative to resource allocation and performance assessment.

**Reclassifications**

Certain reclassifications have been made to the prior period's consolidated financial statements to place them on a comparable basis with the current year. Net income and shareholders' equity previously reported were not affected by these reclassifications.

**Note 2. Recent Accounting Pronouncements**

In March 2016, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2016-08, "Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net)" ("ASU 2016-08"). This guidance amends the previously issued ASU No. 2014-09, "Revenue from Contracts with Customers (Topic 606)." ASU 2016-08 clarifies the implementation guidance on principal versus agent considerations in order to determine if revenue will be recognized on a gross or net basis. This guidance is effective for the Company on January 1, 2018 and is not expected to have a material impact on the consolidated financial statements.

In March 2016, the FASB issued ASU No. 2016-09, "Compensation-Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting" ("ASU 2016-09"). ASU 2016-09 simplifies the accounting for share-based payment transactions for items including income tax consequences, classification of awards as equity or liabilities, and classification on the statement of cash flows. ASU 2016-09 will be effective for the Company on January 1, 2017 and the Company is currently assessing the impact the adoption of this standard will have on the consolidated financial statements.

**Note 3. Earnings Per Share**

Basic and diluted earnings per share are computed based on the weighted average number of shares outstanding during each period. Diluted earnings per share reflects the potential dilution that could occur, upon the exercise of stock options or upon the vesting of restricted stock grants, any of which would result in the issuance of common stock that would then be shared in the net income of the Company.

	Three Months Ended March 31, 2016    2015	
Basic earnings per share:		
Net income available to common shareholders	\$4,691	\$ 8,073
Weighted-average basic shares outstanding	34,176,728	36,201,120
Basic earnings per share	\$0.14	\$ 0.28
Diluted earnings per share:		
Net income available to common shareholders, for diluted earnings per share	\$4,691	\$ 8,073
Total weighted-average basic shares outstanding	34,176,728	36,201,120
Add effect of dilutive stock options and restricted stock grants	777,839	741,721
Total weighted-average diluted shares outstanding	34,954,567	36,942,841
Diluted earnings per share	\$0.13	\$ 0.27
Anti-dilutive shares	2,369,817	20,447



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Notes to Unaudited Consolidated Financial Statements

## Note 4. Securities

The carrying amount of securities and their approximate fair values are reflected in the following table:

	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
March 31, 2016				
US government agencies	\$ 22,005	\$ 129	\$ —	\$22,134
Residential mortgage-backed securities	31,627	22	96	31,553
Mutual fund	1,966	21	—	1,987
Total	\$ 55,598	\$ 172	\$ 96	\$55,674

## December 31, 2015

US government agencies	\$ 21,992	\$ 81	\$ 5	\$22,068
Residential mortgage-backed securities	30,131	1	374	29,758
Mutual fund	1,951	—	15	1,936
Total	\$ 54,074	\$ 82	\$ 394	\$53,762

During the three months ended March 31, 2016, the Company purchased one mortgage-backed security for \$2.4 million for the purpose of complying with the Community Reinvestment Act. During the three months ended March 31, 2016, there was \$15 thousand of dividend reinvestment in the 504 Fund mutual fund. There were no calls, sales or maturities of securities during the three months ended March 31, 2016.

There were no calls, sales or maturities of securities during the three months ended March 31, 2015. On March 31, 2015, the Company invested \$1.9 million in the 504 Fund mutual fund. The investment in this mutual fund was purchased at current market value (190,380.762 shares at \$9.98 per share).

The following tables show gross unrealized losses and fair value, aggregated by investment category and length of time that the individual securities have been in a continuous unrealized loss position.

	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
March 31, 2016						
Residential mortgage-backed securities	\$16,254	\$ 73	\$2,978	\$ 23	\$19,232	\$ 96
Total	\$16,254	\$ 73	\$2,978	\$ 23	\$19,232	\$ 96

	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
December 31, 2015						
US government agencies	\$7,990	\$ 5	\$—	\$ —	\$7,990	\$ 5
Residential mortgage-backed securities	26,015	333	3,019	41	29,034	374
Mutual fund	1,936	15	—	—	1,936	15
Total	\$35,941	\$ 353	\$3,019	\$ 41	\$38,960	\$ 394

At March 31, 2016, there were three mortgage-backed securities in unrealized loss positions for greater than 12 months and six mortgage-backed securities in unrealized loss positions for less than 12 months. Unrealized losses at December 31, 2015 were comprised of three mortgage-backed securities in unrealized loss positions for greater than 12 months and one US government agency security, twelve mortgage-backed securities and the 504 Fund mutual fund investment in an unrealized loss position for less than 12 months.

These unrealized losses are primarily the result of volatility in the market and are related to market interest rates.

Since none of the unrealized losses relate to marketability of the securities or the issuer's ability to honor redemption



obligations, none of the securities are deemed to be other than temporarily impaired.

All residential mortgage-backed securities in the Company's portfolio at March 31, 2016 and December 31, 2015 were backed by US government sponsored enterprises ("GSEs").

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Notes to Unaudited Consolidated Financial Statements

The following is a summary of investment securities by maturity:

	March 31, 2016	
	Available-for-Sale	
	Amortized	Fair
	cost	value
US government agencies		
Within one year	\$9,212	\$9,229
One to five years	12,793	12,905
Total	22,005	22,134
Residential mortgage-backed securities		
Five to ten years	9,095	9,101
After 10 years	22,532	22,452
Total	31,627	31,553
Total	\$53,632	\$53,687

The table above reflects contractual maturities. Actual results will differ as the loans underlying the mortgage-backed securities may repay sooner than scheduled. This table excludes the 504 Fund mutual fund investment.

At March 31, 2016 and December 31, 2015, an investment security with a fair market value of \$1.2 million and \$1.3 million, respectively, was pledged to secure a line of credit with the Company's correspondent bank.

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Notes to Unaudited Consolidated Financial Statements

Note 5. Loans Held for Investment and Allowance for Loan Losses

Loan Portfolio Segments

The following describes the risk characteristics relevant to each of the portfolio segments. Each loan category is assigned a risk grade during the origination and closing process based on criteria described later in this section.

Commercial and Industrial

Commercial and industrial loans (C&I) receive similar underwriting treatment as commercial real estate loans in that the repayment source is analyzed to determine its ability to meet cash flow coverage requirements as set forth by Bank policies. Repayment of the Bank's C&I loans generally comes from the generation of cash flow as the result of the borrower's business operations. This business cycle itself brings a certain level of risk to the portfolio. In some instances, these loans may carry a higher degree of risk due to a variety of reasons – illiquid collateral, specialized equipment, highly depreciable assets, uncollectable accounts receivable, revolving balances, or simply being unsecured. As a result of these characteristics, the SBA guarantee on these loans is an important factor in mitigating risk.

Construction and Development

Construction and development loans are for the purpose of acquisition and development of land to be improved through the construction of commercial buildings. Such loans are usually paid off through the conversion to permanent financing for the long-term benefit of the borrower's ongoing operations. At the completion of the project, if the loan is converted to permanent financing or if scheduled loan amortization begins, it is then reclassified to the "Owner Occupied Commercial Real Estate" segment. Underwriting of construction and development loans typically includes analysis of not only the borrower's financial condition and ability to meet the required debt obligations, but also the general market conditions associated with the area and type of project being funded.

Owner Occupied Commercial Real Estate

Owner occupied commercial real estate loans are extensions of credit secured by owner occupied collateral. Underwriting generally involves intensive analysis of the financial strength of the borrower and guarantor, liquidation value of the subject collateral, the associated unguaranteed exposure, and any available secondary sources of repayment, with the greatest emphasis given to a borrower's capacity to meet cash flow coverage requirements as set forth by Bank policies. Such repayment of owner-occupied loans is commonly derived from the successful ongoing operations of the business occupying the property. These typically include small businesses and professional practices.

Commercial Land

Commercial land loans are extensions of credit secured by farmland. Such loans are often for land improvements related to agricultural endeavors that may include construction of new specialized facilities. These loans are usually repaid through the conversion to permanent financing, or if scheduled loan amortization begins, for the long-term benefit of the borrower's ongoing operations. Underwriting generally involves intensive analysis of the financial strength of the borrower and guarantor, liquidation value of the subject collateral, the associated unguaranteed exposure, and any available secondary sources of repayment, with the greatest emphasis given to a borrower's capacity to meet cash flow coverage requirements as set forth by Bank policies.

Each of the loan types referenced in the sections above is further segmented into verticals in which the Bank chooses to operate. The Bank chooses to finance businesses operating in specific industries because of certain similarities. The similarities range from historical default and loss characteristics to business operations. However, there are differences that create the necessity to underwrite these loans according to varying criteria and guidelines. When underwriting a loan, the Bank considers numerous factors such as cash flow coverage, the credit scores of the guarantors, revenue growth, practice ownership experience and debt service capacity. Minimum guidelines have been set with regard to these various factors and deviations from those guidelines require compensating strengths when considering a proposed loan.



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Notes to Unaudited Consolidated Financial Statements

Loans consist of the following:

	March 31, 2016	December 31, 2015
Commercial & Industrial		
Agriculture	\$23	\$30
Death Care Management	5,084	4,832
Healthcare	17,365	15,240
Independent Pharmacies	43,185	41,588
Registered Investment Advisors	21,649	18,358
Veterinary Industry	22,385	21,579
Other Industries	7,251	3,230
Total	116,942	104,857
Construction & Development		
Agriculture	12,420	11,351
Death Care Management	726	769
Healthcare	8,051	7,231
Independent Pharmacies	279	101
Registered Investment Advisors	286	378
Veterinary Industry	3,646	3,834
Other Industries	1,966	658
Total	27,374	24,322
Owner Occupied Commercial Real Estate		
Agriculture	1,929	1,863
Death Care Management	22,318	20,327
Healthcare	44,286	37,684
Independent Pharmacies	7,285	7,298
Registered Investment Advisors	3,035	2,808
Veterinary Industry	61,744	59,999
Other Industries	5,338	4,752
Total	145,935	134,731
Commercial Land		
Agriculture	23,081	16,036
Total	23,081	16,036
Total Loans <sup>1</sup>	313,332	279,946
Net Deferred Costs	3,330	3,056
Discount on SBA 7(a) Unguaranteed <sup>2</sup>	(3,029 )	(3,033 )
Loans, Net of Unearned	\$313,633	\$279,969

<sup>1</sup> Total loans include \$24.6 million and \$17.2 million of U.S. government guaranteed loans as of March 31, 2016 and December 31, 2015, respectively.

The Company measures the carrying value of the retained portion of loans sold at fair value under ASC Subtopic 2825-10. The value of these retained loan balances is discounted based on the estimates derived from comparable unguaranteed loan sales.



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Credit Risk Profile

The Bank uses internal loan reviews to assess the performance of individual loans by industry segment. An independent review of the loan portfolio is performed annually by an external firm. The goal of the Bank's annual review of select borrowers' financial performance is to validate the adequacy of the risk grade assigned.

The Bank uses a grading system to rank the quality of each loan. The grade is periodically evaluated and adjusted as performance dictates. Loan grades 1 through 4 are passing grades and grade 5 is special mention. Collectively, grades 6 through 8 represent classified loans in the Bank's portfolio. The following guidelines govern the assignment of these risk grades:

**Exceptional Loans (1 Rated):** These loans are of the highest quality, with strong, well-documented sources of repayment. Debt service coverage ("DSC") is over 1.75X based on historical results. Secondary source of repayment is strong, with a loan to value ("LTV") of 65% or less if secured solely by commercial real estate ("CRE"). Discounted collateral coverage from all sources should exceed 125%. Guarantors have credit scores above 740.

**Quality Loans (2 Rated):** These loans are of good quality, with good, well-documented sources of repayment. DSC is over 1.25X based on historical or pro-forma results. Secondary source of repayment is good, with a LTV of 75% or less if secured solely by CRE. Discounted collateral coverage should exceed 100%. Guarantors have credit scores above 700.

**Acceptable Loans (3 rated):** These loans are of acceptable quality, with acceptable sources of repayment. DSC of over 1.00X based on historical or pro-forma results. Companies that do not meet these credit metrics must be evaluated to determine if they should be graded below this level.

**Acceptable Loans (4 rated):** These loans are considered very weak pass. These loans are riskier than a 3-rated credit, but due to various mitigating factors are not considered a Special Mention or worse. The mitigating factors must clearly be identified to offset further downgrade. Examples of loans that may be put in this category include start-up loans and loans with less than 1:1 cash flow coverage with other sources of repayment.

**Special mention (5 rated):** These loans are considered as emerging problems, with potentially unsatisfactory characteristics. These loans require greater management attention. A loan may be put into this category if the Bank is unable to obtain financial reporting from a company to fully evaluate its position.

**Substandard (6 rated):** Loans graded Substandard are inadequately protected by current sound net worth, paying capacity of the borrower, or pledged collateral. They typically have unsatisfactory characteristics causing more than acceptable levels of risk, and have one or more well-defined weaknesses that could jeopardize the repayment of the debt.

**Doubtful (7 rated):** Loans graded Doubtful have inherent weaknesses that make collection or liquidation in full questionable. Loans graded Doubtful must be placed on non-accrual status.

**Loss (8 rated):** Loss rated loans are considered uncollectible and of such little value that their continuance as an active Bank asset is not warranted. The asset should be charged off, even though partial recovery may be possible in the future.

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Live Oak Bancshares, Inc.

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The following tables summarize the risk grades of each category:

	Risk Grades 1 - 4	Risk Grade 5	Risk Grades 6 - 8	Total
March 31, 2016				
Commercial & Industrial				
Agriculture	\$ 23	\$ —	\$ —	\$ 23
Death Care Management	4,971	104	9	5,084
Healthcare	8,187	3,480	5,698	17,365
Independent Pharmacies	38,239	3,328	1,618	43,185
Registered Investment Advisors	20,545	721	383	21,649
Veterinary Industry	17,839	2,066	2,480	22,385
Other Industries	7,251	—	—	7,251
Total	97,055	9,699	10,188	116,942
Construction & Development				
Agriculture	11,515	905	—	12,420
Death Care Management	726	—	—	726
Healthcare	8,051	—	—	8,051
Independent Pharmacies	279	—	—	279
Registered Investment Advisors	286	—	—	286
Veterinary Industry	2,453	1,193	—	3,646
Other Industries	1,966	—	—	1,966
Total	25,276	2,098	—	27,374
Owner Occupied Commercial Real Estate				
Agriculture	1,929	—	—	1,929
Death Care Management	18,639	2,094	1,585	22,318
Healthcare	40,527	3,032	727	44,286
Independent Pharmacies	6,206	1,079	—	7,285
Registered Investment Advisors	3,035	—	—	3,035
Veterinary Industry	46,570	4,304	10,870	61,744
Other Industries	5,338	—	—	5,338
Total	122,244	10,509	13,182	145,935
Commercial Land				
Agriculture	22,362	—	719	23,081
Total	22,362	—	719	23,081
Total <sup>1</sup>	\$ 266,937	\$ 22,306	\$ 24,089	\$ 313,332



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	Risk Grades 1 - 4	Risk Grade 5	Risk Grades 6 - 8	Total
December 31, 2015				
Commercial & Industrial				
Agriculture	\$ 30	\$ —	\$ —	\$ 30
Death Care Management	4,728	104	—	4,832
Healthcare	8,334	2,160	4,746	15,240
Independent Pharmacies	36,704	3,430	1,454	41,588
Registered Investment Advisors	17,508	850	—	18,358
Veterinary Industry	16,800	1,817	2,962	21,579
Other Industries	3,089	141	—	3,230
Total	87,193	8,502	9,162	104,857
Construction & Development				
Agriculture	11,194	157	—	11,351
Death Care Management	769	—	—	769
Healthcare	7,231	—	—	7,231
Independent Pharmacies	101	—	—	101
Registered Investment Advisors	378	—	—	378
Veterinary Industry	2,581	1,253	—	3,834
Other Industries	658	—	—	658
Total	22,912	1,410	—	24,322
Owner Occupied Commercial Real Estate				
Agriculture	1,863	—	—	1,863
Death Care Management	18,223	425	1,679	20,327
Healthcare	33,529	2,930	1,225	37,684
Independent Pharmacies	6,210	1,088	—	7,298
Registered Investment Advisors	2,808	—	—	2,808
Veterinary Industry	45,453	3,171	11,375	59,999
Other Industries	4,752	—	—	4,752
Total	112,838	7,614	14,279	134,731
Commercial Land				
Agriculture	16,036	—	—	16,036
Total	16,036	—	—	16,036
Total <sup>1</sup>	\$ 238,979	\$ 17,526	\$ 23,441	\$ 279,946

Total loans include \$24.6 million of U.S. government guaranteed loans as of March 31, 2016, segregated by risk grade as follows: Risk Grades 1 – 4 = \$5.9 million, Risk Grade 5 = \$3.7 million, Risk Grades 6 – 8 = \$15.0 million. As of December 31, 2015, total loans include \$17.2 million of U.S. government guaranteed loans, segregated by risk grade as follows: Risk Grades 1 – 4 = \$0, Risk Grade 5 = \$2.6 million, Risk Grades 6 – 8 = \$14.6 million.

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Live Oak Bancshares, Inc.

Notes to Unaudited Consolidated Financial Statements

## Past Due Loans

Loans are considered past due if the required principal and interest payments have not been received as of the date such payments were due. Loans less than 30 days past due and accruing are included within current loans shown below. The following tables show an age analysis of past due loans as of the dates presented.

	Less Than 30 Days Past Due & Not Accruing	30-89 Days Past Due & Accruing	30-89 Days Past Due & Not Accruing	Greater Than 90 Days Past Due	Total Not Accruing & Past Due Loans	Current Loans	Total Loans	Loans 90 Days or More Past Due & Still Accruing
March 31, 2016								
Commercial & Industrial								
Agriculture	\$ —	\$ —	\$ —	\$ —	\$ —	\$23	\$23	\$ —
Death Care Management	—	—	—	—	—	5,084	5,084	—
Healthcare	78	188	911	3,222	4,399	12,966	17,365	—
Independent Pharmacies	302	589	270	—	1,161	42,024	43,185	—
Registered Investment Advisors	—	—	—	—	—	21,649	21,649	—
Veterinary Industry	201	—	607	885	1,693	20,692	22,385	—
Other Industries	—	—	—	—	—	7,251	7,251	—
Total	581	777	1,788	4,107	7,253	109,689	116,942	—
Construction & Development								
Agriculture	—	—	—	—	—	12,420	12,420	—
Death Care Management	—	—	—	—	—	726	726	—
Healthcare	—	—	—	—	—	8,051	8,051	—
Independent Pharmacies	—	—	—	—	—	279	279	—
Registered Investment Advisors	—	—	—	—	—	286	286	—
Veterinary Industry	—	—	—	—	—	3,646	3,646	—
Other Industries	—	—	—	—	—	1,966	1,966	—
Total	—	—	—	—	—	27,374	27,374	—
Owner Occupied Commercial Real Estate								
Agriculture	—	—	—	—	—	1,929	1,929	—
Death Care Management	1,423	222	—	—	1,645	20,673	22,318	—
Healthcare	357	258	133	93	841	43,445	44,286	—
Independent Pharmacies	—	—	—	—	—	7,285	7,285	—
Registered Investment Advisors	—	—	—	—	—	3,035	3,035	—
Veterinary Industry	1,363	5,038	908	3,357	10,666	51,078	61,744	—
Other Industries	—	—	—	—	—	5,338	5,338	—
Total	3,143	5,518	1,041	3,450	13,152	132,783	145,935	—
Commercial Land								
Agriculture	719	—	—	—	719	22,362	23,081	—
Total	719	—	—	—	719	22,362	23,081	—

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Total <sup>1</sup>	\$ 4,443	\$ 6,295	\$ 2,829	\$ 7,557	\$ 21,124	\$ 292,208	\$ 313,332	\$ —
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Notes to Unaudited Consolidated Financial Statements

	Less Than 30 Days Past Due & Not Accruing	30-89 Days Past Due & Accruing	30-89 Days Past Due & Not Accruing	Greater Than 90 Days Past Due	Total Not Accruing & Past Due Loans	Current Loans	Total Loans	Loans 90 Days or More Past Due & Still Accruing
December 31, 2015								
Commercial & Industrial								
Agriculture	\$ —	\$ —	\$ —	\$ —	\$ —	\$30	\$30	\$ —
Death Care Management	—	—	—	—	—	4,832	4,832	—
Healthcare	—	1,854	30	2,337	4,221	11,019	15,240	—
Independent Pharmacies	314	603	—	—	917	40,671	41,588	—
Registered Investment Advisors	—	—	—	—	—	18,358	18,358	—
Veterinary Industry	208	466	1,131	394	2,199	19,380	21,579	—
Other Industries	—	—	—	—	—	3,230	3,230	—
Total	522	2,923	1,161	2,731	7,337	97,520	104,857	—
Construction & Development								
Agriculture	—	—	—	—	—	11,351	11,351	—
Death Care Management	—	—	—	—	—	769	769	—
Healthcare	—	—	—	—	—	7,231	7,231	—
Independent Pharmacies	—	—	—	—	—	101	101	—
Registered Investment Advisors	—	—	—	—	—	378	378	—
Veterinary Industry	—	—	—	—	—	3,834	3,834	—
Other Industries	—	—	—	—	—	658	658	—
Total	—	—	—	—	—	24,322	24,322	—
Owner Occupied Commercial Real Estate								
Agriculture	—	—	—	—	—	1,863	1,863	—
Death Care Management	1,456	223	—	—	1,679	18,648	20,327	—
Healthcare	—	240	135	831	1,206	36,478	37,684	—
Independent Pharmacies	—	—	—	—	—	7,298	7,298	—
Registered Investment Advisors	—	—	—	—	—	2,808	2,808	—
Veterinary Industry	311	5,079	2,048	3,172	10,610	49,389	59,999	—
Other Industries	—	—	—	—	—	4,752	4,752	—
Total	1,767	5,542	2,183	4,003	13,495	121,236	134,731	—
Commercial Land								
Agriculture	—	—	—	—	—	16,036	16,036	—
Total	—	—	—	—	—	16,036	16,036	—
Total <sup>1</sup>	\$ 2,289	\$ 8,465	\$ 3,344	\$ 6,734	\$ 20,832	\$259,114	\$279,946	\$ —

<sup>1</sup>Total loans include \$24.6 million of U.S. government guaranteed loans as of March 31, 2016, of which \$6.6 million is greater than 90 days past due, \$5.0 million is 30-89 days past due and \$13.0 million is included in current loans as presented above. As of December 31, 2015, total loans include \$17.2 million of U.S. government guaranteed loans,

of which \$5.9 million is greater than 90 days past due, \$6.7 million is 30-89 days past due and \$4.6 million is included in current loans as presented above.

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Live Oak Bancshares, Inc.

Notes to Unaudited Consolidated Financial Statements

## Nonaccrual Loans

Loans that become 90 days delinquent, or in cases where there is evidence that the borrower's ability to make the required payments is impaired, are placed in nonaccrual status and interest accrual is discontinued. If interest on nonaccrual loans had been accrued in accordance with the original terms, interest income would have increased by approximately \$199 thousand and \$77 thousand for the three months ended March 31, 2016 and 2015, respectively. All nonaccrual loans are included in the held for investment portfolio.

Nonaccrual loans as of March 31, 2016 and December 31, 2015 are as follows:

March 31, 2016	Loan Balance	Guaranteed Balance	Unguaranteed Exposure
Commercial & Industrial			
Healthcare	\$4,211	\$ 3,788	\$ 423
Independent Pharmacies	572	565	7
Veterinary Industry	1,693	1,542	151
Total	6,476	5,895	581
Owner Occupied Commercial Real Estate			
Death Care Management	1,423	1,264	159
Healthcare	583	321	262
Veterinary Industry	5,628	4,388	1,240
Total	7,634	5,973	1,661
Commercial Land			
Agriculture	719	540	179
Total	719	540	179
Total	\$14,829	\$ 12,408	\$ 2,421
December 31, 2015	Loan Balance	Guaranteed Balance	Unguaranteed Exposure
Commercial & Industrial			
Healthcare	\$2,367	\$ 2,188	\$ 179
Independent Pharmacies	314	308	6
Veterinary Industry	1,733	1,572	161
Total	4,414	4,068	346
Owner Occupied Commercial Real Estate			
Death Care Management	1,456	1,290	166
Healthcare	966	798	168
Veterinary Industry	5,531	4,174	1,357
Total	7,953	6,262	1,691
Total	\$12,367	\$ 10,330	\$ 2,037

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Notes to Unaudited Consolidated Financial Statements

Allowance for Loan Loss Methodology

The methodology and the estimation process for calculating the Allowance for Loan Losses (“ALL”) is described below:

Estimated credit losses should meet the criteria for accrual of a loss contingency, i.e., a provision to the ALL, set forth in GAAP. The Company’s methodology for determining the ALL is based on the requirements of GAAP, the Interagency Policy Statement on the Allowance for Loan and Lease Losses and other regulatory and accounting pronouncements. The ALL is determined by the sum of three separate components: (i) the impaired loan component, which addresses specific reserves for impaired loans; (ii) the general reserve component, which addresses reserves for pools of homogeneous loans; and (iii) an unallocated reserve component (if any) based on management’s judgment and experience. The loan pools and impaired loans are mutually exclusive; any loan that is impaired is excluded from its homogenous pool for purposes of that pool’s reserve calculation, regardless of the level of impairment.

The ALL policy for pooled loans is governed in accordance with banking regulatory guidance for homogenous pools of non-impaired loans that have similar risk characteristics. The Company follows a consistent and structured approach for assessing the need for reserves within each individual loan pool.

Loans are considered impaired when, based on current information and events, it is probable that the creditor will be unable to collect all interest and principal payments due according to the originally contracted, or reasonably modified, terms of the loan agreement. The Company has determined that loans that meet the criteria defined below must be reviewed quarterly to determine if they are impaired.

• All commercial loans classified substandard or worse.

• Any other delinquent loan that is in a nonaccrual status, or any loan that is delinquent more than 89 days and still accruing interest.

• Any loan which has been modified such that it meets the definition of a Troubled Debt Restructuring (TDR).

Prior to December 31, 2015, all loans subject to impairment recognition were individually evaluated for impairment. Effective December 31, 2015, the Company’s policy for impaired loan accounting subjects all loans to impairment recognition; however, loan relationships with unguaranteed credit exposure of less than \$100,000 are generally not evaluated on an individual basis for impairment and instead are evaluated collectively using a methodology based on historical specific reserves on similar sized loans. Any loan not meeting the above criteria and determined to be impaired is subjected to an impairment analysis, which is a calculation of the probable loss on the loan. This portion is the loan’s “impairment,” and is established as a specific reserve against the loan, or charged against the ALL. This revision to the allowance methodology did not have a material impact on the allowance recorded at December 31, 2015.

Individual specific reserve amounts imply probability of loss and may not be carried in the reserve indefinitely. When the amount of the actual loss becomes reasonably quantifiable, the amount of the loss is charged off against the ALL, whether or not all liquidation and recovery efforts have been completed. If the total amount of the individual specific reserve that will eventually be charged off cannot yet be sufficiently quantified but some portion of the impairment can be viewed as a confirmed loss, then the confirmed loss portion should be charged off against the ALL and the individual specific reserve reduced by a corresponding amount.

For impaired loans, the reserve amount is calculated on a loan-specific basis. The Company utilizes two methods of analyzing impaired loans not guaranteed by the SBA:

The Fair Market Value of Collateral method utilizes the value at which the collateral could be sold considering the appraised value, appraisal discount rate, prior liens and selling costs. The amount of the reserve is the deficit of the estimated collateral value compared to the loan balance.

• The Present Value of Future Cash Flows method takes into account the amount and timing of cash flows and the effective interest rate used to discount the cash flows.





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The following table details activity in the allowance for loan losses by portfolio segment allowance for the periods presented:

Three months ended:	Construction & Development	Owner Occupied Commercial Real Estate	Commercial & Industrial	Commercial Land	Total
March 31, 2016					
Beginning Balance	\$ 1,064	\$ 2,486	\$ 2,766	\$ 1,099	\$7,415
Charge offs	—	(7 )	(268 )	—	(275 )
Recoveries	—	—	43	—	43
Provision	99	96	804	434	1,433
Ending Balance	\$ 1,163	\$ 2,575	\$ 3,345	\$ 1,533	\$8,616
March 31, 2015					
Beginning Balance	\$ 586	\$ 2,291	\$ 1,369	\$ 161	\$4,407
Charge offs	—	(79 )	(172 )	—	(251 )
Recoveries	—	1	—	—	1
Provision	169	(151 )	866	193	1,077
Ending Balance	\$ 755	\$ 2,062	\$ 2,063	\$ 354	\$5,234

The following tables detail the recorded allowance for loan losses and the investment in loans related to each portfolio segment, disaggregated on the basis of impairment evaluation methodology:

March 31, 2016	Construction & Development	Owner Occupied Commercial Real Estate	Commercial & Industrial	Commercial Land	Total
Allowance for Loan Losses:					
Loans individually evaluated for impairment	\$ —	\$ 1,104	\$ 961	\$ 82	\$2,147
Loans collectively evaluated for impairment <sup>2</sup>	1,163	1,471	2,384	1,451	6,469
Total allowance for loan losses	\$ 1,163	\$ 2,575	\$ 3,345	\$ 1,533	\$8,616
Loans receivable <sup>1</sup> :					
Loans individually evaluated for impairment	\$ —	\$ 11,655	\$ 4,843	\$ 713	\$17,211
Loans collectively evaluated for impairment <sup>2</sup>	27,374	134,280	112,099	22,368	296,121
Total loans receivable	\$ 27,374	\$ 145,935	\$ 116,942	\$ 23,081	\$313,332

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December 31, 2015	Construction & Development	Owner Occupied Commercial Real Estate	Commercial & Industrial	Commercial Land	Total
Allowance for Loan Losses:					
Loans individually evaluated for impairment	\$ —	\$ 1,090	\$ 672	\$ —	\$ 1,762
Loans collectively evaluated for impairment <sup>2</sup>	1,064	1,396	2,094	1,099	5,653
Total allowance for loan losses	\$ 1,064	\$ 2,486	\$ 2,766	\$ 1,099	\$ 7,415
Loans Receivable <sup>1</sup> :					
Loans individually evaluated for impairment	\$ —	\$ 9,821	\$ 3,226	\$ —	\$ 13,047
Loans collectively evaluated for impairment <sup>2</sup>	24,322	124,910	101,631	16,036	266,899
Total loans receivable	\$ 24,322	\$ 134,731	\$ 104,857	\$ 16,036	\$ 279,946

Loans receivable includes \$24.6 million of U.S. government guaranteed loans as of March 31, 2016, of which \$15.4 million are impaired. As of December 31, 2015, loans receivable includes \$17.2 million of U.S. government guaranteed loans, of which \$14.1 million are considered impaired.

Included in loans collectively evaluated for impairment are impaired loans with individual unguaranteed exposure of less than \$100 thousand. As of March 31, 2016, these balances totaled \$9.3 million, of which \$7.4 million are guaranteed by the U.S. government and \$1.9 million are unguaranteed. As of December 31, 2015, these balances totaled \$8.6 million, of which \$7.5 million are guaranteed by the U.S. government and \$1.1 million are unguaranteed. The allowance for loan losses associated with these loans totaled \$602 thousand and \$352 thousand as of March 31, 2016 and December 31, 2015, respectively.

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Loans classified as impaired as of the dates presented are summarized in the following tables.

March 31, 2016	Recorded Investment	Guaranteed Balance	Unguaranteed Exposure
Commercial & Industrial			
Death Care Management	\$ 9	\$ —	\$ 9
Healthcare	5,697	3,788	1,909
Independent Pharmacies	1,960	886	1,074
Registered Investment Advisors	385	—	385
Veterinary Industry	2,793	2,002	791
Total	10,844	6,676	4,168
Owner Occupied Commercial Real Estate			
Death Care Management	1,583	1,264	319
Healthcare	1,062	321	741
Veterinary Industry	12,273	6,551	5,722
Total	14,918	8,136	6,782
Commercial Land			
Agriculture	713	539	174
Total	713	539	174
Total	\$ 26,475	\$ 15,351	\$ 11,124
December 31, 2015	Recorded Investment	Guaranteed Balance	Unguaranteed Exposure
Commercial & Industrial			
Healthcare	\$ 4,442	\$ 3,341	\$ 1,101
Independent Pharmacies	1,546	637	909
Veterinary Industry	2,256	1,731	525
Total	8,244	5,709	2,535
Owner Occupied Commercial Real Estate			
Death Care Management	1,454	1,290	164
Healthcare	965	799	166
Veterinary Industry	11,003	6,349	4,654
Total	13,422	8,438	4,984
Total	\$ 21,666	\$ 14,147	\$ 7,519

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Notes to Unaudited Consolidated Financial Statements

The following table presents evaluated balances of loans classified as impaired at the dates presented that carried an associated reserve as compared to those with no reserve. The recorded investment includes accrued interest and net deferred loan fees or costs.

	March 31, 2016			Unpaid Principal Balance	Related Allowance Recorded
	Recorded Investment With a Recorded Allowanc	With No Recorded Allowance	Total		
Commercial & Industrial					
Death Care Management	\$9	\$ —	\$9	\$9	\$ 3
Healthcare	5,501	196	5,697	6,160	635
Independent Pharmacies	1,616	344	1,960	2,057	311
Registered Investment Advisors	—	385	385	383	—
Veterinary Industry	2,793	—	2,793	3,207	365
Total	9,919	925	10,844	11,816	1,314
Owner Occupied Commercial Real Estate					
Death Care Management	1,583	—	1,583	1,720	55
Healthcare	931	131	1,062	1,062	111
Veterinary Industry	10,009	2,264	12,273	12,995	1,187
Total	12,523	2,395	14,918	15,777	1,353
Commercial Land					
Agriculture	713	—	713	719	82
Total	713	—	713	719	82
Total Impaired Loans	\$23,155	\$ 3,320	\$26,475	\$28,312	\$ 2,749
	December 31, 2015				
	Recorded Investment				
	With a	With No	Total	Unpaid	Related
	Recorded	Recorded		Principal	Allowance
	Allowanc	Allowance		Balance	Recorded
Commercial & Industrial					
Healthcare	\$4,242	\$ 200	\$4,442	\$4,742	\$ 478
Independent Pharmacies	1,199	347	1,546	2,041	287
Veterinary Industry	2,051	205	2,256	3,270	138
Total	7,492	752	8,244	10,053	903
Owner Occupied Commercial Real Estate					
Death Care Management	1,454	—	1,454	1,591	9
Healthcare	965	—	965	1,096	96
Veterinary Industry	9,265	1,738	11,003	11,856	1,106
Total	11,684	1,738	13,422	14,543	1,211
Total Impaired Loans	\$19,176	\$ 2,490	\$21,666	\$24,596	\$ 2,114

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	Three months ended March 31, 2016		Three months ended March 31, 2015	
	Average Balance	Interest Income Recognized	Average Balance	Interest Income Recognized
Commercial & Industrial				
Death Care Management	\$9	\$ —	\$—	\$ —
Healthcare	5,802	79	3,748	23
Independent Pharmacies	1,881	73	1,817	12
Registered Investment Advisors	385	7	—	—
Veterinary Industry	2,814	29	3,804	3
Total	10,891	188	9,369	38
Owner Occupied Commercial Real Estate				
Death Care Management	1,594	7	1,532	—
Healthcare	987	19	2,136	—
Veterinary Industry	12,287	211	11,806	39
Other Industries	—	—	283	—
Total	14,868	237	15,757	39
Commercial Land				
Agriculture	1,120	—	—	—
Total	1,120	—	—	—
Total	\$26,879	\$ 425	\$25,126	\$ 77

The following table represent the types of TDRs that were made during the periods presented:

	Three months ended March 31, 2016		Three months ended March 31, 2015	
	All Restructurings		All Restructurings	
	Pre- modification Number of Loans Recorded	Post- modification Recorded Investment	Pre- modification Number of Loans Recorded	Post- modification Recorded Investment
Interest Only				
Commercial & Industrial				
Healthcare	— \$ —	\$ —	3 \$ 229	\$ 225
Owner Occupied Commercial Real Estate				
Healthcare	—	—	1 41	40
Total Interest Only	—	—	4 270	265
Payment Deferral				
Commercial & Industrial				
Veterinary Industry	1 420	420	—	—
Total Payment Deferral	1 420	420	—	—
Total	1 \$ 420	\$ 420	4 \$ 270	\$ 265

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Concessions made to improve a loan's performance have varying degrees of success. No TDRs that were modified within the twelve months ended March 31, 2016 subsequently defaulted during the three months ended March 31, 2016.

The following table presents loans that were modified as TDRs within the previous twelve months ending March 31, 2015 for which there was a payment default:

	March 31, 2015	TDR Defaults
	Number of	Recorded Investment Restructurings
Interest Only		
Commercial and Industrial:		
Healthcare	3	\$ 223
Owner Occupied Commercial Real Estate:		
Healthcare	1	40
Veterinary Industry	1	74
Total Interest Only	5	337
Payment Deferral		
Owner Occupied Commercial Real Estate:		
Deathcare Management	1	1,697
Total Payment Deferral	1	1,697
Total	6	\$ 2,034

## Note 6. Servicing Assets

Loans serviced for others are not included in the accompanying balance sheet. The unpaid principal balances of loans serviced for others were \$2.05 billion and \$1.94 billion at March 31, 2016 and December 31, 2015, respectively.

The following summarizes the activity pertaining to servicing rights:

	Three Months Ended March 31,	
	2016	2015
Balance at beginning of period	\$44,230	\$34,999
Additions, net	3,715	3,336
Fair value changes:		
Due to changes in valuation inputs or assumptions	821	1,406
Decay due to increases in principal paydowns or runoff	(1,389 )	(1,284 )
Balance at end of period	\$47,377	\$38,457

The fair value of servicing rights was determined using discount rates ranging from 8.40% to 12.60% on March 31, 2016, and 7.30% to 12.00% on March 31, 2015. The fair value of servicing rights was determined using prepayment speeds ranging from 3.90% to 9.90% on March 31, 2016 and 1.80% to 9.60% on March 31, 2015, depending on the stratification of the specific right. Changes to fair value are reported in loan servicing revenue and revaluation within the consolidated statements of income.

The fair value of servicing rights is highly sensitive to changes in underlying assumptions. Changes in prepayment speed assumptions have the most significant impact on the fair value of servicing rights. Generally, as interest rates rise on variable rate loans, loan prepayments increase due to an increase in refinance activity, which results in a

decrease in the fair value of servicing assets. Measurement of fair value is limited to the conditions existing and the assumptions used as of a particular point in time, and those assumptions may not be appropriate if they are applied at a different time.

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## Note 7. Borrowings

Total outstanding long term borrowings consisted of the following:

	March 31, 2016	December 31, 2015
Long term borrowings		
On September 11, 2014, the Company financed the construction of an additional building located on the Company's Tiburon Drive main campus with a \$24 million construction line of credit with an unaffiliated commercial bank, secured by both properties at its Tiburon Drive main facility location. Payments are interest only through September 11, 2016 at a fixed rate of 3.95% for a term of 84 months. Monthly principal and interest payments beginning in October 2016 will be \$146 thousand with all principal and accrued interest due on September 11, 2021. The terms of this loan require the Company to maintain minimum capital, liquidity and Texas ratios. The construction line is fully disbursed and there was no remaining available credit on this construction line at March 31, 2016.	\$23,995	\$ 24,000
On September 18, 2014, the Company entered into a note payable revolving line of credit of \$8.1 million with an unaffiliated commercial bank, with the first advance of \$5 million on December 14, 2014. The note is unsecured and accrues interest at LIBOR plus 3.50% for a term of 36 months. Payments are interest only with all principal and accrued interest due on September 18, 2017. This line of credit was paid in full on July 30, 2015 and there is \$8.1 million of available credit remaining at March 31, 2016.	—	—
On February 23, 2015 the Company transferred two related party loans to an unaffiliated commercial bank in exchange for \$4.7 million. The exchange price equated to the unpaid principal balance plus accrued but uncollected interest at the time of transfer. The terms of the transfer agreement with the unaffiliated commercial bank identified the transaction as a secured borrowing for accounting purposes. Interest accrues at prime plus 1% with monthly principal and interest payments over a term of 60 months. The interest rate at March 31, 2016 is 4.50%. The maturity date is October 5, 2019. The pledged collateral is classified in other assets with a fair value of \$4.3 million at March, 31 2016. Underlying loans carry a risk grade of 3 and are current with no delinquencies. The terms of this loan require the Company to maintain minimum capital, liquidity and Texas ratios.	4,276	4,375
Total long term borrowings	\$28,271	\$ 28,375
The Company may purchase federal funds through secured and unsecured federal funds lines of credit with various correspondent banks, which totaled \$26.5 million as of March 31, 2016 and December 31, 2015. These lines are intended for short-term borrowings and are subject to restrictions limiting the frequency and terms of advances. These lines of credit are payable on demand and bear interest based upon the daily federal funds rate. The Company had no outstanding balances on the lines of credit as of March 31, 2016 or December 31, 2015.		
The Company has entered into a repurchase agreement with a third party for \$5 million as of March 31, 2016 and December 31, 2015. At the time the Company enters into a transaction with the third party, the Company must transfer securities or other assets against the funds received. The terms of the agreement are set at market conditions at the time the Company enters into such transaction. The Company had no outstanding balance on the repurchase agreement as of March 31, 2016 and December 31, 2015.		
The Company may borrow funds through the Federal Reserve Bank's discount window. These borrowings are secured by a blanket floating lien on qualifying loans with a balance of \$224.9 million and \$192.2 million as of March 31, 2016 and December 31, 2015, respectively. At March 31, 2016 and December 31, 2015, the Company		



had approximately \$101.8 million and \$86.7 million, respectively, in borrowing capacity available under these arrangements with no outstanding balance as of March 31, 2016 or December 31, 2015.

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## Note 8. Fair Value of Financial Instruments

## Fair Value Hierarchy

There are three levels of inputs in the fair value hierarchy that may be used to measure fair value. Financial instruments are considered Level 1 when valuation can be based on quoted prices in active markets for identical assets or liabilities. Level 2 financial instruments are valued using quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or models using inputs that are observable or can be corroborated by observable market data of substantially the full term of the assets or liabilities. Financial instruments are considered Level 3 when their values are determined using pricing models, discounted cash flow methodologies or similar techniques and at least one significant model assumption or input is unobservable and when determination of the fair value requires significant management judgment or estimation.

## Financial Instruments Measured at Fair Value

The following sections provide a description of the valuation methodologies used for instruments measured at fair value, as well as the general classification of such instruments pursuant to the fair value hierarchy:

**Investment Securities:** Where quoted prices are available in an active market, securities are classified within Level 1 of the valuation hierarchy. Level 1 securities would include highly liquid government bonds, mortgage products and exchange traded equities. If quoted market prices are not available, then fair values are estimated by using pricing models, quoted prices of securities with similar characteristics, discounted cash flow or at net asset value per share. Level 2 securities would include US government agency securities, mortgage-backed securities, obligations of states and political subdivisions and certain corporate, asset backed mutual fund and other securities. In certain cases where there is limited activity or less transparency around inputs to the valuation, securities are classified within Level 3 of the valuation hierarchy.

**Impaired Loans:** Impairment of a loan is based on the fair value of the collateral of the loan for collateral-dependent loans. Fair value of the loan's collateral, when the loan is dependent on collateral, is determined by appraisals or independent valuation which is then adjusted for the cost related to liquidation of the collateral. For non-collateral dependent loans, impairment is determined by the present value of expected future cash flows. Impaired loans classified as Level 3 are based on management's judgment and estimation.

**Servicing Assets:** Servicing rights do not trade in an active, open market with readily observable prices. While sales of servicing rights do occur, the precise terms and conditions typically are not readily available. Accordingly, the Company estimates the fair value of servicing rights using discounted cash flow models incorporating numerous assumptions from the perspective of a market participant including servicing income, servicing costs, market discount rates and prepayment speeds. Due to the nature of the valuation inputs, servicing rights are classified within Level 3 of the valuation hierarchy.

**Foreclosed Assets:** Foreclosed real estate is adjusted to fair value less selling costs upon transfer of the loans to foreclosed real estate. Subsequently, foreclosed real estate is carried at the lower of carrying value or fair value less selling costs. Fair value is based upon independent market prices, appraised values of the collateral or management's estimation of the value of the collateral. When the fair value of the collateral is based on an observable market price or a current appraised value, the Company records the foreclosed asset as nonrecurring Level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Company records foreclosed real estate as nonrecurring Level 3.

Foreclosed assets classified as Level 3 are based on management's judgment and estimation.

## Recurring Fair Value

The tables below present the recorded amount of assets and liabilities measured at fair value on a recurring basis.

March 31, 2016	Total	Level 1	Level 2	Level 3
Investment securities available-for-sale				
US government agencies	\$22,134	\$	—\$22,134	\$—

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Residential mortgage-backed securities	31,553	—	31,553	—
Mutual fund	1,987	—	1,987	—
Servicing assets <sup>1</sup>	47,377	—	—	47,377
Total assets at fair value	\$103,051	\$	—\$55,674	\$47,377

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December 31, 2015	Total	Level 1	Level 2	Level 3
Investment securities available-for-sale				
US government agencies	\$22,068	\$ —	—\$22,068	\$—
Residential mortgage-backed securities	29,758	—	29,758	—
Mutual fund	1,936	—	1,936	—
Servicing assets <sup>1</sup>	44,230	—	—	44,230
Total assets at fair value	\$97,992	\$ —	—\$53,762	\$44,230

<sup>1</sup> See Note 6 for a rollforward of recurring Level 3 fair values for servicing assets.

## Non-recurring Fair Value

The tables below present the recorded amount of assets and liabilities measured at fair value on a non-recurring basis.

March 31, 2016	Total	Level 1	Level 2	Level 3
Impaired loans	\$20,460	\$ —	—\$20,460	
Foreclosed assets	3,020	—	—	3,020
Total assets at fair value	\$23,480	\$ —	—\$23,480	
December 31, 2015	Total	Level 1	Level 2	Level 3
Impaired loans	\$17,084	\$ —	—\$17,084	
Foreclosed assets	2,666	—	—	2,666
Total assets at fair value	\$19,750	\$ —	—\$19,750	

## Level 3 Analysis

For Level 3 assets and liabilities measured at fair value on a recurring or non-recurring basis as of March 31, 2016 and December 31, 2015 the significant unobservable inputs used in the fair value measurements were as follows:

March 31, 2016

Level 3 Assets with Significant Unobservable Inputs	Fair Value	Valuation Technique	Significant Unobservable Inputs	Range
Impaired Loans	\$ 20,460	Discounted appraisals Discounted expected cash flows	Appraisal adjustments (1) Interest rate & repayment term	10% to 29% Weighted average discount rate 5.76%
Foreclosed Assets	\$ 3,020	Discounted appraisals	Appraisal adjustments (1)	10% to 35%

December 31, 2015

Level 3 Assets with Significant Unobservable Inputs	Fair Value	Valuation Technique	Significant Unobservable Inputs	Range
Impaired Loans	\$ 17,084	Discounted appraisals Discounted expected cash flows	Appraisal adjustments (1) Interest rate & repayment term	10% to 20% Weighted average discount rate 5.57%
Foreclosed Assets	\$ 2,666	Discounted appraisals	Appraisal adjustments (1)	10% to 20%

(1) Appraisals may be adjusted by management for customized discounting criteria, estimated sales costs, and proprietary qualitative adjustments.



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Estimated Fair Value of Other Financial Instruments

GAAP also requires disclosure of fair value information about financial instruments carried at book value on the balance sheet. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. In that regard, the derived fair value estimates cannot be substantiated by comparison to independent markets and, in many cases, could not be realized in immediate settlement of the instruments. Accordingly, the aggregate fair value amounts presented do not represent the underlying value of the Company.

The following methods and assumptions were used by the Company in estimating its fair value disclosures for financial instruments not measured at fair value on the balance sheets:

Cash and due from banks: The carrying amounts reported in the balance sheet for cash and due from banks approximate their fair values.

Certificates of deposit with other banks: The fair value of certificates of deposit with other banks is estimated based on discounting cash flows using the rates currently offered for instruments of similar remaining maturities.

Loans held for sale: The fair values of loans held for sale are based on quoted market prices, where available, and determined by discounting estimated cash flows using interest rates approximating the Company's current origination rates for similar loans adjusted to reflect the inherent credit risk.

Loans held for investment: For variable-rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying amounts. The fair values for other loans are estimated using discounted cash flow analysis, based on interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. Loan fair value estimates include judgments regarding future expected loss experience and risk characteristics. Fair values for impaired loans are estimated using discounted cash flow analysis or underlying collateral values, where applicable.

Accrued Interest: The carrying amounts of accrued interest approximate fair value.

Deposits: The fair values disclosed for demand deposits (e.g., interest and non-interest checking, passbook savings, and certain types of money market accounts) are, by definition, equal to the amount payable on demand at the reporting date (i.e., their carrying amounts). The carrying amounts of variable-rate, fixed-term money market accounts and certificates of deposit approximate their fair values at the reporting date. Fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturities on time deposits.

Short and long term borrowings: The fair values of the Company's short term borrowings approximate fair value while long term borrowings are estimated using discounted cash flow analyses based on the Company's current incremental debt rates for similar types of debt arrangements.

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The carrying amounts and estimated fair values of the Company's financial instruments are as follows:

March 31, 2016	Carrying Amount	Quoted Price In Active Markets for Identical Assets /Liabilities (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Fair Value
Financial assets					
Cash and due from banks	\$226,556	\$ 226,556	\$	—\$	—\$226,556
Certificates of deposit with other banks	9,000	8,995	—	—	8,995
Investment securities, available-for-sale	55,674	—			