

Live Oak Bancshares, Inc.
Form 10-Q
May 07, 2018

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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, 2018

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, smaller reporting company, or an emerging growth company. See definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer x

Non-accelerated filer (Do not check if smaller reporting company) Smaller reporting company

Emerging growth company x

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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.

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As of May 4, 2018, there were 35,360,011 shares of the registrant's voting common stock outstanding and 4,643,530 shares of the registrant's non-voting common stock outstanding.

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 Form 10-Q
 For the Quarterly Period Ended March 31, 2018
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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

Live Oak Bancshares, Inc.

Consolidated Balance Sheets

As of March 31, 2018 (unaudited) and December 31, 2017*

(Dollars in thousands)

| | March 31, 2018 | December 31, 2017* |
|--|-------------------|--------------------------|
| Assets | | |
| Cash and due from banks | \$527,952 | \$295,271 |
| Certificates of deposit with other banks | 2,250 | 3,000 |
| Investment securities available-for-sale | 378,488 | 93,355 |
| Loans held for sale | 720,511 | 680,454 |
| Loans and leases held for investment | 1,442,077 | 1,343,973 |
| Allowance for loan and lease losses | (28,050) | (24,190) |
| Net loans and leases | 1,414,027 | 1,319,783 |
| Premises and equipment, net | 216,831 | 178,790 |
| Foreclosed assets | 1,519 | 1,281 |
| Servicing assets | 53,120 | 52,298 |
| Other assets | 146,165 | 134,242 |
| Total assets | \$3,460,863 | \$2,758,474 |
| Liabilities and Shareholders' Equity | | |
| Liabilities | | |
| Deposits: | | |
| Noninterest-bearing | \$48,755 | \$57,868 |
| Interest-bearing | 2,924,586 | 2,202,395 |
| Total deposits | 2,973,341 | 2,260,263 |
| Long term borrowings | 3,489 | 26,564 |
| Other liabilities | 35,197 | 34,714 |
| Total liabilities | 3,012,027 | 2,321,541 |
| Shareholders' equity | | |
| Preferred stock, no par value, 1,000,000 authorized, none issued or outstanding at March 31, 2018 and December 31, 2017 | — | — |
| Class A common stock, no par value, 100,000,000 shares authorized, 35,330,618 and 35,252,053 shares issued and outstanding at March 31, 2018 and December 31, 2017, respectively | 271,451 | 268,557 |
| Class B common stock, no par value, 10,000,000 shares authorized, 4,643,530 shares issued and outstanding at March 31, 2018 and December 31, 2017 | 49,168 | 49,168 |
| Retained earnings | 131,739 | 120,241 |
| Accumulated other comprehensive loss | (3,522) | (1,033) |
| Total equity | 448,836 | 436,933 |
| Total liabilities and shareholders' equity | \$3,460,863 | \$2,758,474 |

* 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, 2018 and 2017 (unaudited)
 (Dollars in thousands, except per share data)

| | Three Months Ended March 31, | |
|---|------------------------------------|----------|
| | 2018 | 2017 |
| Interest income | | |
| Loans and fees on loans | \$32,691 | \$19,754 |
| Investment securities, taxable | 1,117 | 323 |
| Other interest earning assets | 1,215 | 342 |
| Total interest income | 35,023 | 20,419 |
| Interest expense | | |
| Deposits | 10,418 | 4,543 |
| Borrowings | 129 | 235 |
| Total interest expense | 10,547 | 4,778 |
| Net interest income | 24,476 | 15,641 |
| Provision for loan and lease losses | 4,392 | 1,499 |
| Net interest income after provision for loan and lease losses | 20,084 | 14,142 |
| Noninterest income | | |
| Loan servicing revenue | 6,898 | 5,923 |
| Loan servicing asset revaluation | (5,088) | (2,009) |
| Net gains on sales of loans | 24,418 | 18,952 |
| Lease income | 1,608 | — |
| Construction supervision fee income | 779 | 429 |
| Title insurance income | 1,300 | 1,438 |
| Other noninterest income | 841 | 1,020 |
| Total noninterest income | 30,756 | 25,753 |
| Noninterest expense | | |
| Salaries and employee benefits | 20,209 | 18,682 |
| Travel expense | 1,843 | 1,598 |
| Professional services expense | 1,298 | 1,736 |
| Advertising and marketing expense | 1,662 | 1,485 |
| Occupancy expense | 1,857 | 1,195 |
| Data processing expense | 2,837 | 1,696 |
| Equipment expense | 3,077 | 1,074 |
| Other loan origination and maintenance expense | 1,329 | 1,005 |
| FDIC insurance | 572 | 726 |
| Title insurance closing services expense | 426 | 405 |
| Other expense | 2,962 | 3,383 |
| Total noninterest expense | 38,072 | 32,985 |
| Income before taxes | 12,768 | 6,910 |
| Income tax expense | 315 | 798 |
| Net income | \$12,453 | \$6,112 |
| Basic earnings per share | \$0.31 | \$0.18 |
| Diluted earnings per share | \$0.30 | \$0.17 |

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, 2018 and 2017 (unaudited)
 (Dollars in thousands)

| | Three Months Ended March 31, | |
|---|------------------------------------|---------|
| | 2018 | 2017 |
| Net income | \$12,453 | \$6,112 |
| Other comprehensive loss before tax: | | |
| Net unrealized loss on investment securities arising during the period | (2,955) | (73) |
| Reclassification adjustment for (gain) loss on sale of securities available-for-sale included in net income | — | — |
| Other comprehensive loss before tax | (2,955) | (73) |
| Income tax benefit | 710 | 28 |
| Other comprehensive loss, net of tax | (2,245) | (45) |
| Total comprehensive income | \$10,208 | \$6,067 |
| 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, 2018 and 2017 (unaudited)

(Dollars in thousands)

| | Common stock | | | Retained earnings | Accumulated other comprehensive loss | Total equity |
|---|--------------|-----------|------------|-------------------|--------------------------------------|--------------|
| | Class A | Class B | Amount | | | |
| Balance at December 31, 2016 | 29,530,072 | 4,723,530 | \$ 199,981 | \$ 23,518 | \$ (652) | \$ 222,847 |
| Net income | — | — | — | 6,112 | — | 6,112 |
| Other comprehensive loss | — | — | — | — | (45) | (45) |
| Issuance of restricted stock | 273,946 | — | — | — | — | — |
| Withholding cash issued in lieu of restricted stock issuance | — | — | (4,828) | — | — | (4,828) |
| Employee stock purchase program | 12,411 | — | 241 | — | — | 241 |
| Stock option exercises | 33,136 | — | 186 | — | — | 186 |
| Stock option based compensation expense | — | — | 456 | — | — | 456 |
| Restricted stock expense | — | — | 1,347 | — | — | 1,347 |
| Stock issued in acquisition of Reltco, Inc. | 27,724 | — | 565 | — | — | 565 |
| Dividends (distributions to shareholders) | — | — | — | (692) | — | (692) |
| Balance at March 31, 2017 | 29,877,289 | 4,723,530 | \$ 197,948 | \$ 28,938 | \$ (697) | \$ 226,189 |
| Balance at December 31, 2017 | 35,252,053 | 4,643,530 | \$ 317,725 | \$ 120,241 | \$ (1,033) | \$ 436,933 |
| Net income | — | — | — | 12,453 | — | 12,453 |
| Other comprehensive loss | — | — | — | — | (2,245) | (2,245) |
| Issuance of restricted stock | 17,289 | — | — | — | — | — |
| Withholding cash issued in lieu of restricted stock issuance | — | — | (311) | — | — | (311) |
| Employee stock purchase program | 7,022 | — | 165 | — | — | 165 |
| Stock option exercises | 54,254 | — | 691 | — | — | 691 |
| Stock option based compensation expense | — | — | 463 | — | — | 463 |
| Restricted stock expense | — | — | 1,886 | — | — | 1,886 |
| Reclassification of accumulated other comprehensive income due to tax rate change | — | — | — | 244 | (244) | — |
| Dividends (distributions to shareholders) | — | — | — | (1,199) | — | (1,199) |
| Balance at March 31, 2018 | 35,330,618 | 4,643,530 | \$ 320,619 | \$ 131,739 | \$ (3,522) | \$ 448,836 |

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, 2018 and 2017 (unaudited)
 (Dollars in thousands)

| | Three Months Ended March 31, | |
|---|------------------------------------|-----------|
| | 2018 | 2017 |
| Cash flows from operating activities | | |
| Net income | \$12,453 | \$6,112 |
| Adjustments to reconcile net income to net cash used by operating activities: | | |
| Depreciation and amortization | 3,786 | 1,708 |
| Provision for loan and lease losses | 4,392 | 1,499 |
| Amortization of premium on securities, net of accretion | 153 | 110 |
| Amortization of discount on unguaranteed loans, net | 2,118 | 1,155 |
| Deferred tax expense | 316 | 2,046 |
| Originations of loans held for sale | (302,522) | (329,990) |
| Proceeds from sales of loans held for sale | 277,279 | 227,667 |
| Net gains on sale of loans held for sale | (24,418) | (18,952) |
| Net increase in servicing assets | (822) | (1,590) |
| Net loss on disposal of premises and equipment | — | 213 |
| Stock option based compensation expense | 463 | 456 |
| Restricted stock expense | 1,886 | 1,347 |
| Stock based compensation expense excess tax benefits | 14 | 874 |
| Business combination contingent consideration fair value adjustment | (260) | 200 |
| Changes in assets and liabilities: | | |
| Other assets | (12,065) | 474 |
| Other liabilities | 1,123 | (1,026) |
| Net cash used by operating activities | (36,104) | (107,697) |
| Cash flows from investing activities | | |
| Purchases of securities available-for-sale | (293,046) | (19) |
| Proceeds from sales, maturities, calls, and principal paydowns of securities available-for-sale | 4,805 | 2,262 |
| Business combination, net of cash acquired | — | (7,583) |
| Maturities of certificates of deposit with other banks | 750 | 1,250 |
| Loan and lease originations and principal collections, net | (91,388) | (91,378) |
| Purchases of premises and equipment, net | (41,685) | (37,660) |
| Net cash used by investing activities | (420,564) | (133,128) |
| 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, 2018 and 2017 (unaudited)

(Dollars in thousands)

| | Three Months Ended March 31, | |
|--|---------------------------------|-----------|
| | 2018 | 2017 |
| Cash flows from financing activities | | |
| Net increase in deposits | 713,078 | 154,067 |
| Proceeds from long term borrowings | 18 | — |
| Repayment of long term borrowings | (23,093) | (370) |
| Proceeds from short term borrowings | — | 13,100 |
| Stock option exercises | 691 | 186 |
| Employee stock purchase program | 165 | 241 |
| Withholding cash issued in lieu of restricted stock | (311) | (4,828) |
| Shareholder dividend distributions | (1,199) | (692) |
| Net cash provided by financing activities | 689,349 | 161,704 |
| Net increase (decrease) in cash and cash equivalents | 232,681 | (79,121) |
| Cash and cash equivalents, beginning | 295,271 | 238,008 |
| Cash and cash equivalents, ending | \$527,952 | \$158,887 |
| Supplemental disclosure of cash flow information | | |
| Interest paid | \$10,368 | \$4,836 |
| Income tax paid | 251 | 2,828 |
| Supplemental disclosures of noncash operating, investing, and financing activities | | |
| Unrealized holding losses on available-for-sale securities, net of taxes | \$(2,245) | \$(45) |
| Transfers from loans and leases to foreclosed real estate and other repossessions | 238 | 58 |
| Transfer of loans held for sale to loans and leases held for investment | 11,713 | 3,656 |
| Transfer of loans and leases held for investment to loans held for sale | 6,771 | 1,642 |
| Business combination: | | |
| Assets acquired (excluding goodwill) | — | 5,766 |
| Liabilities assumed | — | 4,681 |
| Purchase price | — | 8,250 |
| Goodwill recorded | — | 7,165 |
| See Notes to Unaudited Consolidated Financial Statements | | |

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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 organized and incorporated under the laws of the State of North Carolina on February 25, 2008 and commenced operations on May 12, 2008. The Bank specializes in providing lending services to small businesses nationwide in targeted industries, which we refer to as verticals. 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) Loan Program and to a lesser extent by the U.S. Department of Agriculture (“USDA”) Rural Energy for America Program (“REAP”) and Business & Industry (“B&I”) loan programs. On July 28, 2015 the Company completed its initial public offering with a secondary offering completed in August of 2017.

In 2010, the Bank formed Live Oak Number One, Inc., a wholly-owned subsidiary, to hold properties foreclosed on by the Bank.

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.

In August 2016, the Company formed Canapi, Inc. for the purpose of investing in businesses that align with the Company's strategic initiative to be a leader in financial technology. Canapi was formerly known as Live Oak Ventures, Inc.

In November 2016, the Company formed Live Oak Clean Energy Financing LLC for the purpose of providing financing to entities for renewable energy applications.

On February 1, 2017, the Company completed its acquisition of Reltco Inc. and National Assurance Title, Inc. (collectively referred to as “Reltco”), two nationwide title agencies under common control based in Tampa, Florida.

The Company earns revenue primarily from the sale of SBA and USDA-guaranteed loans and net interest income. Income from the sale of loans is comprised of net gains on the sale of loans, revenues on the servicing of sold loans and valuation of loan servicing rights. Offsetting these revenues are the cost of funding sources, provision for loan and lease 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, 2018 are not necessarily indicative of the results of operations that may be expected for the year ending December 31, 2018. The consolidated balance sheet as of December 31, 2017 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, 2017, filed with the Securities Exchange Commission on March 8, 2018 (SEC File No. 001-37497) (the “2017 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 2017 Annual Report. These unaudited interim consolidated financial statements should be read in conjunction with the consolidated financial statements and footnotes in the Company's 2017 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.

Unconsolidated Joint Venture

On October 1, 2017, the Company closed the digital banking joint venture between Live Oak Banking Company and First Data Corporation ("First Data"). The new company, named Apiture, combines First Data's and the Bank's digital banking platforms, products, services, and certain human resources used in the creation and delivery of technology solutions for financial institutions. The contributed assets of both the Company and First Data are considered businesses in accordance with relevant accounting standards. At closing both the Bank and First Data received equal voting interests in Apiture in exchange for their respective contributions. As a term of the closing agreements, First Data is entitled to a preference in Apiture's cash earnings from the date of closing through December 31, 2017 and all of 2018, not to exceed \$18.0 million and \$18.9 million, respectively.

As a result of the above cash earnings preference, income (loss) is allocated utilizing the hypothetical liquidation at book value ("HLBV") method. Under the HLBV method, we allocate income or loss based on the change in each unitholders' claim on the net assets of Apiture at period end, after adjusting for any distributions or contributions made during such period. As a result of the HLBV method there was no net income or loss attributed to the Company related its ownership interest in Apiture during the quarter ended March 31, 2018.

As of March 31, 2018 and December 31, 2017 the Company' had a \$68.0 million equity method investment included in other assets on the consolidated balance sheet for this investment.

Derivative Financial Instruments

Interest Rate Futures Contracts

During the fourth quarter of 2016, the Company began using exchange-traded interest rate futures contracts to manage interest rate risk that may impact expected gains arising from future secondary market loan sales. Upon entering into a futures contract, the Company is required to pledge to the counterparty an amount of cash equal to a certain percentage of the contract amount, also known as an initial margin deposit. Subsequent payments, known as variation margin, are made or received by the Company each day to settle the daily fluctuations in the fair value of the underlying contract. Investments in these derivative contracts are subject to risks that can result in a loss of all or part of an investment. Credit risk is considered low because the counterparties are futures exchanges. The Company has not designated any derivative as a hedging instrument under applicable accounting guidance. Changes in fair value of the derivative contracts is recorded as a component of "net gains on sales of loans" on the consolidated statement of income. The fair value of the derivative contracts on the balance sheet date is zero due to the daily cash settlement of contracts.

Equity Warrant Assets

In connection with negotiated credit facilities and certain other services, the Company may obtain equity warrant assets giving the Company the right to acquire stock in private companies in certain verticals. These assets are held for prospective investment gains and are not used to hedge any economic risks. Further, the Company does not use other derivative instruments to hedge economic risks stemming from equity warrant assets.

Equity warrant assets in certain private client companies are recorded as derivatives when they contain net settlement terms and other qualifying criteria under Accounting Standards Codification 815. Equity warrant assets entitle the Company to purchase a specific number of shares of stock at a specific price within a specific time period, generally 10 years. Certain equity warrant assets contain contingent provisions, which adjust the underlying number of shares or purchase price upon the occurrence of certain future events to prevent dilution of the Company's implied ownership

represented by the warrants. Certain warrant agreements contain net share settlement provisions, which permit the receipt of, upon exercise, a share count equal to the intrinsic value of the warrant divided by the share price (otherwise known as a “cashless” exercise). These equity warrant assets are recorded at fair value and are classified as derivative assets, a component of other assets, on the consolidated balance sheet at the time they are obtained.

The grant date fair values of equity warrant assets classified as derivatives received in connection with the issuance of a credit facility are deemed to be loan fees and recognized as an adjustment of loan yield through loan interest income. Similar to other loan fees, the yield adjustment related to grant date fair value of warrants is recognized over the life of that credit facility.

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Live Oak Bancshares, Inc.

Notes to Unaudited Consolidated Financial Statements

Any changes in fair value from the grant date fair value of equity warrant assets classified as derivatives will be recognized as increases or decreases to other assets on the consolidated balance sheet and as net gains or losses on derivative instruments, in other noninterest income, a component of consolidated net income. When a portfolio company is acquired, the Company may exercise these equity warrant assets for shares or cash.

The fair value of equity warrant assets classified as derivatives is reviewed quarterly using a Black-Scholes option pricing model.

For those equity warrant assets that do not contain net share settlement provisions, the Company considers these to be equity investments without readily determinable market values and records the asset at cost.

Revenue Recognition

On January 1, 2018, the Company adopted Accounting Standards Update (“ASU”) No. 2014-09 “Revenue from Contracts with Customers” (Topic 606) and all subsequent ASUs that modified Topic 606. The implementation of the new standard did not have a material impact on the measurement or recognition of revenue and a cumulative effect adjustment to opening retained earnings was not necessary. Results for reporting periods beginning after January 1, 2018 are presented under Topic 606, while prior period amounts were not adjusted and continue to be reported in accordance with the Company's historic accounting under Topic 605.

Topic 606 does not apply to revenue associated with financial instruments, including revenue from loans and lease financings or investment securities. In addition, certain noninterest income streams such as fees associated with servicing rights, financial guarantees, derivatives, title insurance, and equity and cost method investments are also not in scope of the new guidance. Therefore, the recognition of these revenue streams did not change upon adoption of Topic 606. Substantially all of the Company’s revenue is generated from contracts with customers. Noninterest revenue streams in-scope of Topic 606 are discussed below.

Other noninterest income

Other noninterest income consists of other recurring revenue streams from administration of trust assets held by the Company's trust department and from services provided by GLS to its clients for settlement, accounting, and valuation for government guaranteed loan sales and holdings. Trust account administration performance obligations are generally satisfied over time and fees are recognized monthly, based on the month-end market value of assets in fiduciary accounts and the applicable fee rate. Payment is generally received after month end through a direct charge to customers' accounts. The Company does not earn performance-based incentives from trust account administration services. GLS provides services when requested by clients. Each requested service represents a specific performance obligation with a transaction price outlined by GLS' fee schedule. Revenue is recognized as the requested services are completed and payment is generally received the following month.

Contract Balances

A contract asset balance occurs when an entity performs a service for a customer before the customer pays consideration (resulting in a contract receivable) or before payment is due (resulting in a contract asset). A contract liability balance is an entity’s obligation to transfer a service to a customer for which the entity has already received payment (or payment is due) from the customer. The Company’s noninterest revenue streams are largely based on transactional activity, or standard month-end revenue accruals such as trust administration fees based on month-end market values. Consideration is often received immediately or shortly after the Company satisfies its performance obligation and revenue is recognized. The Company does not typically enter into long-term revenue contracts with customers, and therefore, does not experience significant contract balances. As of March 31, 2018 and December 31, 2017, the Company did not have any significant contract balances.

Contract Acquisition Costs

In connection with the adoption of Topic 606, an entity is required to capitalize, and subsequently amortize into expense, certain incremental costs of obtaining a contract with a customer if these costs are expected to be recovered. The incremental costs of obtaining a contract are those costs that an entity incurs to obtain a contract with a customer

that it would not have incurred if the contract had not been obtained (for example, sales commission). The Company utilizes the practical expedient which allows entities to immediately expense contract acquisition costs when the asset that would have resulted from capitalizing these costs would have been amortized in one year or less. Upon adoption of Topic 606, the Company did not capitalize any contract acquisition cost.

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.

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Live Oak Bancshares, Inc.

Notes to Unaudited Consolidated Financial Statements

Note 2. Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (“FASB”) issued ASU No. 2014-09, “Revenue from Contracts with Customers (Topic 606)” (“ASU 2014-09”). This standard is intended to clarify the principles for recognizing revenue and to develop a common revenue standard for GAAP. The Company's revenue is comprised of loan servicing revenue, net gains on sales of loans and net interest income on financial assets and financial liabilities, all of which are explicitly excluded from the scope of ASU 2014-09, and non-interest income. The Company's revenue streams included in non-interest income that are within the scope of the guidance are primarily related to sales of foreclosed assets, construction supervision fees, title insurance income and trust fiduciary fees. The Company adopted the standard in the first quarter of 2018 with no material impact on the consolidated financial statements. Refer to Note 1. Basis of Presentation for additional information.

In January 2016, the FASB issued ASU 2016-01, “Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities” (“ASU 2016-01”). ASU 2016-01, among other things, (i) requires equity investments, with certain exceptions, to be measured at fair value with changes in fair value recognized in net income, (ii) simplifies the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment, (iii) eliminates the requirement for public business entities to disclose the methods and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet, (iv) requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes, (v) requires an entity to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments, (vi) requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset on the balance sheet or the accompanying notes to the financial statements and (viii) clarifies that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale. The Company adopted the standard in the first quarter of 2018 with no material impact on the consolidated financial statements. In accordance with (iv) above, the Company measured the fair value of the loan and lease portfolio using an exit price notion. See Note 10. Fair Value of Financial Instruments for additional information.

In February 2016, the FASB issued ASU No. 2016-02, “Leases (Topic 842)” (“ASU 2016-02”). The FASB issued this ASU to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet by lessees for those leases classified as operating leases under current GAAP and disclosing key information about leasing arrangements. The amendments in this ASU are effective for the Company on January 1, 2019. The impact of this standard will depend on the Company's lease portfolio at the time of the adoption and the Company is currently assessing the effect that the adoption of this standard will have on the consolidated financial statements.

In June 2016, the FASB issued ASU No. 2016-13, “Measurement of Credit Losses on Financial Instruments” (“ASU 2016-13”). This new guidance replaces the incurred loss impairment methodology in current standards with an expected credit loss methodology and requires consideration of a broader range of information to determine credit loss estimates. ASU 2016-13 requires the measurement of all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts and requires enhanced disclosures related to the significant estimates and judgments used in estimating credit losses, as well as the credit quality and underwriting standards of an organization's portfolio. In addition, ASU 2016-13 amends the accounting for credit losses on available-for-sale debt securities and purchased financial assets with credit deterioration. ASU 2016-13 will be effective for the Company on January 1, 2020. The Company is currently evaluating the potential impact of ASU 2016-13 on the consolidated financial statements. In that regard, a cross-functional working group has been formed, under the direction of the Company's Chief Financial Officer and

Chief Credit Officer. The working group is comprised of individuals from various functional areas including credit, risk management, finance and information technology, among others. The Company is currently developing an implementation plan to include assessment of processes, portfolio segmentation, model development, system requirements and the identification of data and resource needs, among other things. The Company has also selected a third-party vendor solution to assist in the application of the ASU 2016-13. While the Company is currently unable to reasonably estimate the impact of adopting ASU 2016-13, the impact of adoption is expected to be significantly influenced by the composition, characteristics and quality of loan and securities portfolios as well as the prevailing economic conditions and forecasts as of the adoption date.

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In January 2017, the FASB issued ASU No. 2017-01, “Business Combinations (Topic 805) - Clarifying the Definition of a Business” (“ASU 2017-01”). ASU 2017-01 clarifies the definition and provides a more robust framework to use in determining when a set of assets and activities constitutes a business. ASU 2017-01 is intended to provide guidance when evaluating whether transactions should be accounted for as acquisitions (or disposals) of assets or businesses. The Company adopted the standard in the first quarter of 2018 with no effect on the consolidated financial statements. In February 2017, the FASB issued ASU No. 2017-05, “Other Income - Gains and Losses from the Derecognition of Nonfinancial Assets (Subtopic 610-20) - Clarifying the Scope of Asset Derecognition Guidance and Accounting for Partial Sales of Nonfinancial Assets” (“ASU 2017-05”). ASU 2017-05 clarifies the scope of Subtopic 610-20 and adds guidance on nonfinancial asset derecognition as well as the accounting for partial sales of nonfinancial assets. The amendments conform the derecognition guidance on nonfinancial assets with the model for transactions in the new revenue standard. The Company adopted the standard in the first quarter of 2018 with no effect on the consolidated financial statements.

In May 2017, the FASB issued ASU No. 2017-09, “Compensation - Stock Compensation (Topic 718) - Scope of Modification Accounting” (“ASU 2017-09”). ASU 2017-09 clarifies when changes to the terms or conditions of a share-based payment award should be accounted for as a modification. This guidance indicates modification accounting is required when the fair value, vesting conditions, or classification of the award changes. The Company adopted the standard in the first quarter of 2018 with no effect on the consolidated financial statements.

In February 2018, the FASB issued ASU No. 2018-02, “Income Statement - Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income” (“ASU 2018-02”). ASU 2018-02 addresses the income tax accounting treatment of the stranded tax effects within other comprehensive income. The ASU allows for an entity to reclassify the stranded tax effects resulting from the Tax Cuts and Jobs Act from accumulated other comprehensive income to retained earnings. ASU 2018-02 will be effective for the Company on January 1, 2019, with early adoption permitted. The Company early adopted ASU 2018-02 in the first quarter of 2018 and reclassified its stranded tax credit of \$244 thousand within accumulated other comprehensive income to retained earnings at March 31, 2018.

In February 2018, the FASB issued 2018-03, “Technical Corrections and Improvements to Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities” (“ASU 2018-03”). ASU 2018-03 amends certain aspects of the guidance issued in ASU 2016-01. The amendments are effective for the Company for fiscal year 2018 with adoption as of July 1, 2018. The Company does not expect these amendments to have a material effect on its consolidated financial statements.

In March 2018, the FASB issued 2018-05, “Income Taxes (Topic 740) - Amendments to SEC Paragraphs Pursuant to SEC Staff Accounting Bulletin (SAB) No. 118” (“ASU 2018-05”). ASU 2018-05 amends Accounting Standard Codification 740 to include recent SEC guidance pursuant to the issuance of SAB 118. These amendments address situations when a registrant does not have the necessary information available, prepared, or analyzed in reasonable detail to complete the accounting for certain income tax effects of the Tax Cuts and Jobs Act. The amendments were effective upon issuance and do not have a material effect on the Company's consolidated financial statements.

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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, | |
|---|------------------------------------|------------|
| | 2018 | 2017 |
| Basic earnings per share: | | |
| Net income available to common shareholders | \$12,453 | \$ 6,112 |
| Weighted-average basic shares outstanding | 39,926,783 | 34,466,904 |
| Basic earnings per share | \$0.31 | \$ 0.18 |
| Diluted earnings per share: | | |
| Net income available to common shareholders, for diluted earnings per share | \$12,453 | \$ 6,112 |
| Total weighted-average basic shares outstanding | 39,926,783 | 34,466,904 |
| Add effect of dilutive stock options and restricted stock grants | 1,473,149 | 1,180,014 |
| Total weighted-average diluted shares outstanding | 41,399,932 | 35,646,918 |
| Diluted earnings per share | \$0.30 | \$ 0.17 |
| Anti-dilutive shares | — | 1,068,595 |

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Note 4. Investment Securities

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

| | Amortized Cost | Unrealized Gains | Unrealized Losses | Fair Value |
|--|-------------------|---------------------|----------------------|---------------|
| March 31, 2018 | | | | |
| US government agencies | \$ 22,787 | \$ 1 | \$ 356 | \$ 22,432 |
| Residential mortgage-backed securities | 358,225 | 10 | 4,214 | 354,021 |
| Mutual fund | 2,111 | — | 76 | 2,035 |
| Total | \$ 383,123 | \$ 11 | \$ 4,646 | \$ 378,488 |
| December 31, 2017 | | | | |
| US government agencies | \$ 22,778 | \$ 3 | \$ 157 | \$ 22,624 |
| Residential mortgage-backed securities | 70,167 | 1 | 1,472 | 68,696 |
| Mutual fund | 2,090 | — | 55 | 2,035 |
| Total | \$ 95,035 | \$ 4 | \$ 1,684 | \$ 93,355 |

There were no sales of securities during the three months ended March 31, 2018 and 2017.

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, 2018 | | | | | | |
| US government agencies | \$ 14,661 | \$ 292 | \$ 6,455 | \$ 64 | \$ 21,116 | \$ 356 |
| Residential mortgage-backed securities | 224,157 | 2,456 | 37,901 | 1,758 | 262,058 | 4,214 |
| Mutual fund | — | — | 2,035 | 76 | 2,035 | 76 |
| Total | \$ 238,818 | \$ 2,748 | \$ 46,391 | \$ 1,898 | \$ 285,209 | \$ 4,646 |
| December 31, 2017 | | | | | | |
| US government agencies | \$ 14,842 | \$ 100 | \$ 6,465 | \$ 57 | \$ 21,307 | \$ 157 |
| Residential mortgage-backed securities | 23,481 | 439 | 40,648 | 1,033 | 64,129 | 1,472 |
| Mutual fund | — | — | 2,035 | 55 | 2,035 | 55 |
| Total | \$ 38,323 | \$ 539 | \$ 49,148 | \$ 1,145 | \$ 87,471 | \$ 1,684 |

At March 31, 2018, there were twenty-three residential mortgage-backed securities, three US government agency securities and the 504 Fund mutual fund in unrealized loss positions for greater than 12 months and thirty-one residential mortgage-backed securities and five US government agency securities in unrealized loss positions for less than 12 months. Unrealized losses at December 31, 2017 were comprised of twenty-three residential mortgage-backed securities, three US government agencies and the 504 mutual fund in unrealized loss positions for greater than 12 months and five US government agency securities and eight residential mortgage-backed securities in unrealized loss positions 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 and the Company has the intent and ability to hold the securities for a sufficient period of time to recover unrealized losses, 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, 2018 and December 31, 2017 were backed by U.S. government sponsored enterprises ("GSEs").

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The following is a summary of investment securities by maturity:

| | March 31, 2018 | |
|--|--------------------|-----------|
| | Available-for-Sale | |
| | Amortized | Fair |
| | cost | value |
| US government agencies | | |
| Within one year | \$6,323 | \$6,290 |
| One to five years | 16,464 | 16,142 |
| Total | 22,787 | 22,432 |
| Residential mortgage-backed securities | | |
| One to five years | 4,691 | 4,526 |
| Five to ten years | 28,998 | 28,878 |
| After 10 years | 324,536 | 320,617 |
| Total | 358,225 | 354,021 |
| Total | \$381,012 | \$376,453 |

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

At March 31, 2018 and December 31, 2017, an investment security with a fair market value of \$100 thousand was pledged to the Ohio State Treasurer to allow the Company's trust department to conduct business in the state of Ohio and investment securities with a fair market value of \$2.5 million were pledged to the Company's trust department for uninsured trust assets held by the trust department.

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

Loan and Lease Portfolio Segments

The following describes the risk characteristics relevant to each of the portfolio segments. Each loan and lease 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 "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.

Commercial Real Estate

Commercial real estate loans are extensions of credit secured by owner occupied and non-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 commercial real estate 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 loans 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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Loans and leases consist of the following:

| | March 31, 2018 | December 31, 2017 |
|---|-------------------|-------------------------|
| Commercial & Industrial | | |
| Agriculture | \$3,605 | \$3,274 |
| Death Care Management | 13,982 | 13,495 |
| Healthcare | 45,001 | 43,301 |
| Independent Pharmacies | 100,528 | 99,920 |
| Registered Investment Advisors | 96,573 | 93,770 |
| Veterinary Industry | 49,797 | 46,387 |
| Other Industries | 209,408 | 184,903 |
| Total | 518,894 | 485,050 |
| Construction & Development | | |
| Agriculture | 35,976 | 34,188 |
| Death Care Management | 6,713 | 6,119 |
| Healthcare | 56,801 | 49,770 |
| Independent Pharmacies | 1,754 | 1,496 |
| Registered Investment Advisors | 883 | 376 |
| Veterinary Industry | 14,001 | 13,184 |
| Other Industries | 68,615 | 58,120 |
| Total | 184,743 | 163,253 |
| Commercial Real Estate | | |
| Agriculture | 49,934 | 46,717 |
| Death Care Management | 69,057 | 67,381 |
| Healthcare | 137,163 | 126,631 |
| Independent Pharmacies | 17,830 | 19,028 |
| Registered Investment Advisors | 11,488 | 11,789 |
| Veterinary Industry | 119,948 | 113,932 |
| Other Industries | 156,220 | 134,172 |
| Total | 561,640 | 519,650 |
| Commercial Land | | |
| Agriculture | 182,499 | 178,897 |
| Total | 182,499 | 178,897 |
| Total Loans and Leases ¹ | 1,447,776 | 1,346,850 |
| Net Deferred Costs | 7,841 | 8,545 |
| Discount on SBA 7(a) and USDA Unguaranteed ² | (13,540) | (11,422) |
| Loans and Leases, Net of Unearned | \$1,442,077 | \$1,343,973 |

¹ Total loans and leases include \$115.5 million and \$99.7 million of U.S. government guaranteed loans as of March 31, 2018 and December 31, 2017, 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 and lease reviews to assess the performance of individual loans and leases by industry segment. An independent review of the loan and lease 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 and lease. The grade is periodically evaluated and adjusted as performance dictates. Loan and lease grades 1 through 4 are passing grades and grade 5 is special mention. Collectively, grades 6 through 8 represent classified loans and leases in the Bank's portfolio. The following guidelines govern the assignment of these risk grades:

Exceptional (1 Rated): These loans and leases 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 (2 Rated): These loans and leases 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 (3 rated): These loans and leases 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 (4 rated): These loans and leases are considered very weak pass. These loans and leases 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 and leases that may be put in this category include start-up loans and leases and loans and leases with less than 1:1 cash flow coverage with other sources of repayment.

Special mention (5 rated): These loans and leases are considered as emerging problems, with potentially unsatisfactory characteristics. These loans and leases require greater management attention. A loan or lease 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 and leases 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 and leases graded Doubtful have inherent weaknesses that make collection or liquidation in full questionable. Loans and leases graded Doubtful must be placed on non-accrual status.

Loss (8 rated): Loss rated loans and leases 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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The following tables summarize the risk grades of each category:

| | Risk Grades 1 - 4 | Risk Grade 5 | Risk Grades 6 - 8 | Total |
|--------------------------------|----------------------|-----------------|----------------------|--------------|
| March 31, 2018 | | | | |
| Commercial & Industrial | | | | |
| Agriculture | \$ 3,087 | \$ 518 | \$ — | \$ 3,605 |
| Death Care Management | 13,776 | 199 | 7 | 13,982 |
| Healthcare | 37,724 | 3,168 | 4,109 | 45,001 |
| Independent Pharmacies | 87,434 | 4,152 | 8,942 | 100,528 |
| Registered Investment Advisors | 93,802 | 2,062 | 709 | 96,573 |
| Veterinary Industry | 45,361 | 1,505 | 2,931 | 49,797 |
| Other Industries | 195,634 | 13,774 | — | 209,408 |
| Total | 476,818 | 25,378 | 16,698 | 518,894 |
| Construction & Development | | | | |
| Agriculture | 30,527 | 5,449 | — | 35,976 |
| Death Care Management | 6,713 | — | — | 6,713 |
| Healthcare | 52,281 | 3,119 | 1,401 | 56,801 |
| Independent Pharmacies | 1,754 | — | — | 1,754 |
| Registered Investment Advisors | 883 | — | — | 883 |
| Veterinary Industry | 12,814 | 1,187 | — | 14,001 |
| Other Industries | 68,280 | 335 | — | 68,615 |
| Total | 173,252 | 10,090 | 1,401 | 184,743 |
| Commercial Real Estate | | | | |
| Agriculture | 49,934 | — | — | 49,934 |
| Death Care Management | 61,343 | 3,833 | 3,881 | 69,057 |
| Healthcare | 117,279 | 8,954 | 10,930 | 137,163 |
| Independent Pharmacies | 15,458 | 2,260 | 112 | 17,830 |
| Registered Investment Advisors | 11,352 | 136 | — | 11,488 |
| Veterinary Industry | 101,884 | 3,285 | 14,779 | 119,948 |
| Other Industries | 155,544 | 676 | — | 156,220 |
| Total | 512,794 | 19,144 | 29,702 | 561,640 |
| Commercial Land | | | | |
| Agriculture | 179,803 | 2,696 | — | 182,499 |
| Total | 179,803 | 2,696 | — | 182,499 |
| Total ¹ | \$ 1,342,667 | \$ 57,308 | \$ 47,801 | \$ 1,447,776 |

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| | Risk Grades 1 - 4 | Risk Grade 5 | Risk Grades 6 - 8 | Total |
|--------------------------------|----------------------|-----------------|----------------------|--------------|
| December 31, 2017 | | | | |
| Commercial & Industrial | | | | |
| Agriculture | \$ 3,052 | \$ 222 | \$ — | \$ 3,274 |
| Death Care Management | 13,371 | 117 | 7 | 13,495 |
| Healthcare | 36,530 | 2,246 | 4,525 | 43,301 |
| Independent Pharmacies | 86,152 | 5,541 | 8,227 | 99,920 |
| Registered Investment Advisors | 90,911 | 2,134 | 725 | 93,770 |
| Veterinary Industry | 42,313 | 1,704 | 2,370 | 46,387 |
| Other Industries | 184,540 | 363 | — | 184,903 |
| Total | 456,869 | 12,327 | 15,854 | 485,050 |
| Construction & Development | | | | |
| Agriculture | 31,738 | 2,450 | — | 34,188 |
| Death Care Management | 6,119 | — | — | 6,119 |
| Healthcare | 47,813 | 699 | 1,258 | 49,770 |
| Independent Pharmacies | 1,496 | — | — | 1,496 |
| Registered Investment Advisors | 376 | — | — | 376 |
| Veterinary Industry | 13,184 | — | — | 13,184 |
| Other Industries | 58,120 | — | — | 58,120 |
| Total | 158,846 | 3,149 | 1,258 | 163,253 |
| Commercial Real Estate | | | | |
| Agriculture | 46,717 | — | — | 46,717 |
| Death Care Management | 60,671 | 3,881 | 2,829 | 67,381 |
| Healthcare | 112,321 | 9,992 | 4,318 | 126,631 |
| Independent Pharmacies | 15,641 | 1,825 | 1,562 | 19,028 |
| Registered Investment Advisors | 11,649 | 140 | — | 11,789 |
| Veterinary Industry | 97,065 | 2,948 | 13,919 | 113,932 |
| Other Industries | 133,493 | 679 | — | 134,172 |
| Total | 477,557 | 19,465 | 22,628 | 519,650 |
| Commercial Land | | | | |
| Agriculture | 176,811 | 2,086 | — | 178,897 |
| Total | 176,811 | 2,086 | — | 178,897 |
| Total ¹ | \$ 1,270,083 | \$ 37,027 | \$ 39,740 | \$ 1,346,850 |

Total loans and leases include \$115.5 million of U.S. government guaranteed loans as of March 31, 2018, segregated by risk grade as follows: Risk Grades 1 – 4 = \$69.1 million, Risk Grade 5 = \$13.3 million, Risk Grades 6 – 8 = \$33.1 million. As of December 31, 2017, total loans and leases include \$99.7 million of U.S. government guaranteed loans, segregated by risk grade as follows: Risk Grades 1 – 4 = \$65.0 million, Risk Grade 5 = \$6.7 million, Risk Grades 6 – 8 = \$28.0 million.

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Past Due Loans and Leases

Loans and leases are considered past due if the required principal and interest payments have not been received as of the date such payments were due. Loans and leases less than 30 days past due and accruing are included within current loans and leases shown below. The following tables show an age analysis of past due loans and leases 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 | Current | Total Loans and Leases | 90 Days or More Past Due & Still Accruing |
|-----------------------------------|--|--------------------------------------|--|--|-------------------------------------|---------|---------------------------|---|
| March 31, 2018 | | | | | | | | |
| Commercial & Industrial | | | | | | | | |
| Agriculture | \$ — | \$ — | \$ — | \$ — | \$ — | \$3,605 | \$3,605 | \$ — |
| Death Care Management | — | — | — | — | — | 13,982 | 13,982 | — |
| Healthcare | 222 | 154 | 453 | 2,735 | 3,564 | 41,437 | 45,001 | — |
| Independent Pharmacies | 100 | — | 499 | 8,018 | 8,617 | 91,911 | 100,528 | — |
| Registered Investment Advisors | — | — | — | — | — | 96,573 | 96,573 | — |
| Veterinary Industry | 209 | 128 | 491 | 1,072 | 1,900 | 47,897 | 49,797 | — |
| Other Industries | — | — | — | — | — | 209,408 | 209,408 | — |
| Total | 531 | 282 | 1,443 | 11,825 | 14,081 | 504,813 | 518,894 | — |
| Construction & Development | | | | | | | | |
| Agriculture | — | — | 2,451 | — | 2,451 | 33,525 | 35,976 | — |
| Death Care Management | — | — | — | — | — | 6,713 | 6,713 | — |
| Healthcare | — | — | — | — | — | 56,801 | 56,801 | — |
| Independent Pharmacies | — | — | — | — | — | 1,754 | 1,754 | — |
| Registered Investment Advisors | — | — | — | — | — | 883 | 883 | — |
| Veterinary Industry | — | — | — | — | — | 14,001 | 14,001 | — |
| Other Industries | — | — | — | — | — | 68,615 | 68,615 | — |
| Total | — | — | 2,451 | — | 2,451 | 182,292 | 184,743 | — |
| Commercial Real Estate | | | | | | | | |
| Agriculture | — | 643 | — | — | 643 | 49,291 | 49,934 | — |
| Death Care Management | 162 | — | — | 1,369 | 1,531 | 67,526 | 69,057 | — |
| Healthcare | 1,816 | 2,530 | 5,982 | 1,549 | 11,877 | 125,286 | 137,163 | — |
| Independent Pharmacies | — | — | — | 112 | 112 | 17,718 | 17,830 | — |
| Registered Investment Advisors | — | — | — | — | — | 11,488 | 11,488 | — |
| Veterinary Industry | 2,935 | 3,370 | 955 | 5,646 | 12,906 | 107,042 | 119,948 | — |
| Other Industries | — | — | — | — | — | 156,220 | 156,220 | — |
| Total | 4,913 | 6,543 | 6,937 | 8,676 | 27,069 | 534,571 | 561,640 | — |
| Commercial Land | | | | | | | | |
| Agriculture | — | — | — | — | — | 182,499 | 182,499 | — |
| Total | — | — | — | — | — | 182,499 | 182,499 | — |

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| | | | | | | | | |
|--------------------|----------|----------|-----------|-----------|-----------|--------------|--------------|------|
| Total ¹ | \$ 5,444 | \$ 6,825 | \$ 10,831 | \$ 20,501 | \$ 43,601 | \$ 1,404,175 | \$ 1,447,776 | \$ — |
|--------------------|----------|----------|-----------|-----------|-----------|--------------|--------------|------|

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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 | Current | Total Loans and Leases | 90 Days or More Past Due & Still Accruing |
|-----------------------------------|--|--------------------------------------|--|--|-------------------------------------|--------------|---------------------------|---|
| December 31, 2017 | | | | | | | | |
| Commercial & Industrial | | | | | | | | |
| Agriculture | \$ — | \$ — | \$ — | \$ — | \$ — | \$3,274 | \$3,274 | \$ — |
| Death Care Management | — | — | — | — | — | 13,495 | 13,495 | — |
| Healthcare | 788 | 131 | 14 | 3,004 | 3,937 | 39,364 | 43,301 | — |
| Independent Pharmacies | 236 | 2,930 | 1,349 | 3,376 | 7,891 | 92,029 | 99,920 | — |
| Registered Investment Advisors | — | 321 | — | — | 321 | 93,449 | 93,770 | — |
| Veterinary Industry | 212 | 594 | 508 | 797 | 2,111 | 44,276 | 46,387 | — |
| Other Industries | — | — | — | — | — | 184,903 | 184,903 | — |
| Total | 1,236 | 3,976 | 1,871 | 7,177 | 14,260 | 470,790 | 485,050 | — |
| Construction & Development | | | | | | | | |
| Agriculture | — | — | — | — | — | 34,188 | 34,188 | — |
| Death Care Management | — | — | — | — | — | 6,119 | 6,119 | — |
| Healthcare | — | — | — | — | — | 49,770 | 49,770 | — |
| Independent Pharmacies | — | — | — | — | — | 1,496 | 1,496 | — |
| Registered Investment Advisors | — | — | — | — | — | 376 | 376 | — |
| Veterinary Industry | — | — | — | — | — | 13,184 | 13,184 | — |
| Other Industries | — | — | — | — | — | 58,120 | 58,120 | — |
| Total | — | — | — | — | — | 163,253 | 163,253 | — |
| Commercial Real Estate | | | | | | | | |
| Agriculture | — | — | — | — | — | 46,717 | 46,717 | — |
| Death Care Management | — | — | 168 | 1,391 | 1,559 | 65,822 | 67,381 | — |
| Healthcare | 40 | 54 | 1,916 | 1,550 | 3,560 | 123,071 | 126,631 | — |
| Independent Pharmacies | — | — | — | 1,562 | 1,562 | 17,466 | 19,028 | — |
| Registered Investment Advisors | — | — | — | — | — | 11,789 | 11,789 | — |
| Veterinary Industry | 1,804 | 3,226 | — | 4,765 | 9,795 | 104,137 | 113,932 | — |
| Other Industries | — | — | — | — | — | 134,172 | 134,172 | — |
| Total | 1,844 | 3,280 | 2,084 | 9,268 | 16,476 | 503,174 | 519,650 | — |
| Commercial Land | | | | | | | | |
| Agriculture | — | — | — | — | — | 178,897 | 178,897 | — |
| Total | — | — | — | — | — | 178,897 | 178,897 | — |
| Total ¹ | \$ 3,080 | \$ 7,256 | \$ 3,955 | \$ 16,445 | \$ 30,736 | \$ 1,316,114 | \$ 1,346,850 | \$ — |

¹Total loans and leases include \$115.5 million of U.S. government guaranteed loans as of March 31, 2018, of which \$18.1 million is greater than 90 days past due, \$11.2 million is 30-89 days past due and \$86.2 million is included in current loans and leases as presented above. As of December 31, 2017, total loans and leases include \$99.7 million

of U.S. government guaranteed loans, of which \$15.0 million is greater than 90 days past due, \$7.4 million is 30-89 days past due and \$77.3 million is included in current loans and leases as presented above.

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Nonaccrual Loans and Leases

Loans and leases 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 and leases had been accrued in accordance with the original terms, interest income would have increased by approximately \$457 thousand and \$280 thousand for the three months ended March 31, 2018 and 2017, respectively. All nonaccrual loans and leases are included in the held for investment portfolio.

Nonaccrual loans and leases as of March 31, 2018 and December 31, 2017 are as follows:

| | Loan and Lease Balance | Guaranteed Balance | Unguaranteed Exposure |
|----------------------------|---------------------------------|-----------------------|--------------------------|
| March 31, 2018 | | | |
| Commercial & Industrial | | | |
| Healthcare | \$3,410 | \$ 2,954 | \$ 456 |
| Independent Pharmacies | 8,617 | 7,290 | 1,327 |
| Veterinary Industry | 1,772 | 1,733 | 39 |
| Total | 13,799 | 11,977 | 1,822 |
| Construction & Development | | | |
| Agriculture | 2,451 | 1,838 | 613 |
| Total | 2,451 | 1,838 | 613 |
| Commercial Real Estate | | | |
| Death Care Management | 1,531 | 1,219 | 312 |
| Healthcare | 9,347 | 6,357 | 2,990 |
| Independent Pharmacies | 112 | — | 112 |
| Veterinary Industry | 9,536 | 7,999 | 1,537 |
| Total | 20,526 | 15,575 | 4,951 |
| Total | \$36,776 | \$ 29,390 | \$ 7,386 |
| December 31, 2017 | Loan and Lease Balance | Guaranteed Balance | Unguaranteed Exposure |
| Commercial & Industrial | | | |
| Healthcare | \$3,806 | \$ 3,235 | \$ 571 |
| Independent Pharmacies | 4,961 | 3,906 | 1,055 |
| Veterinary Industry | 1,517 | 1,478 | 39 |
| Total | 10,284 | 8,619 | 1,665 |
| Commercial Real Estate | | | |
| Death Care Management | 1,559 | 1,237 | 322 |
| Healthcare | 3,506 | 2,719 | 787 |
| Independent Pharmacies | 1,562 | 1,562 | — |
| Veterinary Industry | 6,569 | 5,733 | 836 |
| Total | 13,196 | 11,251 | 1,945 |
| Total | \$23,480 | \$ 19,870 | \$ 3,610 |

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Allowance for Loan and Lease Loss Methodology

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

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

The ALLL policy for pooled loans and leases is governed in accordance with banking regulatory guidance for homogenous pools of non-impaired loans and leases that have similar risk characteristics. The Company follows a consistent and structured approach for assessing the need for reserves within each individual loan and lease pool. Loans and leases 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 or lease agreement. The Company has determined that loans and leases that meet the criteria defined below must be reviewed quarterly to determine if they are impaired.

• All commercial loans and leases classified substandard or worse.

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

• Any loan or lease which has been modified such that it meets the definition of a Troubled Debt Restructuring (TDR). The Company’s policy for impaired loan and lease accounting subjects all loans and leases to impairment recognition; however, loan and lease 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 and leases. Any loan or lease 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 or lease. This portion is the loan’s or lease’s “impairment,” and is established as a specific reserve against the loan or lease, or charged against the ALLL.

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 ALLL, 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 ALLL and the individual specific reserve reduced by a corresponding amount.

For impaired loans or leases, the reserve amount is calculated on a loan or lease-specific basis. The Company utilizes two methods of analyzing impaired loans and leases 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 or lease 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 and lease losses by portfolio segment allowance for the periods presented:

| Three months ended | Construction & Development | Commercial Real Estate | Commercial & Industrial | Commercial Land | Total |
|--------------------|----------------------------|------------------------|-------------------------|-----------------|----------|
| March 31, 2018 | | | | | |
| Beginning Balance | \$ 2,030 | \$ 9,180 | \$ 10,751 | \$ 2,229 | \$24,190 |
| Charge offs | — | — | (672) | — | (672) |
| Recoveries | — | 4 | 136 | — | 140 |
| Provision | 398 | 2,060 | 1,986 | (52) | 4,392 |
| Ending Balance | \$ 2,428 | \$ 11,244 | \$ 12,201 | \$ 2,177 | \$28,050 |
| March 31, 2017 | | | | | |
| Beginning Balance | \$ 1,693 | \$ 5,897 | \$ 8,413 | \$ 2,206 | \$18,209 |
| Charge offs | — | (268) | (1,233) | (35) | (1,536) |
| Recoveries | — | 9 | 14 | — | 23 |
| Provision | 191 | 588 | 652 | 68 | 1,499 |
| Ending Balance | \$ 1,884 | \$ 6,226 | \$ 7,846 | \$ 2,239 | \$18,195 |

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

| March 31, 2018 | Construction & Development | Commercial Real Estate | Commercial & Industrial | Commercial Land | Total |
|---|----------------------------|------------------------|-------------------------|-----------------|-------------|
| Allowance for Loan and Lease Losses: | | | | | |
| Loans and leases individually evaluated for impairment | \$ 205 | \$ 2,847 | \$ 1,617 | \$ — | \$4,669 |
| Loans and leases collectively evaluated for impairment ² | 2,223 | 8,397 | 10,584 | 2,177 | 23,381 |
| Total allowance for loan and lease losses | \$ 2,428 | \$ 11,244 | \$ 12,201 | \$ 2,177 | \$28,050 |
| Loans and leases receivable ¹ : | | | | | |
| Loans and leases individually evaluated for impairment | \$ 4,435 | \$ 24,434 | \$ 6,820 | \$ — | \$35,689 |
| Loans and leases collectively evaluated for impairment ² | 180,308 | 537,206 | 512,074 | 182,499 | 1,412,087 |
| Total loans and leases receivable | \$ 184,743 | \$ 561,640 | \$ 518,894 | \$ 182,499 | \$1,447,776 |
| December 31, 2017 | | | | | |
| Allowance for Loan and Lease Losses: | | | | | |
| Loans and leases individually evaluated for impairment | \$ 157 | \$ 1,502 | \$ 1,126 | \$ — | \$2,785 |
| Loans and leases collectively evaluated for impairment ² | 1,873 | 7,678 | 9,625 | 2,229 | 21,405 |
| Total allowance for loan and lease losses | \$ 2,030 | \$ 9,180 | \$ 10,751 | \$ 2,229 | \$24,190 |
| Loans and leases receivable ¹ : | | | | | |
| Loans and leases individually evaluated for impairment | \$ 1,237 | \$ 17,105 | \$ 8,672 | \$ — | \$27,014 |
| | 162,016 | 502,545 | 476,378 | 178,897 | 1,319,836 |

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Loans and leases collectively evaluated for
impairment²

| | | | | | |
|-----------------------------------|------------|------------|------------|------------|-------------|
| Total loans and leases receivable | \$ 163,253 | \$ 519,650 | \$ 485,050 | \$ 178,897 | \$1,346,850 |
|-----------------------------------|------------|------------|------------|------------|-------------|

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Notes to Unaudited Consolidated Financial Statements

Loans and leases receivable includes \$115.5 million of U.S. government guaranteed loans as of March 31, 2018, of which \$35.4 million are impaired. As of December 31, 2017, loans and leases receivable includes \$99.7 million of U.S. government guaranteed loans, of which \$28.1 million are considered impaired.

Included in loans and leases collectively evaluated for impairment are impaired loans and leases with individual unguaranteed exposure of less than \$100 thousand. As of March 31, 2018, these balances totaled \$16.6 million, of which \$14.8 million are guaranteed by the U.S. government and \$1.8 million are unguaranteed. As of December 31, 2017, these balances totaled \$14.8 million, of which \$13.2 million are guaranteed by the U.S. government and \$1.6 million are unguaranteed. The allowance for loan and lease losses associated with these loans and leases totaled \$332 thousand and \$279 thousand as of March 31, 2018 and December 31, 2017, respectively.

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

| March 31, 2018 | Recorded Investment | Guaranteed Balance | Unguaranteed Exposure |
|--------------------------------|------------------------|-----------------------|--------------------------|
| Commercial & Industrial | | | |
| Death Care Management | \$ 7 | \$ — | \$ 7 |
| Healthcare | 4,139 | 2,954 | 1,185 |
| Independent Pharmacies | 9,241 | 7,533 | 1,708 |
| Registered Investment Advisors | 717 | — | 717 |
| Veterinary Industry | 3,095 | 2,232 | 863 |
| Total | 17,199 | 12,719 | 4,480 |
| Construction & Development | | | |
| Agriculture | 2,445 | 1,838 | 607 |
| Healthcare | 1,990 | 1,510 | 480 |
| Total | 4,435 | 3,348 | 1,087 |
| Commercial Real Estate | | | |
| Death Care Management | 3,901 | 2,305 | 1,596 |
| Healthcare | 10,907 | 6,604 | 4,303 |
| Independent Pharmacies | — | — | — |
| Veterinary Industry | 15,895 | 10,466 | 5,429 |
| Total | 30,703 | 19,375 | 11,328 |
| Total | \$ 52,337 | \$ 35,442 | \$ 16,895 |
| December 31, 2017 | Recorded Investment | Guaranteed Balance | Unguaranteed Exposure |
| Commercial & Industrial | | | |
| Death Care Management | \$ 7 | \$ — | \$ 7 |
| Healthcare | 4,551 | 3,235 | 1,316 |
| Independent Pharmacies | 8,571 | 6,356 | 2,215 |
| Registered Investment Advisors | 733 | — | 733 |
| Veterinary Industry | 2,762 | 2,001 | 761 |
| Total | 16,624 | 11,592 | 5,032 |
| Construction & Development | | | |
| Healthcare | 1,237 | 944 | 293 |
| Total | 1,237 | 944 | 293 |
| Commercial Real Estate | | | |
| Death Care Management | 2,831 | 1,237 | 1,594 |
| Healthcare | 4,315 | 2,967 | 1,348 |
| Independent Pharmacies | 1,562 | 1,562 | — |
| Veterinary Industry | 15,266 | 9,768 | 5,498 |
| Total | 23,974 | 15,534 | 8,440 |
| Commercial Land | | | |
| Agriculture | — | — | — |
| Total | — | — | — |
| Total | \$ 41,835 | \$ 28,070 | \$ 13,765 |

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Notes to Unaudited Consolidated Financial Statements

The following table presents evaluated balances of loans and leases 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 and lease fees or costs.

| | March 31, 2018 | | Total | Unpaid Principal Balance | Related Allowance Recorded |
|---------------------------------|--|----------------------------------|----------|--------------------------------|----------------------------------|
| | Recorded Investment With a Recorded Allowanc | With No Recorded Allowance | | | |
| Commercial & Industrial | | | | | |
| Death Care Management | \$7 | \$ — | \$7 | \$7 | \$ 1 |
| Healthcare | 3,387 | 752 | 4,139 | 4,702 | 186 |
| Independent Pharmacies | 8,933 | 308 | 9,241 | 10,370 | 902 |
| Registered Investment Advisors | 717 | — | 717 | 709 | 480 |
| Veterinary Industry | 3,095 | — | 3,095 | 3,437 | 248 |
| Total | 16,139 | 1,060 | 17,199 | 19,225 | 1,817 |
| Construction & Development | | | | | |
| Agriculture | 2,445 | — | 2,445 | 2,450 | 13 |
| Healthcare | 1,990 | — | 1,990 | 2,013 | 192 |
| Total | 4,435 | — | 4,435 | 4,463 | 205 |
| Commercial Real Estate | | | | | |
| Death Care Management | 3,451 | 450 | 3,901 | 4,016 | 330 |
| Healthcare | 10,532 | 375 | 10,907 | 10,944 | 1,460 |
| Independent Pharmacies | — | — | — | 483 | — |
| Veterinary Industry | 14,363 | 1,532 | 15,895 | 17,215 | 1,189 |
| Total | 28,346 | 2,357 | 30,703 | 32,658 | 2,979 |
| Total Impaired Loans and Leases | \$48,920 | \$ 3,417 | \$52,337 | \$56,346 | \$ 5,001 |

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| | December 31, 2017 | | Total | Unpaid Principal Balance | Related Allowance Recorded |
|---------------------------------|--|----------------------------------|----------|--------------------------------|----------------------------------|
| | Recorded Investment With a Recorded Allowance | With No Recorded Allowance | | | |
| Commercial & Industrial | | | | | |
| Death Care Management | \$— | \$ 7 | \$7 | \$7 | \$ — |
| Healthcare | 3,521 | 1,030 | 4,551 | 5,643 | 165 |
| Independent Pharmacies | 8,154 | 417 | 8,571 | 9,078 | 521 |
| Registered Investment Advisors | 662 | 71 | 733 | 725 | 504 |
| Veterinary Industry | 2,505 | 257 | 2,762 | 3,113 | 182 |
| Total | 14,842 | 1,782 | 16,624 | 18,566 | 1,372 |
| Construction & Development | | | | | |
| Healthcare | 1,237 | — | 1,237 | 1,258 | 157 |
| Total | 1,237 | — | 1,237 | 1,258 | 157 |
| Commercial Real Estate | | | | | |
| Death Care Management | 2,221 | 610 | 2,831 | 2,964 | 260 |
| Healthcare | 3,717 | 598 | 4,315 | 4,332 | 192 |
| Independent Pharmacies | 1,562 | — | 1,562 | 1,933 | 8 |
| Veterinary Industry | 13,711 | 1,555 | 15,266 | 16,584 | 1,075 |
| Total | 21,211 | 2,763 | 23,974 | 25,813 | 1,535 |
| Commercial Land | | | | | |
| Agriculture | — | — | — | 58 | — |
| Total | — | — | — | 58 | — |
| Total Impaired Loans and Leases | \$37,290 | \$ 4,545 | \$41,835 | \$45,695 | \$ 3,064 |

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The following table presents the average recorded investment of impaired loans and leases for each period presented and interest income recognized during the period in which the loans and leases were considered impaired.

| | Three months ended March 31, 2018 | | Three months ended March 31, 2017 | |
|---------------------------------------|--------------------------------------|----------------------------------|--------------------------------------|----------------------------------|
| | Average Balance | Interest Income Recognized | Average Balance | Interest Income Recognized |
| Commercial & Industrial | | | | |
| Death Care Management | \$7 | \$ — | \$112 | \$ 2 |
| Healthcare | 4,263 | 12 | 7,583 | 20 |
| Independent Pharmacies | 9,717 | 20 | 5,690 | 13 |
| Registered Investment Advisors | 720 | 12 | 790 | 12 |
| Veterinary Industry | 3,138 | 20 | 2,394 | 9 |
| Total | 17,845 | 64 | 16,569 | 56 |
| Construction & Development | | | | |
| Agriculture | 2,457 | 5 | — | — |
| Healthcare | 1,976 | 23 | — | — |
| Veterinary Industry | — | — | 1,961 | 9 |
| Total | 4,433 | 28 | 1,961 | 9 |
| Commercial Real Estate | | | | |
| Death Care Management | 3,903 | 37 | 2,544 | 6 |
| Healthcare | 11,057 | 16 | 987 | 12 |
| Independent Pharmacies | 1,080 | — | 1,076 | — |
| Veterinary Industry | 16,108 | 137 | 14,171 | 88 |
| Total | 32,148 | 190 | 18,778 | 106 |
| Commercial Land | | | | |
| Agriculture | — | — | 219 | — |
| Total | — | — | 219 | — |
| Total | \$54,426 | \$ 282 | \$37,527 | \$ 171 |

During the three months ended March 31, 2018, there was one construction and development healthcare loan modified to extend the interest only period. The TDR had a pre-modification and post-modification recorded investment of \$612 thousand. There were no TDRs modified during the three months ended March 31, 2017.

Concessions made to improve a loan and lease's performance have varying degrees of success. No TDRs that were modified within the twelve months ended March 31, 2018 subsequently defaulted during the three months ended March 31, 2018.

During the three months ended March 31, 2017, one TDR that was modified within the twelve months ended March 31, 2017 subsequently defaulted. This TDR was a commercial and industrial healthcare loan that was previously modified for payment deferral. The recorded investment for this TDR at March 31, 2017 was \$107 thousand.

Note 6. Equipment Leasing

The Company purchases new equipment for the purpose of leasing such equipment to customers within its verticals. Equipment purchased to fulfill commitments to commercial renewable energy projects is rented out under operating leases while leases of equipment outside of the renewable energy vertical are generally direct financing leases. Accordingly, leased assets under operating leases are included in premises and equipment while leased assets under direct financing leases are included in loans and leases held for investment.

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Direct Financing Leases

Interest income on direct financing leases is recognized when earned. Unearned interest is recognized over the lease term on a basis which results in a constant rate of return on the unrecovered lease investment. The term of each lease is generally 4-6 years which is consistent with the useful life of the equipment with no residual value. The gross lease payments receivable and the net investment included in accounts receivable for such leases are as follows:

| | As of | |
|--|-----------|--------------|
| | March 31, | December 31, |
| | 2018 | 2017 |
| Gross direct finance lease payments receivable | \$3,692 | \$ 2,399 |
| Less – unearned interest | (589) | (373) |
| Net investment in direct financing leases | \$3,103 | \$ 2,026 |

Future minimum lease payments under finance leases are as follows:

| As of March 31, 2018 | Amount |
|----------------------|----------|
| 2018 | \$ 552 |
| 2019 | 764 |
| 2020 | 754 |
| 2021 | 678 |
| 2022 | 518 |
| Thereafter | 426 |
| Total | \$ 3,692 |

Interest income of \$47 thousand was recognized in the three months ended March 31, 2018.

Operating Leases

The term of each operating lease is generally 10 to 15 years. The Company retains ownership of the equipment and associated tax benefits such as investment tax credits and accelerated depreciation. At the end of the lease term, the lessee has the option to renew the lease for two additional terms or purchase the equipment at the then current fair market value.

Rental revenue from operating leases is recognized over a straight-line basis over the term of the lease. Rental equipment is recorded at cost and depreciated to an estimated residual value on a straight-line basis over the estimated useful life. The useful lives generally range from 20 to 25 years and residual values generally range from 20% to 40%, however, they are subject to periodic evaluation. Changes in useful lives or residual values will impact depreciation expense and any gain or loss from the sale of used equipment. The estimated useful lives and residual values of the Company's leasing equipment are based on industry disposal experience and the Company's expectations for future sale prices.

If the Company decides to sell or otherwise dispose of rental equipment, it is carried at the lower of cost or fair value less costs to sell or dispose. Repair and maintenance costs that do not extend the lives of the rental equipment are charged to direct operating expenses at the time the costs are incurred.

As of March 31, 2018, the Company had a net investment of \$124.6 million in assets included in premises and equipment that are subject to operating leases. Of the net investment, the gross balance of the assets was \$128.5 million and accumulated depreciation was \$3.9 million as of March 31, 2018. Depreciation expense recognized on these assets for the three months ended March 31, 2018 was \$1.7 million.

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A maturity analysis of future minimum lease payments under non-cancelable operating leases is as follows:

| As of March 31, 2018 | Amount |
|----------------------|----------|
| 2018 | \$8,283 |
| 2019 | 6,953 |
| 2020 | 7,002 |
| 2021 | 7,053 |
| 2022 | 7,096 |
| Thereafter | 46,798 |
| Total | \$83,185 |

Note 7. Servicing Assets

Loans serviced for others are not included in the accompanying balance sheet. The unpaid principal balances of loans serviced for others requiring recognition of a servicing asset were \$2.55 billion and \$2.44 billion at March 31, 2018 and December 31, 2017, respectively. The unpaid principal balance for all loans serviced for others was \$2.64 billion and \$2.54 billion at March 31, 2018 and December 31, 2017, respectively.

The following summarizes the activity pertaining to servicing rights:

| | Three Months Ended March 31, | |
|--|------------------------------------|----------|
| | 2018 | 2017 |
| Balance at beginning of period | \$52,298 | \$51,994 |
| Additions, net | 4,874 | 3,382 |
| Fair value changes: | | |
| Due to changes in valuation inputs or assumptions | (819) | 766 |
| Decay due to increases in principal paydowns or runoff | (3,233) | (2,558) |
| Balance at end of period | \$53,120 | \$53,584 |

The fair value of servicing rights was determined using discount rates ranging from 0.0% to 15.3% on March 31, 2018 and 8.6% to 13.4% on March 31, 2017. The fair value of servicing rights was determined using prepayment speeds ranging from 0.0% to 19.9% on March 31, 2018 and 2.8% to 9.9% on March 31, 2017, depending on the stratification of the specific right. Changes to fair value are reported in loan servicing asset 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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Notes to Unaudited Consolidated Financial Statements

Note 8. Borrowings

Total outstanding short and long term borrowings consisted of the following:

| | March 31, 2018 | December 31, 2017 |
|--|----------------------|-------------------------|
| Short term borrowings | | |
| On October 20, 2017, the Company entered into a revolving line of credit of \$20 million with an unaffiliated commercial bank. The note is unsecured and accrues interest at LIBOR plus 1.750% for a term of 12 months. Payments are interest only with all principal and accrued interest due on October 19, 2018. The terms of this loan require the Company to maintain minimum capital and debt service coverage ratios. No advances have been made to this line of credit and there is \$20 million of available credit remaining at March 31, 2018. | \$ — | — |
| Total short term borrowings | \$ — | — |
| | March 31, 2018 | December 31, 2017 |
| 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 were interest only through September 11, 2016 at a fixed rate of 3.95% for a term of 84 months. Monthly principal and interest payments of \$146 thousand began in October 2016 with all principal and accrued interest due on September 11, 2021. This note was repaid in full on January 31, 2018. | \$ — | \$ 22,990 |
| 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, 2018 is 5.50%. The maturity date is October 5, 2019. The pledged collateral is classified in other assets with a fair value of \$3.5 million at March 31, 2018. Underlying loans carry a risk grade of 3 and are current with no delinquencies. | 3,471 | 3,574 |
| On September 18, 2014, the Company entered into a note payable revolving line of credit of \$8.1 million with an unaffiliated commercial bank. On April 18, 2017, the Company renewed and increased the revolving line of credit to \$25 million. The note is unsecured and accrues interest at Prime minus 0.50% for a term of 24 months. Payments are interest only with all principal and accrued interest due on April 30, 2019. The terms of this loan require the Company to maintain minimum capital, liquidity and Texas ratios. This line of credit was paid in full on August 25, 2017, and there is \$25 million of available credit remaining at March 31, 2018. | — | — |
| In October 2017, the Company entered into a capital lease of \$19 thousand with an unaffiliated equipment lease company, secured by fitness equipment which is included in premises and equipment on the consolidated balance sheet. Payments are principal and interest due monthly starting December 15, 2018 over a term of 60 months. At the end of the lease term there is a \$1.00 bargain purchase option. | 18 | — |

Total long term borrowings \$3,489 \$ 26,564

The Company may purchase federal funds through unsecured federal funds lines of credit with various correspondent banks, which totaled \$67.5 million and \$47.5 million as of March 31, 2018 and December 31, 2017, respectively.

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, 2018 and December 31, 2017.

The Company has entered into a repurchase agreement with a third party for \$5 million as of March 31, 2018 and December 31, 2017. 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, 2018 and December 31, 2017.

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Notes to Unaudited Consolidated Financial Statements

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 \$363.6 million and \$348.5 million as of March 31, 2018 and December 31, 2017, respectively. At March 31, 2018 and December 31, 2017, the Company had approximately \$199.2 million and \$189.1 million, respectively, in borrowing capacity available under these arrangements with no outstanding balance as of March 31, 2018 and December 31, 2017.

Note 9. Income Taxes

The Company's effective tax rate is lower than the U.S. statutory rate primarily because of the anticipated effect of investment tax credits during 2018. The Company's effective tax rate in the future will depend on the actual investment tax credits earned as a part of its financing renewable energy applications.

Note 10. 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 U.S. 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. Given the lack of observable market prices for identical properties and market

discounts applied to appraised values, the Company generally classifies foreclosed assets as nonrecurring Level 3.

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Equity warrant assets: Fair value measurements of equity warrant assets of private companies are priced based on a Black-Scholes option pricing model to estimate the asset value by using stated strike prices, option expiration dates, risk-free interest rates and option volatility assumptions. Option volatility assumptions used in the Black-Scholes model are based on public companies that operate in similar industries as the companies in our private company portfolio. Option expiration dates are modified to account for estimates to actual life relative to stated expiration. Values are further adjusted for a general lack of liquidity due to the private nature of the associated underlying company. The Company classifies equity warrant assets within Level 3 of the valuation hierarchy.

Contingent consideration liability: Contingent consideration associated with the acquisition of Reltco will be adjusted to fair value quarterly until settled. The assumptions used to measure fair value are based on internal metrics that are unobservable and therefore the contingent consideration liability is classified within Level 3 of the valuation hierarchy.

Recurring Fair Value

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

| March 31, 2018 | Total | Level 1 | Level 2 | Level 3 |
|--|-----------|---------|------------|----------|
| Investment securities available-for-sale | | | | |
| US government agencies | \$22,432 | \$ | —\$22,432 | \$— |
| Residential mortgage-backed securities | 354,021 | — | 354,021 | — |
| Mutual fund | 2,035 | — | 2,035 | — |
| Servicing assets ¹ | 53,120 | — | — | 53,120 |
| Equity warrant assets | 400 | — | — | 400 |
| Total assets at fair value | \$432,008 | \$ | —\$378,488 | \$53,520 |

| | | | | |
|---|---------|----|------|---------|
| Contingent consideration liability ² | \$1,640 | \$ | —\$— | \$1,640 |
| Total liabilities at fair value | \$1,640 | \$ | —\$— | \$1,640 |

| December 31, 2017 | Total | Level 1 | Level 2 | Level 3 |
|--|-----------|---------|-----------|----------|
| Investment securities available-for-sale | | | | |
| US government agencies | \$22,624 | \$ | —\$22,624 | \$— |
| Residential mortgage-backed securities | 68,696 | — | 68,696 | — |
| Mutual fund | 2,035 | — | 2,035 | — |
| Servicing assets ¹ | 52,298 | — | — | 52,298 |
| Total assets at fair value | \$145,653 | \$ | —\$93,355 | \$52,298 |

| | | | | |
|---|---------|----|------|---------|
| Contingent consideration liability ² | \$1,900 | \$ | —\$— | \$1,900 |
| Total liabilities at fair value | \$1,900 | \$ | —\$— | \$1,900 |

¹ See Note 7 for a rollforward of recurring Level 3 fair values for servicing assets and various assumptions used in the fair value measurement.

Activity for the contingent consideration liability during the three months ended March 31, 2018 consisted of a \$260 thousand negative fair value adjustment. During the three months ended March 31, 2017, \$4.3 million of contingent consideration was recorded upon the acquisition of Reltco as well as a \$200 thousand positive fair value adjustment.

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Notes to Unaudited Consolidated Financial Statements

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, 2018 | Total | Level 1 | Level 2 | Level 3 |
|----------------------------|----------|---------|---------|-----------|
| Impaired loans and leases | \$44,089 | \$ — | \$ — | -\$44,089 |
| Foreclosed assets | 1,519 | — | — | 1,519 |
| Total assets at fair value | \$45,608 | \$ — | \$ — | -\$45,608 |
| December 31, 2017 | Total | Level 1 | Level 2 | Level 3 |
| Impaired loans and leases | \$34,493 | \$ — | \$ — | -\$34,493 |
| Foreclosed assets | 1,281 | — | — | 1,281 |
| Total assets at fair value | \$35,774 | \$ — | \$ — | -\$35,774 |

Level 3 Analysis

For Level 3 assets and liabilities measured at fair value on a recurring or non-recurring basis as of March 31, 2018 and December 31, 2017 the significant unobservable inputs used in the fair value measurements were as follows:

March 31, 2018

| Level 3 Assets with Significant Unobservable Inputs | Fair Value | Valuation Technique | Significant Unobservable Inputs | Range |
|---|------------|---|---|--|
| Impaired loans and leases | \$ 44,089 | Discounted appraisals Discounted expected cash flows | Appraisal adjustments (1) Interest rate & repayment term | 10% to 58% Weighted average discount rate 6.51% |
| Foreclosed assets | \$ 1,519 | Discounted appraisals | Appraisal adjustments (1) Volatility | 10% to 37% |
| Equity warrant assets | \$ 400 | Black-Scholes option pricing model | Risk-free interest rate Marketability discount Remaining life Volatility | 19.53% 2.74% 20% 10 years |
| Contingent consideration liability | \$ 1,640 | Monte Carlo simulation | Risk-free rate of return Dividend yield Remaining life | 25.00% 2.09% 0.43% 2.75 years |

December 31, 2017

| Level 3 Assets with Significant Unobservable Inputs | Fair Value | Valuation Technique | Significant Unobservable Inputs | Range |
|---|------------|---|---|--|
| Impaired loans and leases | \$ 34,493 | Discounted appraisals Discounted expected cash flows | Appraisal adjustments (1) Interest rate & repayment term | 10% to 25% Weighted average discount rate 6.26% |
| Foreclosed assets | \$ 1,281 | Discounted appraisals | Appraisal adjustments (1) | 10% to 37% |
| | \$ 1,900 | Monte Carlo simulation | | |

Contingent consideration
liability

| | |
|-----------------------------|----------------|
| Volatility | 25.00% |
| Risk-free rate of return | 1.43% 0.51% |
| Dividend yield | 3.00 years |
| Remaining life | |

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

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Notes to Unaudited Consolidated Financial Statements

Estimated Fair Value of Other Financial Instruments

GAAP also requires disclosure of the fair value of financial instruments carried at book value on the consolidated balance sheet. The carrying amounts and estimated fair values of the Company's financial instruments are as follows:

| | 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 |
|---|-----------------|--|---|---|------------------|
| March 31, 2018 | | | | | |
| Financial assets | | | | | |
| Cash and due from banks | \$527,952 | \$ 527,952 | \$ — | —\$ | —\$527,952 |
| Certificates of deposit with other banks | 2,250 | 2,239 | — | — | 2,239 |
| Investment securities, available-for-sale | 378,488 | — | 378,488 | — | 378,488 |
| Loans held for sale ⁽¹⁾ | 720,511 | — | — | 738,041 | 738,041 |
| Loans and leases, net of allowance for loan and lease losses ⁽¹⁾ | 1,414,027 | — | — | 1,408,836 | 1,408,836 |
| Servicing assets | 53,120 | — | — | 53,120 | 53,120 |
| Accrued interest receivable | 11,971 | 11,971 | — | — | 11,971 |
| Financial liabilities | | | | | |
| Deposits | 2,973,341 | — | 2,922,279 | — | 2,922,279 |
| Accrued interest payable | 546 | 546 | — | — | 546 |
| Long term borrowings | 3,489 | — | — | 3,515 | 3,515 |
| December 31, 2017 | | | | | |
| Financial assets | | | | | |
| Cash and due from banks | \$295,271 | \$ 295,271 | \$ — | —\$ | —\$295,271 |
| Certificates of deposit with other banks | 3,000 | 2,993 | — | — | 2,993 |
| Investment securities, available-for-sale | 93,355 | — | 93,355 | — | 93,355 |
| Loans held for sale ⁽¹⁾ | 680,454 | — | — | 706,972 | 706,972 |
| Loans and leases, net of allowance for loan and lease losses ⁽¹⁾ | 1,319,783 | — | — | 1,319,615 | 1,319,615 |
| Servicing assets | 52,298 | — | — | 52,298 | 52,298 |
| Accrued interest receivable | 10,160 | 10,160 | — | — | 10,160 |
| Financial liabilities | | | | | |
| Deposits | 2,260,263 | — | 2,232,370 | — | 2,232,370 |
| Accrued interest payable | 367 | 367 | — | — | 367 |
| Long term borrowings | 26,564 | — | — | 27,390 | 27,390 |

In accordance with the adoption of ASU 2016-01, as of March 31, 2018, the fair value of loans and leases were (1) measured using an exit price notion. As of December 31, 2017, the fair value of loans and leases were measured using an entry price notion.

Note 11. Commitments and Contingencies

Litigation

In the normal course of business the Company is involved in various legal proceedings. Management believes that the outcome of such proceedings will not materially affect the financial position, results of operations or cash flows of the Company.

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Notes to Unaudited Consolidated Financial Statements

Financial Instruments with Off-balance-sheet Risk

The Company is party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. These instruments involve, to varying degrees, credit risk in excess of the amount recognized in the balance sheet.

The Company's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual amount of those instruments. The Company uses the same credit policies in making commitments and conditional obligations as for on-balance-sheet instruments. A summary of the Company's commitments is as follows:

| | March 31, 2018 | December 31, 2017 |
|--|-------------------|-------------------------|
| Commitments to extend credit | \$1,448,428 | \$1,701,137 |
| Standby letters of credit | 1,905 | 2,298 |
| Solar purchase commitments | 67,900 | 106,921 |
| Airplane purchase agreement commitments | 25,450 | 25,450 |
| Total unfunded off-balance-sheet credit risk | \$1,543,683 | \$1,835,806 |

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Company evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Company upon extension of credit, is based on management's credit evaluation of the party. Collateral held varies, but may include accounts receivable, inventory, property and equipment, residential real estate and income-producing commercial properties. In 2012, the Company began issuing commitment letters after approval of the loan by the Credit Department. Commitment letters generally expire ninety days after issuance.

Standby letters of credit are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. Collateral held varies as specified above and is required in instances which the Company deems necessary.

Solar purchase commitments are to purchase solar assets to fulfill leasing obligations.

As of March 31, 2018 and December 31, 2017, the Company had unfunded commitments to provide capital contributions for on-balance sheet investments in the amount of \$3.3 million and \$3.5 million, respectively.

Concentrations of Credit Risk

Although the Company is not subject to any geographic concentrations, a substantial amount of the Company's loans, leases, and commitments to extend credit have been granted to customers in the agriculture, healthcare and veterinary verticals. The concentrations of credit by type of loan are set forth in Note 5. The distribution of commitments to extend credit approximates the distribution of loans outstanding. The Company does not have a significant number of credits to any single borrower or group of related borrowers whereby their retained unguaranteed exposure exceeds \$7.5 million, except for eight relationships that have a retained unguaranteed exposure of \$96.7 million of which \$81.7 million of the unguaranteed exposure has been disbursed.

Additionally, the Company has future minimum lease payments due under non-cancelable operating leases totaling \$83.2 million, of which \$63.2 million is due from four relationships.

The Company from time-to-time may have cash and cash equivalents on deposit with financial institutions that exceed federally-insured limits.

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Note 12. Stock Plans

On March 20, 2015, the Company adopted the 2015 Omnibus Stock Incentive Plan which replaced the previously existing Amended Incentive Stock Option Plan and Nonstatutory Stock Option Plan. Subsequently on May 24, 2016, the 2015 Omnibus Stock Incentive Plan was amended to authorize awards covering a maximum of 7,000,000 common voting shares and has an expiration date of March 20, 2025. Options or restricted shares granted under the Amended and Restated 2015 Omnibus Stock Incentive Plan (the "Plan") expire no more than 10 years from the date of grant. Exercise prices under the Plan are set by the Board of Directors at the date of grant, but shall not be less than 100% of fair market value of the related stock at the date of the grant. Options or restricted shares vest over a minimum of three years from the date of the grant.

Stock Options

Compensation cost relating to share-based payment transactions are recognized in the financial statements with measurement based upon the fair value of the equity or liability instruments issued. For the three months ended March 31, 2018 and 2017, the Company recognized \$433 thousand and \$414 thousand in compensation expense for stock options, respectively.

Stock option activity under the Plan during the three month periods ended March 31, 2018 and 2017 is summarized below.

| | Shares | Weighted Average Exercise Price | Weighted Average Remaining Contractual Term | Aggregate Intrinsic Value |
|----------------------------------|-----------|---------------------------------------|---|---------------------------------|
| Outstanding at December 31, 2017 | 3,058,459 | \$ 11.30 | | |
| Exercised | 54,254 | 12.74 | | |
| Forfeited | 57,629 | 14.94 | | |
| Granted | — | — | | |
| Outstanding at March 31, 2018 | 2,946,576 | \$ 11.20 | 6.77 years | \$48,921,416 |
| Exercisable at March 31, 2018 | 806,424 | \$ 9.36 | 6.48 years | \$14,872,227 |
| | Shares | Weighted Average Exercise Price | Weighted Average Remaining Contractual Term | Aggregate Intrinsic Value |
| Outstanding at December 31, 2016 | 3,478,208 | \$ 11.51 | | |
| Exercised | 33,136 | 5.61 | | |
| Forfeited | 149,530 | 13.96 | | |
| Granted | — | — | | |
| Outstanding at March 31, 2017 | 3,295,542 | \$ 11.46 | 7.81 years | \$33,586,061 |
| Exercisable at March 31, 2017 | 604,054 | \$ 8.95 | 7.41 years | \$7,669,515 |

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The following is a summary of non-vested stock option activity for the Company for the three months ended March 31, 2018 and 2017.

| | Shares | Weighted Average Grant Date Fair Value |
|---------------------------------|------------|---|
| Non-vested at December 31, 2017 | 2,364,999 | \$ 4.65 |
| Granted | — | — |
| Vested | (167,218) | 2.86 |
| Forfeited | (57,629) | 7.07 |
| Non-vested at March 31, 2018 | 2,140,152 | 4.83 |

| | Shares | Weighted Average Grant Date Fair Value |
|---------------------------------|------------|---|
| Non-vested at December 31, 2016 | 3,016,100 | \$ 4.78 |
| Granted | — | — |
| Vested | (175,082) | 1.65 |
| Forfeited | (149,530) | 5.94 |
| Non-vested at March 31, 2017 | 2,691,488 | 4.92 |

The total intrinsic value of options exercised at March 31, 2018 and 2017 was \$768 thousand and \$508 thousand, respectively.

At March 31, 2018, unrecognized compensation costs relating to stock options amounted to \$8.0 million which will be recognized over a weighted average period of 2.65 years.

The weighted average fair value of each stock option grant is estimated on the date of grant using the Black-Scholes option-pricing model. The expected volatility is based on historical volatility. The risk-free interest rates for periods within the contractual life of the awards are based on the U.S. Treasury yield curve in effect at the time of the grant. The expected life is based on historical exercise experience. The dividend yield assumption is based on the Company's history and expectation of dividend payouts. There were no stock options granted during the three months ended March 31, 2018 or 2017.

Restricted Stock

Restricted stock awards are authorized in the form of restricted stock awards or units ("RSU"s) and restricted stock awards or units with a market price condition ("Market RSU"s).

RSUs have a restriction based on the passage of time and may also have a restriction based on a non-market-related performance criteria. The fair value of the RSUs is based on the closing price on the date of the grant.

Market RSUs also have a restriction based on the passage of time and non-market-related performance criteria, but also have a restriction based on market price criteria related to the Company's share price closing at or above a specified price ranging from \$34.00 to \$38.00 per share for at least twenty (20) consecutive trading days at any time prior to expiration date. The amount of Market RSUs earned will not exceed 100% of the Market RSUs awarded. The fair value of the Market RSUs and the implied service period is calculated using the Monte Carlo simulation method.

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Live Oak Bancshares, Inc.

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RSU stock activity under the Plan during the first three months of 2018 is summarized below.

| | Shares | Weighted Average Grant Date Fair Value |
|---------------------------------|-----------|--|
| Non-vested at December 31, 2017 | 181,814 | \$ 20.03 |
| Granted | 52,627 | 26.15 |
| Vested | (28,884) | 24.58 |
| Forfeited | (1,010) | 18.51 |
| Non-vested at March 31, 2018 | 204,547 | 20.97 |

For the three months ended March 31, 2018 and 2017, the Company recognized \$915 thousand and \$159 thousand in compensation expense for RSUs, respectively.

At March 31, 2018, unrecognized compensation costs relating to RSUs amounted to \$3.6 million which will be recognized over a weighted average period of 4.70 years.

Market RSU stock activity under the Plan during the first three months of 2018 is summarized below.

| | Shares | Weighted Average Grant Date Fair Value |
|---------------------------------|------------|--|
| Non-vested at December 31, 2017 | 2,532,808 | \$ 8.78 |
| Granted | — | — |
| Vested | — | — |
| Forfeited | (104,218) | 9.07 |
| Non-vested at March 31, 2018 | 2,428,590 | 8.77 |

The compensation expense for Market RSUs is measured based on their grant date fair value as calculated using the Monte Carlo simulation and is recognized on a straight-line basis over the average vesting period. The Monte Carlo simulation used 100,000 simulation paths to assess the expected date of achieving the market price criteria.

For the three months ended March 31, 2018 and 2017, the Company recognized \$972 thousand and \$1.2 million in compensation expense for Market RSUs, respectively.

At March 31, 2018, unrecognized compensation costs relating to Market RSUs amounted to \$14.1 million which will be recognized over a weighted average period of 2.76 years.

Employee Stock Purchase Plan

The Company adopted an Employee Stock Purchase Plan on October 8, 2014. On May 24, 2016, the plan was amended and the Amended and Restated Employee Stock Purchase Plan (the "ESPP") became effective within the meaning of Section 423 of the Internal Revenue Code of 1986, as amended. Under the ESPP, eligible employees are able to purchase available shares with post-tax dollars as of the grant date. In order for employees to be eligible to participate in the ESPP they must be employed or on an authorized leave of absence from the Company or any subsidiary immediately prior to the grant date. ESPP stock purchases cannot exceed \$25 thousand in fair market value per employee per calendar year. Options to purchase shares under the ESPP are granted at a 15% discount to fair market value. Expense recognized in relation to the ESPP for the three months ended March 31, 2018 and 2017 was \$29 thousand and \$43 thousand, respectively.

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Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations

The following presents management’s discussion and analysis of the financial condition and results of operations of Live Oak Bancshares, Inc. (the “Company” or “LOB”). This discussion should be read in conjunction with the financial statements and related notes included elsewhere in this quarterly report on Form 10-Q and with the Company’s Annual Report on Form 10-K for the fiscal year ended December 31, 2017 (the “2017 Annual Report”). Results of operations for the periods included in this quarterly report on Form 10-Q are not necessarily indicative of results to be obtained during any future period.

Important Note Regarding Forward-Looking Statements

This quarterly report on Form 10-Q contains statements that management believes are forward-looking statements, within the meaning of the Private Securities Litigation Reform Act of 1995. These statements generally relate to the Company’s financial condition, results of operations, plans, objectives, future performance or business. They usually can be identified by the use of forward-looking terminology, such as “believes,” “expects,” or “are expected to,” “plans,” “projects,” “goals,” “estimates,” “will,” “may,” “should,” “could,” “would,” “continues,” “intends to,” “outlook” or “anticipate” of these and similar words, or by discussions of strategies that involve risks and uncertainties. You should not place undue reliance on these statements, as they are subject to risks and uncertainties, including but not limited to, those described in this quarterly report on Form 10-Q. When considering these forward-looking statements, you should keep in mind these risks and uncertainties, as well as any cautionary statements management may make. Moreover, you should treat these statements as speaking only as of the date they are made and based only on information actually known to the Company at the time. Management undertakes no obligation to update publicly any forward-looking statements, whether as a result of new information, future events or otherwise. Forward-looking statements contained in this quarterly report on Form 10-Q are based on current expectations, estimates and projections about the Company’s business, management’s beliefs and assumptions made by management. These statements are not guarantees of the Company’s future performance and involve certain risks, uncertainties and assumptions, which are difficult to predict. Therefore, actual outcomes and results may differ materially from what is expressed or forecasted in the forward-looking statements. These risks, uncertainties and assumptions include, without limitation:

- deterioration in the financial condition of borrowers resulting in significant increases in the Company’s loan and lease losses and provisions for those losses and other adverse impacts to results of operations and financial condition;
- changes in Small Business Administration (“SBA”) rules, regulations and loan products, including specifically the Section 7(a) program, changes in SBA standard operating procedures or changes to the status of Live Oak Banking Company (the “Bank”) as an SBA Preferred Lender;
- changes in rules, regulations or procedures for other government loan programs, including those of the United States Department of Agriculture;
- changes in interest rates that affect the level and composition of deposits, loan demand and the values of loan collateral, securities, and interest sensitive assets and liabilities;
- the failure of assumptions underlying the establishment of reserves for possible loan and lease losses;
 - changes in loan underwriting, credit review or loss reserve policies associated with economic conditions, examination conclusions, or regulatory developments;
- a reduction in or the termination of the Company’s ability to use the technology-based platform that is critical to the success of the Company’s business model, including a failure in or a breach of the Company’s operational or security systems or those of its third party service providers;
 - changes in financial market conditions, either internationally, nationally or locally in areas in which the Company conducts operations, including reductions in rates of business formation and growth, demand for the Company’s products and services, commercial and residential real estate development and prices, premiums paid in the secondary market for the sale of loans, and valuation of servicing rights;
- changes in accounting principles, policies, and guidelines applicable to bank holding companies and banking;
- fluctuations in markets for equity, fixed-income, commercial paper and other securities, which could affect availability, market liquidity levels, and pricing;
-

the effects of competition from other commercial banks, non-bank lenders, consumer finance companies, credit unions, securities brokerage firms, insurance companies, money market and mutual funds, and other financial institutions operating in the Company's market area and elsewhere, including institutions operating regionally, nationally and internationally, together with such competitors offering banking products and services by mail, telephone and the Internet;

the Company's ability to attract and retain key personnel;

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changes in governmental monetary and fiscal policies as well as other legislative and regulatory changes, including with respect to SBA lending programs and investment tax credits;

changes in political and economic conditions;

the impact of heightened regulatory scrutiny of financial products and services, primarily led by the Consumer Financial Protection Bureau;

the Company's ability to comply with any requirements imposed on it by regulators, and the potential negative consequences that may result;

operational, compliance and other factors, including conditions in local areas in which the Company conducts business such as inclement weather or a reduction in the availability of services or products for which loan proceeds will be used, that could prevent or delay closing and funding loans before they can be sold in the secondary market;

the effect of any mergers, acquisitions or other transactions, to which the Company or the Bank may from time to time be a party, including management's ability to successfully integrate any businesses acquired;

other risk factors listed from time to time in reports that the Company files with the SEC, including in the Company's 2017 Annual Report; and

the success at managing the risks involved in the foregoing.

Except as otherwise disclosed, forward-looking statements do not reflect: (i) the effect of any acquisitions, divestitures or similar transactions that have not been previously disclosed; (ii) any changes in laws, regulations or regulatory interpretations; or (iii) any change in current dividend or repurchase strategies, in each case after the date as of which such statements are made. All forward-looking statements speak only as of the date on which such statements are made, and the Company undertakes no obligation to update any statement, to reflect events or circumstances after the date on which such statement is made or to reflect the occurrence of unanticipated events.

Amounts in all tables in Management's Discussion and Analysis of Financial Condition and Results of Operations have been presented in thousands, except percentage, time period, stock option, share and per share data or where otherwise indicated.

Nature of Operations

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 incorporated in February 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 selected industry sectors, or verticals, by leveraging expertise within those industries. A significant portion of the loans originated by the Bank are guaranteed by the SBA under its 7(a) program. In 2010, the Bank formed Live Oak Number One, Inc., a wholly-owned subsidiary, to hold properties foreclosed on by the Bank.

Effective July 29, 2016, the Company elected to become a "financial holding company" within the meaning of the Bank Holding Company Act. A financial holding company, and the nonbank companies under its control, are permitted to engage in activities considered financial in nature or incidental to financial activities. For the Company to become and remain eligible for financial holding company status, it and the Bank must meet certain criteria, including capital, management and Community Reinvestment Act ("CRA") requirements. The failure to meet such criteria could, depending on which requirements were not met, result in the Company facing restrictions on new financial activities or acquisitions or being required to discontinue existing activities that are not otherwise permissible for bank holding companies.

In 2017, the Bank entered into a joint venture, Apiture LLC ("Apiture"), with First Data Corporation for the purpose of creating next generation technology for financial institutions. In addition to the Bank, the Company owns Reltco Inc. and National Assurance Title, Inc. (collectively referred to as ("Reltco") which were acquired on February 1, 2017; Live Oak Clean Energy Financing LLC, formed in November 2016, for the purpose of providing financing to entities for renewable energy applications; Canapi, Inc. (formerly known as "Live Oak Ventures, Inc."), formed in August 2016, for the purpose of investing in businesses that align with the Company's strategic initiative to be a leader in financial technology; 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 U.S. Department of Agriculture ("USDA")-guaranteed loans; and 504 Fund Advisors, LLC ("504FA"), which was formed to serve as the investment advisor to The 504 Fund, a closed-end mutual fund organized to invest in SBA section 504 loans.

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The Company generates revenue primarily from the sale of SBA-guaranteed loans and USDA guaranteed Rural Energy for America Program ("REAP") and Business & Industry ("B&I") loans and net interest income. Income from the sale of loans is comprised of loan servicing revenue and revaluation of related servicing assets and net gains on sales of loans. Offsetting these revenues are the cost of funding sources, provision for loan and lease 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.

On July 23, 2015 the Company closed on its initial public offering with a secondary offering completed in August of 2017.

Business Outlook

Below is a discussion of management's current expectations regarding company performance over the near-term based on market conditions, the regulatory environment and business strategies as of the time the Company filed this Report. Actual outcomes and results may differ materially from what is expressed or forecasted in these forward-looking statements. See "Important Note Regarding Forward-Looking Statements" in this Report for more information on forward-looking statements.

The Company expects the loan and lease portfolio to continue to grow and to maintain an effective tax rate in the very low single digit range for the full year of 2018.

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Results of Operations

Performance Summary

Three months ended March 31, 2018 compared with three months ended March 31, 2017

For the three months ended March 31, 2018, the Company reported net income of \$12.5 million, or \$0.30 per diluted share, as compared to \$6.1 million, or \$0.17 per diluted share, for the three months ended March 31, 2017. This increase in net income is primarily due to the following items:

- Increased net interest income of \$8.8 million, or 56.5%, predominately driven by significant growth in the combined held for sale and held for investment loan and lease portfolios;

Increased net gains on sales of loans of \$5.5 million, or 28.8%, as a result of increased loan sales combined with improving premiums; and

Revenues of \$1.6 million from lease activities that began in the second quarter of 2017.

Partially offsetting the above factors were increases in the various cost factors as follows: \$2.9 million in the provision expense for loan and lease losses, \$3.0 million in the loan servicing asset revaluation loss, \$1.5 million in salaries and employee benefits, \$1.1 million in data processing expense, and \$2.0 million in equipment expense.

Net Interest Income and Margin

Net interest income represents the difference between the income that the Company earns on interest-earning assets and the cost it incurs on interest-bearing liabilities. The Company's net interest income depends upon the volume of interest-earning assets and interest-bearing liabilities and the interest rates that the Company earns or pays on them. Net interest income is affected by changes in the amount and mix of interest-earning assets and interest-bearing liabilities, referred to as "volume changes." It is also affected by changes in yields earned on interest-earning assets and rates paid on interest-bearing deposits and other borrowed funds, referred to as "rate changes." Without a branch network, the Bank generates deposits over the Internet and in the community in which it is headquartered. Due to the nature of a branchless bank and the relatively low overhead required for deposit gathering, the rates that the Bank offers are generally above the industry average.

Three months ended March 31, 2018 compared with three months ended March 31, 2017

For the three months ended March 31, 2018, net interest income increased \$8.8 million, or 56.5%, to \$24.5 million compared to \$15.6 million for the three months ended March 31, 2017. This increase was principally due to the significant growth in average interest earning assets and to a lesser extent by higher yields on these assets which outpaced the growth and change in the cost of interest bearing liabilities. Average interest earning assets increased by \$984.9 million, or 58.4%, to \$2.67 billion for the three months ended March 31, 2018, compared to \$1.69 billion for the three months ended March 31, 2017, while the yield on average interest earning assets increased forty-one basis points to 5.32%. The cost of funds on interest bearing liabilities for the three months ended March 31, 2018 increased forty-six basis points to 1.70%, and the average balance of interest bearing liabilities increased by \$957.2 million, or 61.3%, over the same period in 2017. As indicated in the rate/volume table below, the increase in interest bearing liabilities and corresponding cost of funds was outpaced by the positive effects of the increased volume of interest earning assets along with an improving yield, resulting in increased interest income of \$14.6 million and increased interest expense of \$5.8 million for the three months ended March 31, 2018 compared to the three months ended March 31, 2017. For the three months ended March 31, 2018 compared to the three months ended March 31, 2017, net interest margin declined from 3.76% to 3.72%, respectively, principally due to the narrowing of the interest rate spread during the quarter. This short-term compression of the spread was largely the result of strategic liquidity initiatives which were accomplished during the first quarter of 2018.

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Average Balances and Yields. The following table presents information regarding average balances for assets and liabilities, the total dollar amounts of interest income and dividends from average interest-earning assets, the total dollar amount of interest expense on average interest-bearing liabilities, and the resulting average yields and costs. The yields and costs for the periods indicated are derived by dividing the income or expense by the average balances for assets or liabilities, respectively, for the periods presented and annualizing that result. Loan fees are included in interest income on loans.

| | Three months ended March 31, | | | | | |
|--|------------------------------|----------|--------------------|-----------------|----------|--------------------|
| | 2018 | | | 2017 | | |
| | Average Balance | Interest | Average Yield/Rate | Average Balance | Interest | Average Yield/Rate |
| Interest earning assets: | | | | | | |
| Interest earning balances in other banks | \$354,028 | \$1,215 | 1.39 % | \$194,176 | \$342 | 0.71 % |
| Investment securities | 181,900 | 1,117 | 2.49 | 71,075 | 323 | 1.84 |
| Loans held for sale | 727,696 | 11,046 | 6.16 | 466,567 | 6,521 | 5.67 |
| Loans and leases held for investment ⁽¹⁾ | 1,408,112 | 21,645 | 6.23 | 955,021 | 13,233 | 5.62 |
| Total interest earning assets | 2,671,736 | 35,023 | 5.32 | 1,686,839 | 20,419 | 4.91 |
| Less: allowance for loan and lease losses | (24,219) | | | (18,199) | | |
| Non-interest earning assets | 396,920 | | | 167,644 | | |
| Total assets | \$3,044,437 | | | \$1,836,284 | | |
| Interest bearing liabilities: | | | | | | |
| Interest bearing checking | \$43,597 | \$103 | 0.96 % | \$44,351 | \$65 | 0.59 % |
| Savings | 822,266 | 3,118 | 1.54 | — | — | — |
| Money market accounts | 168,954 | 521 | 1.25 | 479,545 | 948 | 0.80 |
| Certificates of deposit | 1,473,054 | 6,676 | 1.84 | 1,009,915 | 3,530 | 1.42 |
| Total deposits | 2,507,871 | 10,418 | 1.68 | 1,533,811 | 4,543 | 1.20 |
| Other borrowings | 11,228 | 129 | 4.66 | 28,068 | 235 | 3.40 |
| Total interest bearing liabilities | 2,519,099 | 10,547 | 1.70 | 1,561,879 | 4,778 | 1.24 |
| Non-interest bearing deposits | 56,596 | | | 28,686 | | |
| Non-interest bearing liabilities | 19,022 | | | 22,042 | | |
| Shareholders' equity | 449,720 | | | 223,677 | | |
| Total liabilities and shareholders' equity | \$3,044,437 | | | \$1,836,284 | | |
| Net interest income and interest rate spread | | \$24,476 | 3.62 % | | \$15,641 | 3.67 % |
| Net interest margin | | | 3.72 | | | 3.76 |
| Ratio of average interest-earning assets to average interest-bearing liabilities | | | 106.06 % | | | 108.00 % |

(1) Average loan and lease balances include non-accruing loans.

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Rate/Volume Analysis. The following table sets forth the effects of changing rates and volumes on net interest income. The rate column shows the effects attributable to changes in rate (changes in rate multiplied by prior volume). The volume column shows the effects attributable to changes in volume (changes in volume multiplied by prior rate). The total column represents the sum of the prior columns. For purposes of this table, increases or decreases attributable to changes in both rate and volume that cannot be segregated have been allocated proportionally based on the changes due to rate and the changes due to volume.

| | Three months ended March 31, 2018 vs. 2017 | | |
|--|--|---------|---------|
| | Increase (Decrease) Due to | | |
| | Rate | Volume | Total |
| Interest income: | | | |
| Interest earning balances in other banks | \$458 | \$415 | \$873 |
| Investment securities | 202 | 592 | 794 |
| Loans held for sale | 718 | 3,807 | 4,525 |
| Loans and leases held for investment | 1,791 | 6,621 | 8,412 |
| Total interest income | 3,169 | 11,435 | 14,604 |
| Interest expense: | | | |
| Interest bearing checking | 39 | (1) | 38 |
| Savings | — | 3,118 | 3,118 |
| Money market accounts | 359 | (786) | (427) |
| Certificates of deposit | 1,287 | 1,859 | 3,146 |
| Other borrowings | 61 | (167) | (106) |
| Total interest expense | 1,746 | 4,023 | 5,769 |
| Net interest income | \$1,423 | \$7,412 | \$8,835 |

Provision for Loan and Lease Losses

The provision for loan and lease losses represents the amount necessary to be charged against the current period's earnings to maintain the allowance for loan and lease losses at a level that is appropriate in relation to the estimated losses inherent in the loan and lease portfolio. A number of factors are considered in determining the required level of loan and lease loss reserves and the provision required to achieve the appropriate reserve level, including loan and lease growth, credit risk rating trends, nonperforming loan and lease levels, delinquencies, loan and lease portfolio concentrations and economic and market trends.

Losses inherent in loan relationships are mitigated if a portion of the loan is guaranteed by the SBA or USDA. A typical SBA 7(a) loan carries a 75% guarantee while USDA guarantees range from 60% to 80% depending on loan size, which reduces the risk profile of these loans. The Company believes that its focus on compliance with regulations and guidance from the SBA and USDA are key factors to managing this risk.

The provision for loan and lease losses for the first quarter of 2018 was \$4.4 million compared to \$1.5 million for the same period in 2017, an increase of \$2.9 million, or 193.0%, largely driven by overall loan and lease growth and loans classified as Risk Grade 5 combined with higher specific reserve requirements.

Loans and leases held for investment of \$1.44 billion as of March 31, 2018 increased by \$442.8 million, or 44.3%, compared to March 31, 2017. This growth was fueled by strong loan origination volumes combined with continued disbursements for loans in the construction portfolio and related balance sheet retention over the past year.

Net charge-offs were \$532 thousand, or 0.15% of average quarterly loans and leases held for investment on an annualized basis, for the three months ended March 31, 2018, compared to net charge-offs of \$1.5 million, or 0.63%, for the three months ended March 31, 2017. Net charge-offs are a key element of historical experience in the Company's estimation of the allowance for loan and lease losses.

In addition, at March 31, 2018, nonperforming loans and leases not guaranteed by the SBA totaled \$7.4 million, which was 0.51% of the held-for-investment loan and lease portfolio compared to \$3.6 million, or 0.36% of loans and leases held for investment at March 31, 2017.

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Noninterest Income

Noninterest income is principally comprised of net gains from the sale of SBA and USDA-guaranteed loans along with loan servicing revenue and revaluation. Revenue from the sale of loans depends upon the volume, maturity structure and rates of underlying loans as well as the pricing and availability of funds in the secondary markets prevailing in the period between completed loan funding and closing of sale. In addition, the loan servicing revaluation is significantly impacted by changes in market rates and other underlying assumptions such as prepayment speeds and default rates. Noninterest income also commonly includes lease income, construction supervision fee income and title insurance income. Other less common elements of noninterest income include nonrecurring gains and losses on investments.

The following table shows the components of noninterest income and the dollar and percentage changes for the periods presented.

| | Three Months Ended | | Increase (Decrease) | |
|-------------------------------------|--------------------|----------------|---------------------|----------|
| | March 31, 2018 | March 31, 2017 | Amount | Percent |
| Noninterest income | | | | |
| Loan servicing revenue | \$6,898 | \$5,923 | \$975 | 16.46 % |
| Loan servicing asset revaluation | (5,088) | (2,009) | (3,079) | (153.26) |
| Net gains on sales of loans | 24,418 | 18,952 | 5,466 | 28.84 |
| Lease income | 1,608 | — | 1,608 | 100.00 |
| Construction supervision fee income | 779 | 429 | 350 | 81.59 |
| Title insurance income | 1,300 | 1,438 | (138) | (9.60) |
| Other noninterest income | 841 | 1,020 | (179) | (17.55) |
| Total noninterest income | \$30,756 | \$25,753 | \$5,003 | 19.43 % |

For the three months ended March 31, 2018, noninterest income increased by \$5.0 million, or 19.4%, compared to the three months ended March 31, 2017. The increase from the prior year is primarily the result of net gains on sales of loans increasing \$5.5 million to \$24.4 million in the first quarter of 2018 compared to \$19.0 million in the first quarter of 2017, as a function of higher volume of guaranteed loans sales coupled with an improvement in the average net gain on sale of guaranteed loans. Lease income of \$1.6 million related to renewable energy initiatives and increased loan servicing revenues of \$975 thousand arising from growth in the serviced loan portfolio also contributed to higher levels of noninterest income in the first quarter of 2018. Partially offsetting the overall increase in noninterest income was a higher negative loan servicing revaluation adjustment of \$3.1 million.

The following table reflects loan and lease production, sales of guaranteed loans and the aggregate balance in guaranteed loans sold. These components are key drivers of the Company's noninterest income.

| | Three months ended | | For years ended December 31, | | | |
|---|--------------------|----------------|------------------------------|-------------|-------------|-----------|
| | March 31, 2018 | March 31, 2017 | 2017 | 2016 | 2015 | 2014 |
| Amount of loans and leases originated | \$397,559 | \$468,663 | \$1,934,238 | \$1,537,010 | \$1,158,640 | \$848,090 |
| Guaranteed portions of loans sold | 247,243 | 208,715 | 787,926 | 761,933 | 640,886 | 433,912 |
| Outstanding balance of guaranteed loans sold ⁽¹⁾ | 2,812,108 | 2,410,791 | 2,680,641 | 2,278,618 | 1,779,989 | 1,302,828 |

(1) This represents the outstanding principal balance of guaranteed loans serviced, as of the last day of the applicable period, which have been sold into the secondary market.

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Changes in various components of noninterest income are discussed in more detail below.

Loan Servicing Revenue: While portions of the loans that the Bank originates are sold and generate gain on sale revenue, servicing rights for all loans that the Bank originates, including loans sold, are retained by the Bank. In exchange for continuing to service loans that are sold, the Bank receives fee income represented in loan servicing revenue equivalent to one percent of the outstanding balance of SBA loans sold and 0.40% of the outstanding balance of USDA loans sold. In addition, the cost of servicing sold loans is approximately 0.40% of the balance of the loans sold, which is included in the loan servicing revaluation computations. Unrecognized servicing revenue is reflected in a servicing asset recorded on the balance sheet. Revenues associated with the servicing of loans are recognized over the expected life of the loan through the income statement, and the servicing asset is reduced as this revenue is recognized. For three months ended March 31, 2018, loan servicing revenue increased \$975 thousand, or 16.5%, to \$6.9 million as compared to the three months ended March 31, 2017, as a result of an increase in the average outstanding balance of guaranteed loans sold. At March 31, 2018, the outstanding balance of government guaranteed loans sold in the secondary market was \$2.81 billion. At March 31, 2017, the outstanding balance of SBA guaranteed loans sold was \$2.41 billion.

Loan Servicing Revaluation: The Company revalues its serviced loan portfolio at least quarterly. The revaluation considers the amortization of the portfolio, current market conditions for loan sale premiums, and current prepayment speeds. For the three months ended March 31, 2018, there was a net negative loan servicing revaluation adjustment of \$5.1 million compared to a net negative revaluation adjustment of \$2.0 million for the three months ended March 31, 2017. The higher negative loan servicing revaluation amount for the first quarter of 2018 as compared to the first quarter of 2017 was principally driven by amortization of the serviced portfolio during that period.

Net Gains on Sale of Loans: For the three months ended March 31, 2018, net gains on sales of loans increased \$5.5 million, or 28.8% compared to the three months ended March 31, 2017. For the three months ended March 31, 2018, the volume of guaranteed loans sold increased \$38.5 million, or 18.5%, to \$247.2 million from \$208.7 million for the three months ended March 31, 2017. The average net gain on sale of loans for the three months ended March 31, 2018 was higher at \$99 thousand of revenue for each \$1 million in loans sold compared to \$91 thousand of revenue for each \$1 million in loans sold for the three months ended March 31, 2017.

Noninterest Expense

Noninterest expense comprises all operating costs of the Company, such as employee related costs, travel, professional services, advertising and marketing expenses, exclusive of interest and income tax expense.

The following table shows the components of noninterest expense and the related dollar and percentage changes for the periods presented.

| | Three Months | | Increase (Decrease) | | |
|--|----------------------------|----------|---------------------|---------|---|
| | Ended March 31, 2018 | 2017 | Amount | Percent | |
| Noninterest expense | | | | | |
| Salaries and employee benefits | \$20,209 | \$18,682 | \$1,527 | 8.17 | % |
| Non-staff expenses: | | | | | |
| Travel expense | 1,843 | 1,598 | 245 | 15.33 | |
| Professional services expense | 1,298 | 1,736 | (438) | (25.23) |) |
| Advertising and marketing expense | 1,662 | 1,485 | 177 | 11.92 | |
| Occupancy expense | 1,857 | 1,195 | 662 | 55.40 | |
| Data processing expense | 2,837 | 1,696 | 1,141 | 67.28 | |
| Equipment expense | 3,077 | 1,074 | 2,003 | 186.50 | |
| Other loan origination and maintenance expense | 1,329 | 1,005 | 324 | 32.24 | |
| FDIC insurance | 572 | 726 | (154) | (21.21) |) |
| Title insurance closing services expense | 426 | 405 | 21 | 5.19 | |
| Other expense | 2,962 | 3,383 | (421) | (12.44) |) |

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| | | | | | |
|---------------------------|----------|----------|---------|-------|---|
| Total non-staff expenses | 17,863 | 14,303 | 3,560 | 24.89 | |
| Total noninterest expense | \$38,072 | \$32,985 | \$5,087 | 15.42 | % |

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Total noninterest expense for the three months ended March 31, 2018 increased \$5.1 million, or 15.4% compared to the same period in 2017. The increase in noninterest expense was principally comprised of increased personnel, occupancy, data processing and equipment expense driven by the significant growth of the Company's core business. Changes in various components of noninterest expense are discussed below.

Salaries and employee benefits: Total personnel expense for the three months ended March 31, 2018 increased by \$1.5 million, or 8.2%, compared to the same period in 2017. Primary drivers for this increase was the incremental personnel costs arising from the acquisition of a nationwide title insurance business on February 1, 2017 combined with the continued investment in human capital to support the growing loan and lease production from new and existing verticals. Total full-time equivalent employees increased from 476 at March 31, 2017 to 517 at March 31, 2018. Salaries and employee benefits expense included \$2.3 million and \$1.8 million of stock-based compensation in the three months ended March 31, 2018 and 2017, respectively. Expenses related to the employee stock purchase program, stock grants, stock option compensation and restricted stock expense are all considered stock-based compensation.

Of the total stock-based compensation, \$352 thousand and \$346 thousand for the first quarters of 2018 and 2017, respectively, was related to restricted stock unit ("RSU") awards for key employee retention with an effective grant date of May 24, 2016.

Occupancy expense: For the three months ended March 31, 2018, total occupancy processing expense increased \$662 thousand, or 55.4%, compared to the same period in 2017. This increase was driven by continued investment in facilities and infrastructure to support the Company's growth initiatives.

Data processing expense: For the three months ended March 31, 2018, total data processing expense increased \$1.1 million, or 67.3%, compared to the same period in 2017. Largely influencing this increase in data processing was the contribution of software development resources to Apiture which transferred the recognition of costs associated with the Company's technology development from salaries and employee benefits to data processing.

Equipment expense: For the three months ended March 31, 2018, the total costs associated with equipment increased \$2.0 million, or 186.5%, compared to the same period in 2017. A major factor behind this increase was the higher level of depreciation related to solar panels acquired to meet leasing commitments.

Income Tax Expense

The effective tax rate for the three months ended March 31, 2018 was 2.5% compared to the effective rate of 11.5% for the three months ended March 31, 2017. The tax rate principally reflected the generation of investment tax credits by the solar panel leasing activity under the Company's strategic initiatives in the renewable energy sector.

Discussion and Analysis of Financial Condition

March 31, 2018 vs. December 31, 2017

Total assets at March 31, 2018 were \$3.46 billion, an increase of \$702.4 million, or 25.5%, compared to total assets of \$2.76 billion at December 31, 2017. The growth in total assets was principally driven by the following:

- Increased cash and due from banks due largely to the significant growth from deposit gathering campaigns to strengthen the liquidity profile generating \$713.1 million in new deposits;
- Increased investment in securities available-for-sale of \$285.1 million which was driven by the Company's strategic plan to enhance contingency funding sources;
 - Growth in loan and lease originations combined with longer retention times of loans held for sale, comprised largely of loans intentionally held for longer periods and those in newer verticals which require a period of loan advances to become fully funded prior to being sold; and
- Increased premises and equipment related primarily to expansion of facilities to accommodate Company growth and the addition of solar panels to meet leasing commitments.

Cash and cash equivalents were \$528.0 million at March 31, 2018, an increase of \$232.7 million, or 78.8%, compared to \$295.3 million at December 31, 2017. This increase primarily reflected the results of a successful deposit gathering campaigns.

Total investment securities increased \$285.1 million during the first three months of 2018, from \$93.4 million at December 31, 2017, to \$378.5 million at March 31, 2018, an increase of 305.4%. The Company purchased \$293.0

million in residential mortgage-backed securities during the first quarter of 2018 as part of the aforementioned strategic plan to enhance contingent funding sources. The investment portfolio is comprised of U.S. government agency securities, residential mortgage-backed securities and a mutual fund.

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Loans held for sale increased \$40.1 million, or 5.9%, during the first three months of 2017, from \$680.5 million at December 31, 2017, to \$720.5 million at March 31, 2017. The increase was primarily the result of loan origination activities during the quarter and the strategy to enhance interest income by increasing the retention time of guaranteed loans along with growth in certain loans that take time to fully fund.

Loans and leases held for investment increased \$98.1 million, or 7.3%, during the first three months of 2018, from \$1.34 billion at December 31, 2017, to \$1.44 billion at March 31, 2018. The increase was primarily the result of continued loan and lease growth from origination activities during the first quarter of 2018 combined with greater retention of loans on the consolidated balance sheet.

Premises and equipment, net increased \$38.0 million, or 21.3%, during the first three months of 2018. This increase was primarily driven by construction of new facilities to accommodate Company growth and the addition of solar panels to meet leasing commitments.

Servicing assets increased \$822 thousand, or 1.6%, during the first three months of 2018, from \$52.3 million at December 31, 2017, to \$53.1 million at March 31, 2018. The increase in servicing assets is primarily the result of loan sales outpacing the amortization of the existing serviced portfolio.

Other assets increased \$11.9 million, or 8.9%, during the first three months of 2018, from \$134.2 million at December 31, 2017 to \$146.2 million at March 31, 2018. The increase in other assets was primarily comprised of \$1.2 million in SBA related receivables, \$3.4 million in guarantee fees receivable and a \$3.0 million cost method investment by Canapi in a financial services startup.

Total deposits were \$2.97 billion at March 31, 2018, an increase of \$713.1 million, or 31.5%, from \$2.26 billion at December 31, 2017. The increase in deposits was driven by success of deposit gathering campaigns to support the growth in loan and lease originations and strategic liquidity initiatives.

Long term borrowings decreased \$23.1 million, or 86.9%, during the first three months of 2018, from \$26.6 million at December 31, 2017 to \$3.5 million at March 31, 2018. The decrease in long term borrowings was primarily the result of debt reduction following a successful capital raise in the third quarter of 2017.

Shareholders' equity at March 31, 2018 was \$448.8 million as compared to \$436.9 million at December 31, 2017. The book value per share was \$11.23 at March 31, 2018 compared to \$10.95 at December 31, 2017. Average equity to average assets was 14.8% for the three months ended March 31, 2018 compared to 13.5% for the year ended December 31, 2017. The increase in shareholders' equity was principally the result of net income to common shareholders for the three months ended March 31, 2018 of \$12.5 million combined with stock-based compensation expense of \$2.3 million, partially offset by other comprehensive losses of \$2.2 million and \$1.2 million in dividends.

Asset Quality

Management considers asset quality to be of primary importance. A formal loan review function, independent of loan origination, is used to identify and monitor problem loans. This function reports directly to the Audit & Risk Committee of the Board of Directors.

Nonperforming Assets

The Bank places loans on nonaccrual status when they become 90 days past due as to principal or interest payments, or prior to that if management has determined based upon current information available to them that the timely collection of principal or interest is not probable. When a loan is placed on nonaccrual status, any interest previously accrued as income but not actually collected is reversed and recorded as a reduction of loan interest and fee income. Typically, collections of interest and principal received on a nonaccrual loan are applied to the outstanding principal as determined at the time of collection of the loan.

Troubled debt restructurings occur when, because of economic or legal reasons pertaining to the debtor's financial difficulties, debtors are granted concessions that would not otherwise be considered. Such concessions would include, but are not limited to, the transfer of assets or the issuance of equity interests by the debtor to satisfy all or part of the debt, modification of the terms of debt or the substitution or addition of debtor(s).

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The following table provides information with respect to nonperforming assets and troubled debt restructurings at the dates indicated.

| | March 31, 2018 | December 31, 2017 | | March 31, 2018 | December 31, 2017 |
|---|-------------------|----------------------|-----------|-------------------|----------------------|
| Nonperforming assets: | | | | | |
| Total nonperforming loans (all on nonaccrual) | \$36,776 | \$ 23,480 | | | |
| Total accruing loans past due 90 days or more | — | — | | | |
| Foreclosed assets | 1,519 | 1,281 | | | |
| Total troubled debt restructurings | 11,516 | 10,223 | | | |
| Less nonaccrual troubled debt restructurings | (9,069) | (8,129) | | | |
| Total performing troubled debt restructurings | 2,447 | 2,094 | | | |
| Total nonperforming assets and troubled debt restructurings | \$40,742 | \$ 26,855 | | | |
| Total nonperforming loans to total loans and leases held for investment | 2.55 | % 1.75 | % | | |
| Total nonperforming loans to total assets | 1.06 | % 0.85 | % | | |
| Total nonperforming assets and troubled debt restructurings to total assets | 1.18 | % 0.97 | % | | |
| Nonperforming assets guaranteed by U.S. government: | | | | | |
| Total nonperforming loans guaranteed by the SBA (all on nonaccrual) | | \$29,390 | \$ 19,870 | | |
| Total accruing loans past due 90 days or more guaranteed by the SBA | | — | — | | |
| Foreclosed assets guaranteed by the SBA | | 1,418 | 1,191 | | |
| Total troubled debt restructurings guaranteed by the SBA | | 8,374 | 7,178 | | |
| Less nonaccrual troubled debt restructurings guaranteed by the SBA | | (7,849) | (7,099) | | |
| Total performing troubled debt restructurings guaranteed by SBA | | 525 | 79 | | |
| Total nonperforming assets and troubled debt restructurings guaranteed by the SBA | | \$31,333 | \$ 21,140 | | |
| Total nonperforming loans not guaranteed by the SBA to total held for investment loans and leases | | 0.51 | % 0.27 | % | |
| Total nonperforming loans not guaranteed by the SBA to total assets | | 0.21 | % 0.13 | % | |
| Total nonperforming assets and troubled debt restructurings not guaranteed by the SBA to total assets | | 0.27 | % 0.21 | % | |

Total nonperforming assets and troubled debt restructurings at March 31, 2018 were \$40.7 million, which represented a \$13.9 million, or 51.7%, increase from December 31, 2017. Total nonperforming assets at March 31, 2018 were comprised of \$36.8 million in nonaccrual loans and \$1.5 million in foreclosed assets. Of the \$40.7 million of nonperforming assets and troubled debt restructurings ("TDRs"), \$31.3 million carried an SBA guarantee, leaving an unguaranteed exposure of \$9.4 million in total nonperforming assets and TDRs at March 31, 2018. The unguaranteed exposure in total nonperforming assets and TDRs at December 31, 2017 was \$5.7 million. Unguaranteed exposure relating to nonperforming assets and TDRs at March 31, 2018 increased by \$3.7 million, or 64.6%, compared to December 31, 2017.

As a percentage of the Bank's total capital, nonperforming loans represented 10.4% at March 31, 2018, compared to nonperforming loans of 7.8% of the Bank's total capital at December 31, 2017. Adjusting the ratio to include only the unguaranteed portion of nonperforming loans to reflect management's belief that the greater magnitude of risk resides in this portion, the ratios at March 31, 2018 and December 31, 2017 were 2.1% and 1.2%, respectively.

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As of March 31, 2018 and December 31, 2017, potential problem and impaired loans and leases totaled \$105.1 million and \$76.8 million, respectively. Risk Grades 5 through 8 represent the spectrum of criticized and impaired loans and leases. At March 31, 2018, the portion of criticized loans and leases guaranteed by the SBA of USDA totaled \$46.4 million resulting in unguaranteed exposure risk of \$58.7 million, or 4.4% of total held for investment unguaranteed exposure. This compares to the December 31, 2017 portion of criticized loans and leases guaranteed by the SBA or USDA which totaled \$34.7 million resulting in unguaranteed exposure risk of \$42.1 million, or 3.4% of total held for investment unguaranteed exposure. As of March 31, 2018 loans and leases in Healthcare, Veterinary and Independent Pharmacies industry verticals comprise the largest portion of the total potential problem and impaired loans at 30.1%, 22.5% and 14.7%, respectively. As of December 31, 2017 loans in the Healthcare and Veterinary industries comprise the largest portion of the total potential problem and impaired loans and leases at 30.0% and 27.3%, respectively. No systemic issues were identified in the first quarter increase in potential problem and impaired loans and leases which were comprised of a relatively small number of borrowers in our most mature verticals. Furthermore, the Company believes that its underwriting and credit quality standards have improved as the business has matured.

The Bank does not classify loans and leases that experience insignificant payment delays and payment shortfalls as impaired. The Bank considers an “insignificant period of time” from payment delays to be a period of 90 days or less. The Bank would consider a modification for a customer experiencing what is expected to be a short-term event that has temporarily impacted cash flow. This could be due, among other reasons, to illness, weather, impact from a one-time expense, slower than expected start-up, construction issues or other short-term issues. In all cases, credit will review the request to determine if the customer is stressed and how the event has impacted the ability of the customer to repay the loan or lease long term. To date, the only types of short term modifications the Bank has given are payment deferral and interest only extensions. The Bank does not typically alter the rate or lengthen the amortization of the note due to insignificant payment delays. Short term modifications are not classified as TDRs, because they do not meet the definition set by the applicable accounting standards and the Federal Deposit Insurance Corporation. Management endeavors to be proactive in its approach to identify and resolve problem loans and leases and is focused on working with the borrowers and guarantors of these loans and leases to provide loan and lease modifications when warranted. Management implements a proactive approach to identifying and classifying loans and leases as criticized, Risk Grade 5. For example, at March 31, 2018 and December 31, 2017, Risk Grade 5 loans and leases totaled \$57.3 million and \$37.0 million, respectively. The increase in Risk Grade 5 loans from December 31, 2017 to March 31, 2018 was principally confined to three verticals; Government Contracting (\$12.8 million or 63.0% of increase), Agriculture (\$3.9 million or 19.3% of increase) and Healthcare (\$2.3 million or 11.4% of increase). The large increase in Risk Grade 5 loans from December 31, 2017 to March 31, 2018 related to Government Contracting was the result of applying the Company’s current risk rating methodology, which is not designed for the asset-based, collateral intensive, highly monitored loans being generated by this vertical. As a result, applying these loans to the current risk grading methodology resulted in more severe risk grades than would be expected with a more refined model tailored for this new type of credit being extended. Credit management is revising the current risk grade methodology so that it appropriately measures risk for asset-based credits. This revised methodology will be formalized during the second quarter of 2018. Credit management fully expects many of the Government Contracting loans will have improved risk grades once the enhanced risk grading methodology is applied, however as an abundance of caution the risk grade results of the current model were reported and reserved for at March 31, 2018. The first quarter 2018 increase in Risk Grade 5 loans related to Agriculture and Healthcare was due to the ongoing maturity of larger existing verticals. At March 31, 2018, approximately 90.9% of loans classified as Risk Grade 5 are performing with no current payments past due. While the level of nonperforming assets fluctuates in response to changing economic and market conditions, the relative size and composition of the loan portfolio, and management’s degree of success in resolving problem assets, management believes that a proactive approach to early identification and intervention is critical to successfully managing a small business loan portfolio.

Allowance for Loan and Lease Losses

The allowance for loan and lease losses (“ALLL”), a material estimate which could change significantly in the near-term in the event of rapidly deteriorating credit quality, is established through a provision for loan and lease losses charged

to earnings to account for losses that are inherent in the loan and lease portfolio and estimated to occur, and is maintained at a level that management considers appropriate to absorb potential losses in the portfolio. Loan and lease losses are charged against the ALLL when management believes that the collectibility of the principal loan and lease balance is unlikely. Subsequent recoveries, if any, are credited to the ALLL when received.

Judgment in determining the adequacy of the ALLL is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available and as situations and information change. The ALLL is evaluated on a quarterly basis by management and takes into consideration such factors as changes in the nature and volume of the loan and lease portfolio, overall portfolio quality, review of specific problem loans and leases and current economic conditions and trends that may affect the borrower's ability to repay.

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

The ALLL of \$24.2 million at December 31, 2017 increased by \$3.9 million, or 16.0%, to \$28.1 million at March 31, 2018. The ALLL, as a percentage of loans and leases held for investment, amounted to 2.0% at March 31, 2018 and 1.8% at December 31, 2017. The increase in the allowance for loan and lease losses was largely attributable to continued growth in the loan and lease portfolio, as addressed in the Provision for Loan and Lease Losses section of Results of Operations. General reserves as a percentage of non-impaired loans amounted to 1.66% at March 31, 2018 and 1.62% December 31, 2017. See the aforementioned Provision for Loan and Lease Losses section of this section for a discussion of the Company's charge-off experience.

Actual past due loans and leases have decreased since December 31, 2017 as management continues to work to improve asset quality. Management believes the ALLL of \$24.2 million at March 31, 2018 is appropriate in light of the risk inherent in the loan and lease portfolio. Management’s judgments are based on numerous assumptions about current events that it believes to be reasonable, but which may or may not be valid. Thus, there can be no assurance that loan and lease losses in future periods will not exceed the current ALLL or that future increases in the ALLL will not be required. No assurance can be given that management’s ongoing evaluation of the loan and lease portfolio in light of changing economic conditions and other relevant circumstances will not require significant future additions to the ALLL, thus adversely affecting the Company’s operating results. Additional information on the ALLL is presented in Note 7 - Loans and Leases Held for Investment and Allowance for Loan and Lease Losses of the Notes to the Unaudited Consolidated Financial Statements in this report.

Liquidity Management

Liquidity management refers to the ability to meet day-to-day cash flow requirements based primarily on activity in loan and deposit accounts of the Company’s customers. Liquidity is immediately available from four major sources: (a) cash on hand and on deposit at other banks; (b) the outstanding balance of federal funds sold; (c) the market value of unpledged investment securities; and (d) availability under lines of credit. At March 31, 2018, the total amount of these four items was \$1.22 billion, or 35.3% of total assets, an increase of \$548.7 million from \$674.2 million, or 24.4% of total assets, at December 31, 2017.

Loans and other assets are funded by loan sales, wholesale deposits and core deposits. To date, an increasing retail deposit base and an increased amount of long-term brokered deposits have been adequate to meet loan obligations, while maintaining the desired level of immediate liquidity. Additionally, an investment securities portfolio is available for both immediate and secondary liquidity purposes.

At March 31, 2018, none of the investment securities portfolio was pledged to secure public deposits or pledged to retail repurchase agreements, while \$100 thousand was pledged for trust activities in the State of Ohio and \$2.5 million was pledged for uninsured trust assets, leaving \$375.9 million available as lendable collateral.

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Contractual Obligations

The following table presents the Company's significant fixed and determinable contractual obligations by payment date as of March 31, 2018. The payment amounts represent those amounts contractually due to the recipient. The table excludes liabilities recorded where management cannot reasonably estimate the timing of any payments that may be required in connection with these liabilities.

| | Payments Due by Period | | | | |
|--|------------------------|--------------------------|--------------------------|---------------------------|----------------------------|
| | Total | Less than One Year | One to Three Years | Three to Five Years | More Than Five Years |
| Contractual Obligations | | | | | |
| Deposits without stated maturity | \$1,209,919 | \$1,209,919 | \$— | \$— | \$— |
| Time deposits | 1,763,422 | 1,066,053 | 532,596 | 88,601 | 76,172 |
| Long term borrowings | 3,489 | 4 | 3,478 | 7 | — |
| Operating lease obligations ¹ | 2,710 | 1,009 | 1,050 | 481 | 170 |
| Total | \$2,979,540 | \$2,276,985 | \$537,124 | \$89,089 | \$76,342 |

¹ The following obligations only include base rent and does not include any additional payments such as taxes, insurance, maintenance and repairs or common area maintenance.

As of March 31, 2018 and December 31, 2017, the Company had unfunded commitments to provide capital contributions for on-balance sheet investments in the amount of \$3.3 million and \$3.5 million, respectively.

Asset/Liability Management and Interest Rate Sensitivity

One of the primary objectives of asset/liability management is to maximize the net interest margin while minimizing the earnings risk associated with changes in interest rates. One method used to manage interest rate sensitivity is to measure, over various time periods, the interest rate sensitivity positions, or gaps. This method, however, addresses only the magnitude of timing differences and does not address earnings or market value. Therefore, management uses an earnings simulation model to prepare, on a regular basis, earnings projections based on a range of interest rate scenarios to more accurately measure interest rate risk.

The balance sheet is asset-sensitive with a total cumulative gap position of 2.2% at March 31, 2018. The addition of long-term wholesale deposits during the quarter decreased the asset-liability sensitivity of the Company in the current period. An asset-sensitive position means that net interest income will generally move in the same direction as interest rates. For instance, if interest rates increase, net interest income can be expected to increase, and if interest rates decrease, net interest income can be expected to decrease. The Company attempts to mitigate interest rate risk with the majority of assets and liabilities being short-term, adjustable rate instruments. The quarterly revaluation adjustment to the servicing asset, however, adjusts in an opposite direction to interest rate changes. Asset/liability sensitivity is primarily derived from the prime-based loans that adjust as the prime interest rate changes and the longer duration of indeterminate term deposits.

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Capital

The maintenance of appropriate levels of capital is a management priority and is monitored on a regular basis. The Company's principal goals related to the maintenance of capital are to provide adequate capital to support the Company's risk profile consistent with the risk appetite approved by the Board of Directors; provide financial flexibility to support future growth and client needs; comply with relevant laws, regulations, and supervisory guidance; achieve optimal credit ratings for the Company and its subsidiaries; and provide a competitive return to shareholders. Management regularly monitors the capital position of the Company on both a consolidated and bank level basis. In this regard, management's goal is to maintain capital at levels that are in excess of the regulatory "well capitalized" levels. Risk-based capital ratios, which include Tier 1 Capital, Total Capital and Common Equity Tier 1 Capital, are calculated based on regulatory guidance related to the measurement of capital and risk-weighted assets. The Basel III Capital Rules, a comprehensive capital framework for U.S. banking organizations, became effective for the Company and Bank on January 1, 2015 (subject to a phase-in period for certain provisions). Quantitative measures established by the Basel III Capital Rules to ensure capital adequacy require the maintenance of minimum amounts and ratios (set forth in the table below) of Common Equity Tier 1 capital, Tier 1 capital and Total capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier 1 capital to adjusted quarterly average assets (as defined).

When fully phased in on January 1, 2019, the Basel III Capital Rules will require the Company and Bank to maintain (i) a minimum ratio of Common Equity Tier 1 capital to risk-weighted assets of at least 4.5%, plus a 2.5% "capital conservation buffer" (which is added to the 4.5% Common Equity Tier 1 capital ratio as that buffer is phased in, effectively resulting in a minimum ratio of Common Equity Tier 1 capital to risk-weighted assets of at least 7.0% upon full implementation), (ii) a minimum ratio of Tier 1 capital to risk-weighted assets of at least 6.0%, plus the capital conservation buffer (which is added to the 6.0% Tier 1 capital ratio as that buffer is phased in, effectively resulting in a minimum Tier 1 capital ratio of 8.5% upon full implementation), (iii) a minimum ratio of Total capital (that is, Tier 1 plus Tier 2) to risk-weighted assets of at least 8.0%, plus the capital conservation buffer (which is added to the 8.0% total capital ratio as that buffer is phased in, effectively resulting in a minimum total capital ratio of 10.5% upon full implementation) and (iv) a minimum leverage ratio of 4.0%, calculated as the ratio of Tier 1 capital to average quarterly assets.

The implementation of the capital conservation buffer began on January 1, 2016 at the 0.625% level and will be phased in over a three-year period (increasing by that amount on each subsequent January 1, until it reaches 2.5% on January 1, 2019). Banking institutions with a ratio of Common Equity Tier 1 capital to risk-weighted assets below the effective minimum (4.5% plus the capital conservation buffer) will face constraints on dividends, equity repurchases and compensation based on the amount of the shortfall.

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Capital amounts and ratios as of March 31, 2018 and December 31, 2017, are presented in the table below.

| | Actual | | Minimum Capital Requirement | | Minimum To Be Well Capitalized Under Prompt Corrective Action Provisions ⁽¹⁾ | |
|--|-----------|--------|-----------------------------|-------|---|--------|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| Consolidated - March 31, 2018 | | | | | | |
| Common Equity Tier 1 (to Risk-Weighted Assets) | \$401,239 | 16.36% | \$110,340 | 4.50% | N/A | N/A |
| Total Capital (to Risk-Weighted Assets) | \$429,290 | 17.51% | \$196,160 | 8.00% | N/A | N/A |
| Tier 1 Capital (to Risk-Weighted Assets) | \$401,239 | 16.36% | \$147,120 | 6.00% | N/A | N/A |
| Tier 1 Capital (to Average Assets) | \$401,239 | 13.32% | \$120,490 | 4.00% | N/A | N/A |
| Bank - March 31, 2018 | | | | | | |
| Common Equity Tier 1 (to Risk-Weighted Assets) | \$326,445 | 13.49% | \$108,902 | 4.50% | \$157,303 | 6.50% |
| Total Capital (to Risk-Weighted Assets) | \$354,743 | 14.66% | \$193,603 | 8.00% | \$242,004 | 10.00% |
| Tier 1 Capital (to Risk-Weighted Assets) | \$326,445 | 13.49% | \$145,203 | 6.00% | \$193,603 | 8.00% |
| Tier 1 Capital (to Average Assets) | \$326,445 | 11.14% | \$117,205 | 4.00% | \$146,507 | 5.00% |
| Consolidated - December 31, 2017 | | | | | | |
| Common Equity Tier 1 (to Risk-Weighted Assets) | \$390,816 | 17.81% | \$98,764 | 4.50% | N/A | N/A |
| Total Capital (to Risk-Weighted Assets) | \$415,006 | 18.91% | \$175,580 | 8.00% | N/A | N/A |
| Tier 1 Capital (to Risk-Weighted Assets) | \$390,816 | 17.81% | \$131,685 | 6.00% | N/A | N/A |
| Tier 1 Capital (to Average Assets) | \$390,816 | 15.50% | \$100,828 | 4.00% | N/A | N/A |
| Bank - December 31, 2017 | | | | | | |
| Common Equity Tier 1 (to Risk-Weighted Assets) | \$277,943 | 12.89% | \$97,060 | 4.50% | \$140,197 | 6.50% |
| Total Capital (to Risk-Weighted Assets) | \$302,385 | 14.02% | \$172,551 | 8.00% | \$215,688 | 10.00% |
| Tier 1 Capital (to Risk-Weighted Assets) | \$277,943 | 12.89% | \$129,413 | 6.00% | \$172,551 | 8.00% |
| Tier 1 Capital (to Average Assets) | \$277,943 | 11.36% | \$97,864 | 4.00% | \$122,330 | 5.00% |

(1) Prompt corrective action provisions are not applicable at the bank holding company level.

Critical Accounting Policies and Estimates

The preparation of consolidated financial statements in accordance with GAAP requires the Company to make estimates and judgments that affect reported amounts of assets, liabilities, income and expenses and related disclosure of contingent assets and liabilities. The Company bases estimates on historical experience and on various other assumptions that are believed to be reasonable under current circumstances, results of which form the basis for making judgments about the carrying value of certain assets and liabilities that are not readily available from other sources. Estimates are evaluated on an ongoing basis. Actual results may differ from these estimates under different assumptions or conditions.

Accounting policies, as described in detail in the Notes to the Company's Unaudited Consolidated Financial Statements in this report, are an integral part of the Company's consolidated financial statements. A thorough understanding of these accounting policies is essential when reviewing the Company's reported results of operations and financial position. Management believes that the critical accounting policies and estimates listed below require the Company to make difficult, subjective or complex judgments about matters that are inherently uncertain.

• Determination of the allowance for loan and lease losses;

• Valuation of servicing assets;

• Income taxes;

• Restricted stock unit awards with market price conditions;

• Valuation of foreclosed assets;

• Business combination and goodwill; and

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Unconsolidated joint ventures.

Changes in these estimates, that are likely to occur from period to period, or the use of different estimates that the Company could have reasonably used in the current period, would have a material impact on the Company's financial position, results of operations or liquidity.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Management considers interest rate risk the most significant market risk. Interest rate risk is the exposure to adverse changes in net interest income due to changes in interest rates. Consistency of net interest income is largely dependent upon the effective management of interest rate risk.

The Company's Asset/Liability Management Committee ("ALCO"), which includes senior management representatives and reports to the Board of Directors, monitors and manages interest rate risk. See "Asset/Liability Management and Interest Rate Sensitivity" in Item 2 of this Form 10-Q for further discussion.

The objective of asset/liability management is the maximization of net interest income within the Company's risk guidelines. This objective is accomplished through management of the balance sheet composition, maturities, liquidity, and interest rate risk exposures arising from changing economic conditions, interest rates and customer preferences.

To identify and manage its interest rate risk, the Company employs an earnings simulation model to analyze net interest income sensitivity to changing interest rates. The model is based on contractual cash flows and repricing characteristics and incorporates market-based assumptions regarding the effect of changing interest rates on the prepayment rates of certain assets and liabilities. The model also includes management projections for activity levels in each of the product lines offered by the Bank. Assumptions are inherently uncertain, and the measurement of net interest income or the impact of rate fluctuations on net interest income cannot be precisely predicted. Actual results may differ materially from simulated results due to timing, magnitude, and frequency of interest rate changes as well as changes in market conditions and management strategies.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

An evaluation of the Company's disclosure controls and procedures (as defined in Rules 13(a)-15(e) and 15(d)-15(e) of the Securities Exchange Act of 1934, as amended (the "Exchange Act")), was carried out under the supervision and with the participation of the Company's Chief Executive Officer and Chief Financial Officer as of March 31, 2018, the last day of the period covered by this Quarterly Report. The Company's Chief Executive Officer and Chief Financial Officer concluded that the disclosure controls and procedures were effective as of March 31, 2018 in ensuring that the information required to be disclosed in the reports the Company files or submits under the Exchange Act is (i) accumulated and communicated to management (including the Company's Chief Executive Officer and Chief Financial Officer) as appropriate to allow timely decisions regarding required disclosures, and (ii) recorded, processed, summarized, and reported within the time periods specified in the SEC's rules and forms.

Changes in Internal Control Over Financial Reporting

There were no changes in the Company's internal control over financial reporting during the three months ended March 31, 2018 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

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PART II. OTHER INFORMATION

Item 1. Legal Proceedings

In the ordinary course of operations, the Company is party to various legal proceedings. The Company is not involved in, nor has it terminated during the three months ended March 31, 2018, any pending legal proceedings other than nonmaterial proceedings occurring in the ordinary course of business.

Item 1A. Risk Factors

There have been no material changes to the risk factors that have been previously disclosed in the Company's 2017 Annual Report filed with the SEC.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

None.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

None.

Item 6. Exhibits

Exhibits to this report are listed in the Index to Exhibits section of this report.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Live Oak Bancshares, Inc.
(Registrant)

Date: May 7, 2018 By: /s/ S. Brett Caines
S. Brett Caines
Chief Financial Officer

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INDEX TO EXHIBITS

Exhibit
No. Description of Exhibit

- 3.1 Amended and Restated Articles of Incorporation of Live Oak Bancshares, Inc. (incorporated by reference to Exhibit 3.1 of the registration statement on Form S-1, filed on June 19, 2015)
- 3.2 Amended Bylaws of Live Oak Bancshares, Inc. (incorporated by reference to Exhibit 3.2 of the registration statement on Form S-1, filed on June 19, 2015)
- 4.1 Form of Common Stock Certificate (incorporated by reference to Exhibit 4.1 of the registration statement on Form S-1, filed on June 19, 2015)
- 4.2 Registration and Other Rights Agreement between Live Oak Bancshares, Inc. and Wellington purchasers (incorporated by reference to Exhibit 4.2 of the registration statement on Form S-1, filed on June 19, 2015)
- 31.1 Certification of Principal Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002*
- 31.2 Certification of Principal Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002*
- 32 Certification Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002**
Interactive data files pursuant to Rule 405 of Regulation S-T: (i) Consolidated Balance Sheets as of March 31, 2018 and December 31, 2017; (ii) Consolidated Statements of Income for the Three Months Ended March 31, 2018 and 2017; (iii) Consolidated Statements of Comprehensive Income for the Three Months Ended March 31, 2018 and 2017; (iv) Consolidated Statements of Changes in Shareholders' Equity for the Three Months Ended March 31, 2018 and 2017; (v) Consolidated Statements of Cash Flows for the Three Months Ended March 31, 2018 and 2017; and (vi) Notes to Consolidated Financial Statements*

* Indicates a document being filed with this Form 10-Q.

Furnished herewith. This exhibit shall not be deemed "filed" for purposes of Section 18 of the Securities Exchange

** Act of 1934, or otherwise subject to the liability of that Section. Such exhibit shall not be deemed incorporated into any filing under the Securities Act of 1933 or the Securities Exchange Act of 1934.