

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

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

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

or
Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the transition period from to .
Commission file number: 001-37497

LIVE OAK BANCSHARES, INC.

(Exact name of registrant as specified in its charter)

North Carolina

26-4596286

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

1741 Tiburon Drive

28403

Wilmington, North Carolina

(Address of principal executive offices)

(Zip Code)

(910) 790-5867

(Registrant's telephone number, including area code)

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

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

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

Large Accelerated Filer ``

Accelerated Filer ``

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

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

APPLICABLE ONLY TO CORPORATE ISSUERS:

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

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

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 For the Quarterly Period Ended March 31, 2016
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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

Live Oak Bancshares, Inc.

Consolidated Balance Sheets

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

(Dollars in thousands)

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

* Derived from audited consolidated financial statements.

See Notes to Unaudited Consolidated Financial Statements

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Live Oak Bancshares, Inc.

Consolidated Statements of Income

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

(Dollars in thousands, except per share data)

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

See Notes to Unaudited Consolidated Financial Statements

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Live Oak Bancshares, Inc.

Consolidated Statements of Comprehensive Income

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

(Dollars in thousands)

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

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Live Oak Bancshares, Inc.

Consolidated Statements of Changes in Shareholders' Equity

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

(Dollars in thousands)

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

See Notes to Unaudited Consolidated Financial Statements

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

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

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

| | Three Months Ended March 31, | |
|--|---------------------------------|----------|
| | 2016 | 2015 |
| Cash flows from financing activities | | |
| Net increase in deposits | 210,677 | 34,003 |
| Proceeds from long term borrowings | — | 8,468 |
| Repayment of long term borrowings | (104) | (107) |
| Repayment of short term borrowings | — | (6,100) |
| Stock option exercises | 48 | 16 |
| Shareholder dividend distributions | (1,026) | (1,363) |
| Net cash provided by financing activities | 209,595 | 34,917 |
| Net increase in cash and cash equivalents | 123,949 | 17,662 |
| Cash and cash equivalents, beginning | 102,607 | 29,902 |
| Cash and cash equivalents, ending | \$226,556 | \$47,564 |
| Supplemental disclosure of cash flow information | | |
| Interest paid | \$2,690 | \$1,915 |
| Income tax | 2,181 | 1,974 |
| Supplemental disclosures of noncash operating, investing, and financing activities | | |
| Unrealized holding gains on available-for-sale securities, net of taxes | \$239 | \$124 |
| Transfers from loans to foreclosed real estate and other repossessions | 406 | — |
| Transfers of loans accounted for as secured borrowing collateral to other assets | — | 4,674 |
| Dividends declared but not paid | — | 169 |
| Transfer of loans held for sale to loans held for investment | 13,763 | 2,294 |
| Transfer of loans held for investment to loans held for sale | 752 | 1,370 |
| Contingent consideration in acquisition of controlling interest in equity method of investment | — | 170 |
| 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 established in May 2008 as a North Carolina-chartered commercial bank. The Bank specializes in providing lending services to small businesses nationwide in targeted industries. The Bank identifies and grows within credit-worthy industries through expertise within those industries. A significant portion of the loans originated by the Bank are guaranteed by the Small Business Administration ("SBA") under the 7(a) program. On July 23, 2015 the Company closed on its initial public offering. In 2010, the Bank formed Live Oak Number One, Inc., a wholly-owned subsidiary, to hold properties foreclosed on by the Bank.

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

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

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

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

General

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

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

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

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

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Live Oak Bancshares, Inc.

Notes to Unaudited Consolidated Financial Statements

Business Segments

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

Reclassifications

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

Note 2. Recent Accounting Pronouncements

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

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

Note 3. Earnings Per Share

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

| | Three Months Ended March 31, 2016 2015 | |
|---|--|------------|
| Basic earnings per share: | | |
| Net income available to common shareholders | \$4,691 | \$ 8,073 |
| Weighted-average basic shares outstanding | 34,176,728 | 36,620,120 |
| Basic earnings per share | \$0.14 | \$ 0.28 |
| Diluted earnings per share: | | |
| Net income available to common shareholders, for diluted earnings per share | \$4,691 | \$ 8,073 |
| Total weighted-average basic shares outstanding | 34,176,728 | 36,620,120 |
| Add effect of dilutive stock options and restricted stock grants | 777,839 | 741,721 |
| Total weighted-average diluted shares outstanding | 34,954,592 | 37,361,841 |
| Diluted earnings per share | \$0.13 | \$ 0.27 |
| Anti-dilutive shares | 2,369,817 | 20,447 |

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Live Oak Bancshares, Inc.

Notes to Unaudited Consolidated Financial Statements

Note 4. Securities

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

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

December 31, 2015

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

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

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

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

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

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

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

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

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

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

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

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Live Oak Bancshares, Inc.

Notes to Unaudited Consolidated Financial Statements

The following is a summary of investment securities by maturity:

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

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

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

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Live Oak Bancshares, Inc.

Notes to Unaudited Consolidated Financial Statements

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

Loan Portfolio Segments

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

Commercial and Industrial

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

Construction and Development

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

Owner Occupied Commercial Real Estate

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

Commercial Land

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

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

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Loans consist of the following:

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

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

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

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Credit Risk Profile

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

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

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

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

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

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

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

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

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

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

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The following tables summarize the risk grades of each category:

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

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

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

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Notes to Unaudited Consolidated Financial Statements

Past Due Loans

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

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

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| | | | | | | | | |
|--------------------|----------|----------|----------|----------|-----------|------------|------------|------|
| Total ¹ | \$ 4,443 | \$ 6,295 | \$ 2,829 | \$ 7,557 | \$ 21,124 | \$ 292,208 | \$ 313,332 | \$ — |
|--------------------|----------|----------|----------|----------|-----------|------------|------------|------|

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Live Oak Bancshares, Inc.

Notes to Unaudited Consolidated Financial Statements

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

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

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

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Nonaccrual Loans

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

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

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

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Allowance for Loan Loss Methodology

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

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

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

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

• All commercial loans classified substandard or worse.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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Notes to Unaudited Consolidated Financial Statements

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

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

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

Note 6. Servicing Assets

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

The following summarizes the activity pertaining to servicing rights:

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

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

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

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

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Notes to Unaudited Consolidated Financial Statements

Note 7. Borrowings

Total outstanding long term borrowings consisted of the following:

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

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

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Notes to Unaudited Consolidated Financial Statements

Note 8. Fair Value of Financial Instruments

Fair Value Hierarchy

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

Financial Instruments Measured at Fair Value

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

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

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

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

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

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

Recurring Fair Value

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

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

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

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Notes to Unaudited Consolidated Financial Statements

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

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

Non-recurring Fair Value

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

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

Level 3 Analysis

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

March 31, 2016

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

December 31, 2015

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

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

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Notes to Unaudited Consolidated Financial Statements

Estimated Fair Value of Other Financial Instruments

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

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

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

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

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

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

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

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

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

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

| | 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, 2016 | | | | | |
| Financial assets | | | | | |
| Cash and due from banks | \$ 226,556 | \$ 226,556 | \$ — | —\$ | —\$ 226,556 |
| Certificates of deposit with other banks | 9,000 | 8,995 | — | — | 8,995 |
| Investment securities, available-for-sale | 55,674 | — | 55,674 | — | 55,674 |
| Loans held for sale | 537,293 | — | — | 555,691 | 555,691 |
| Loans, net of allowance for loan losses | 305,017 | — | — | 300,807 | 300,807 |
| Servicing assets | 47,377 | — | — | 47,377 | 47,377 |
| Accrued interest receivable | 6,066 | 6,066 | — | — | 6,066 |
| Financial liabilities | | | | | |
| Deposits | 1,015,465 | — | 1,015,324 | — | 1,015,324 |
| Accrued interest payable | 207 | 207 | — | — | 207 |
| Long term borrowings | 28,271 | — | — | 30,871 | 30,871 |
| December 31, 2015 | | | | | |
| Financial assets | | | | | |
| Cash and due from banks | \$ 102,607 | \$ 102,607 | \$ — | —\$ | —\$ 102,607 |
| Certificates of deposit with other banks | 10,250 | 10,176 | — | — | 10,176 |
| Investment securities, available-for-sale | 53,762 | — | 53,762 | — | 53,762 |
| Loans held for sale | 480,619 | — | — | 497,868 | 497,868 |
| Loans, net of allowance for loan losses | 272,554 | — | — | 268,816 | 268,816 |
| Servicing assets | 44,230 | — | — | 44,230 | 44,230 |
| Accrued interest receivable | 5,556 | 5,556 | — | — | 5,556 |
| Financial liabilities | | | | | |
| Deposits | 804,788 | — | 792,820 | — | 792,820 |
| Accrued interest payable | 211 | 211 | — | — | 211 |
| Long term borrowings | 28,375 | — | — | 30,523 | 30,523 |

Note 9. 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.

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.

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Notes to Unaudited Consolidated Financial Statements

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 | December |
|---|-----------|-----------|
| | 31, | 31, |
| | 2016 | 2015 |
| Commitments to extend credit | \$953,576 | \$737,572 |
| Plexus Capital - Fund II Investment Commitment | 100 | 100 |
| Plexus Capital - Fund III Investment Commitment | 300 | 300 |
| Five Points Mezzanine Fund III Commitment | 1,500 | 1,500 |
| Total unfunded off-balance sheet credit risk | \$955,476 | \$739,472 |

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. There were no standby letters of credit for the periods presented.

Concentrations of Credit Risk

Although the Company is not subject to any geographic concentrations, a substantial amount of the Company's loans and commitments to extend credit have been granted to customers in the independent pharmacy 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 \$2.0 million, except for six relationships that have a retained unguaranteed exposure of \$16.1 million.

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

Note 10. Stock Plans

On March 20, 2015, the Company adopted the 2015 Omnibus Stock Incentive Plan ("2015 Omnibus Plan") which replaced the previously existing Amended Incentive Stock Option Plan and Nonstatutory Stock Option Plan. The 2015 Omnibus Plan authorized awards covering a maximum of 4,300,000 common voting shares and has an expiration date of March 20, 2025. Options or restricted shares granted under this plan expire no more than 10 years from 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, 2016 and 2015, the Company recognized \$592 thousand and \$118 thousand in compensation expense for stock options, respectively.

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Notes to Unaudited Consolidated Financial Statements

Stock option activity under the plan during the three month periods ended March 31, 2016 and 2015 is summarized below.

| | Shares | Weighted Average Exercise Price | Weighted Average Remaining Contractual Term | Aggregate Intrinsic Value |
|----------------------------------|-----------|---------------------------------------|---|---------------------------------|
| Outstanding at December 31, 2015 | 3,546,992 | \$ 11.17 | | |
| Exercised | 8,203 | 5.80 | | |
| Forfeited | 12,583 | 9.24 | | |
| Granted | 139,354 | 13.59 | | |
| Outstanding at March 31, 2016 | 3,665,560 | \$ 11.28 | 8.78 years | \$16,655,155 |
| Exercisable at March 31, 2016 | 327,417 | \$ 5.30 | 7.88 years | \$3,176,186 |

| | Shares | Weighted Average Exercise Price | Weighted Average Remaining Contractual Terms | Aggregate Intrinsic Value |
|----------------------------------|-----------|---------------------------------------|--|---------------------------------|
| Outstanding at December 31, 2014 | 1,737,570 | \$ 5.51 | | |
| Exercised | 3,679 | 4.40 | | |
| Forfeited | 20,823 | 5.10 | | |
| Granted | 394,753 | 10.63 | | |
| Outstanding at March 31, 2015 | 2,107,821 | \$ 6.48 | 9.19 years | \$8,759,162 |
| Exercisable at March 31, 2015 | 180,509 | \$ 3.87 | 8.54 years | \$1,220,457 |

The following is a summary of non-vested stock option activity for the Company for the three months ended March 31, 2016 and 2015.

| | Shares | Weighted Average Grant Date Fair Value |
|---------------------------------|-----------|---|
| Non-vested at December 31, 2015 | 3,393,441 | \$ 4.56 |
| Granted | 139,354 | 6.37 |
| Vested | 182,069 | 1.19 |
| Forfeited | 12,583 | 3.10 |
| Non-vested at March 31, 2016 | 3,338,143 | \$ 4.82 |
| | Shares | Weighted Average Grant Date Fair Value |
| Non-vested at December 31, 2014 | 1,704,230 | \$ 1.18 |
| Granted | 394,753 | 3.87 |
| Vested | 150,848 | 0.58 |
| Forfeited | 20,823 | 0.95 |
| Non-vested at March 31, 2015 | 1,927,312 | \$ 1.79 |

The total intrinsic value of options exercised at March 31, 2016 and 2015 was \$70 thousand and \$23 thousand, respectively.

At March 31, 2016, unrecognized compensation costs relating to stock options amounted to \$14.5 million which will be recognized over a weighted average period of 3.82 years.

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Live Oak Bancshares, Inc.

Notes to Unaudited Consolidated Financial Statements

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. Weighted average assumptions used for options granted during 2016 were as follows: risk free rate of 1.54%, dividend yield of 0.05%, volatility of 44.20% and average life of 7 years.

Restricted Stock

Restricted stock activity under the plan during the first three months of 2016 is summarized below.

| | Shares | Weighted Average Grant Date Fair Value |
|---------------------------------|--------|--|
| Non-vested at December 31, 2015 | 64,271 | \$ 16.17 |
| Granted | — | — |
| Vested | 2,798 | 10.63 |
| Forfeited | — | — |
| Non-vested at March 31, 2016 | 61,473 | \$ 16.42 |

For the three months ended March 31, 2016 and 2015, the Company recognized \$67 thousand and \$8 thousand in compensation expense for restricted stock, respectively.

At March 31, 2016, unrecognized compensation costs relating to restricted stock amounted to \$824 thousand which will be recognized over a weighted average period of 1.54 years.

The fair value of each restricted stock unit is based on the market value of the Company's stock on the date of the grant.

Stock Awards

On March 23, 2016 the 162(m) Subcommittee of the Compensation Committee of the Board of Directors of the Company approved restricted stock unit ("RSU") awards. The vesting of these awards is subject to the approval by the Company's shareholders of certain amendments to the Company's 2015 Omnibus Plan, including an increase in the number of shares authorized under the 2015 Omnibus Plan. These items for shareholder approval will be submitted for a vote at the annual meeting of shareholders scheduled for May 24, 2016. In the event that such amendments are not approved by the shareholders, then the RSUs will be canceled. Accordingly, the grant date of these RSU awards will not occur until requisite shareholder approval is received. As such, expense related to these awards will not be measurable for recognition unless and until approval occurs. The terms of these RSU awards are discussed in more detail below.

RSU awards: Recipients are entitled to receive 507,500 shares of the Company's voting common stock upon vesting of the RSUs. The vesting of the RSUs is subject to the Company achieving total revenue of at least \$100 million for fiscal year 2016. A subcommittee of the Compensation Committee will, promptly following the conclusion of fiscal year 2016 and no later than April 30, 2017, certify in writing whether the performance criteria has been achieved. In the event the Company does not meet this performance criteria, all of the RSUs will be forfeited. If employment terminates for any reason (other than death or Disability, as such term is defined in the Plan) before the RSUs vest, all of the RSUs will be forfeited. Shares delivered under the award will be subject to clawback in the event of voluntary termination of employment before December 31, 2020.

RSU awards with market price condition: Recipients are entitled to receive 850,000 shares of the Company's voting common stock upon vesting of the RSUs. The vesting of the RSUs under this award is subject to the Company achieving total revenue of at least \$100 million for fiscal year 2016. In addition, in order for the RSUs to vest, the Company's voting common stock must attain a closing price equal to or greater than \$34.00 per share for at least twenty (20) consecutive trading days at any time prior to March 23, 2023. In the event of a Corporate Transaction (as

such term is defined in the Plan) or the termination of employment due to death or Disability, in each case prior to March 23, 2023, a portion of the RSUs are eligible for vesting if the applicable modified stock price is achieved.

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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, 2015 (the "2015 Annual Report"). Results of operations for the periods included in this review 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" variations 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 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 Bank's status as an SBA Preferred Lender;
- 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 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;

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

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changes in political and economic conditions, including continuing political and economic effects of the global economic downturn and other major developments;

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 2015 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 established in May 2008 as a North Carolina-chartered commercial bank. The Bank specializes in providing lending services to small businesses nationwide in targeted industries. The Bank identifies and grows within 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 the 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.

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"), 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.

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

On July 23, 2015 the Company closed on its initial public offering.

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 to originate between \$1.35 billion and \$1.40 billion in loans in 2016, with approximately 40% of those loans fully funded at closing.

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Results of Operations

Performance Summary

Three months ended March 31, 2016 compared with three months ended March 31, 2015

For the three months ended March 31, 2016, the Company reported net income of \$4.7 million, or \$0.13 per diluted share, as compared to \$8.1 million, or \$0.27 per diluted share, for the three months ended March 31, 2015. This decrease in net income is primarily due to the following items:

• Decrease in noninterest income related to a first quarter 2015 one-time gain of \$3.8 million related to the sale of an investment in nCino, Inc. ("nCino"); and

Increase in salaries and employee benefits, travel and occupancy expenses of \$5.7 million, or 55.5%, arising primarily from increased investments in human capital and infrastructure to support growing loan production from new and existing verticals as well as development of a new small-loan and deposit platform.

Partially offsetting the above items was a 72.3% increase in net interest income of \$3.7 million combined with higher levels of net gains on sales of loans of \$964 thousand, or 6.2%, and an increase in loan servicing revenue and revaluation of \$652 thousand, or 15.9%.

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 of 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." As a bank without a branch network, the Bank gathers 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, 2016 compared with three months ended March 31, 2015

For the three months ended March 31, 2016, net interest income increased \$3.7 million, or 72.3%, to \$8.7 million compared to the three months ended March 31, 2015. This increase was due to growth in average interest earning assets and an increased yield on interest earning assets outpacing the change in the cost of interest bearing liabilities. Average interest earning assets increased by \$303.6 million, or 44.0%, to \$993.0 million for the three months ended March 31, 2016, compared to \$689.4 million for the three months ended March 31, 2015, while the yield on average interest earning assets increased by fifty basis points to 4.60%. The cost of funds on interest bearing liabilities for the three months ended March 31, 2016 increased slightly by three basis points to 1.21%, and the average balance in interest bearing liabilities increased by \$227.3 million, or 34.4%, over the same period. This increase in the cost of funds was driven by \$252.0 million in additional interest bearing deposits during the first three months of 2016, following a successful deposit gathering campaign. As indicated in the rate/volume table below, the slight increase in the cost of funds was outpaced by the effects of the increased volume of interest earning assets along with increased yields, resulting in increased interest income of \$4.4 million and increased interest expense of \$768 thousand for the three months ended March 31, 2016 compared to the first quarter of 2015. For the three months ended March 31, 2016 compared to the three months ended March 31, 2015, net interest margin increased from 2.97% to 3.52% due to the aforementioned effects.

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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, | | | | | |
|--|------------------------------|----------|--------------------|-----------------|----------|--------------------|
| | 2016 | | | 2015 | | |
| | Average Balance | Interest | Average Yield/Rate | Average Balance | Interest | Average Yield/Rate |
| Interest earning assets: | | | | | | |
| Interest earning balances in other banks | \$ 113,304 | \$ 138 | 0.49 % | \$ 82,036 | \$ 66 | 0.33 % |
| Investment securities | 53,935 | 251 | 1.87 | 58,910 | 176 | 1.21 |
| Loans held for sale | 520,538 | 6,992 | 5.39 | 336,520 | 4,173 | 5.03 |
| Loans held for investment | 305,206 | 4,013 | 5.27 | 211,944 | 2,557 | 4.89 |
| Total interest earning assets | 992,983 | 11,394 | 4.60 | 689,410 | 6,972 | 4.10 |
| Less: Allowance for loan losses | (7,379) | | | (4,403) | | |
| Non-interest earning assets | 140,097 | | | 93,816 | | |
| Total assets | \$ 1,125,701 | | | \$ 778,823 | | |
| Interest bearing liabilities: | | | | | | |
| Money market accounts | \$ 387,209 | \$ 722 | 0.75 % | \$ 310,992 | \$ 596 | 0.78 % |
| Certificates of deposit | 472,942 | 1,722 | 1.46 | 297,153 | 880 | 1.20 |
| Total deposits | 860,151 | 2,444 | 1.14 | 608,145 | 1,476 | 0.98 |
| Small business lending fund | — | — | — | 6,800 | 25 | 1.50 |
| Other borrowings | 28,593 | 241 | 3.38 | 46,510 | 416 | 3.63 |
| Total interest bearing liabilities | 888,744 | 2,685 | 1.21 | 661,455 | 1,917 | 1.18 |
| Non-interest bearing deposits | 17,872 | | | 13,415 | | |
| Non-interest bearing liabilities | 18,994 | | | 12,662 | | |
| Shareholders' equity | 200,058 | | | 91,316 | | |
| Noncontrolling interest | 33 | | | (25) | | |
| Total liabilities and shareholders' equity | \$ 1,125,701 | | | \$ 778,823 | | |
| Net interest income and interest rate spread | | \$ 8,709 | 3.39 % | | \$ 5,055 | 2.92 % |
| Net interest margin | | | 3.52 | | | 2.97 |
| Ratio of average interest-earning assets to average interest-bearing liabilities | | | 111.73 % | | | 104.23 % |

(1) Average loan 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 current 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, changes 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, 2016 vs. 2015 Increase (Decrease) Due to | | |
|--|---|---------|---------|
| | Rate | Volume | Total |
| Interest income: | | | |
| Interest earning balances in other banks | \$40 | \$32 | \$72 |
| Investment securities | 94 | (19) | 75 |
| Loans held for sale | 442 | 2,377 | 2,819 |
| Loans held for investment | 280 | 1,176 | 1,456 |
| Total interest income | 856 | 3,566 | 4,422 |
| Interest expense: | | | |
| Money market accounts | (18) | 144 | 126 |
| Certificates of deposit | 262 | 580 | 842 |
| Small business lending fund | — | (25) | (25) |
| Other borrowings | (19) | (156) | (175) |
| Total interest expense | 225 | 543 | 768 |
| Net interest income | \$631 | \$3,023 | \$3,654 |

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

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

For the three months ended March 31, 2016, the provision for loan losses was \$1.4 million, an increase of \$356 thousand, or 33.1%, compared to the same period in 2015. This increase in provision for loan losses was principally due to growth in new lending verticals with higher loss factors due to the Company's lack of historical loss experience in those industries.

Net charge-offs were \$232 thousand, or 0.30% of average loans held for investment, for the three months ended March 31, 2016, compared to net charge-offs of \$250 thousand, or 0.47%, for the three months ended March 31, 2015. In addition, at March 31, 2016, nonperforming loans not guaranteed by the SBA totaled \$2.4 million, which was 0.8% of the held-for-investment loan portfolio compared to \$2.9 million, or 1.3%, of loans held for investment at March 31, 2015.

Noninterest Income

Noninterest income is principally comprised of net gains from the sale of SBA-guaranteed loans along with loan servicing revenue and revaluation. Revenue from the sale of loans depends upon the volume and rates of underlying loans as well as the cost 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. Other less common elements of noninterest income include nonrecurring gains and losses on investments.

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

| | Three Months | | Increase (Decrease) | |
|--|--------------|----------|---------------------|----------|
| | Ended | | Amount | Percent |
| | March 31, | | | |
| | 2016 | 2015 | | |
| Noninterest income | | | | |
| Loan servicing revenue | \$4,784 | \$3,593 | \$1,191 | 33.15 % |
| Loan servicing revaluation | (26) | 513 | (539) | (105.07) |
| Net gains on sales of loans | 16,425 | 15,461 | 964 | 6.24 |
| Gain of sale of investment in non-consolidated affiliate | — | 3,782 | (3,782) | (100.00) |
| Equity in loss of non-consolidated affiliates | — | (26) | 26 | 100.00 |
| Construction supervision fee income | 630 | 216 | 414 | 191.67 |
| Other noninterest income | 619 | 516 | 103 | 19.96 |
| Total noninterest income | \$22,432 | \$24,055 | \$(1,623) | (6.75)% |

For the three months ended March 31, 2016, noninterest income decreased by \$1.6 million, or 6.8%, compared to the three months ended March 31, 2015. Increases in the serviced loan portfolio and the volume of loans sold in the secondary market, the core components of the Company's business, combined to generate \$1.2 million of increased servicing revenue and \$964 thousand of increased net gains on sale of loans. There was also a \$414 thousand increase in additional fees earned for monitoring higher levels of multi-advance loans in the first quarter of 2016. Contributing to the overall decline in noninterest income from the same period a year ago was a first quarter 2015 one-time gain of \$3.8 million related to the sale of an investment in nCino combined with an increase in the downward adjustment in the valuation of servicing rights of \$539 thousand compared to the same period in 2015.

The following table reflects loan 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 | | For years ended December 31, | | | |
|---|--------------|-----------|------------------------------|-----------|-----------|-----------|
| | Ended | | | | | |
| | March 31, | | | | | |
| | 2016 | 2015 | 2015 | 2014 | 2013 | 2012 |
| Amount of loans originated | \$284,530 | \$248,058 | \$1,158,640 | \$848,090 | \$498,752 | \$413,763 |
| SBA-guaranteed portions of loans sold | 155,643 | 137,047 | 640,886 | 433,912 | 339,342 | 276,676 |
| Outstanding balance of guaranteed loans sold ⁽¹⁾ | 1,894,428 | 1,403,968 | 1,779,989 | 1,302,828 | 1,005,764 | 767,721 |

⁽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.

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 the 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 the three months ended March 31, 2016, loan servicing revenue increased \$1.2 million, or 33.2%, compared to the three months ended March 31, 2015, as a result of an increase in the average outstanding balance of guaranteed loans sold. At March 31, 2016, the outstanding balance of guaranteed loans sold in the secondary market was \$1.89 billion, with a weighted average servicing rate of 1.06%. At March 31, 2015, the outstanding balance of guaranteed loans sold was \$1.40 billion, with a weighted average servicing rate of 1.10%. Prior to January 2010, the Company sold loans for servicing in excess of

1.0%. As loans sold for servicing fee rates in excess of 1.0% prior to fiscal year 2010 amortize, the Company expects that the weighted average servicing rate will approach and stabilize at approximately 1.0%.

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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, 2016, there was a net negative loan servicing revaluation adjustment of \$26 thousand compared to a net positive revaluation adjustment of \$513 thousand during the three months ended March 31, 2015. The decline in service valuation for the three-month period ended March 31, 2016, compared to the same period ended March 31, 2015, was primarily due to an increase in the amortization rate of the serviced portfolio and a decline in the premium market.

Net Gains on Sale of Loans: For the three months ended March 31, 2016, net gains on sales of loans increased \$964 thousand, or 6.2%, compared to the three months ended March 31, 2015 primarily due to an increase in the volume of guaranteed loans sold. For the three months ended March 31, 2016, the volume of guaranteed loans sold increased \$18.6 million, or 13.6%, to \$155.6 million from \$137.0 million for the three months ended March 31, 2015. The premium market had a negative impact on the net gain on sale of loans. The average net gain on sale for the three months ended March 31, 2016, was somewhat lower at \$106 thousand of revenue for each \$1 million in loans sold, compared to \$113 thousand of revenue for each \$1 million sold for the three months ended March 31, 2015.

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 Ended | | 2015/2016 | | |
|--|--------------------|----------|-----------|---------|---|
| | March 31, 2016 | 2015 | Amount | Percent | |
| Noninterest expense | | | | | |
| Salaries and employee benefits | \$12,993 | \$8,355 | \$4,638 | 55.51 | % |
| Non-staff expenses: | | | | | |
| Travel expense | 1,846 | 1,476 | 370 | 25.07 | |
| Professional services expense | 528 | 850 | (322) | (37.88) |) |
| Advertising and marketing expense | 963 | 1,008 | (45) | (4.46) |) |
| Occupancy expense | 1,193 | 481 | 712 | 148.02 | |
| Data processing expense | 1,208 | 893 | 315 | 35.27 | |
| Equipment expense | 551 | 443 | 108 | 24.38 | |
| Other loan origination and maintenance expense | 574 | 477 | 97 | 20.34 | |
| Other expense | 1,855 | 719 | 1,136 | 158.00 | |
| Total non-staff expenses | 8,718 | 6,347 | 2,371 | 37.36 | |
| Total noninterest expense | \$21,711 | \$14,702 | \$7,009 | 47.67 | % |

Total noninterest expense for the three months ended March 31, 2016 increased \$7.0 million, or 47.7%, compared to the same period in 2015. The increase in noninterest expense was predominately impacted by increased personnel, travel, occupancy and other expenses. Other expenses is comprised of various expense categories that are predominantly driven by the growth of the Bank. Changes in various components of noninterest expense are discussed below.

Salaries and employee benefits: Total personnel expense for the three months ended March 31, 2016 increased by \$4.6 million, or 55.5%, compared to the same period in 2015. This increase primarily resulted from further investment in human capital to support the growing loan production from new and existing verticals as well as development of a new small-loan and deposit platform. Full-time equivalent employees increased from 246 at March 31, 2015 to 381 at March 31, 2016, further supporting the increase in personnel expense. Salaries and employee benefits expense included \$659 thousand and \$126 thousand of stock based compensation in the first quarter of 2016 and 2015, respectively. Expenses related to the employee stock purchase program, stock grants, stock options, stock option

compensation and restricted stock expense are all considered stock based compensation.

In March 2016, the 162(m) Subcommittee of the Compensation Committee of the Board of Directors of the Company approved restricted stock unit ("RSU") awards covering a total of 1,357,500 shares of the Company's voting common stock; comprised of 507,500 shares related to RSU awards and 850,000 shares related to RSU awards with a market price condition of \$34 per share. The vesting of the awards is subject to the approval by the Company's shareholders of certain amendments to the Company's 2015 Omnibus Plan, including an increase in the number of shares authorized under the 2015 Omnibus Plan. The grant date of these

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awards will not occur until requisite shareholder approval is received. As such, expense related to these awards will not be measurable for recognition unless and until approval occurs. See Note 10 - Stock Plans for more information. If the amendments to the 2015 Omnibus Plan are approved at the annual meeting of shareholders and other vesting conditions are satisfied, the Company expects (i) the 507,500 shares under the aforementioned RSU awards to vest at the end of 2016, (ii) the expense associated with these awards to be recognized during the remainder of fiscal year 2016 and (iii) the total amount of such expense to be equal to the closing price on the date of shareholder approval of one share of the Company's voting common stock times 507,500 shares.

Travel expense: For the three months ended March 31, 2016, total travel expenses increased by \$370 thousand, or 25.1%, compared to the same period in 2015. Travel costs are an inherent function of the Company's business strategy because the Company does not maintain branch locations across its national footprint. The increase in travel-related expenses was primarily driven by growing loan production (up \$36.5 million, or 14.7%, for the three months ended March 31, 2016 compared to the same period in 2015). Travel costs also increased due to the Company's customer relationship management strategy via the Company's business advisory group, or BAG, as a result of servicing a \$2.94 billion loan portfolio as of March 31, 2016. Travel expense represented 8.5% of total noninterest expense for the three month period ended March 31, 2016.

Professional service expense: For the three months ended March 31, 2016, the total cost of professional services decreased by \$322 thousand, or 37.9%, compared to the same period in 2015. The decrease is primarily attributable to a shift in internal audit service providers in early 2015 combined with hiring an internal general counsel in the latter part of 2015.

Occupancy expense: For the three months ended March 31, 2016, total occupancy costs increased \$712 thousand, or 148.0%, compared to the same period in 2015. The primary driver of the increase in occupancy expense was increased levels of personnel who support loan production and portfolio service along with related infrastructure.

Data processing expense: For the three months ended March 31, 2016, the total costs associated with data processing and development increased \$315 thousand, or 35.3%, compared to the same periods in 2015. This increase was principally due to the increased levels of activity in the core system from the substantial growth in loan originations, software and applications to operate and expand the Company's digital platform.

Income Tax Expense

The effective tax rates for the three months ended March 31, 2016 and 2015 were 41.4% and 39.6%, respectively. The effective tax rate for the three months ended March 31, 2016, was higher than the corresponding period in 2015 principally due to higher levels of nondeductible incentive stock option expense in 2016.

Discussion and Analysis of Financial Condition

March 31, 2016 vs. December 31, 2015

Total assets at March 31, 2016 were \$1.27 billion, an increase of \$215.9 million, or 20.5%, compared to total assets of \$1.05 billion at December 31, 2015. The growth in total assets was principally driven by the following:

- Increased levels of deposits of \$210.7 million, arising from a successful deposit gathering campaign; and
- Growth in loan originations combined with longer retention times of loans held for sale, comprised largely of loans to newer verticals which require a period of loan advances prior to being sold.

Cash and cash equivalents were \$226.6 million at March 31, 2016, an increase of \$123.9 million, or 120.8%, compared to \$102.6 million at December 31, 2015, primarily as a result of increases in the deposit portfolio.

Total investment securities increased \$1.9 million during the first three months of 2016, from \$53.8 million at December 31, 2015, to \$55.7 million at March 31, 2016, an increase of 3.6%. The portfolio is comprised of US government agency securities, residential mortgage-backed securities and a mutual fund.

Loans held for sale increased \$56.7 million, or 11.8%, during the first three months of 2016, from \$480.6 million at December 31, 2015, to \$537.3 million at March 31, 2016. The increase was primarily the result of new loan originations combined with the general lengthening of time to sell loans in the portfolio due to originations of multi-advance loans in newer verticals.

Loans held for investment increased \$33.7 million, or 12.0%, during the first three months of 2016, from \$280.0 million at December 31, 2015, to \$313.6 million at March 31, 2016. The increase was primarily the result of new loan

originations.

Servicing assets increased \$3.1 million, or 7.1%, during the first three months of 2016, from \$44.2 million at December 31, 2015, to \$47.4 million at March 31, 2016. The increase in servicing assets is primarily the result of loan sales during the first quarter of 2016 significantly outpacing the amortization of the existing serviced portfolio.

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Total deposits were \$1.02 billion at March 31, 2016, an increase of \$210.7 million, or 26.2%, from \$804.8 million at December 31, 2015. The increase in deposits was driven by execution of a deposit gathering campaign to support the growth in loan originations.

Shareholders' equity at March 31, 2016 was \$204.4 million as compared to \$199.5 million at December 31, 2015. The book value per share was \$5.98 at March 31, 2016 and average equity to average assets was 17.8% for the three months ended March 31, 2016, compared to a book value per share of \$5.84 at December 31, 2015 and average equity to average assets of 15.5% for the year ended December 31, 2015. The change in shareholders' equity principally represents net income to common shareholders for the three months ended March 31, 2016 of \$4.7 million combined with stock based compensation expense of \$659 thousand partially offset by \$684 thousand 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).

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

| | March 31, 2016 | December 31, 2015 | |
|---|-------------------|----------------------|---|
| Nonperforming assets: | | | |
| Total nonperforming loans (all on nonaccrual) | \$14,829 | \$12,367 | |
| Total accruing loans past due 90 days or more | — | — | |
| Foreclosed assets | 3,020 | 2,666 | |
| Total troubled debt restructurings | 11,260 | 11,021 | |
| Less nonaccrual troubled debt restructurings | (8,612) | (8,814) | |
| Total performing troubled debt restructurings | 2,648 | 2,207 | |
| Total nonperforming assets and troubled debt restructurings | \$20,497 | \$17,240 | |
| Total nonperforming loans to total loans held for investment | 4.73 | % 4.42 | % |
| Total nonperforming loans to total assets | 1.17 | % 1.17 | % |
| Total nonperforming assets and troubled debt restructurings to total assets | 1.62 | % 1.64 | % |

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| | March 31, 2016 | December 31, 2015 | | |
|---|-------------------|----------------------|---|--|
| Nonperforming assets guaranteed by U.S. government: | | | | |
| Total nonperforming loans guaranteed by the SBA (all on nonaccrual) | \$ 12,408 | \$ 10,330 | | |
| Total accruing loans past due 90 days or more guaranteed by the SBA | — | — | | |
| Foreclosed assets guaranteed by the SBA | 2,582 | 2,293 | | |
| Total troubled debt restructurings guaranteed by the SBA | 7,887 | 7,710 | | |
| Less nonaccrual troubled debt restructurings guaranteed by the SBA | (7,426) | (7,550) | | |
| Total performing troubled debt restructurings guaranteed by SBA | 461 | 160 | | |
| Total nonperforming assets and troubled debt restructurings guaranteed by the SBA | \$ 15,451 | \$ 12,783 | | |
| Total nonperforming loans not guaranteed by the SBA to total held for investment loans | 0.77 | % 0.73 | % | |
| Total nonperforming loans not guaranteed by the SBA to total assets | 0.19 | % 0.19 | % | |
| Total nonperforming assets and troubled debt restructurings not guaranteed by the SBA to total assets | 0.40 | % 0.42 | % | |

Total nonperforming assets and troubled debt restructurings at March 31, 2016 were \$20.5 million, which represented a \$3.3 million, or 18.9%, increase from December 31, 2015. Total nonperforming assets at March 31, 2016 were comprised of \$14.8 million in nonaccrual loans and \$3.0 million in foreclosed assets. Of the \$20.5 million of nonperforming assets and troubled debt restructurings, \$15.5 million carried an SBA guarantee, leaving an unguaranteed exposure of \$5.0 million in total nonperforming assets at March 31, 2016. The unguaranteed exposure in total nonperforming assets at December 31, 2015 was \$4.5 million. Unguaranteed exposure relating to nonperforming assets at March 31, 2016 increased by \$589 thousand, or 13.2%, compared to December 31, 2015.

As a percentage of the Bank's total capital, nonperforming loans represented 14.5% at March 31, 2016, compared to nonperforming loans of 12.0% of the Bank's total capital at December 31, 2015. Adjusting the ratio to include only the unguaranteed portion of nonperforming loans to reflect the management's belief that the greater magnitude of risk resides in this portion, the ratios at March 31, 2016 and December 31, 2015 were 2.4% and 2.0%, respectively.

As of March 31, 2016, potential problem loans and impaired loans totaled \$46.4 million. Risk Grades 5 through 8 represent the spectrum of criticized and impaired loans. At March 31, 2016 potential problem loans and impaired loans were comprised of 45.1% and 27.9% in Veterinary and Healthcare Industries, our two largest verticals, respectively. As of December 31, 2015, potential problem and impaired loans totaled \$41.0 million with loans in the Veterinary and Healthcare Industry verticals comprising 50.2% and 27.0%, respectively. The majority of the impaired loans in the Veterinary Industry were originated prior to 2010. The Company believes that its underwriting and credit quality standards have improved as the business has matured. At March 31, 2016, the portion of criticized loans guaranteed by the SBA totaled \$18.7 million resulting in unguaranteed exposure risk of \$27.7 million, or 9.6% of total held for investment unguaranteed exposure. This compares to total criticized and impaired loans of \$41.0 million at December 31, 2015, of which \$17.2 million was guaranteed by the SBA.

The Bank does not classify loans 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 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 alter the rate or lengthen the amortization of the note due to insignificant payment delays. Short term modifications are not classified as troubled debt restructurings, or TDRs, because they do not meet the definition set by the applicable accounting standards and the Federal Deposit Insurance Corporation.

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Management endeavors to be proactive in its approach to identify and resolve problem loans and is focused on working with the borrowers and guarantors of these loans to provide loan modifications when warranted. Management implements a proactive approach to identifying and classifying loans as criticized, Risk Grade 5. For example, at March 31, 2016 and December 31, 2015, Risk Grade 5 loans totaled \$22.3 million and \$17.5 million, respectively. The increase in Risk Grade 5 loans from December 31, 2015 to March 31, 2016 was principally confined to three verticals; Deathcare (\$1.7 million or 34.9% of increase), Healthcare (\$1.4 million or 29.8% of increase) and Veterinary (\$1.3 million or 27.7% of increase). The underlying cause of the increase in Risk Grade 5 loans from December 31, 2015 to March 31, 2016 was ongoing maturation of legacy verticals combined with a \$1.4 million migration of Risk Grade 6 loans to Risk Grade 5. 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 Losses

The allowance for loan losses ("ALL"), 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 losses charged to earnings to account for losses that are inherent in the loan portfolio and estimated to occur, and is maintained at a level that management considers appropriate to absorb losses in the loan portfolio. Loan losses are charged against the ALL when management believes that the collectability of the principal loan balance is unlikely. Subsequent recoveries, if any, are credited to the ALL when received.

Judgment in determining the adequacy of the ALL 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 ALL is evaluated on a quarterly basis by management and takes into consideration such factors as changes in the nature and volume of the loan portfolio, overall portfolio quality, review of specific problem loans and current economic conditions and trends that may affect the borrower's ability to repay.

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

The ALL of \$7.4 million at December 31, 2015 increased by \$1.2 million, or 16.2%, to \$8.6 million at March 31, 2016. The ALL, as a percentage of loans held for investment, amounted to 2.7% at March 31, 2016 and 2.6% at December 31, 2015. The majority of this increase was in general reserves and was attributed to growth in loans held for investment and expansion into new verticals with higher loss factors due to the Company's lack of experience in those industries. General reserves as a percentage of non-impaired loans amounted to 2.05% at March 31, 2016 and December 31, 2015. Net charge-offs were \$232 thousand for the three months ended March 31, 2016, compared to net charge-offs of \$250 thousand for the three months ended March 31, 2015. Annualized net charge-offs in the first three months of 2016 were 0.30% of average loans held for investment, compared to annualized net charge-offs of 0.47% in the same period of 2015.

Actual past due loans have declined, and loan charge-offs have remained relatively stable as management continues to work to improve asset quality. Management believes the ALL of \$8.6 million at March 31, 2016 is appropriate in light of the risk inherent in the loan 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 losses in future periods will not exceed the current ALL or that future increases in the ALL will not be required. No assurance can be given that management's ongoing evaluation of the loan portfolio in light of changing economic

conditions and other relevant circumstances will not require significant future additions to the ALL, thus adversely affecting the Company's operating results. Additional information on the ALL is presented in Note 5 to the consolidated financial statements included with this report.

Table of Contents**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, 2016, the total amount of these four items was \$430.6 million, or 33.9% of total assets, an increase of \$139.2 million from \$291.4 million, or 27.7% of total assets, at December 31, 2015.

Loans and other assets are funded primarily by loan sales, wholesale deposits and core deposits. To date, an increasing retail deposit base and a level amount of 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, 2016, none of the investment securities portfolio was pledged to secure public deposits or pledged to retail repurchase agreements, and \$1.2 million was pledged for secured federal funds lines of credit, leaving \$54.4 million available as lendable collateral.

Contractual Obligations

The following table presents the Company's significant fixed and determinable contractual obligations by payment date as of March 31, 2016. 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 | \$425,426 | \$425,426 | \$— | \$— | \$— |
| Time deposits | 590,039 | 343,026 | 174,726 | 72,287 | — |
| Long term borrowings | 28,271 | 396 | 1,665 | 6,080 | 20,130 |
| Operating lease obligations | 1,459 | 452 | 640 | 367 | — |
| Total | \$1,045,195 | \$769,300 | \$177,031 | \$78,734 | \$20,130 |

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 liability-sensitive with a total cumulative gap position of -6.148% at March 31, 2016. During 2015, the flat interest rate environment led to extension of longer term fixed rate deposits to more closely align with the term of fixed rate agriculture loans. A liability-sensitive position means that net interest income will generally move in the opposite direction as interest rates. For instance, if interest rates increase, net interest income can be expected to decrease, and if interest rates decrease, net interest income can be expected to increase. 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. Capital amounts and ratios as of March 31, 2016 and December 31, 2015, 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, 2016 | | | | | | |
| Common Equity Tier 1 (to Risk-Weighted Assets) | \$ 189,932 | 20.61 % | \$ 41,473 | 4.50 % | N/A | N/A |
| Total Capital (to Risk-Weighted Assets) | \$ 198,548 | 21.54 % | \$ 73,729 | 8.00 % | N/A | N/A |
| Tier 1 Capital (to Risk-Weighted Assets) | \$ 189,932 | 20.61 % | \$ 55,297 | 6.00 % | N/A | N/A |
| Tier 1 Capital (to Average Assets) | \$ 189,932 | 17.09 % | \$ 44,450 | 4.00 % | N/A | N/A |
| Bank - March 31, 2016 | | | | | | |
| Common Equity Tier 1 (to Risk-Weighted Assets) | \$ 93,817 | 10.73 % | \$ 39,363 | 4.50 % | \$ 56,858 | 6.50 % |
| Total Capital (to Risk-Weighted Assets) | \$ 102,433 | 11.71 % | \$ 69,979 | 8.00 % | \$ 87,473 | 10.00 % |
| Tier 1 Capital (to Risk-Weighted Assets) | \$ 93,817 | 10.73 % | \$ 52,484 | 6.00 % | \$ 69,979 | 8.00 % |
| Tier 1 Capital (to Average Assets) | \$ 93,817 | 8.84 % | \$ 42,471 | 4.00 % | \$ 53,089 | 5.00 % |
| Consolidated - December 31, 2015 | | | | | | |
| Common Equity Tier 1 (to Risk-Weighted Assets) | \$ 191,366 | 23.22 % | \$ 37,087 | 4.50 % | N/A | N/A |
| Total Capital (to Risk-Weighted Assets) | \$ 198,781 | 24.12 % | \$ 65,933 | 8.00 % | N/A | N/A |
| Tier 1 Capital (to Risk-Weighted Assets) | \$ 191,366 | 23.22 % | \$ 49,450 | 6.00 % | N/A | N/A |
| Tier 1 Capital (to Average Assets) | \$ 191,366 | 18.36 % | \$ 41,702 | 4.00 % | N/A | N/A |
| Bank - December 31, 2015 | | | | | | |
| Common Equity Tier 1 (to Risk-Weighted Assets) | \$ 96,056 | 12.28 % | \$ 35,207 | 4.50 % | \$ 50,855 | 6.50 % |
| Total Capital (to Risk-Weighted Assets) | \$ 103,471 | 13.23 % | \$ 62,591 | 8.00 % | \$ 78,238 | 10.00 % |
| Tier 1 Capital (to Risk-Weighted Assets) | \$ 96,056 | 12.28 % | \$ 46,943 | 6.00 % | \$ 62,591 | 8.00 % |
| Tier 1 Capital (to Average Assets) | \$ 96,056 | 9.75 % | \$ 39,398 | 4.00 % | \$ 49,248 | 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.

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Accounting policies, as described in detail in the notes to the Company's consolidated financial statements, 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 losses;

• Valuation of servicing assets; and

• Valuation of foreclosed assets.

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, 2016, 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, 2016 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

Management has not evaluated any changes in the Company's internal control over financial reporting that occurred during the quarterly period ended March 31, 2016 due to a transition period established by the rules of the Securities and Exchange Commission for newly public companies.

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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, 2016, any pending legal proceedings other than routine, 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 2015 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 12, 2016 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) |
| 10.1 | Performance RSU Award Agreement for Neil L. Underwood dated March 23, 2016 (incorporated by reference to Exhibit 99.1 of the Current Report on Form 8-K filed on March 25, 2016) |
| 10.2 | Performance RSU Award Agreement with Stock Price Condition for Neil L. Underwood dated March 23, 2016 (incorporated by reference to Exhibit 99.2 of the Current Report on Form 8-K filed on March 25, 2016) |
| 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 |
| 101 | Interactive data files pursuant to Rule 405 of Regulation S-T: (i) Consolidated Balance Sheets as of March 31, 2016 and December 31, 2015; (ii) Consolidated Statements of Income for the Three Months Ended March 31, 2016 and 2015; (iii) Consolidated Statements of Comprehensive Income for the Three Months Ended March 31, 2016 and 2015; (iv) Consolidated Statements of Changes in Shareholders' Equity for the Three Months Ended March 31, 2016 and 2015; (v) Consolidated Statements of Cash Flows for the Three Months Ended March 31, 2016 and 2015; and (vi) Notes to Consolidated Financial Statements |