

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

Table of Contents

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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 September 30, 2018

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

Commission file number: 001-37497

LIVE OAK BANCSHARES, INC.

(Exact name of registrant as specified in its charter)

North Carolina

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

1741 Tiburon Drive

Wilmington, North Carolina

(Address of principal executive offices)

(910) 790-5867

(Registrant's telephone number, including area code)

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 every Interactive Data File required to be submitted 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 such files). YES ý NO

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

Large accelerated filer  Accelerated filer  x

Non-accelerated filer  Smaller reporting company

Emerging growth company

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

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

APPLICABLE ONLY TO CORPORATE ISSUERS:

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

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As of November 6, 2018, there were 35,503,535 shares of the registrant's voting common stock outstanding and 4,643,530 shares of the registrant's non-voting common stock outstanding.

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Table of Contents

Live Oak Bancshares, Inc. and Subsidiaries  
 Form 10-Q  
 For the Quarterly Period Ended September 30, 2018  
 TABLE OF CONTENTS

|   | Page      |
|---|-----------|
| PART I. FINANCIAL INFORMATION   |           |
| Item 1. <u>Financial Statements (Unaudited)</u>   | <u>1</u>  |
| <u>Condensed Consolidated Balance Sheets as of September 30, 2018 and December 31, 2017</u>                                       | <u>1</u>  |
| <u>Condensed Consolidated Statements of Income for the Three and Nine Months Ended September 30, 2018 and 2017</u>                | <u>2</u>  |
| <u>Condensed Consolidated Statements of Comprehensive Income for the Three and Nine Months Ended September 30, 2018 and 2017</u>  | <u>3</u>  |
| <u>Condensed Consolidated Statements of Changes in Shareholders' Equity for the Nine Months Ended September 30, 2018 and 2017</u> | <u>4</u>  |
| <u>Condensed Consolidated Statements of Cash Flows for the Nine Months Ended September 30, 2018 and 2017</u>                      | <u>5</u>  |
| <u>Notes to Unaudited Condensed Consolidated Financial Statements</u>   | <u>7</u>  |
| Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>                              | <u>44</u> |
| Item 3. <u>Quantitative and Qualitative Disclosures about Market Risk</u>   | <u>63</u> |
| Item 4. <u>Controls and Procedures</u>  | <u>63</u> |
| PART II. OTHER INFORMATION  |           |
| Item 1. <u>Legal Proceedings</u>  | <u>64</u> |
| Item 1A. <u>Risk Factors</u>  | <u>64</u> |
| Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>  | <u>64</u> |
| Item 3. <u>Defaults Upon Senior Securities</u>  | <u>64</u> |
| Item 4. <u>Mine Safety Disclosures</u>  | <u>64</u> |
| Item 5. <u>Other Information</u>  | <u>64</u> |
| Item 6. <u>Exhibits</u>   | <u>64</u> |
| <u>Signatures</u>   | <u>65</u> |
| <u>Index to Exhibits</u>  | <u>66</u> |

Table of Contents

## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements

Live Oak Bancshares, Inc.

Condensed Consolidated Balance Sheets

As of September 30, 2018 (unaudited) and December 31, 2017\*

(Dollars in thousands)

|  | September<br>30,<br>2018 | December<br>31,<br>2017* |
|--|--------------------------|--------------------------|
| Assets   |                          |                          |
| Cash and due from banks  | \$368,565                | \$295,271                |
| Certificates of deposit with other banks   | 750                      | 3,000                    |
| Investment securities available-for-sale   | 374,284                  | 93,355                   |
| Loans held for sale  | 646,475                  | 680,454                  |
| Loans and leases held for investment   | 1,631,337                | 1,343,973                |
| Allowance for loan and lease losses  | (26,797 )                | (24,190 )                |
| Net loans and leases   | 1,604,540                | 1,319,783                |
| Premises and equipment, net  | 263,861                  | 178,790                  |
| Foreclosed assets  | 1,429                    | 1,281                    |
| Servicing assets   | 49,261                   | 52,298                   |
| Other assets   | 135,592                  | 134,242                  |
| Total assets   | \$3,444,757              | \$2,758,474              |
| Liabilities and Shareholders' Equity   |                          |                          |
| Liabilities  |                          |                          |
| Deposits:  |                          |                          |
| Noninterest-bearing  | \$48,622                 | \$57,868                 |
| Interest-bearing   | 2,875,666                | 2,202,395                |
| Total deposits   | 2,924,288                | 2,260,263                |
| Long term borrowings   | 1,506                    | 26,564                   |
| Other liabilities  | 41,733                   | 34,714                   |
| Total liabilities  | 2,967,527                | 2,321,541                |
| Shareholders' equity   |                          |                          |
| Preferred stock, no par value, 1,000,000 authorized, none issued or outstanding at September 30, 2018 and December 31, 2017  | —                        | —                        |
| Class A common stock, no par value, 100,000,000 shares authorized, 35,496,887 and 35,252,053 shares issued and outstanding at September 30, 2018 and December 31, 2017, respectively | 276,831                  | 268,557                  |
| Class B common stock, no par value, 10,000,000 shares authorized, 4,643,530 shares issued and outstanding at September 30, 2018 and December 31, 2017                                | 49,168                   | 49,168                   |
| Retained earnings  | 157,839                  | 120,241                  |
| Accumulated other comprehensive loss   | (6,608 )                 | (1,033 )                 |
| Total equity   | 477,230                  | 436,933                  |
| Total liabilities and shareholders' equity   | \$3,444,757              | \$2,758,474              |

\* Derived from audited consolidated financial statements.

See Notes to Unaudited Condensed Consolidated Financial Statements

Table of Contents

Live Oak Bancshares, Inc.

Condensed Consolidated Statements of Income

For the three and nine months ended September 30, 2018 and 2017 (unaudited)

(Dollars in thousands, except per share data)

|   | Three Months<br>Ended<br>September 30, |          | Nine Months Ended<br>September 30, |          |
|---|--|----------|------------------------------------|----------|
|   | 2018                                   | 2017     | 2018                               | 2017     |
| Interest income   |  |          |                                    |          |
| Loans and fees on loans                                       | \$37,724                               | \$26,977 | \$106,682                          | \$70,290 |
| Investment securities, taxable                                | 2,528                                  | 325      | 6,175                              | 964      |
| Other interest earning assets                                 | 1,638                                  | 870      | 5,032                              | 1,682    |
| Total interest income   | 41,890                                 | 28,172   | 117,889                            | 72,936   |
| Interest expense  |  |          |                                    |          |
| Deposits  | 14,165                                 | 6,758    | 38,510                             | 16,893   |
| Borrowings  | 1                                      | 389      | 131                                | 985      |
| Total interest expense  | 14,166                                 | 7,147    | 38,641                             | 17,878   |
| Net interest income   | 27,724                                 | 21,025   | 79,248                             | 55,058   |
| Provision for (recovery of) loan and lease losses             | (243 )                                 | 2,426    | 6,236                              | 5,481    |
| Net interest income after provision for loan and lease losses | 27,967                                 | 18,599   | 73,012                             | 49,577   |
| Noninterest income  |  |          |                                    |          |
| Loan servicing revenue  | 7,506                                  | 6,490    | 21,369                             | 18,587   |
| Loan servicing asset revaluation                              | (9,380 )                               | (3,691 ) | (18,138 )                          | (6,864 ) |
| Net gains on sales of loans                                   | 22,004                                 | 18,148   | 69,483                             | 55,276   |
| Lease income  | 2,194                                  | 682      | 5,722                              | 691      |
| Construction supervision fee income                           | 578                                    | 362      | 1,954                              | 1,077    |
| Title insurance income  | 479                                    | 1,968    | 2,775                              | 5,803    |
| Other noninterest income                                      | 950                                    | 1,101    | 2,535                              | 2,910    |
| Total noninterest income                                      | 24,331                                 | 25,060   | 85,700                             | 77,480   |
| Noninterest expense   |  |          |                                    |          |
| Salaries and employee benefits                                | 20,553                                 | 19,037   | 62,908                             | 55,687   |
| Travel expense  | 2,003                                  | 2,289    | 5,887                              | 6,035    |
| Professional services expense                                 | 1,228                                  | 1,068    | 3,645                              | 4,228    |
| Advertising and marketing expense                             | 1,462                                  | 1,516    | 4,992                              | 4,977    |
| Occupancy expense   | 1,588                                  | 1,473    | 5,327                              | 4,018    |
| Data processing expense                                       | 3,661                                  | 1,982    | 9,404                              | 5,536    |
| Equipment expense   | 3,649                                  | 2,228    | 10,094                             | 5,005    |
| Other loan origination and maintenance expense                | 1,742                                  | 1,601    | 4,485                              | 3,587    |
| FDIC insurance  | 1,105                                  | 858      | 2,687                              | 2,308    |
| Title insurance closing services expense                      | 114                                    | 687      | 912                                | 1,877    |
| Impairment expense on goodwill and other intangibles, net     | 2,680                                  | —        | 2,680                              | —        |
| Other expense   | 1,459                                  | 3,117    | 7,125                              | 8,883    |
| Total noninterest expense                                     | 41,244                                 | 35,856   | 120,146                            | 102,141  |
| Income before taxes   | 11,054                                 | 7,803    | 38,566                             | 24,916   |
| Income tax benefit  | (3,198 )                               | (5,059 ) | (2,392 )                           | (3,853 ) |
| Net income  | \$14,252                               | \$12,862 | \$40,958                           | \$28,769 |
| Basic earnings per share                                      | \$0.36                                 | \$0.34   | \$1.02                             | \$0.81   |
| Diluted earnings per share                                    | \$0.34                                 | \$0.33   | \$0.98                             | \$0.78   |

See Notes to Unaudited Condensed Consolidated Financial Statements

2

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Table of Contents

Live Oak Bancshares, Inc.

Condensed Consolidated Statements of Comprehensive Income

For the three and nine months ended September 30, 2018 and 2017 (unaudited)

(Dollars in thousands)

|  | Three Months<br>Ended<br>September 30, |          | Nine Months<br>Ended<br>September 30, |          |
|--|--|----------|---------------------------------------|----------|
|  | 2018                                   | 2017     | 2018                                  | 2017     |
| Net income   | \$14,252                               | \$12,862 | \$40,958                              | \$28,769 |
| Other comprehensive (loss) income before tax:  |  |          |                                       |          |
| Net unrealized (loss) gain on investment securities arising during the period                                  | (2,094 )                               | (168 )   | (7,014 )                              | 52       |
| Reclassification adjustment for (gain) loss on sale of securities<br>available-for-sale included in net income | —                                      | —        | —                                     | —        |
| Other comprehensive (loss) income before tax   | (2,094 )                               | (168 )   | (7,014 )                              | 52       |
| Income tax benefit (expense)   | 502                                    | 65       | 1,683                                 | (20 )    |
| Other comprehensive (loss) income, net of tax  | (1,592 )                               | (103 )   | (5,331 )                              | 32       |
| Total comprehensive income   | \$12,660                               | \$12,759 | \$35,627                              | \$28,801 |

See Notes to Unaudited Condensed Consolidated Financial Statements

3

Table of Contents

Live Oak Bancshares, Inc.

Condensed Consolidated Statements of Changes in Shareholders' Equity

For the nine months ended September 30, 2018 and 2017 (unaudited)

(Dollars in thousands)

|  | Common stock |           |            | Retained   | Accumulated   | Total        |
|--|--------------|-----------|------------|------------|---------------|--------------|
|  | Shares       |           | Amount     | earnings   | other         | equity       |
|  | Class A      | Class B   |            |            | comprehensive | loss         |
| Balance at December 31, 2016   | 29,530,072   | 4,723,530 | \$ 199,981 | \$ 23,518  | \$ (652       | ) \$ 222,847 |
| Net income   | —            | —         | —          | 28,769     | —             | 28,769       |
| Other comprehensive income   | —            | —         | —          | —          | 32            | 32           |
| Issuance of restricted stock   | 306,902      | —         | —          | —          | —             | —            |
| Withholding cash issued in lieu of restricted stock issuance                       | —            | —         | (4,891     | ) —        | —             | (4,891       |
| Employee stock purchase program  | 22,634       | —         | 445        | —          | —             | 445          |
| Stock option exercises   | 76,285       | —         | 602        | —          | —             | 602          |
| Stock option based compensation expense  | —            | —         | 1,496      | —          | —             | 1,496        |
| Restricted stock expense   | —            | —         | 4,210      | —          | —             | 4,210        |
| Stock issued in acquisition of Reltco, Inc.  | 27,724       | —         | 565        | —          | —             | 565          |
| Non-voting common stock converted to voting common stock-private sale              | 80,000       | (80,000   | ) —        | —          | —             | —            |
| Issuance of common stock in connection with secondary offering, net of issue costs | 5,175,000    | —         | 113,096    | —          | —             | 113,096      |
| Cash dividends (\$0.07 per share)  | —            | —         | —          | (2,580     | ) —           | (2,580       |
| Balance at September 30, 2017  | 35,218,617   | 4,643,530 | \$ 315,504 | \$ 49,707  | \$ (620       | ) \$ 364,591 |
| Balance at December 31, 2017   | 35,252,053   | 4,643,530 | \$ 317,725 | \$ 120,241 | \$ (1,033     | ) \$ 436,933 |
| Net income   | —            | —         | —          | 40,958     | —             | 40,958       |
| Other comprehensive loss   | —            | —         | —          | —          | (5,331        | ) (5,331     |
| Issuance of restricted stock   | 59,162       | —         | —          | —          | —             | —            |
| Withholding cash issued in lieu of restricted stock issuance                       | —            | —         | (708       | ) —        | —             | (708         |
| Employee stock purchase program  | 14,339       | —         | 342        | —          | —             | 342          |
| Stock option exercises   | 171,333      | —         | 1,587      | —          | —             | 1,587        |
| Stock option based compensation expense  | —            | —         | 1,310      | —          | —             | 1,310        |
| Restricted stock expense   | —            | —         | 5,743      | —          | —             | 5,743        |
| Reclassification of accumulated other comprehensive income due to tax rate change  | —            | —         | —          | 244        | (244          | ) —          |
| Cash dividends (\$0.09 per share)  | —            | —         | —          | (3,604     | ) —           | (3,604       |
| Balance at September 30, 2018  | 35,496,887   | 4,643,530 | \$ 325,999 | \$ 157,839 | \$ (6,608     | ) \$ 477,230 |

See Notes to Unaudited Condensed Consolidated Financial Statements



Table of Contents

Live Oak Bancshares, Inc.  
 Condensed Consolidated Statements of Cash Flows  
 For the nine months ended September 30, 2018 and 2017 (unaudited)  
 (Dollars in thousands)

|   | Nine Months<br>Ended<br>September 30, |           |
|---|---------------------------------------|-----------|
|   | 2018                                  | 2017      |
| Cash flows from operating activities  |                                       |           |
| Net income  | \$40,958                              | \$28,769  |
| Adjustments to reconcile net income to net cash provided (used) by operating activities:        |                                       |           |
| Depreciation and amortization   | 12,009                                | 7,020     |
| Net provision for loan and lease losses   | 6,236                                 | 5,481     |
| Amortization of premium on securities, net of accretion   | 576                                   | 355       |
| Amortization of discount on unguaranteed loans, net   | 5,282                                 | 1,263     |
| Impairment expense on goodwill and other intangibles, net                                       | 2,680                                 | —         |
| Deferred tax (benefit) expense  | (2,392 )                              | 413       |
| Originations of loans held for sale   | (826,478)                             | (884,741) |
| Proceeds from sales of loans held for sale  | 966,076                               | 648,300   |
| Net gains on sale of loans held for sale  | (69,483 )                             | (55,276 ) |
| Net loss on sale of foreclosed assets   | 19                                    | 30        |
| Net increase (decrease) in servicing assets   | 3,037                                 | (1,398 )  |
| Net loss on disposal of premises and equipment  | 37                                    | 213       |
| Stock option based compensation expense   | 1,310                                 | 1,496     |
| Restricted stock expense  | 5,743                                 | 4,210     |
| Stock based compensation expense excess tax benefits  | 110                                   | 1,073     |
| Business combination contingent consideration fair value adjustment                             | (260 )                                | 350       |
| Changes in assets and liabilities:  |                                       |           |
| Other assets  | (4,158 )                              | (17,661 ) |
| Other liabilities   | 2,665                                 | 3,875     |
| Net cash provided (used) by operating activities  | 143,967                               | (256,228) |
| Cash flows from investing activities  |                                       |           |
| Purchases of securities available-for-sale  | (327,422)                             | (13,009 ) |
| Proceeds from sales, maturities, calls, and principal paydowns of securities available-for-sale | 36,813                                | 7,187     |
| Proceeds from sale/collection of foreclosed assets  | 392                                   | 50        |
| Business combination, net of cash acquired  | —                                     | (7,696 )  |
| Sale of title insurance business, net of cash sold  | (209 )                                | —         |
| Maturities of certificates of deposit with other banks  | 2,250                                 | 4,000     |
| Loan and lease originations and principal collections, net                                      | (332,115)                             | (273,501) |
| Proceeds from sale of premises and equipment  | 865                                   | —         |
| Purchases of premises and equipment, net  | (87,831 )                             | (71,420 ) |
| Net cash used by investing activities   | (707,257)                             | (354,389) |
| See Notes to Unaudited Condensed Consolidated Financial Statements                              |                                       |           |

Table of Contents

Live Oak Bancshares, Inc.  
 Condensed Consolidated Statements of Cash Flows (Continued)  
 For the nine months ended September 30, 2018 and 2017 (unaudited)  
 (Dollars in thousands)

|  | Nine Months Ended<br>September 30, |           |
|--|------------------------------------|-----------|
|  | 2018                               | 2017      |
| Cash flows from financing activities   |                                    |           |
| Net increase in deposits   | 664,025                            | 527,815   |
| Proceeds from long term borrowings   | 18                                 | 16,900    |
| Repayment of long term borrowings  | (25,076 )                          | (25,971 ) |
| Proceeds from short term borrowings  | —                                  | 23,100    |
| Repayment of short term borrowings   | —                                  | (15,000 ) |
| Stock option exercises   | 1,587                              | 602       |
| Employee stock purchase program  | 342                                | 445       |
| Withholding cash issued in lieu of restricted stock                                | (708 )                             | (4,891 )  |
| Sale of common stock, net of issuance costs  | —                                  | 113,096   |
| Shareholder dividend distributions   | (3,604 )                           | (2,580 )  |
| Net cash provided by financing activities  | 636,584                            | 633,516   |
| Net increase in cash and cash equivalents  | 73,294                             | 22,899    |
| Cash and cash equivalents, beginning   | 295,271                            | 238,008   |
| Cash and cash equivalents, ending  | \$368,565                          | \$260,907 |
| Supplemental disclosure of cash flow information                                   |                                    |           |
| Interest paid  | \$38,598                           | \$17,927  |
| Income tax (refunds) payments, net   | (383 )                             | 7,094     |
| Supplemental disclosures of noncash operating, investing, and financing activities |                                    |           |
| Unrealized holding (losses) gains on available-for-sale securities, net of taxes   | \$(5,331 )                         | \$32      |
| Transfers from loans and leases to foreclosed real estate and other repossessions  | 346                                | 663       |
| Net transfers from SBA receivable to foreclosed real estate                        | 213                                | —         |
| Transfer of loans held for sale to loans and leases held for investment            | 43,185                             | 5,713     |
| Transfer of loans and leases held for investment to loans held for sale            | 89,980                             | 18,990    |
| Transfers from short term borrowings to long term borrowings                       | —                                  | 8,100     |
| Accrued premises and equipment additions   | 10,518                             | 6         |
| Loans to finance sale of other assets  | 3,642                              | —         |
| Business combination:  |                                    |           |
| Assets acquired (excluding goodwill)   | —                                  | 5,766     |
| Liabilities assumed  | —                                  | 4,681     |
| Purchase price   | —                                  | 8,363     |
| Goodwill recorded  | —                                  | 7,278     |
| See Notes to Unaudited Condensed Consolidated Financial Statements                 |                                    |           |

Table of Contents

Live Oak Bancshares, Inc.

Notes to Unaudited Condensed Consolidated Financial Statements

Note 1. Basis of Presentation

Nature of Operations

Live Oak Bancshares, Inc. (the “Company” or “LOB”) is a bank holding company headquartered in Wilmington, North Carolina incorporated under the laws of North Carolina in December 2008. The Company conducts business operations primarily through its commercial bank subsidiary, Live Oak Banking Company (the “Bank”). The Bank was organized and incorporated under the laws of the State of North Carolina on February 25, 2008 and commenced operations on May 12, 2008. The Bank specializes in providing lending services to small businesses nationwide. The Bank identifies and grows lending to credit-worthy borrowers both within specific industries, also called verticals, through expertise within those industries, and more broadly to select borrowers outside of those industries. A significant portion of the loans originated by the Bank are guaranteed by the Small Business Administration (“SBA”) under the 7(a) Loan Program and the U.S. Department of Agriculture (“USDA”) Rural Energy for America Program (“REAP”) and Business & Industry (“B&I”) loan programs. On July 28, 2015 the Company completed its initial public offering with a secondary offering completed in August of 2017.

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

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

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

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

On February 1, 2017, the Company completed its acquisition of Reltco Inc. and National Assurance Title, Inc. (collectively referred to as “Reltco”), two nationwide title agencies under common control based in Tampa, Florida. Effective August 1, 2018, Reltco was sold. For more information regarding the sale, see subheading Sale of Title Insurance Business.

In June 2018, the Bank formed Live Oak Private Wealth, LLC for the purpose of providing high-net-worth individuals and families with strategic wealth and investment management services.

The Company earns revenue primarily from the sale of SBA and USDA-guaranteed loans and net interest income. Income from the sale of loans is comprised of net gains on the sale of loans, revenues on the servicing of sold loans and valuation of loan servicing rights. Offsetting these revenues are the cost of funding sources, provision for loan and lease losses, any costs related to foreclosed assets and other operating costs such as salaries and employee benefits, travel, professional services, occupancy, advertising and marketing, data processing, equipment 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 nine months ended September 30, 2018 are not necessarily indicative of the results of operations that may be expected for the year ending December 31, 2018. The consolidated balance sheet as of December 31, 2017 has been derived from the audited consolidated financial statements contained in the Company’s Annual Report on Form 10-K for the fiscal year ended December 31, 2017, filed with the Securities Exchange Commission on March 8, 2018 (SEC File No. 001-37497) (the “2017 Annual Report”). A summary description of the significant accounting policies followed by the Company is set forth in Note 1 of the Notes to Consolidated Financial Statements in the Company’s 2017 Annual Report. These unaudited interim condensed

consolidated financial statements should be read in conjunction with the consolidated financial statements and footnotes in the Company's 2017 Annual Report.

The preparation of financial statements in conformity with United States generally accepted accounting principles, or GAAP, requires management to make estimates and assumptions that affect reported amounts of assets and liabilities and the reported amounts of revenues and expenses during the reporting period. Actual results could differ significantly from those estimates.

Table of Contents

Live Oak Bancshares, Inc.

Notes to Unaudited Condensed Consolidated Financial Statements

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

**Business Segments**

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

**Unconsolidated Joint Venture**

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

As a result of the above cash earnings preference, income (loss) is allocated utilizing the hypothetical liquidation at book value ("HLBV") method. Under the HLBV method, we allocate income or loss based on the change in each unitholders' claim on the net assets of Apiture at period end, after adjusting for any distributions or contributions made during such period. As a result of the HLBV method there was no net income or loss attributed to the Company related to its ownership interest in Apiture during the three and nine months ended September 30, 2018.

As of September 30, 2018 and December 31, 2017 the Company had a \$68.0 million equity method investment included in other assets on the consolidated balance sheet for this investment.

**Derivative Financial Instruments**

**Interest Rate Futures Contracts**

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

**Equity Warrant Assets**

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

Equity warrant assets in certain private client companies are recorded as derivatives when they contain net settlement terms and other qualifying criteria under Accounting Standards Codification 815. Equity warrant assets entitle the Company to purchase a specific number of shares of stock at a specific price within a specific time period, generally

10 years. Certain equity warrant assets contain contingent provisions, which adjust the underlying number of shares or purchase price upon the occurrence of certain future events to prevent dilution of the Company's implied ownership represented by the warrants. Certain warrant agreements contain net share settlement provisions, which permit the receipt of, upon exercise, a share count equal to the intrinsic value of the warrant divided by the share price (otherwise known as a "cashless" exercise). These equity warrant assets are recorded at fair value and are classified as derivative assets, a component of other assets, on the consolidated balance sheet at the time they are obtained.

Table of Contents

Live Oak Bancshares, Inc.

Notes to Unaudited Condensed Consolidated Financial Statements

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

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

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

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

**Sale of Title Insurance Business**

On August 1, 2018, the Company financed the sale of its entire interest in Reltco, Inc. and National Assurance Title, Inc. for \$3.0 million. The Company's divestiture was driven by expectations of future profitability under current market conditions impacting the mortgage industry. As a result of these expectations, the Company recorded a \$3.0 million reserve against the amount financed on the date of the sale. In total, the transaction resulted in a net cost of \$2.7 million which is recorded as "Impairment expense on goodwill and other intangibles, net" on the consolidated statements of income.

**Revenue Recognition**

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

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

**Other noninterest income**

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

**Contract Balances**

A contract asset balance occurs when an entity performs a service for a customer before the customer pays consideration (resulting in a contract receivable) or before payment is due (resulting in a contract asset). A contract

liability balance is an entity's obligation to transfer a service to a customer for which the entity has already received payment (or payment is due) from the customer. The Company's noninterest revenue streams are largely based on transactional activity, or standard month-end revenue accruals such as trust administration fees based on month-end market values. Consideration is often received immediately or shortly after the Company satisfies its performance obligation and revenue is recognized. The Company does not typically enter into long-term revenue contracts with customers, and therefore, does not experience significant contract balances. As of September 30, 2018 and December 31, 2017, the Company did not have any significant contract balances.



Table of Contents

Live Oak Bancshares, Inc.

Notes to Unaudited Condensed Consolidated Financial Statements

Contract Acquisition Costs

In connection with the adoption of Topic 606, an entity is required to capitalize, and subsequently amortize into expense, certain incremental costs of obtaining a contract with a customer if these costs are expected to be recovered. The incremental costs of obtaining a contract are those costs that an entity incurs to obtain a contract with a customer that it would not have incurred if the contract had not been obtained (for example, sales commission). The Company utilizes the practical expedient which allows entities to immediately expense contract acquisition costs when the asset that would have resulted from capitalizing these costs would have been amortized in one year or less. Upon adoption of Topic 606, the Company did not capitalize any contract acquisition cost.

Reclassifications

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

Note 2. Recent Accounting Pronouncements

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

In February 2016, the FASB issued ASU No. 2016-02, "Leases (Topic 842)" ("ASU 2016-02"). The FASB issued this ASU to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet by lessees for those leases classified as operating leases under current GAAP and disclosing key information about leasing arrangements. The amendments in this ASU are effective for the Company on January 1, 2019. The Company has created an implementation team that is currently evaluating the impact this standard will have on the consolidated financial statements upon adoption. Furthermore, the Company expects to adopt on a prospective basis.

In June 2016, the FASB issued ASU No. 2016-13, "Measurement of Credit Losses on Financial Instruments" ("ASU 2016-13"). This new guidance replaces the incurred loss impairment methodology in current standards with an expected credit loss methodology and requires consideration of a broader range of information to determine credit loss estimates. ASU 2016-13 requires the measurement of all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts and requires enhanced disclosures related to the significant estimates and judgments used in estimating credit losses, as well as the credit quality and underwriting standards of an organization's portfolio. In addition, ASU 2016-13 amends the accounting for credit losses on available-for-sale debt securities and purchased financial assets with credit

deterioration. ASU 2016-13 will be effective for the Company on January 1, 2020. The Company is currently evaluating the potential impact of ASU 2016-13 on the consolidated financial statements. In that regard, a cross-functional working group has been formed, under the direction of the Company's Chief Financial Officer and Chief Credit Officer. The working group is comprised of individuals from various functional areas including credit, risk management, finance and information technology, among others. Implementation efforts continue with model development, ongoing system requirements evaluation and the identification of data and resource needs, among other things. The Company has also engaged a third-party vendor solution to assist in the application of ASU 2016-13. While the Company is currently unable to reasonably estimate the impact of adopting ASU 2016-13, the impact of adoption is expected to be significantly influenced by the composition, characteristics and quality of loan and securities portfolios as well as the prevailing economic conditions and forecasts as of the adoption date.

Table of Contents

Live Oak Bancshares, Inc.

Notes to Unaudited Condensed Consolidated Financial Statements

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

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

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

In February 2018, the FASB issued ASU No. 2018-03, “Technical Corrections and Improvements to Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities” (“ASU 2018-03”). ASU 2018-03 amendments clarify certain aspects of the guidance issued in ASU 2016-01. The amendments are effective for the Company for fiscal year 2018 with adoption as of July 1, 2018. The Company adopted the standard in the third quarter of 2018 with no material impact on the consolidated financial statements.

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

In June 2018, the FASB issued ASU No. 2018-07, “Compensation - Stock Compensation (Topic 718) Improvements to Nonemployee Share-Based Payment Accounting” (“ASU 2018-07”). ASU 2018-07 amends Accounting Standard Codification 718 to largely align accounting for share-based payment awards issued to employees and nonemployees. Under the new guidance, existing employee guidance will generally apply to nonemployee share-based transactions, except for specific guidance on inputs into option pricing models and the attribution of cost. The amendments are effective for the Company on January 1, 2019 with early adoption permitted. The Company does not expect these amendments to have a material effect on its consolidated financial statements.

In July 2018, the FASB issued ASU No. 2018-10, “Codification Improvements to Topic 842, Leases” (“ASU 2018-10”). ASU 2018-10 provides clarification on narrow aspects to Topic 842 and to correct unintended application of the guidance. The amendments are effective for the Company on January 1, 2019. The Company is currently assessing the effect the adoption of these amendments will have on the consolidated financial statements. See ASU 2016-02 for further discussion of implementation efforts.

Table of Contents

Live Oak Bancshares, Inc.

Notes to Unaudited Condensed Consolidated Financial Statements

In July 2018, the FASB issued ASU No. 2018-11, “Leases (Topic 842) Targeted Improvements” (“ASU 2018-11”). ASU 2018-11 provides an additional transition method to adopt ASU 2016-02. The transition method allows an entity to apply ASU 2016-02 at the adoption date and recognize a cumulative-effect adjustment to the opening balance of retained earnings in the period of adoption. An entity that elects this transition method must provide required disclosures under Topic 840 for all periods that are in accordance with Topic 840. ASU 2018-11 also provides lessors with a practical expedient to not separate non-lease components from lease components by class of underlying asset. The amendments in this ASU are effective for the Company on January 1, 2019. The Company is currently assessing the effect the adoption of these amendments will have on the consolidated financial statements. See ASU 2016-02 for further discussion of implementation efforts.

In August 2018, the FASB issued ASU No. 2018-13, “Fair Value Measurement (Topic 820): Disclosure Framework - Changes to the Disclosure Requirements for Fair Value Measurement” (“ASU 2018-13”). ASU 2018-13 removes, modifies and adds certain fair value disclosure requirements on fair value measurements. The amendments are effective for the Company on January 1, 2020 with early adoption permitted. The Company does not expect these amendments to have a material effect on its consolidated financial statements.

In August 2018, the FASB issued ASU No. 2018-15, “Intangibles - Goodwill and Other - Internal-Use Software (Subtopic 350-40): Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract” (“ASU 2018-15”). ASU 2018-15 aligns the requirements for capitalizing implementation costs incurred in a hosting arrangement that is a service contract with the requirements for capitalizing implementation costs incurred to develop or obtain internal-use software. The amendments are effective for the Company on January 1, 2020 with early adoption permitted. The Company is currently assessing the effect that 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<br>September 30,<br>2018 |            | Nine Months Ended<br>September 30,<br>2018 |            |
|---|---|------------|--|------------|
| Basic earnings per share:   |   |            |  |            |
| Net income available to common shareholders                                 | \$ 14,252                                   | \$ 12,862  | \$ 40,958                                  | \$ 28,769  |
| Weighted-average basic shares outstanding                                   | 40,119,567                                  | 37,366,041 | 40,025,265                                 | 35,485,371 |
| Basic earnings per share  | \$0.36                                      | \$ 0.34    | \$ 1.02                                    | \$ 0.81    |
| Diluted earnings per share:   |   |            |  |            |
| Net income available to common shareholders, for diluted earnings per share | \$ 14,252                                   | \$ 12,862  | \$ 40,958                                  | \$ 28,769  |
| Total weighted-average basic shares outstanding                             | 40,119,567                                  | 37,366,041 | 40,025,265                                 | 35,485,371 |
| Add effect of dilutive stock options and restricted stock grants            | 1,568,869                                   | 1,278,636  | 1,561,722                                  | 2,244,683  |
| Total weighted-average diluted shares outstanding                           | 41,688,436                                  | 38,644,677 | 41,586,987                                 | 37,730,054 |
| Diluted earnings per share  | \$0.34                                      | \$ 0.33    | \$ 0.98                                    | \$ 0.78    |
| Anti-dilutive shares  | —   | 243,199    | —  | 250,698    |



Table of Contents

Live Oak Bancshares, Inc.

Notes to Unaudited Condensed Consolidated Financial Statements

## Note 4. Investment Securities

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

|  | Amortized<br>Cost | Unrealized<br>Gains | Unrealized<br>Losses | Fair<br>Value |
|--|-------------------|---------------------|----------------------|---------------|
| September 30, 2018                     |                   |                     |                      |               |
| US treasury securities                 | \$ 4,965          | \$ —                | \$ 31                | \$4,934       |
| US government agencies                 | 33,598            | —                   | 523                  | 33,075        |
| Residential mortgage-backed securities | 344,415           | 14                  | 8,154                | 336,275       |
| Total                                  | \$ 382,978        | \$ 14               | \$ 8,708             | \$ 374,284    |
| December 31, 2017                      |                   |                     |                      |               |
| US government agencies                 | \$ 22,778         | \$ 3                | \$ 157               | \$22,624      |
| Residential mortgage-backed securities | 70,167            | 1                   | 1,472                | 68,696        |
| Mutual fund <sup>(1)</sup>             | 2,090             | —                   | 55                   | 2,035         |
| Total                                  | \$ 95,035         | \$ 4                | \$ 1,684             | \$93,355      |

(1) The following mutual fund was reclassified from investment securities available-for-sale to other assets in accordance with the adoption of ASU 2016-01.

There were no sales of securities during the three and nine months ended September 30, 2018 and 2017.

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

|  | Less Than 12 Months |                      | 12 Months or More |                      | Total         |                      |
|--|---------------------|----------------------|-------------------|----------------------|---------------|----------------------|
|  | Fair<br>Value       | Unrealized<br>Losses | Fair<br>Value     | Unrealized<br>Losses | Fair<br>Value | Unrealized<br>Losses |
| September 30, 2018                     |                     |                      |                   |                      |               |                      |
| US treasury securities                 | \$4,934             | \$ 31                | \$—               | \$ —                 | \$4,934       | \$ 31                |
| US government agencies                 | 26,603              | 486                  | 6,472             | 37                   | 33,075        | 523                  |
| Residential mortgage-backed securities | 286,015             | 5,426                | 47,812            | 2,728                | 333,827       | 8,154                |
| Total                                  | \$317,552           | \$ 5,943             | \$54,284          | \$ 2,765             | \$371,836     | \$ 8,708             |
| December 31, 2017                      |                     |                      |                   |                      |               |                      |
| US government agencies                 | \$14,842            | \$ 100               | \$6,465           | \$ 57                | \$21,307      | \$ 157               |
| Residential mortgage-backed securities | 23,481              | 439                  | 40,648            | 1,033                | 64,129        | 1,472                |
| Mutual fund                            | —                   | —                    | 2,035             | 55                   | 2,035         | 55                   |
| Total                                  | \$38,323            | \$ 539               | \$49,148          | \$ 1,145             | \$87,471      | \$ 1,684             |

At September 30, 2018, there were twenty-nine residential mortgage-backed securities and three US government agency securities in unrealized loss positions for greater than 12 months and one US treasury security, forty residential mortgage-backed securities and eight US government agency securities in unrealized loss positions for less than 12 months. Unrealized losses at December 31, 2017 were comprised of twenty-three residential mortgage-backed securities, three US government agencies and the 504 mutual fund in unrealized loss positions for greater than 12 months and five US government agency securities and eight residential mortgage-backed securities in unrealized loss positions for less than 12 months.

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

Since none of the unrealized losses relate to marketability of the securities or the issuer's ability to honor redemption obligations and the Company has the intent and ability to hold the securities for a sufficient period of time to recover unrealized losses, none of the securities are deemed to be other than temporarily impaired.

All residential mortgage-backed securities in the Company's portfolio at September 30, 2018 and December 31, 2017 were backed by U.S. government sponsored enterprises ("GSEs").



Table of Contents

Live Oak Bancshares, Inc.

Notes to Unaudited Condensed Consolidated Financial Statements

The following is a summary of investment securities by maturity:

|  | September 30, 2018 |            |
|--|--------------------|------------|
|  | Available-for-Sale | Amortized  |
|  | cost               | Fair value |
| US treasury securities                 |                    |            |
| One to five years                      | \$4,965            | \$4,934    |
| Total                                  | 4,965              | 4,934      |
| US government agencies                 |                    |            |
| Within one year                        | 6,510              | 6,472      |
| One to five years                      | 27,088             | 26,603     |
| Total                                  | 33,598             | 33,075     |
| Residential mortgage-backed securities |                    |            |
| One to five years                      | 3,806              | 3,617      |
| Five to ten years                      | 48,752             | 47,673     |
| After 10 years                         | 291,857            | 284,985    |
| Total                                  | 344,415            | 336,275    |
| Total                                  | \$382,978          | \$374,284  |

The table above reflects contractual maturities. Actual results will differ as the loans underlying the residential mortgage-backed securities may repay sooner than scheduled.

At September 30, 2018 and December 31, 2017, an investment security with a fair market value of \$98 thousand and \$100 thousand, respectively, was pledged to the Ohio State Treasurer to allow the Company's trust department to conduct business in the state of Ohio and investment securities with a fair market value of \$2.5 million were pledged to the Company's trust department for uninsured trust assets held by the trust department.

Table of Contents

Live Oak Bancshares, Inc.

Notes to Unaudited Condensed Consolidated Financial Statements

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

Loan and Lease Portfolio Segments

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

Commercial and Industrial

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

Construction and Development

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

Commercial Real Estate

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

Commercial Land

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

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

proposed loan.

15

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Table of Contents

Live Oak Bancshares, Inc.

Notes to Unaudited Condensed Consolidated Financial Statements

Loans and leases consist of the following:

|   | September<br>30,<br>2018 | December<br>31,<br>2017 |
|---|--------------------------|-------------------------|
| Commercial & Industrial                                 |                          |                         |
| Agriculture   | \$4,980                  | \$3,274                 |
| Death Care Management                                   | 16,665                   | 13,495                  |
| Healthcare  | 47,324                   | 43,301                  |
| Independent Pharmacies                                  | 108,026                  | 99,920                  |
| Registered Investment Advisors                          | 91,334                   | 93,770                  |
| Veterinary Industry                                     | 47,821                   | 46,387                  |
| Other Industries  | 216,157                  | 184,903                 |
| Total   | 532,307                  | 485,050                 |
| Construction & Development                              |                          |                         |
| Agriculture   | 31,213                   | 34,188                  |
| Death Care Management                                   | 9,366                    | 6,119                   |
| Healthcare  | 71,429                   | 49,770                  |
| Independent Pharmacies                                  | 2,314                    | 1,496                   |
| Registered Investment Advisors                          | 1,276                    | 376                     |
| Veterinary Industry                                     | 19,522                   | 13,184                  |
| Other Industries  | 78,807                   | 58,120                  |
| Total   | 213,927                  | 163,253                 |
| Commercial Real Estate                                  |                          |                         |
| Agriculture   | 52,353                   | 46,717                  |
| Death Care Management                                   | 69,514                   | 67,381                  |
| Healthcare  | 167,365                  | 126,631                 |
| Independent Pharmacies                                  | 18,872                   | 19,028                  |
| Registered Investment Advisors                          | 8,121                    | 11,789                  |
| Veterinary Industry                                     | 122,537                  | 113,932                 |
| Other Industries  | 233,856                  | 134,172                 |
| Total   | 672,618                  | 519,650                 |
| Commercial Land   |                          |                         |
| Agriculture   | 220,326                  | 178,897                 |
| Total   | 220,326                  | 178,897                 |
| Total Loans and Leases <sup>1</sup>                     | 1,639,178                | 1,346,850               |
| Net Deferred Costs                                      | 7,336                    | 8,545                   |
| Discount on SBA 7(a) and USDA Unguaranteed <sup>2</sup> | (15,177 )                | (11,422 )               |
| Loans and Leases, Net of Unearned                       | \$1,631,337              | \$1,343,973             |

<sup>1</sup> Total loans and leases include \$192.4 million and \$99.7 million of U.S. government guaranteed loans as of September 30, 2018 and December 31, 2017, respectively.

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



Table of Contents

Live Oak Bancshares, Inc.

Notes to Unaudited Condensed Consolidated Financial Statements

Credit Risk Profile

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

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

Exceptional (1 Rated): These loans and leases are of the highest quality, with strong, well-documented sources of repayment. Debt service coverage ("DSC") is over 2.00X based on historical results. Borrower has ownership experience and has demonstrated excellent revenue growth and/or profitability. Guarantors have credit scores above 750 and have strong personal liquidity.

Quality (2 Rated): These loans and leases are of good quality, with good, well-documented sources of repayment. DSC is over 1.74X based on historical results. Borrower has ownership experience and has demonstrated very good revenue growth and/or profitability. Guarantors have credit scores above 724 and have good personal liquidity.

Acceptable (3 rated): These loans and leases are of acceptable quality, with acceptable sources of repayment. DSC of over 1.24X based on historical or pro-forma results. Companies that do not meet these credit metrics must be evaluated to determine if they should be graded below this level.

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

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

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

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

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

Table of Contents

Live Oak Bancshares, Inc.

Notes to Unaudited Condensed Consolidated Financial Statements

The following tables summarize the risk grades of each category:

|                                | Risk Grades<br>1 - 4 | Risk Grade<br>5 | Risk Grades<br>6 - 8 | Total        |
|--------------------------------|----------------------|-----------------|----------------------|--------------|
| September 30, 2018             |                      |                 |                      |              |
| Commercial & Industrial        |                      |                 |                      |              |
| Agriculture                    | \$ 4,775             | \$ 205          | \$ —                 | \$ 4,980     |
| Death Care Management          | 16,464               | 195             | 6                    | 16,665       |
| Healthcare                     | 37,035               | 3,179           | 7,110                | 47,324       |
| Independent Pharmacies         | 92,735               | 4,545           | 10,746               | 108,026      |
| Registered Investment Advisors | 86,713               | 1,407           | 3,214                | 91,334       |
| Veterinary Industry            | 44,374               | 1,171           | 2,276                | 47,821       |
| Other Industries               | 198,875              | 15,860          | 1,422                | 216,157      |
| Total                          | 480,971              | 26,562          | 24,774               | 532,307      |
| Construction & Development     |                      |                 |                      |              |
| Agriculture                    | 31,213               | —               | —                    | 31,213       |
| Death Care Management          | 9,366                | —               | —                    | 9,366        |
| Healthcare                     | 67,862               | 1,420           | 2,147                | 71,429       |
| Independent Pharmacies         | 2,314                | —               | —                    | 2,314        |
| Registered Investment Advisors | 1,276                | —               | —                    | 1,276        |
| Veterinary Industry            | 19,522               | —               | —                    | 19,522       |
| Other Industries               | 78,807               | —               | —                    | 78,807       |
| Total                          | 210,360              | 1,420           | 2,147                | 213,927      |
| Commercial Real Estate         |                      |                 |                      |              |
| Agriculture                    | 51,786               | 567             | —                    | 52,353       |
| Death Care Management          | 62,600               | 3,823           | 3,091                | 69,514       |
| Healthcare                     | 141,583              | 7,682           | 18,100               | 167,365      |
| Independent Pharmacies         | 12,959               | 3,369           | 2,544                | 18,872       |
| Registered Investment Advisors | 7,993                | 128             | —                    | 8,121        |
| Veterinary Industry            | 102,781              | 4,869           | 14,887               | 122,537      |
| Other Industries               | 231,798              | 2,058           | —                    | 233,856      |
| Total                          | 611,500              | 22,496          | 38,622               | 672,618      |
| Commercial Land                |                      |                 |                      |              |
| Agriculture                    | 200,608              | 8,514           | 11,204               | 220,326      |
| Total                          | 200,608              | 8,514           | 11,204               | 220,326      |
| Total <sup>1</sup>             | \$ 1,503,439         | \$ 58,992       | \$ 76,747            | \$ 1,639,178 |

Table of Contents

Live Oak Bancshares, Inc.

Notes to Unaudited Condensed Consolidated Financial Statements

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

Total loans and leases include \$192.4 million of U.S. government guaranteed loans as of September 30, 2018, segregated by risk grade as follows: Risk Grades 1 – 4 = \$126.4 million, Risk Grade 5 = \$9.9 million, Risk Grades 6 – 8 = \$56.1 million. As of December 31, 2017, total loans and leases include \$99.7 million of U.S. government guaranteed loans, segregated by risk grade as follows: Risk Grades 1 – 4 = \$65.0 million, Risk Grade 5 = \$6.7 million, Risk Grades 6 – 8 = \$28.0 million.



Table of Contents

Live Oak Bancshares, Inc.

Notes to Unaudited Condensed Consolidated Financial Statements

## Past Due Loans and Leases

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

|                                   | Less Than 30<br>Days Past<br>Due & Not<br>Accruing | 30-89 Days<br>Past Due &<br>Accruing | 30-89 Days<br>Past Due &<br>Not Accruing | 90 Days<br>or More<br>Past<br>Due | Total Not<br>Accruing<br>& Past Due | Current | Total Loans<br>and Leases | 90<br>Days or More<br>Past Due<br>&<br>Still Accruing |
|-----------------------------------|--|--------------------------------------|--|-----------------------------------|-------------------------------------|---------|---------------------------|---|
| September 30, 2018                |  |                                      |  |                                   |                                     |         |                           |   |
| Commercial & Industrial           |  |                                      |  |                                   |                                     |         |                           |   |
| Agriculture                       | \$ —   | \$ —                                 | \$ —                                     | \$ —                              | \$ —                                | \$4,980 | \$4,980                   | \$ —  |
| Death Care Management             | —  | 74                                   | —  | —                                 | 74                                  | 16,591  | 16,665                    | —   |
| Healthcare                        | 44   | 2,874                                | 687                                      | 2,680                             | 6,285                               | 41,039  | 47,324                    | —   |
| Independent Pharmacies            | —  | —                                    | 3,869                                    | 6,573                             | 10,442                              | 97,584  | 108,026                   | —   |
| Registered Investment<br>Advisors | —  | 241                                  | —  | 2,856                             | 3,097                               | 88,237  | 91,334                    | —   |
| Veterinary Industry               | 162  | —                                    | 569                                      | 796                               | 1,527                               | 46,294  | 47,821                    | —   |
| Other Industries                  | —  | 1,123                                | —  | 651                               | 1,774                               | 214,383 | 216,157                   | —   |
| Total                             | 206  | 4,312                                | 5,125                                    | 13,556                            | 23,199                              | 509,108 | 532,307                   | —   |
| Construction &<br>Development     |  |                                      |  |                                   |                                     |         |                           |   |
| Agriculture                       | —  | —                                    | —  | —                                 | —                                   | 31,213  | 31,213                    | —   |
| Death Care Management             | —  | —                                    | —  | —                                 | —                                   | 9,366   | 9,366                     | —   |
| Healthcare                        | —  | 2,147                                | —  | —                                 | 2,147                               | 69,282  | 71,429                    | —   |
| Independent Pharmacies            | —  | —                                    | —  | —                                 | —                                   | 2,314   | 2,314                     | —   |
| Registered Investment<br>Advisors | —  | —                                    | —  | —                                 | —                                   | 1,276   | 1,276                     | —   |
| Veterinary Industry               | —  | —                                    | —  | —                                 | —                                   | 19,522  | 19,522                    | —   |
| Other Industries                  | —  | —                                    | —  | —                                 | —                                   | 78,807  | 78,807                    | —   |
| Total                             | —  | 2,147                                | —  | —                                 | 2,147                               | 211,780 | 213,927                   | —   |
| Commercial Real Estate            |  |                                      |  |                                   |                                     |         |                           |   |
| Agriculture                       | —  | —                                    | —  | —                                 | —                                   | 52,353  | 52,353                    | —   |
| Death Care Management             | 153  | —                                    | —  | 2,789                             | 2,942                               | 66,572  | 69,514                    | —   |
| Healthcare                        | 44   | 687                                  | —  | 7,134                             | 7,865                               | 159,500 | 167,365                   | —   |
| Independent Pharmacies            | —  | 446                                  | —  | 2,544                             | 2,990                               | 15,882  | 18,872                    | —   |
| Registered Investment<br>Advisors | —  | —                                    | —  | —                                 | —                                   | 8,121   | 8,121                     | —   |
| Veterinary Industry               | 1,709  | 3,173                                | —  | 8,246                             | 13,128                              | 109,409 | 122,537                   | —   |
| Other Industries                  | —  | —                                    | —  | —                                 | —                                   | 233,856 | 233,856                   | —   |
| Total                             | 1,906  | 4,306                                | —  | 20,713                            | 26,925                              | 645,693 | 672,618                   | —   |
| Commercial Land                   |  |                                      |  |                                   |                                     |         |                           |   |
| Agriculture                       | 6,288  | —                                    | 2,482                                    | 2,433                             | 11,203                              | 209,123 | 220,326                   | —   |
| Total                             | 6,288  | —                                    | 2,482                                    | 2,433                             | 11,203                              | 209,123 | 220,326                   | —   |

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|                    |          |           |          |          |           |             |             |    |   |
|--------------------|----------|-----------|----------|----------|-----------|-------------|-------------|----|---|
| Total <sup>1</sup> | \$ 8,400 | \$ 10,765 | \$ 7,607 | \$36,702 | \$ 63,474 | \$1,575,704 | \$1,639,178 | \$ | — |
|--------------------|----------|-----------|----------|----------|-----------|-------------|-------------|----|---|

20

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Table of Contents

Live Oak Bancshares, Inc.

Notes to Unaudited Condensed Consolidated Financial Statements

|                                   | Less Than<br>30 Days<br>Past<br>Due &<br>Not<br>Accruing | 30-89 Days<br>Past Due<br>& Accruing | 30-89 Days<br>Past Due &<br>Not Accruing | 90 Days<br>or More<br>Past<br>Due | Total Not<br>Accruing<br>& Past Due | Current      | Total Loans<br>and Leases | 90<br>Days or More<br>Past Due<br>&<br>Still Accruing |
|-----------------------------------|--|--------------------------------------|--|-----------------------------------|-------------------------------------|--------------|---------------------------|---|
| December 31, 2017                 |  |                                      |  |                                   |                                     |              |                           |   |
| Commercial & Industrial           |  |                                      |  |                                   |                                     |              |                           |   |
| Agriculture                       | \$ —   | \$ —                                 | \$ —                                     | \$ —                              | \$ —                                | \$3,274      | \$3,274                   | \$ —  |
| Death Care Management             | —  | —                                    | —  | —                                 | —                                   | 13,495       | 13,495                    | —   |
| Healthcare                        | 788  | 131                                  | 14                                       | 3,004                             | 3,937                               | 39,364       | 43,301                    | —   |
| Independent Pharmacies            | 236  | 2,930                                | 1,349                                    | 3,376                             | 7,891                               | 92,029       | 99,920                    | —   |
| Registered Investment<br>Advisors | —  | 321                                  | —  | —                                 | 321                                 | 93,449       | 93,770                    | —   |
| Veterinary Industry               | 212  | 594                                  | 508                                      | 797                               | 2,111                               | 44,276       | 46,387                    | —   |
| Other Industries                  | —  | —                                    | —  | —                                 | —                                   | 184,903      | 184,903                   | —   |
| Total                             | 1,236  | 3,976                                | 1,871                                    | 7,177                             | 14,260                              | 470,790      | 485,050                   | —   |
| Construction &<br>Development     |  |                                      |  |                                   |                                     |              |                           |   |
| Agriculture                       | —  | —                                    | —  | —                                 | —                                   | 34,188       | 34,188                    | —   |
| Death Care Management             | —  | —                                    | —  | —                                 | —                                   | 6,119        | 6,119                     | —   |
| Healthcare                        | —  | —                                    | —  | —                                 | —                                   | 49,770       | 49,770                    | —   |
| Independent Pharmacies            | —  | —                                    | —  | —                                 | —                                   | 1,496        | 1,496                     | —   |
| Registered Investment<br>Advisors | —  | —                                    | —  | —                                 | —                                   | 376          | 376                       | —   |
| Veterinary Industry               | —  | —                                    | —  | —                                 | —                                   | 13,184       | 13,184                    | —   |
| Other Industries                  | —  | —                                    | —  | —                                 | —                                   | 58,120       | 58,120                    | —   |
| Total                             | —  | —                                    | —  | —                                 | —                                   | 163,253      | 163,253                   | —   |
| Commercial Real Estate            |  |                                      |  |                                   |                                     |              |                           |   |
| Agriculture                       | —  | —                                    | —  | —                                 | —                                   | 46,717       | 46,717                    | —   |
| Death Care Management             | —  | —                                    | 168                                      | 1,391                             | 1,559                               | 65,822       | 67,381                    | —   |
| Healthcare                        | 40   | 54                                   | 1,916                                    | 1,550                             | 3,560                               | 123,071      | 126,631                   | —   |
| Independent Pharmacies            | —  | —                                    | —  | 1,562                             | 1,562                               | 17,466       | 19,028                    | —   |
| Registered Investment<br>Advisors | —  | —                                    | —  | —                                 | —                                   | 11,789       | 11,789                    | —   |
| Veterinary Industry               | 1,804  | 3,226                                | —  | 4,765                             | 9,795                               | 104,137      | 113,932                   | —   |
| Other Industries                  | —  | —                                    | —  | —                                 | —                                   | 134,172      | 134,172                   | —   |
| Total                             | 1,844  | 3,280                                | 2,084                                    | 9,268                             | 16,476                              | 503,174      | 519,650                   | —   |
| Commercial Land                   |  |                                      |  |                                   |                                     |              |                           |   |
| Agriculture                       | —  | —                                    | —  | —                                 | —                                   | 178,897      | 178,897                   | —   |
| Total                             | —  | —                                    | —  | —                                 | —                                   | 178,897      | 178,897                   | —   |
| Total <sup>1</sup>                | \$ 3,080   | \$ 7,256                             | \$ 3,955                                 | \$ 16,445                         | \$ 30,736                           | \$ 1,316,114 | \$ 1,346,850              | \$ —  |

<sup>1</sup>Total loans and leases include \$192.4 million of U.S. government guaranteed loans as of September 30, 2018, of which \$30.3 million is greater than 90 days past due, \$12.3 million is 30-89 days past due and \$149.8 million is included in current loans and leases as presented above. As of December 31, 2017, total loans and leases include

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\$99.7 million of U.S. government guaranteed loans, of which \$15.0 million is greater than 90 days past due, \$7.4 million is 30-89 days past due and \$77.3 million is included in current loans and leases as presented above.

Table of Contents

Live Oak Bancshares, Inc.

Notes to Unaudited Condensed Consolidated Financial Statements

## Nonaccrual Loans and Leases

Loans and leases that become 90 days delinquent, or in cases where there is evidence that the borrower's ability to make the required payments is impaired, are placed in nonaccrual status and interest accrual is discontinued. If interest on nonaccrual loans and leases had been accrued in accordance with the original terms, interest income would have increased by approximately \$800 thousand and \$302 thousand for the three months ended September 30, 2018 and 2017, respectively, and for the nine months ended September 30, 2018 and 2017 interest income would have increased approximately \$1.8 million and \$831 thousand, respectively. All nonaccrual loans and leases are included in the held for investment portfolio.

Nonaccrual loans and leases as of September 30, 2018 and December 31, 2017 are as follows:

|                                | Loan<br>and<br>Lease<br>Balance | Guaranteed<br>Balance | Unguaranteed<br>Exposure |
|--------------------------------|---------------------------------|-----------------------|--------------------------|
| September 30, 2018             |                                 |                       |                          |
| Commercial & Industrial        |                                 |                       |                          |
| Healthcare                     | \$ 3,411                        | \$ 3,085              | \$ 326                   |
| Independent Pharmacies         | 10,442                          | 9,214                 | 1,228                    |
| Registered Investment Advisors | 2,856                           | 2,536                 | 320                      |
| Veterinary Industry            | 1,527                           | 1,381                 | 146                      |
| Other Industries               | 651                             | 488                   | 163                      |
| Total                          | 18,887                          | 16,704                | 2,183                    |
| Commercial Real Estate         |                                 |                       |                          |
| Death Care Management          | 2,942                           | 2,282                 | 660                      |
| Healthcare                     | 7,178                           | 4,751                 | 2,427                    |
| Independent Pharmacies         | 2,544                           | 2,126                 | 418                      |
| Veterinary Industry            | 9,955                           | 8,452                 | 1,503                    |
| Total                          | 22,619                          | 17,611                | 5,008                    |
| Commercial Land                |                                 |                       |                          |
| Agriculture                    | 11,203                          | 5,497                 | 5,706                    |
| Total                          | 11,203                          | 5,497                 | 5,706                    |
| Total                          | \$ 52,709                       | \$ 39,812             | \$ 12,897                |
| December 31, 2017              |                                 |                       |                          |
| Commercial & Industrial        |                                 |                       |                          |
| Healthcare                     | \$ 3,806                        | \$ 3,235              | \$ 571                   |
| Independent Pharmacies         | 4,961                           | 3,906                 | 1,055                    |
| Veterinary Industry            | 1,517                           | 1,478                 | 39                       |
| Total                          | 10,284                          | 8,619                 | 1,665                    |
| Commercial Real Estate         |                                 |                       |                          |
| Death Care Management          | 1,559                           | 1,237                 | 322                      |
| Healthcare                     | 3,506                           | 2,719                 | 787                      |
| Independent Pharmacies         | 1,562                           | 1,562                 | —                        |
| Veterinary Industry            | 6,569                           | 5,733                 | 836                      |
| Total                          | 13,196                          | 11,251                | 1,945                    |

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Total                    \$23,480   \$ 19,870     \$ 3,610

22

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Table of Contents

Live Oak Bancshares, Inc.

Notes to Unaudited Condensed Consolidated Financial Statements

Allowance for Loan and Lease Loss Methodology

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

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

The ALLL policy for pooled loans and leases is governed in accordance with banking regulatory guidance for homogenous pools of non-impaired loans and leases that have similar risk characteristics. The Company follows a consistent and structured approach for assessing the need for reserves within each individual loan and lease pool. Loans and leases are considered impaired when, based on current information and events, it is probable that the creditor will be unable to collect all interest and principal payments due according to the originally contracted, or reasonably modified, terms of the loan or lease agreement. The Company has determined that loans and leases that meet the criteria defined below must be reviewed quarterly to determine if they are impaired.

• All commercial loans and leases classified substandard or worse.

• Any other delinquent loan or lease that is in a nonaccrual status, or any loan or lease that is delinquent 90 days or more and still accruing interest.

• Any loan or lease which has been modified such that it meets the definition of a Troubled Debt Restructuring (TDR). The Company’s policy for impaired loan and lease accounting subjects all loans and leases to impairment recognition; however, loan and lease relationships with unguaranteed credit exposure of less than \$100,000 are generally not evaluated on an individual basis for impairment and instead are evaluated collectively using a methodology based on historical specific reserves on similar sized loans and leases. Any loan or lease not meeting the above criteria and determined to be impaired is subjected to an impairment analysis, which is a calculation of the probable loss on the loan or lease. This portion is the loan’s or lease’s “impairment,” and is established as a specific reserve against the loan or lease, or charged against the ALLL.

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

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

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

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





Table of Contents

Live Oak Bancshares, Inc.

Notes to Unaudited Condensed Consolidated Financial Statements

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

| Three months ended | Construction & Development | Commercial Real Estate | Commercial & Industrial | Commercial Land | Total    |
|--------------------|----------------------------|------------------------|-------------------------|-----------------|----------|
| September 30, 2018 |                            |                        |                         |                 |          |
| Beginning Balance  | \$ 2,227                   | \$ 11,408              | \$ 13,377               | \$ 2,338        | \$29,350 |
| Charge offs        | —                          | (397 )                 | (1,966 )                | (106 )          | (2,469 ) |
| Recoveries         | —                          | 141                    | 18                      | —               | 159      |
| Provision          | (555 )                     | (1,115 )               | (148 )                  | 1,575           | (243 )   |
| Ending Balance     | \$ 1,672                   | \$ 10,037              | \$ 11,281               | \$ 3,807        | \$26,797 |
| September 30, 2017 |                            |                        |                         |                 |          |
| Beginning Balance  | \$ 1,603                   | \$ 7,494               | \$ 8,351                | \$ 2,112        | \$19,560 |
| Charge offs        | —                          | (665 )                 | (343 )                  | —               | (1,008 ) |
| Recoveries         | —                          | 4                      | 39                      | 6               | 49       |
| Provision          | 36                         | 1,565                  | 827                     | (2 )            | 2,426    |
| Ending Balance     | \$ 1,639                   | \$ 8,398               | \$ 8,874                | \$ 2,116        | \$21,027 |
| September 30, 2018 |                            |                        |                         |                 |          |
| Beginning Balance  | \$ 2,030                   | \$ 9,180               | \$ 10,751               | \$ 2,229        | \$24,190 |
| Charge offs        | —                          | (816 )                 | (3,187 )                | (106 )          | (4,109 ) |
| Recoveries         | —                          | 174                    | 306                     | —               | 480      |
| Provision          | (358 )                     | 1,499                  | 3,411                   | 1,684           | 6,236    |
| Ending Balance     | \$ 1,672                   | \$ 10,037              | \$ 11,281               | \$ 3,807        | \$26,797 |
| September 30, 2017 |                            |                        |                         |                 |          |
| Beginning Balance  | \$ 1,693                   | \$ 5,897               | \$ 8,413                | \$ 2,206        | \$18,209 |
| Charge offs        | —                          | (952 )                 | (1,754 )                | (35 )           | (2,741 ) |
| Recoveries         | —                          | 17                     | 55                      | 6               | 78       |
| Provision          | (54 )                      | 3,436                  | 2,160                   | (61 )           | 5,481    |
| Ending Balance     | \$ 1,639                   | \$ 8,398               | \$ 8,874                | \$ 2,116        | \$21,027 |

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

| September 30, 2018  | Construction & Development | Commercial Real Estate | Commercial & Industrial | Commercial Land | Total     |
|---|----------------------------|------------------------|-------------------------|-----------------|-----------|
| Allowance for Loan and Lease Losses:                                |                            |                        |                         |                 |           |
| Loans and leases individually evaluated for impairment              | \$ 11                      | \$ 2,141               | \$ 1,344                | \$ 3,140        | \$6,636   |
| Loans and leases collectively evaluated for impairment <sup>2</sup> | 1,661                      | 7,896                  | 9,937                   | 667             | 20,161    |
| Total allowance for loan and lease losses                           | \$ 1,672                   | \$ 10,037              | \$ 11,281               | \$ 3,807        | \$26,797  |
| Loans and leases receivable <sup>1</sup> :                          |                            |                        |                         |                 |           |
| Loans and leases individually evaluated for impairment              | \$ 2,172                   | \$ 34,842              | \$ 12,520               | \$ 21,755       | \$71,289  |
| Loans and leases collectively evaluated for impairment <sup>2</sup> | 211,755                    | 637,776                | 519,787                 | 198,571         | 1,567,889 |

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|                                   |            |            |            |            |             |
|-----------------------------------|------------|------------|------------|------------|-------------|
| Total loans and leases receivable | \$ 213,927 | \$ 672,618 | \$ 532,307 | \$ 220,326 | \$1,639,178 |
|-----------------------------------|------------|------------|------------|------------|-------------|

24

---

Table of Contents

Live Oak Bancshares, Inc.

Notes to Unaudited Condensed Consolidated Financial Statements

| December 31, 2017   | Construction<br>&<br>Development | Commercial<br>Real Estate | Commercial<br>& Industrial | Commercial<br>Land | Total        |
|---|----------------------------------|---------------------------|----------------------------|--------------------|--------------|
| Allowance for Loan and Lease Losses:                                |                                  |                           |                            |                    |              |
| Loans and leases individually evaluated for impairment              | \$ 157                           | \$ 1,502                  | \$ 1,126                   | \$ —               | \$ 2,785     |
| Loans and leases collectively evaluated for impairment <sup>2</sup> | 1,873                            | 7,678                     | 9,625                      | 2,229              | 21,405       |
| Total allowance for loan and lease losses                           | \$ 2,030                         | \$ 9,180                  | \$ 10,751                  | \$ 2,229           | \$ 24,190    |
| Loans and leases receivable <sup>1</sup> :                          |                                  |                           |                            |                    |              |
| Loans and leases individually evaluated for impairment              | \$ 1,237                         | \$ 17,105                 | \$ 8,672                   | \$ —               | \$ 27,014    |
| Loans and leases collectively evaluated for impairment <sup>2</sup> | 162,016                          | 502,545                   | 476,378                    | 178,897            | 1,319,836    |
| Total loans and leases receivable                                   | \$ 163,253                       | \$ 519,650                | \$ 485,050                 | \$ 178,897         | \$ 1,346,850 |

Loans and leases receivable includes \$192.4 million of U.S. government guaranteed loans as of September 30, 2018, 1 of which \$63.3 million are impaired. As of December 31, 2017, loans and leases receivable includes \$99.7 million of U.S. government guaranteed loans, of which \$28.1 million are considered impaired.

Included in loans and leases collectively evaluated for impairment are impaired loans and leases with individual unguaranteed exposure of less than \$100 thousand. As of September 30, 2018, these balances totaled \$17.3 million, of which \$15.9 million are guaranteed by the U.S. government and \$1.4 million are unguaranteed. As of <sup>2</sup>December 31, 2017, these balances totaled \$14.8 million, of which \$13.2 million are guaranteed by the U.S. government and \$1.6 million are unguaranteed. The allowance for loan and lease losses associated with these loans and leases totaled \$397 thousand and \$279 thousand as of September 30, 2018 and December 31, 2017, respectively.

Table of Contents

Live Oak Bancshares, Inc.

Notes to Unaudited Condensed Consolidated Financial Statements

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

| September 30, 2018             | Recorded<br>Investment | Guaranteed<br>Balance | Unguaranteed<br>Exposure |
|--------------------------------|------------------------|-----------------------|--------------------------|
| Commercial & Industrial        |                        |                       |                          |
| Death Care Management          | \$ 6                   | \$ —                  | \$ 6                     |
| Healthcare                     | 7,159                  | 5,488                 | 1,671                    |
| Independent Pharmacies         | 10,057                 | 8,458                 | 1,599                    |
| Registered Investment Advisors | 3,217                  | 2,536                 | 681                      |
| Veterinary Industry            | 2,382                  | 1,861                 | 521                      |
| Other Industries               | 1,435                  | 648                   | 787                      |
| Total                          | 24,256                 | 18,991                | 5,265                    |
| Construction & Development     |                        |                       |                          |
| Healthcare                     | 2,172                  | 1,610                 | 562                      |
| Total                          | 2,172                  | 1,610                 | 562                      |
| Commercial Real Estate         |                        |                       |                          |
| Death Care Management          | 3,088                  | 2,282                 | 806                      |
| Healthcare                     | 18,757                 | 13,275                | 5,482                    |
| Independent Pharmacies         | 2,543                  | 2,126                 | 417                      |
| Veterinary Industry            | 15,977                 | 11,815                | 4,162                    |
| Total                          | 40,365                 | 29,498                | 10,867                   |
| Commercial Land                |                        |                       |                          |
| Agriculture                    | 21,755                 | 13,199                | 8,556                    |
| Total                          | 21,755                 | 13,199                | 8,556                    |
| Total                          | \$ 88,548              | \$ 63,298             | \$ 25,250                |
| December 31, 2017              | Recorded<br>Investment | Guaranteed<br>Balance | Unguaranteed<br>Exposure |
| Commercial & Industrial        |                        |                       |                          |
| Death Care Management          | \$ 7                   | \$ —                  | \$ 7                     |
| Healthcare                     | 4,551                  | 3,235                 | 1,316                    |
| Independent Pharmacies         | 8,571                  | 6,356                 | 2,215                    |
| Registered Investment Advisors | 733                    | —                     | 733                      |
| Veterinary Industry            | 2,762                  | 2,001                 | 761                      |
| Total                          | 16,624                 | 11,592                | 5,032                    |
| Construction & Development     |                        |                       |                          |
| Healthcare                     | 1,237                  | 944                   | 293                      |
| Total                          | 1,237                  | 944                   | 293                      |
| Commercial Real Estate         |                        |                       |                          |
| Death Care Management          | 2,831                  | 1,237                 | 1,594                    |
| Healthcare                     | 4,315                  | 2,967                 | 1,348                    |
| Independent Pharmacies         | 1,562                  | 1,562                 | —                        |
| Veterinary Industry            | 15,266                 | 9,768                 | 5,498                    |
| Total                          | 23,974                 | 15,534                | 8,440                    |
| Commercial Land                |                        |                       |                          |
| Agriculture                    | —                      | —                     | —                        |
| Total                          | —                      | —                     | —                        |

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|       |           |           |           |
|-------|-----------|-----------|-----------|
| Total | \$ 41,835 | \$ 28,070 | \$ 13,765 |
|-------|-----------|-----------|-----------|

26

---

Table of Contents

Live Oak Bancshares, Inc.

Notes to Unaudited Condensed Consolidated Financial Statements

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

|                                 | September 30, 2018                                    |                                  | Total    | Unpaid<br>Principal<br>Balance | Related<br>Allowance<br>Recorded |
|---------------------------------|---|----------------------------------|----------|--------------------------------|----------------------------------|
|                                 | Recorded Investment<br>With a<br>Recorded<br>Allowanc | With No<br>Recorded<br>Allowance |          |                                |                                  |
| Commercial & Industrial         |   |                                  |          |                                |                                  |
| Death Care Management           | \$—   | \$ 6                             | \$6      | \$6                            | \$ —                             |
| Healthcare                      | 7,093   | 66                               | 7,159    | 7,402                          | 416                              |
| Independent Pharmacies          | 9,758   | 299                              | 10,057   | 11,680                         | 415                              |
| Registered Investment Advisors  | 3,217   | —                                | 3,217    | 3,740                          | 513                              |
| Veterinary Industry             | 2,259   | 123                              | 2,382    | 2,657                          | 129                              |
| Other Industries                | 979   | 456                              | 1,435    | 1,998                          | 213                              |
| Total                           | 23,306  | 950                              | 24,256   | 27,483                         | 1,686                            |
| Construction & Development      |   |                                  |          |                                |                                  |
| Healthcare                      | 2,172   | —                                | 2,172    | 2,147                          | 11                               |
| Total                           | 2,172   | —                                | 2,172    | 2,147                          | 11                               |
| Commercial Real Estate          |   |                                  |          |                                |                                  |
| Death Care Management           | 2,786   | 302                              | 3,088    | 3,226                          | 16                               |
| Healthcare                      | 18,523  | 234                              | 18,757   | 18,751                         | 1,174                            |
| Independent Pharmacies          | 2,543   | —                                | 2,543    | 2,835                          | 14                               |
| Veterinary Industry             | 15,867  | 110                              | 15,977   | 16,955                         | 992                              |
| Total                           | 39,719  | 646                              | 40,365   | 41,767                         | 2,196                            |
| Commercial Land                 |   |                                  |          |                                |                                  |
| Agriculture                     | 21,563  | 192                              | 21,755   | 21,764                         | 3,140                            |
| Total                           | 21,563  | 192                              | 21,755   | 21,764                         | 3,140                            |
| Total Impaired Loans and Leases | \$86,760  | \$ 1,788                         | \$88,548 | \$93,161                       | \$ 7,033                         |

Table of Contents

Live Oak Bancshares, Inc.

Notes to Unaudited Condensed Consolidated Financial Statements

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

28

Table of Contents

Live Oak Bancshares, Inc.

Notes to Unaudited Condensed Consolidated Financial Statements

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

|                                       | Three months ended<br>September 30, 2018 |                                  | Three months ended<br>September 30, 2017 |                                  |
|---------------------------------------|--|----------------------------------|--|----------------------------------|
|                                       | Average<br>Balance                       | Interest<br>Income<br>Recognized | Average<br>Balance                       | Interest<br>Income<br>Recognized |
| <b>Commercial &amp; Industrial</b>    |  |                                  |  |                                  |
| Death Care Management                 | \$6                                      | \$ —                             | \$42                                     | \$ 1                             |
| Healthcare                            | 7,152                                    | 28                               | 7,076                                    | 11                               |
| Independent Pharmacies                | 10,325                                   | 4                                | 4,266                                    | 26                               |
| Registered Investment Advisors        | 3,589                                    | 7                                | 894                                      | 14                               |
| Veterinary Industry                   | 2,423                                    | 16                               | 2,511                                    | 11                               |
| Other Industries                      | 1,822                                    | 17                               | —  | —                                |
| Total                                 | 25,317                                   | 72                               | 14,789                                   | 63                               |
| <b>Construction &amp; Development</b> |  |                                  |  |                                  |
| Healthcare                            | 2,162                                    | 12                               | 602                                      | 2                                |
| Total                                 | 2,162                                    | 12                               | 602                                      | 2                                |
| <b>Commercial Real Estate</b>         |  |                                  |  |                                  |
| Death Care Management                 | 3,098                                    | 24                               | 2,512                                    | 13                               |
| Healthcare                            | 18,765                                   | 150                              | 3,079                                    | 11                               |
| Independent Pharmacies                | 2,739                                    | —                                | 1,985                                    | —                                |
| Veterinary Industry                   | 16,731                                   | 98                               | 13,950                                   | 132                              |
| Total                                 | 41,333                                   | 272                              | 21,526                                   | 156                              |
| <b>Commercial Land</b>                |  |                                  |  |                                  |
| Agriculture                           | 21,792                                   | 38                               | 23                                       | —                                |
| Total                                 | 21,792                                   | 38                               | 23                                       | —                                |
| Total                                 | \$90,604                                 | \$ 394                           | \$36,940                                 | \$ 221                           |

29



Table of Contents

Live Oak Bancshares, Inc.

Notes to Unaudited Condensed Consolidated Financial Statements

|                                       | Nine months ended<br>September 30, 2018 |                                  | Nine months ended<br>September 30, 2017 |                                  |
|---------------------------------------|---|----------------------------------|---|----------------------------------|
|                                       | Average<br>Balance                      | Interest<br>Income<br>Recognized | Average<br>Balance                      | Interest<br>Income<br>Recognized |
| <b>Commercial &amp; Industrial</b>    |   |                                  |   |                                  |
| Death Care Management                 | \$7                                     | \$ —                             | \$313                                   | \$ 3                             |
| Healthcare                            | 7,232                                   | 59                               | 4,996                                   | 25                               |
| Independent Pharmacies                | 10,180                                  | 31                               | 7,998                                   | 52                               |
| Registered Investment Advisors        | 3,007                                   | 31                               | 1,438                                   | 28                               |
| Veterinary Industry                   | 2,488                                   | 54                               | 4,329                                   | 24                               |
| Other Industries                      | 1,875                                   | 22                               | —                                       | —                                |
| <b>Total</b>                          | <b>24,789</b>                           | <b>197</b>                       | <b>19,074</b>                           | <b>132</b>                       |
| <b>Construction &amp; Development</b> |   |                                  |   |                                  |
| Healthcare                            | 2,162                                   | 63                               | 120                                     | 2                                |
| <b>Total</b>                          | <b>2,162</b>                            | <b>63</b>                        | <b>120</b>                              | <b>2</b>                         |
| <b>Commercial Real Estate</b>         |   |                                  |   |                                  |
| Death Care Management                 | 3,115                                   | 88                               | 2,030                                   | 30                               |
| Healthcare                            | 17,535                                  | 230                              | 2,940                                   | 24                               |
| Independent Pharmacies                | 2,763                                   | 1                                | 149                                     | —                                |
| Veterinary Industry                   | 17,081                                  | 333                              | 13,069                                  | 278                              |
| <b>Total</b>                          | <b>40,494</b>                           | <b>652</b>                       | <b>18,188</b>                           | <b>332</b>                       |
| <b>Commercial Land</b>                |   |                                  |   |                                  |
| Agriculture                           | 21,803                                  | 68                               | 199                                     | —                                |
| <b>Total</b>                          | <b>21,803</b>                           | <b>68</b>                        | <b>199</b>                              | <b>—</b>                         |
| <b>Total</b>                          | <b>\$89,248</b>                         | <b>\$ 980</b>                    | <b>\$37,581</b>                         | <b>\$ 466</b>                    |

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

|  | Three months ended<br>September 30, 2018                      |   | Three months ended<br>September 30, 2017                |   |
|--|---|---|---|---|
|  | All Restructurings  |   | All Restructurings                                      |   |
|  | Pre-<br>modification<br>of<br>Loans<br>Recorded<br>Investment | Post-<br>modification<br>Recorded<br>Investment | Pre-<br>modification<br>Loans<br>Recorded<br>Investment | Post-<br>modification<br>Recorded<br>Investment |
| <b>Interest Only and Rate Concession</b>       |   |   |   |   |
| <b>Commercial Land</b>                         |   |   |   |   |
| Agriculture                                    | 4   | \$ 10,276                                       | —   | \$ —  |
| <b>Total Interest Only and Rate Concession</b> | <b>4</b>  | <b>10,276</b>                                   | <b>—</b>  | <b>—</b>  |
| <b>Extended Amortization</b>                   |   |   |   |   |
| <b>Commercial Land</b>                         |   |   |   |   |
| Agriculture                                    | 1   | 8   | —   | —   |
| <b>Total Extended Amortization</b>             | <b>1</b>  | <b>8</b>  | <b>—</b>  | <b>—</b>  |
| <b>Payment Deferral</b>                        |   |   |   |   |
| <b>Commercial &amp; Industrial</b>             |   |   |   |   |
| Veterinary Industry                            | —   | —   | 2   | 559   |

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|                        |             |           |          |        |
|------------------------|-------------|-----------|----------|--------|
| Total Payment Deferral | —           | —         | 2 559    | 559    |
| Total                  | 5 \$ 10,284 | \$ 10,284 | 2 \$ 559 | \$ 559 |

30

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Table of Contents

Live Oak Bancshares, Inc.

Notes to Unaudited Condensed Consolidated Financial Statements

|  | Nine months ended<br>September 30, 2018        |   | Nine months ended<br>September 30, 2017        |   |
|--|--|---|--|---|
|  | All Restructurings                             |   | All Restructurings                             |   |
|  | Pre-<br>modification<br>Recorded<br>Investment | Post-<br>modification<br>Recorded<br>Investment | Pre-<br>modification<br>Recorded<br>Investment | Post-<br>modification<br>Recorded<br>Investment |
| Interest Only                                    |  |   |  |   |
| Construction and Development                     |  |   |  |   |
| Healthcare                                       | 1 \$ 612                                       | \$ 612  | —\$ —  | \$ —  |
| Total Interest Only                              | 1 612  | 612   | —  | —   |
| Interest Only and Rate Concession                |  |   |  |   |
| Commercial Land                                  |  |   |  |   |
| Agriculture                                      | 4 10,276                                       | 10,276  | —  | —   |
| Total Interest Only and Rate Concession          | 4 10,276                                       | 10,276  | —  | —   |
| Extended Amortization                            |  |   |  |   |
| Commercial Land                                  |  |   |  |   |
| Agriculture                                      | 1 8  | 8   | —  | —   |
| Total Extended Amortization                      | 1 8  | 8   | —  | —   |
| Payment Deferral and Extended Amortization       |  |   |  |   |
| Commercial & Industrial                          |  |   |  |   |
| Independent Pharmacies                           | —  | —   | 1 262  | 262   |
| Total Payment Deferral and Extended Amortization | —  | —   | 1 262  | 262   |
| Payment Deferral                                 |  |   |  |   |
| Commercial & Industrial                          |  |   |  |   |
| Veterinary Industry                              | —  | —   | 2 559  | 559   |
| Total Payment Deferral                           | —  | —   | 2 559  | 559   |
| Total  | 6 \$ 10,896                                    | \$ 10,896                                       | 3 \$ 821                                       | \$ 821  |

Concessions made to improve a loan and lease's performance have varying degrees of success. No TDRs that were modified within the twelve months ended September 30, 2018 and 2017 subsequently defaulted during the three and nine months ended September 30, 2018 and 2017.

Table of Contents

Live Oak Bancshares, Inc.

Notes to Unaudited Condensed Consolidated Financial Statements

## Note 6. Equipment Leasing

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

## Direct Financing Leases

Interest income on direct financing leases is recognized when earned. Unearned interest is recognized over the lease term on a basis which results in a constant rate of return on the unrecovered lease investment. The term of each lease is generally 3-7 years which is consistent with the useful life of the equipment with no residual value. The gross lease payments receivable and the net investment included in accounts receivable for such leases are as follows:

|  | As of         |              |
|--|---------------|--------------|
|  | September 30, | December 31, |
|  | 2018          | 2017         |
| Gross direct finance lease payments receivable | \$6,548       | \$ 2,399     |
| Less – unearned interest                       | (1,116 )      | (373 )       |
| Net investment in direct financing leases      | \$5,432       | \$ 2,026     |

Future minimum lease payments under finance leases are as follows:

| As of September 30, 2018 | Amount   |
|--------------------------|----------|
| 2018                     | \$ 325   |
| 2019                     | 1,384    |
| 2020                     | 1,373    |
| 2021                     | 1,287    |
| 2022                     | 1,107    |
| Thereafter               | 1,072    |
| Total                    | \$ 6,548 |

Interest income of \$100 thousand and \$14 thousand was recognized in the three months ended September 30, 2018 and 2017, respectively. Interest income of \$220 thousand and \$21 thousand was recognized in the nine months ended September 30, 2018 and 2017, respectively.

## Operating Leases

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

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

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



Table of Contents

Live Oak Bancshares, Inc.

Notes to Unaudited Condensed Consolidated Financial Statements

As of September 30, 2018, the Company had a net investment of \$144.9 million in assets included in premises and equipment that are subject to operating leases. Of the net investment, the gross balance of the assets was \$153.0 million and accumulated depreciation was \$8.1 million as of September 30, 2018. Depreciation expense recognized on these assets for the three and nine months ended September 30, 2018 was \$2.2 million and \$5.9 million, respectively. Depreciation expense recognized for the three and nine months ended September 30, 2017 was \$840 thousand and \$1.1 million, respectively.

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

| As of September 30, 2018 | Amount   |
|--------------------------|----------|
| 2018                     | \$1,765  |
| 2019                     | 8,284    |
| 2020                     | 8,341    |
| 2021                     | 8,385    |
| 2022                     | 8,417    |
| Thereafter               | 53,939   |
| Total                    | \$89,131 |

## Note 7. Servicing Assets

Loans serviced for others are not included in the accompanying balance sheet. The unpaid principal balances of loans serviced for others requiring recognition of a servicing asset were \$2.70 billion and \$2.44 billion at September 30, 2018 and December 31, 2017, respectively. The unpaid principal balance for all loans serviced for others was \$2.78 billion and \$2.54 billion at September 30, 2018 and December 31, 2017, respectively.

The following summarizes the activity pertaining to servicing rights:

|  | Three Months<br>Ended<br>September 30,<br>2018 |          | Nine Months<br>Ended<br>September 30,<br>2017 |          |
|--|--|----------|---|----------|
| Balance at beginning of period                         | \$52,689                                       | \$53,675 | \$52,298                                      | \$51,994 |
| Additions, net   | 5,558  | 3,527    | 14,634  | 9,412    |
| Fair value changes:                                    |  |          |   |          |
| Due to changes in valuation inputs or assumptions      | (5,336 )                                       | (789 )   | (7,336 )                                      | 342      |
| Decay due to increases in principal paydowns or runoff | (3,650 )                                       | (3,021 ) | (10,335 )                                     | (8,356 ) |
| Balance at end of period                               | \$49,261                                       | \$53,392 | \$49,261                                      | \$53,392 |

The fair value of servicing rights was determined using a weighted average discount rate of 16.1% on September 30, 2018 and 12.6% on September 30, 2017. The fair value of servicing rights was determined using a weighted average prepayment speed of 11.1% on September 30, 2018 and 7.3% on September 30, 2017, depending on the stratification of the specific right. Changes to fair value are reported in loan servicing asset revaluation within the consolidated statements of income.

The fair value of servicing rights is highly sensitive to changes in underlying assumptions. Changes in prepayment speed assumptions have the most significant impact on the fair value of servicing rights. Generally, as interest rates rise on variable rate loans, loan prepayments increase due to an increase in refinance activity, which results in a decrease in the fair value of servicing assets. Measurement of fair value is limited to the conditions existing and the assumptions used as of a particular point in time, and those assumptions may not be appropriate if they are applied at a different time.



Table of Contents

Live Oak Bancshares, Inc.

Notes to Unaudited Condensed Consolidated Financial Statements

## Note 8. Borrowings

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

|   | September<br>30,<br>2018 | December<br>31,<br>2017 |
|---|--------------------------|-------------------------|
| <b>Short term borrowings</b>  |                          |                         |
| On October 20, 2017, the Company entered into a revolving line of credit of \$20 million with an unaffiliated commercial bank. The note is unsecured and accrues interest at LIBOR plus 1.750% for a term of 12 months. Payments are interest only with all principal and accrued interest due on October 19, 2018. On October 2, 2018, the Company renewed the revolving line of credit for an additional 12 months with a maturity date of October 18, 2019. The terms of this loan require the Company to maintain minimum capital and debt service coverage ratios. No advances have been made to this line of credit and there is \$20 million of available credit remaining at September 30, 2018.  | \$                       | —\$ —                   |
| On September 18, 2014, the Company entered into a note payable revolving line of credit of \$8.1 million with an unaffiliated commercial bank. On April 18, 2017, the Company renewed and increased the revolving line of credit to \$25 million. The note is unsecured and accrues interest at Prime minus 0.50% for a term of 24 months. Payments are interest only with all principal and accrued interest due on April 30, 2019. The terms of this loan require the Company to maintain minimum capital, liquidity and Texas ratios. This line of credit was paid in full on August 25, 2017, and there is \$25 million of available credit remaining at September 30, 2018.  | —                        | —                       |
| <b>Total short term borrowings</b>  | <b>\$</b>                | <b>—\$ —</b>            |
|   | September<br>30,<br>2018 | December<br>31,<br>2017 |
| <b>Long term borrowings</b>   |                          |                         |
| On September 11, 2014, the Company financed the construction of an additional building located on the Company's Tiburon Drive main campus with a \$24 million construction line of credit with an unaffiliated commercial bank, secured by both properties at its Tiburon Drive main facility location. Payments were interest only through September 11, 2016 at a fixed rate of 3.95% for a term of 84 months. Monthly principal and interest payments of \$146 thousand began in October 2016 with all principal and accrued interest due on September 11, 2021. This note was repaid in full on January 31, 2018.   | —                        | \$ 22,990               |
| On February 23, 2015, the Company transferred two related party loans to an unaffiliated commercial bank in exchange for \$4.7 million. The exchange price equated to the unpaid principal balance plus accrued but uncollected interest at the time of transfer. The terms of the transfer agreement with the unaffiliated commercial bank identified the transaction as a secured borrowing for accounting purposes. One of the loans with an outstanding balance of \$1.3 million was paid in full on August 17, 2018. Interest accrues at prime plus 1% with monthly principal and interest payments over a term of 60 months. The interest rate at September 30, 2018 is 6.00%. The maturity date is October 5, 2019. The pledged collateral is classified in other assets with a fair value of \$1.5 million at September 30, 2018. Underlying loan carries a risk grade of 3 and is current with no delinquencies. | 1,489                    | 3,574                   |
| In October 2017, the Company entered into a capital lease of \$19 thousand with an unaffiliated equipment lease company, secured by fitness equipment which is included in premises and   | 17                       | —                       |



equipment on the consolidated balance sheet. Payments are principal and interest due monthly starting December 15, 2017 over a term of 60 months. At the end of the lease term there is a \$1.00 bargain purchase option.

Total long term borrowings \$ 1,506    \$ 26,564

The Company may purchase federal funds through unsecured federal funds lines of credit with various correspondent banks, which totaled \$72.5 million and \$47.5 million as of September 30, 2018 and December 31, 2017, respectively. These lines are intended for short-term borrowings and are subject to restrictions limiting the frequency and terms of advances. These lines of credit are payable on demand and bear interest based upon the daily federal funds rate. The Company had no outstanding balances on the lines of credit as of September 30, 2018 and December 31, 2017.

Table of Contents

Live Oak Bancshares, Inc.

Notes to Unaudited Condensed Consolidated Financial Statements

The Company has entered into a repurchase agreement with a third party for \$5.0 million as of September 30, 2018 and December 31, 2017. At the time the Company enters into a transaction with the third party, the Company must transfer securities or other assets against the funds received. The terms of the agreement are set at market conditions at the time the Company enters into such transaction. The Company had no outstanding balance on the repurchase agreement as of September 30, 2018 and December 31, 2017.

On June 18, 2018, the Company entered into a borrowing agreement with the Federal Home Loan Bank of Atlanta. These borrowings must be secured with eligible collateral approved by the Federal Home Loan Bank of Atlanta. As of September 30, 2018, there was \$854.2 million of potential borrowing capacity available under this agreement. There is no collateral pledged and no advances outstanding as of September 30, 2018.

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 \$376.9 million and \$348.5 million as of September 30, 2018 and December 31, 2017, respectively. At September 30, 2018 and December 31, 2017, the Company had approximately \$210.1 million and \$189.1 million, respectively, in borrowing capacity available under these arrangements with no outstanding balance as of September 30, 2018 and December 31, 2017.

Note 9. Income Taxes

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

Note 10. Fair Value of Financial Instruments

Fair Value Hierarchy

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

Financial Instruments Measured at Fair Value

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

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

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



Table of Contents

Live Oak Bancshares, Inc.

Notes to Unaudited Condensed Consolidated Financial Statements

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

**Foreclosed assets:** Foreclosed real estate is adjusted to fair value less selling costs upon transfer of the loans to foreclosed real estate. Subsequently, foreclosed real estate is carried at the lower of carrying value or fair value less selling costs. Fair value is based upon independent market prices, appraised values of the collateral or management's estimation of the value of the collateral. Given the lack of observable market prices for identical properties and market discounts applied to appraised values, the Company generally classifies foreclosed assets as nonrecurring Level 3.

**Mutual fund:** The following mutual fund is registered with the Securities and Exchange Commission as a closed-end, non-diversified management investment company and operates as an interval fund. The fund primarily invests in the unguaranteed portion of SBA504 First Lien Loans secured by owner-occupied commercial real estate. This investment is valued using quoted prices in markets that are not active and is classified as Level 2 within the valuation hierarchy.

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

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

**Recurring Fair Value**

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

| September 30, 2018                       | Total     | Level 1 | Level 2    | Level 3  |
|--|-----------|---------|------------|----------|
| Investment securities available-for-sale |           |         |            |          |
| US treasury securities                   | \$4,934   | \$      | —\$4,934   | \$—      |
| US government agencies                   | 33,075    | —       | 33,075     | —        |
| Residential mortgage-backed securities   | 336,275   | —       | 336,275    | —        |
| Servicing assets <sup>1</sup>            | 49,261    | —       | —          | 49,261   |
| Mutual fund                              | 2,068     | —       | 2,068      | —        |
| Equity warrant assets                    | 538       | —       | —          | 538      |
| Total assets at fair value               | \$426,151 | \$      | —\$376,352 | \$49,799 |

Table of Contents

Live Oak Bancshares, Inc.

Notes to Unaudited Condensed Consolidated Financial Statements

| December 31, 2017                               | Total     | Level 1 | Level 2   | Level 3  |
|---|-----------|---------|-----------|----------|
| Investment securities available-for-sale        |           |         |           |          |
| US government agencies                          | \$22,624  | \$      | —\$22,624 | \$—      |
| Residential mortgage-backed securities          | 68,696    | —       | 68,696    | —        |
| Mutual fund                                     | 2,035     | —       | 2,035     | —        |
| Servicing assets <sup>1</sup>                   | 52,298    | —       | —         | 52,298   |
| Total assets at fair value                      | \$145,653 | \$      | —\$93,355 | \$52,298 |
| Contingent consideration liability <sup>2</sup> | \$1,900   | \$      | —\$—      | \$1,900  |
| Total liabilities at fair value                 | \$1,900   | \$      | —\$—      | \$1,900  |

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

Activity for the contingent consideration liability during the three months ended September 30, 2018 consisted of a \$1.6 million write-off as a result of the disposition of Reltco during the quarter. During the nine months ended September 30, 2018, the Company recorded a \$260 thousand negative fair value adjustment and \$1.6 million write-off as a result of the disposition of Reltco. There was no activity for the contingent consideration liability during the three months ended September 30, 2017. During the nine months ended September 30, 2017, \$4.3 million of contingent consideration was recorded upon the acquisition of Reltco as well as \$350 thousand positive fair value adjustments.

## Non-recurring Fair Value

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

| September 30, 2018         | Total    | Level 1 | Level 2 | Level 3   |
|----------------------------|----------|---------|---------|-----------|
| Impaired loans and leases  | \$79,727 | \$      | —\$     | —\$79,727 |
| Foreclosed assets          | 1,429    | —       | —       | 1,429     |
| Total assets at fair value | \$81,156 | \$      | —\$     | —\$81,156 |
| December 31, 2017          | Total    | Level 1 | Level 2 | Level 3   |
| Impaired loans and leases  | \$34,493 | \$      | —\$     | —\$34,493 |
| Foreclosed assets          | 1,281    | —       | —       | 1,281     |
| Total assets at fair value | \$35,774 | \$      | —\$     | —\$35,774 |

## Level 3 Analysis

For Level 3 assets and liabilities measured at fair value on a recurring or non-recurring basis as of September 30, 2018 and December 31, 2017 the significant unobservable inputs used in the fair value measurements were as follows:

September 30, 2018

| Level 3 Assets with Significant Unobservable Inputs | Fair Value | Valuation Technique                                     | Significant Unobservable Inputs                             | Range  |
|---|------------|---|---|--|
| Impaired loans and leases                           | \$ 79,727  | Discounted appraisals<br>Discounted expected cash flows | Appraisal adjustments (1)<br>Interest rate & repayment term | 10% to 48%<br>Weighted average discount rate 6.16% |
| Foreclosed assets                                   | \$ 1,429   | Discounted appraisals                                   | Appraisal adjustments (1)                                   | 9% to 37%  |
| Equity warrant assets                               | \$ 538     | Black-Scholes option pricing model                      | Volatility<br>Risk-free interest rate                       | 20.00%<br>2.85%<br>20%                             |

|                |            |
|----------------|------------|
| Marketability  | 9-10 years |
| discount       |            |
| Remaining life |            |

Table of Contents

Live Oak Bancshares, Inc.

Notes to Unaudited Condensed Consolidated Financial Statements

December 31, 2017

| Level 3 Assets with Significant Unobservable Inputs | Fair Value | Valuation Technique                                     | Significant Unobservable Inputs                              | Range  |
|---|------------|---|--|--|
| Impaired loans and leases                           | \$ 34,493  | Discounted appraisals<br>Discounted expected cash flows | Appraisal adjustments (1)<br>Interest rate & repayment term  | 10% to 25%<br>Weighted average discount rate 6.26% |
| Foreclosed assets                                   | \$ 1,281   | Discounted appraisals                                   | Appraisal adjustments (1)<br>Volatility                      | 10% to 37%<br>25.00%                               |
| Contingent consideration liability                  | \$ 1,900   | Monte Carlo simulation                                  | Risk-free rate of return<br>Dividend yield<br>Remaining life | 1.43%<br>0.51%<br>3.00 years                       |

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

## Estimated Fair Value of Other Financial Instruments

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

| September 30, 2018  | 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 |
|---|-----------------|--|---|---|------------------|
| <b>Financial assets</b>   |                 |  |   |   |                  |
| Cash and due from banks   | \$ 368,565      | \$ 368,565   | \$ —  | —   | —\$368,565       |
| Certificates of deposit with other banks                                    | 750             | 748  | —   | —   | 748              |
| Investment securities, available-for-sale                                   | 374,284         | —  | 374,284                                       | —   | 374,284          |
| Loans held for sale <sup>(1)</sup>  | 646,475         | —  | —   | 649,054                                   | 649,054          |
| Loans and leases, net of allowance for loan and lease losses <sup>(1)</sup> | 1,604,540       | —  | —   | 1,594,589                                 | 1,594,589        |
| Servicing assets  | 49,261          | —  | —   | 49,261                                    | 49,261           |
| Accrued interest receivable   | 14,147          | 14,147   | —   | —   | 14,147           |
| <b>Financial liabilities</b>  |                 |  |   |   |                  |
| Deposits  | 2,924,288       | —  | 2,871,159                                     | —   | 2,871,159        |
| Accrued interest payable  | 410             | 410  | —   | —   | 410              |
| Long term borrowings  | 1,506           | —  | —   | 1,507                                     | 1,507            |

Table of Contents

Live Oak Bancshares, Inc.

Notes to Unaudited Condensed Consolidated Financial Statements

| December 31, 2017   | 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 |
|---|-----------------|--|---|---|------------------|
| <b>Financial assets</b>   |                 |  |   |   |                  |
| Cash and due from banks   | \$ 295,271      | \$ 295,271   | \$ —  | \$ —                                      | \$ 295,271       |
| Certificates of deposit with other banks                                    | 3,000           | 2,993  | —   | —   | 2,993            |
| Investment securities, available-for-sale                                   | 93,355          | —  | 93,355  | —   | 93,355           |
| Loans held for sale <sup>(1)</sup>  | 680,454         | —  | —   | 706,972                                   | 706,972          |
| Loans and leases, net of allowance for loan and lease losses <sup>(1)</sup> | 1,319,783       | —  | —   | 1,319,615                                 | 1,319,615        |
| Servicing assets  | 52,298          | —  | —   | 52,298                                    | 52,298           |
| Accrued interest receivable   | 10,160          | 10,160   | —   | —   | 10,160           |
| <b>Financial liabilities</b>  |                 |  |   |   |                  |
| Deposits  | 2,260,263       | —  | 2,232,370                                     | —   | 2,232,370        |
| Accrued interest payable  | 367             | 367  | —   | —   | 367              |
| Long term borrowings  | 26,564          | —  | —   | 27,390                                    | 27,390           |

In accordance with the adoption of ASU 2016-01, as of September 30, 2018, the fair value of loans and leases were (1) measured using an exit price notion. As of December 31, 2017, the fair value of loans and leases were measured using an entry price notion.

## Note 11. Commitments and Contingencies

## Litigation

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

## Financial Instruments with Off-balance-sheet Risk

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

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

|  | September 30, 2018 | December 31, 2017 |
|--|--------------------|-------------------|
| Commitments to extend credit                 | \$ 1,432,771       | \$ 1,701,137      |
| Standby letters of credit                    | 2,279              | 2,298             |
| Solar purchase commitments                   | 10,158             | 106,921           |
| Airplane purchase agreement commitments      | 10,450             | 25,450            |
| Total unfunded off-balance-sheet credit risk | \$ 1,455,658       | \$ 1,835,806      |





Table of Contents

Live Oak Bancshares, Inc.

Notes to Unaudited Condensed Consolidated Financial Statements

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

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

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

As of September 30, 2018 and December 31, 2017, the Company had unfunded commitments to provide capital contributions for on-balance sheet investments in the amount of \$3.0 million and \$3.5 million, respectively.

Concentrations of Credit Risk

Although the Company is not subject to any geographic concentrations, a substantial amount of the Company's loans, leases, and commitments to extend credit have been granted to customers in the agriculture, healthcare and veterinary verticals. The concentrations of credit by type of loan are set forth in Note 5. The distribution of commitments to extend credit approximates the distribution of loans outstanding. The Company does not have a significant number of credits to any single borrower or group of related borrowers whereby their retained unguaranteed exposure exceeds \$7.5 million, except for ten relationships that have a retained unguaranteed exposure of \$121.1 million of which \$102.3 million of the unguaranteed exposure has been disbursed.

Additionally, the Company has future minimum lease payments due under non-cancelable operating leases totaling \$89.1 million, of which \$67.4 million is due from four relationships.

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

Note 12. Stock Plans

On March 20, 2015, the Company adopted the 2015 Omnibus Stock Incentive Plan which replaced the previously existing Amended Incentive Stock Option Plan and Nonstatutory Stock Option Plan. Subsequently on May 24, 2016, the 2015 Omnibus Stock Incentive Plan was amended to authorize awards covering a maximum of 7,000,000 common voting shares and has an expiration date of March 20, 2025. On May 15, 2018, the Amended and Restated 2015 Omnibus Stock Incentive Plan was amended to authorize awards covering a maximum of 8,750,000 common voting shares. Options or restricted shares granted under the Amended and Restated 2015 Omnibus Stock Incentive Plan (the "Plan") expire no more than 10 years from the date of grant. Exercise prices under the Plan are set by the Board of Directors at the date of grant, but shall not be less than 100% of fair market value of the related stock at the date of the grant. Options or restricted shares vest over a minimum of three years from the date of the grant.

Stock Options

Compensation cost relating to share-based payment transactions are recognized in the financial statements with measurement based upon the fair value of the equity or liability instruments issued. For the three months ended September 30, 2018 and 2017, the Company recognized \$470 thousand and \$536 thousand in compensation expense for stock options, respectively. For the nine months ended September 30, 2018 and 2017, the Company recognized \$1.2 million and \$1.4 million in compensation expense for stock options, respectively.



Table of Contents

Live Oak Bancshares, Inc.

Notes to Unaudited Condensed Consolidated Financial Statements

Stock option activity under the Plan during the nine month periods ended September 30, 2018 and 2017 is summarized below.

|                                   | Shares    | Weighted<br>Average<br>Exercise Price | Weighted<br>Average<br>Remaining<br>Contractual<br>Term | Aggregate<br>Intrinsic<br>Value |
|-----------------------------------|-----------|---------------------------------------|---|---------------------------------|
| Outstanding at December 31, 2017  | 3,058,459 | \$ 11.30                              |   |                                 |
| Exercised                         | 171,333   | 9.26                                  |   |                                 |
| Forfeited                         | 174,845   | 13.69                                 |   |                                 |
| Granted                           | —         | —                                     |   |                                 |
| Outstanding at September 30, 2018 | 2,712,281 | \$ 11.27                              | 6.28 years  | \$47,005,905                    |
| Exercisable at September 30, 2018 | 813,730   | \$ 10.67                              | 6.11 years  | \$14,587,733                    |

|                                   | Shares    | Weighted<br>Average<br>Exercise Price | Weighted<br>Average<br>Remaining<br>Contractual<br>Term | Aggregate<br>Intrinsic<br>Value |
|-----------------------------------|-----------|---------------------------------------|---|---------------------------------|
| Outstanding at December 31, 2016  | 3,478,208 | \$ 11.51                              |   |                                 |
| Exercised                         | 76,285    | 7.89                                  |   |                                 |
| Forfeited                         | 203,671   | 14.12                                 |   |                                 |
| Granted                           | —         | —                                     |   |                                 |
| Outstanding at September 30, 2017 | 3,198,252 | \$ 11.43                              | 7.31 years  | \$38,411,802                    |
| Exercisable at September 30, 2017 | 703,425   | \$ 10.41                              | 7.06 years  | \$9,171,805                     |

The following is a summary of non-vested stock option activity for the Company for the nine months ended September 30, 2018 and 2017.

|                                  | Shares     | Weighted<br>Average<br>Grant Date<br>Fair Value |
|----------------------------------|------------|---|
| Non-vested at December 31, 2017  | 2,364,999  | \$ 4.65   |
| Granted                          | —          | —   |
| Vested                           | (291,603 ) | 3.95  |
| Forfeited                        | (174,845 ) | 5.98  |
| Non-vested at September 30, 2018 | 1,898,551  | 4.63  |
|                                  | Shares     | Weighted<br>Average<br>Grant Date<br>Fair Value |
| Non-vested at December 31, 2016  | 3,016,100  | \$ 4.78   |
| Granted                          | —          | —   |
| Vested                           | (317,602 ) | 4.17  |
| Forfeited                        | (203,671 ) | 6.03  |
| Non-vested at September 30, 2017 | 2,494,827  | 4.75  |

The total intrinsic value of options exercised at September 30, 2018 and 2017 was \$3.3 million and \$1.1 million, respectively.

At September 30, 2018, unrecognized compensation costs relating to stock options amounted to \$6.6 million which will be recognized over a weighted average period of 2.31 years.

Table of Contents

Live Oak Bancshares, Inc.

Notes to Unaudited Condensed 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. There were no stock options granted during the three and nine months ended September 30, 2018 or 2017.

**Restricted Stock**

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

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

Market RSUs also have a restriction based on the passage of time and non-market-related performance criteria, but also have a restriction based on market price criteria related to the Company's share price closing at or above a specified price ranging from \$34.00 to \$55.00 per share for at least twenty (20) consecutive trading days at any time prior to expiration date. The amount of Market RSUs earned will not exceed 100% of the Market RSUs awarded. The fair value of the Market RSUs and the implied service period is calculated using the Monte Carlo simulation method. RSU stock activity under the Plan during the first nine months of 2018 is summarized below.

|                                  | Shares  | Weighted<br>Average Grant<br>Date Fair Value |
|----------------------------------|---------|--|
| Non-vested at December 31, 2017  | 181,814 | \$ 20.03                                     |
| Granted                          | 230,599 | 28.72  |
| Vested                           | 83,829  | 23.68  |
| Forfeited                        | 38,793  | 22.96  |
| Non-vested at September 30, 2018 | 289,791 | 25.50  |

For the three months ended September 30, 2018 and 2017, the Company recognized \$401 thousand and \$191 thousand in compensation expense for RSUs, respectively. For the nine months ended September 30, 2018 and 2017, the Company recognized \$2.2 million and \$517 thousand in compensation expense for RSUs, respectively.

At September 30, 2018, unrecognized compensation costs relating to RSUs amounted to \$6.6 million which will be recognized over a weighted average period of 5.19 years.

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

|                                  | Shares    | Weighted<br>Average Grant<br>Date Fair Value |
|----------------------------------|-----------|--|
| Non-vested at December 31, 2017  | 2,532,808 | \$ 8.78                                      |
| Granted                          | 485,000   | 15.73  |
| Vested                           | —         | —  |
| Forfeited                        | 223,128   | 9.08   |
| Non-vested at September 30, 2018 | 2,794,680 | 9.96   |

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

Related to the 75,000 Market RSUs granted on May 14, 2018, the share price simulation was based on the Cox, Ross & Rubinstein option pricing methodology for a period of 7.0 years. The implied term of the restricted stock was 3.3 years. The Monte Carlo Simulation used various assumptions that included a risk free rate of return of 2.96%,

expected volatility of 27.00% and a dividend yield of 0.42%.

42

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Table of Contents

Live Oak Bancshares, Inc.

Notes to Unaudited Condensed Consolidated Financial Statements

Related to the 410,000 Market RSUs granted on August 10, 2018, the share price simulation was based on the Cox, Ross & Rubinstein option pricing methodology for a period of 7.0 years. The implied term of the restricted stock ranges from 1.6 years to 3.5 years. The Monte Carlo Simulation used various assumptions that included a risk free rate of return of 2.78%, expected volatility of 28.10% and a dividend yield of 0.40%.

For the three months ended September 30, 2018 and 2017, the Company recognized \$1.6 million and \$1.3 million in compensation expense for Market RSUs, respectively. For the nine months ended September 30, 2018 and 2017, the Company recognized \$3.5 million and \$3.7 million in compensation expense for Market RSUs, respectively.

At September 30, 2018, unrecognized compensation costs relating to Market RSUs amounted to \$18.4 million which will be recognized over a weighted average period of 2.66 years.

Employee Stock Purchase Plan

The Company adopted an Employee Stock Purchase Plan on October 8, 2014. On May 24, 2016, the plan was amended and the Amended and Restated Employee Stock Purchase Plan (the "ESPP") became effective within the meaning of Section 423 of the Internal Revenue Code of 1986, as amended. Under the ESPP, eligible employees are able to purchase available shares with post-tax dollars as of the grant date. In order for employees to be eligible to participate in the ESPP they must be employed or on an authorized leave of absence from the Company or any subsidiary immediately prior to the grant date. ESPP stock purchases cannot exceed \$25 thousand in fair market value per employee per calendar year. Options to purchase shares under the ESPP are granted at a 15% discount to fair market value. For the three months ended September 30, 2018 and 2017, the Company recognized \$31 thousand and \$36 thousand, respectively. For the nine months ended September 30, 2018 and 2017 the Company recognized \$60 thousand and \$79 thousand expense, respectively.



Table of Contents

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

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

Important Note Regarding Forward-Looking Statements

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

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

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

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

Table of Contents

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

changes in political and economic conditions;

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

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

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

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

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

the success at managing the risks involved in the foregoing.

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

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

Nature of Operations

LOB is a bank holding company headquartered in Wilmington, North Carolina incorporated under the laws of North Carolina in December 2008. The Company conducts business operations primarily through its commercial bank subsidiary, Live Oak Banking Company (the "Bank"). The Bank was incorporated in February 2008 as a North Carolina-chartered commercial bank. The Bank specializes in providing lending services to small businesses nationwide. The Bank identifies and grows within selected industry sectors, or verticals, by leveraging expertise within those industries, and more broadly to select borrowers outside of those industries. A significant portion of the loans originated by the Bank are guaranteed by the SBA under its 7(a) program. In 2010, the Bank formed Live Oak Number One, Inc., a wholly-owned subsidiary, to hold properties foreclosed on by the Bank.

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

## Table of Contents

In June 2018, the Bank formed Live Oak Private Wealth, LLC for the purpose of providing high-net-worth individuals and families with strategic wealth and investment management services. In 2017, the Bank entered into a joint venture, Apiture LLC (“Apiture”), with First Data Corporation for the purpose of creating next generation technology for financial institutions. In addition to the Bank, the Company owns Live Oak Clean Energy Financing LLC, formed in November 2016, for the purpose of providing financing to entities for renewable energy applications; Live Oak Ventures, Inc. (formerly known as “Canapi, Inc.”), formed in August 2016, for the purpose of investing in businesses that align with the Company's strategic initiative to be a leader in financial technology; Live Oak Grove, LLC, opened in September 2015 for the purpose of providing Company employees and business visitors an on-site restaurant location; Government Loan Solutions, Inc. (“GLS”), a management and technology consulting firm that specializes in the settlement, accounting, and securitization processes for government guaranteed loans, including loans originated under the SBA 7(a) loan program and U.S. Department of Agriculture (“USDA”)-guaranteed loans; and 504 Fund Advisors, LLC (“504FA”), which was formed to serve as the investment advisor to The 504 Fund, a closed-end mutual fund organized to invest in SBA section 504 loans. In addition, the Company owned Reltco Inc. and National Assurance Title, Inc. (collectively referred to as “Reltco”) until the Company sold Reltco on August 1, 2018. See Note 1 under the subheading Sale of Title Insurance Business for more information.

The Company generates revenue primarily from the sale of SBA-guaranteed loans and USDA guaranteed Rural Energy for America Program (“REAP”) and Business & Industry (“B&I”) loans and net interest income. Income from the sale of loans is comprised of loan servicing revenue and revaluation of related servicing assets and net gains on sales of loans. Offsetting these revenues are the cost of funding sources, provision for loan and lease losses, any costs related to foreclosed assets and other operating costs such as salaries and employee benefits, travel, professional services, occupancy, advertising and marketing, data processing, equipment and tax expense.

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

### Business Outlook

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

For the full year of 2018, the Company expects to originate approximately \$1.70 billion to \$1.80 billion in loans and leases. During the fourth quarter of 2018, the Company expects to retain more loans on the consolidated balance sheet by selling less into the secondary market, compared to historical trends.

### Results of Operations

#### Performance Summary

Three months ended September 30, 2018 compared with three months ended September 30, 2017

For the three months ended September 30, 2018, the Company reported net income of \$14.3 million, or \$0.34 per diluted share, as compared to \$12.9 million, or \$0.33 per diluted share, for the three months ended September 30, 2017. This increase in net income is primarily due to the following items:

• Increased net interest income of \$6.7 million, or 31.9%, predominately driven by significant growth in the combined held for sale and held for investment loan and lease portfolios along with higher investment security holdings;

• A decline in the provision for loan and lease losses of \$2.7 million, or 110.0%, primarily as a result of updated loss factors consistent with our methodology for estimating the allowance for loan and lease losses;

• Increased net gains on sales of loans of \$3.9 million, or 21.3%, as a result of higher loan sale volumes partially offset by lower average premiums;

• Increased loan servicing revenue of \$1.0 million, or 15.7%, attributable to a higher serviced loan portfolio; and

• Increased lease income of \$1.5 million for lease activities that began during the second quarter of 2017.

Partially offsetting the above factors was a decline in title insurance income of \$1.5 million combined with increases in various cost factors as follows: \$5.7 million in the loan servicing asset revaluation loss, \$1.5 million in salaries and

employee benefits, \$1.7 million in data processing expense, \$1.4 million in equipment expense, \$2.7 million one-time net impairment expense associated with the sale of the title insurance business and a lower income tax benefit of \$1.9 million.

Table of Contents

Nine months ended September 30, 2018 compared with nine months ended September 30, 2017

For the nine months ended September 30, 2018, the Company reported net income of \$41.0 million, or \$0.98 per diluted share, as compared to \$28.8 million, or \$0.78 per diluted share, for the nine months ended September 30, 2017. This increase in net income is primarily attributable to the following items:

- Increased net interest income of \$24.2 million, or 43.9%, predominately driven by significant growth in the loans and leases held for sale and held for investment portfolios along with higher investment security holdings;

- Increased loan servicing revenue of \$2.8 million, or 15.0%, as a result of continued growth in the servicing portfolio due to ongoing loan sales;

- Increased net gains on sales of loans of \$14.2 million, or 25.7%, due to a higher year-to-date sale volume partially offset by a decrease in the average net gain per loan sold; and

- Increased lease income of \$5.0 million for operating lease activities that began during the second quarter of 2017. Partially offsetting the above factors was a decline in title insurance income of \$3.0 million combined with increases in various cost factors as follows: \$11.3 million in the loan servicing asset revaluation loss, \$7.2 million in salaries and employee benefits, \$1.3 million in occupancy expense, \$3.9 million in data processing expense, \$5.1 million in equipment expense, \$2.7 million one-time net impairment expense associated with the sale of the title insurance business and a lower income tax benefit of \$1.5 million.

Net Interest Income and Margin

Net interest income represents the difference between the income that the Company earns on interest-earning assets and the cost it incurs on interest-bearing liabilities. The Company's net interest income depends upon the volume of interest-earning assets and interest-bearing liabilities and the interest rates that the Company earns or pays on them.

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

Three months ended September 30, 2018 compared with three months ended September 30, 2017

For the three months ended September 30, 2018, net interest income increased \$6.7 million, or 31.9%, to \$27.7 million compared to \$21.0 million for the three months ended September 30, 2017. This increase was principally due to the significant growth in average interest earning assets, predominately loans, leases and investment securities, and to a lesser extent by higher yields on these assets which outpaced the relative growth and change in the cost of interest bearing liabilities, primarily related to deposits. Average interest earning assets increased by \$909.5 million, or 42.6%, to \$3.04 billion for the three months ended September 30, 2018, compared to \$2.13 billion for the three months ended September 30, 2017, while the yield on average interest earning assets increased twenty-two basis points to 5.46%.

The cost of funds on interest bearing liabilities for the three months ended September 30, 2018 increased fifty basis points to 1.93%, and the average balance of interest bearing liabilities increased by \$925.4 million, or 46.6%, over the same period in 2017. As indicated in the rate/volume table below, the increase in interest earning assets and corresponding yields outpaced the higher volume of interest bearing liabilities along with an increasing cost of funds, resulting in increased interest income of \$13.7 million and increased interest expense of \$7.0 million for the three months ended September 30, 2018 compared to the three months ended September 30, 2017. For the three months ended September 30, 2017 compared to the three months ended September 30, 2018, net interest margin declined from 3.91% to 3.61%, respectively, principally due to the narrowing of the interest rate spread during the quarter. This compression of the spread was largely the result of strategic liquidity initiatives which were accomplished during the first quarter of 2018 which led to much higher levels of investment securities and cash balances held with other banks which carry much lower yields.

Table of Contents

Nine months ended September 30, 2018 compared with nine months ended September 30, 2017

For the nine months ended September 30, 2018, net interest income increased \$24.2 million, or 43.9%, to \$79.2 million compared to \$55.1 million for the nine months ended September 30, 2017. This increase was principally due to the significant growth in average interest earning assets and to a lesser extent higher yields on these assets outpacing the growth and change in the cost of interest bearing liabilities. Average interest earning assets increased by \$1.05 billion, or 55.0%, to \$2.95 billion for the nine months ended September 30, 2018 compared to \$1.90 billion for the nine months ended September 30, 2017, while the yield on average interest earning assets increased by twenty-two basis points to 5.34%. The cost of funds on interest bearing liabilities for the nine months ended September 30, 2018 increased by fifty basis points to 1.84%, and the average balance of interest bearing liabilities increased by \$1.03 billion, or 58.1%, during the same period. As indicated in the rate/volume table below, the increase in interest bearing liabilities and corresponding cost of funds was outpaced by the positive effects of the increased volume of interest earning assets along with higher yields, resulting in increased interest income of \$45.0 million and increased interest expense of \$20.8 million for the nine months ended September 30, 2018. For the nine months ended September 30, 2017 compared to the nine months ended September 30, 2018, net interest margin declined from 3.87% to 3.59% due to the aforementioned effects.

Table of Contents

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 September 30, |          |                    |                 |          |                    |
|--|----------------------------------|----------|--------------------|-----------------|----------|--------------------|
|  | 2018                             |          |                    | 2017            |          |                    |
|  | Average Balance                  | Interest | Average Yield/Rate | Average Balance | Interest | Average Yield/Rate |
| <b>Interest earning assets:</b>  |                                  |          |                    |                 |          |                    |
| Interest earning balances in other banks   | \$349,739                        | \$1,638  | 1.86 %             | \$292,066       | \$870    | 1.18 %             |
| Investment securities  | 388,520                          | 2,528    | 2.58               | 73,312          | 325      | 1.76               |
| Loans held for sale  | 693,517                          | 11,270   | 6.45               | 653,342         | 9,922    | 6.03               |
| Loans and leases held for investment <sup>(1)</sup>                              | 1,612,699                        | 26,454   | 6.51               | 1,116,209       | 17,055   | 6.06               |
| Total interest earning assets  | 3,044,475                        | 41,890   | 5.46               | 2,134,929       | 28,172   | 5.24               |
| Less: allowance for loan and lease losses  | (29,266 )                        |          |                    | (19,544 )       |          |                    |
| Non-interest earning assets  | 434,963                          |          |                    | 242,014         |          |                    |
| Total assets   | \$3,450,172                      |          |                    | \$2,357,399     |          |                    |
| <b>Interest bearing liabilities:</b>   |                                  |          |                    |                 |          |                    |
| Interest bearing checking  | \$31,950                         | \$87     | 1.08 %             | \$35,127        | \$51     | 0.58 %             |
| Savings  | 943,958                          | 4,026    | 1.69               | 196,220         | 682      | 1.38               |
| Money market accounts  | 120,702                          | 314      | 1.03               | 453,985         | 1,303    | 1.14               |
| Certificates of deposit  | 1,810,040                        | 9,738    | 2.13               | 1,257,072       | 4,722    | 1.49               |
| Total deposits   | 2,906,650                        | 14,165   | 1.93               | 1,942,404       | 6,758    | 1.38               |
| Other borrowings   | 3,365                            | 1        | 0.12               | 42,219          | 389      | 3.66               |
| Total interest bearing liabilities   | 2,910,015                        | 14,166   | 1.93               | 1,984,623       | 7,147    | 1.43               |
| Non-interest bearing deposits  | 46,272                           |          |                    | 43,652          |          |                    |
| Non-interest bearing liabilities   | 21,804                           |          |                    | 22,650          |          |                    |
| Shareholders' equity   | 472,081                          |          |                    | 306,474         |          |                    |
| Total liabilities and shareholders' equity                                       | \$3,450,172                      |          |                    | \$2,357,399     |          |                    |
| Net interest income and interest rate spread                                     |                                  | \$27,724 | 3.53 %             |                 | \$21,025 | 3.81 %             |
| Net interest margin  |                                  |          | 3.61               |                 |          | 3.91               |
| Ratio of average interest-earning assets to average interest-bearing liabilities |                                  |          | 104.62 %           |                 |          | 107.57 %           |

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



Table of Contents

|   | Nine months ended September 30, |          |                       |   |                    |          |                       |   |
|---|---------------------------------|----------|-----------------------|---|--------------------|----------|-----------------------|---|
|   | 2018                            |          |                       |   | 2017               |          |                       |   |
|   | Average<br>Balance              | Interest | Average<br>Yield/Rate |   | Average<br>Balance | Interest | Average<br>Yield/Rate |   |
| Interest earning assets:  |                                 |          |                       |   |                    |          |                       |   |
| Interest earning balances in other banks  | \$403,024                       | \$5,032  | 1.67                  | % | \$229,074          | \$1,682  | 0.98                  | % |
| Investment securities   | 315,120                         | 6,175    | 2.62                  |   | 71,319             | 964      | 1.81                  |   |
| Loans held for sale   | 722,308                         | 34,423   | 6.37                  |   | 561,408            | 24,679   | 5.88                  |   |
| Loans and leases held for investment <sup>(1)</sup>                                 | 1,508,833                       | 72,259   | 6.40                  |   | 1,041,265          | 45,611   | 5.86                  |   |
| Total interest earning assets   | 2,949,285                       | 117,889  | 5.34                  |   | 1,903,066          | 72,936   | 5.12                  |   |
| Less: allowance for loan and lease losses   | (27,157 )                       |          |                       |   | (18,652 )          |          |                       |   |
| Non-interest earning assets   | 422,295                         |          |                       |   | 206,653            |          |                       |   |
| Total assets  | \$3,344,423                     |          |                       |   | \$2,091,067        |          |                       |   |
| Interest bearing liabilities:   |                                 |          |                       |   |                    |          |                       |   |
| Interest bearing checking   | \$37,448                        | \$290    | 1.04                  | % | \$39,973           | \$173    | 0.58                  | % |
| Savings   | 922,028                         | 11,206   | 1.62                  |   | 67,395             | 693      | 1.37                  |   |
| Money market accounts   | 147,002                         | 1,297    | 1.18                  |   | 469,505            | 3,365    | 0.96                  |   |
| Certificates of deposit   | 1,697,620                       | 25,717   | 2.03                  |   | 1,163,081          | 12,662   | 1.46                  |   |
| Total deposits  | 2,804,098                       | 38,510   | 1.84                  |   | 1,739,954          | 16,893   | 1.30                  |   |
| Other borrowings  | 5,998                           | 131      | 2.92                  |   | 37,736             | 985      | 3.49                  |   |
| Total interest bearing liabilities  | 2,810,096                       | 38,641   | 1.84                  |   | 1,777,690          | 17,878   | 1.34                  |   |
| Non-interest bearing deposits   | 52,225                          |          |                       |   | 35,073             |          |                       |   |
| Non-interest bearing liabilities  | 20,691                          |          |                       |   | 22,288             |          |                       |   |
| Shareholders' equity  | 461,411                         |          |                       |   | 256,016            |          |                       |   |
| Total liabilities and shareholders' equity  | \$3,344,423                     |          |                       |   | \$2,091,067        |          |                       |   |
| Net interest income and interest rate spread  |                                 | \$79,248 | 3.50                  | % |                    | \$55,058 | 3.78                  | % |
| Net interest margin   |                                 |          | 3.59                  |   |                    |          | 3.87                  |   |
| Ratio of average interest-earning assets to<br>average interest-bearing liabilities |                                 |          | 104.95                | % |                    |          | 107.05                | % |

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

Table of Contents

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

|  | Three months ended<br>September 30,<br>2018 vs. 2017 |         |         | Nine months ended<br>September 30,<br>2018 vs. 2017 |          |          |
|--|--|---------|---------|---|----------|----------|
|  | Increase (Decrease) Due<br>to                        |         |         | Increase (Decrease) Due to                          |          |          |
|  | Rate   | Volume  | Total   | Rate  | Volume   | Total    |
| Interest income:                         |  |         |         |   |          |          |
| Interest earning balances in other banks | \$547  | \$221   | \$768   | \$1,625   | \$1,725  | \$3,350  |
| Investment securities                    | 479  | 1,724   | 2,203   | 1,175   | 4,036    | 5,211    |
| Loans held for sale                      | 717  | 631     | 1,348   | 2,373   | 7,371    | 9,744    |
| Loans and leases held for investment     | 1,534  | 7,865   | 9,399   | 5,211   | 21,437   | 26,648   |
| Total interest income                    | 3,277  | 10,441  | 13,718  | 10,384  | 34,569   | 44,953   |
| Interest expense:                        |  |         |         |   |          |          |
| Interest bearing checking                | 43   | (7 )    | 36      | 132   | (15 )    | 117      |
| Savings                                  | 450  | 2,894   | 3,344   | 926   | 9,587    | 10,513   |
| Money market accounts                    | (77 )  | (912 )  | (989 )  | 510   | (2,578 ) | (2,068 ) |
| Certificates of deposit                  | 2,490  | 2,526   | 5,016   | 6,097   | 6,958    | 13,055   |
| Other borrowings                         | (202 )   | (186 )  | (388 )  | (96 )   | (758 )   | (854 )   |
| Total interest expense                   | 2,704  | 4,315   | 7,019   | 7,569   | 13,194   | 20,763   |
| Net interest income                      | \$573  | \$6,126 | \$6,699 | \$2,815   | \$21,375 | \$24,190 |

## Provision for Loan and Lease Losses

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

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

For the third quarter of 2018 there was a negative provision for loan and lease losses of \$243 thousand compared to provision expenses of \$2.4 million for the same period in 2017, a decrease of \$2.7 million, or 110.0%. For the nine months ended September 30, 2018 the provision was \$6.2 million compared to \$5.5 million for the same period in 2017, an increase of \$755 thousand, or 13.8%. The decrease in the provision for loan and lease losses compared to the prior year quarter along with the reduced level of increase in year to year periods was primarily attributable to updated loss factors in the third quarter 2018 consistent with our methodology for estimating the allowance for loan and lease losses. Specifically, during the third quarter of 2018, the family entertainment portfolio passed the Company's allowance policy criteria for new verticals to transition to mature status thereby moving from using industry loss rates to actual incurred loss rates. This transition to actual loss rates reduced the provision by \$2.9 million in the third quarter of 2018. Also contributing to lower provision costs was a strategic transfer of \$29.9 million in unguaranteed renewable energy loans from held for investment to held for sale in the third quarter of 2018. This change in intent to

designate loans for sale that were previously held for investment decreased the provision by \$434 thousand. Loans and leases held for investment were \$1.63 billion as of September 30, 2018, increasing by \$461.5 million, or 39.4%, compared to September 30, 2017. This growth was fueled by strong loan origination volumes and ongoing disbursements for loans in the construction portfolio over the past year.

Table of Contents

Net charge-offs were \$2.3 million, or 0.57% of average quarterly loans and leases held for investment on an annualized basis, for the three months ended September 30, 2018, compared to net charge-offs of \$959 thousand, or 0.34%, for the three months ended September 30, 2017. Net charge-offs for the first nine months of 2018 and 2017 totaled \$3.6 million and \$2.7 million, respectively. Year to date net charge-offs as a percentage of year to date average loans and leases held for investment were 0.24% and 0.26% at September 30, 2018 and 2017, respectively. Net charge-offs are a key element of historical experience in the Company's estimation of the allowance for loan and lease losses.

In addition, at September 30, 2018, nonperforming loans and leases not guaranteed by the SBA totaled \$12.9 million, which was 0.79% of the held-for-investment loan and lease portfolio compared to \$3.3 million, or 0.28% of loans and leases held for investment at September 30, 2017.

**Noninterest Income**

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

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

|                                     | Three Months                   |          | Increase (Decrease) |          |
|-------------------------------------|--------------------------------|----------|---------------------|----------|
|                                     | Ended<br>September 30,<br>2018 | 2017     | Amount              | Percent  |
| <b>Noninterest income</b>           |                                |          |                     |          |
| Loan servicing revenue              | \$7,506                        | \$6,490  | \$1,016             | 15.65 %  |
| Loan servicing asset revaluation    | (9,380 )                       | (3,691 ) | (5,689 )            | (154.13) |
| Net gains on sales of loans         | 22,004                         | 18,148   | 3,856               | 21.25    |
| Lease income                        | 2,194                          | 682      | 1,512               | 221.70   |
| Construction supervision fee income | 578                            | 362      | 216                 | 59.67    |
| Title insurance income              | 479                            | 1,968    | (1,489 )            | (75.66 ) |
| Other noninterest income            | 950                            | 1,101    | (151 )              | (13.71 ) |
| Total noninterest income            | \$24,331                       | \$25,060 | \$(729 )            | (2.91 )% |
| <b>Nine Months</b>                  |                                |          |                     |          |
|                                     | Ended<br>September 30,<br>2018 | 2017     | Amount              | Percent  |
| <b>Noninterest income</b>           |                                |          |                     |          |
| Loan servicing revenue              | \$21,369                       | \$18,587 | \$2,782             | 14.97 %  |
| Loan servicing asset revaluation    | (18,138 )                      | (6,864 ) | (11,274)            | (164.25) |
| Net gains on sales of loans         | 69,483                         | 55,276   | 14,207              | 25.70    |
| Lease income                        | 5,722                          | 691      | 5,031               | 728.08   |
| Construction supervision fee income | 1,954                          | 1,077    | 877                 | 81.43    |
| Title insurance income              | 2,775                          | 5,803    | (3,028 )            | (52.18 ) |
| Other noninterest income            | 2,535                          | 2,910    | (375 )              | (12.89 ) |
| Total noninterest income            | \$85,700                       | \$77,480 | \$8,220             | 10.61 %  |

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For the three months ended September 30, 2018, noninterest income decreased by \$729 thousand, or 2.9%, compared to the three months ended September 30, 2017. The decrease from the prior year is primarily the result of \$9.4 million in the loan servicing asset revaluation loss in the third quarter of 2018 compared to \$3.7 million in the third quarter of 2017. The higher negative revaluation results from the current rising rate environment and flattening yield curve which has led to increased prepayment speeds and fewer active loan purchasers relative to the growing pool of loans available for sale.

52

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Table of Contents

Also impacting the overall decrease in noninterest income was a decline in title insurance income of \$1.5 million. The title insurance business was sold on August 1, 2018. Partially offsetting the overall decrease in noninterest income was growth in loan servicing revenue of \$1.0 million, net gains on sale of loans of \$3.9 million, and operating lease income of \$1.5 million.

For the nine months ended September 30, 2018, noninterest income increased by \$8.2 million, or 10.6%, compared to the nine months ended September 30, 2017. The higher noninterest income total was primarily the result of higher year-to-date levels in the serviced loan portfolio and the volume of loans sold in the secondary market which generated \$2.8 million of increased servicing revenue and \$14.2 million of increased net gains on sale of loans. Also contributing to increased levels of noninterest income was \$5.0 million of operating lease income. Partly offsetting the overall increase in noninterest income was a higher negative loan servicing revaluation adjustment of \$11.3 million and a decline in title insurance income of \$3.0 million.

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

|   | Three months ended<br>September 30, |             | Three months ended<br>June 30, |             | Three months ended<br>March 31, |           |
|---|-------------------------------------|-------------|--------------------------------|-------------|---------------------------------|-----------|
|   | 2018                                | 2017        | 2018                           | 2017        | 2018                            | 2017      |
| Amount of loans and leases originated                       | \$377,337                           | \$395,682   | \$491,797                      | \$586,471   | \$397,559                       | \$468,663 |
| Guaranteed portions of loans sold                           | 298,073                             | 163,843     | 295,216                        | 203,714     | 247,243                         | 208,715   |
| Outstanding balance of guaranteed loans sold <sup>(1)</sup> | 3,102,820                           | 2,584,163   | 2,951,379                      | 2,521,506   | 2,812,108                       | 2,410,791 |
|   | Nine months ended<br>September 30,  |             | For years ended December 31,   |             |                                 |           |
|   | 2018                                | 2017        | 2017                           | 2016        | 2015                            | 2014      |
| Amount of loans and leases originated                       | \$1,266,693                         | \$1,450,816 | \$1,934,238                    | \$1,537,010 | \$1,158,640                     | \$848,090 |
| Guaranteed portions of loans sold                           | 840,532                             | 576,272     | 787,926                        | 761,933     | 640,886                         | 433,912   |
| Outstanding balance of guaranteed loans sold <sup>(1)</sup> | 3,102,820                           | 2,584,163   | 2,680,641                      | 2,278,618   | 1,779,989                       | 1,302,828 |

<sup>(1)</sup> 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 SBA loans sold and 0.40% of the outstanding balance of USDA loans sold. In addition, the cost of servicing sold loans is approximately 0.40% of the balance of the loans sold, which is included in the loan servicing revaluation computations. Unrecognized servicing revenue is reflected in a servicing asset recorded on the consolidated balance sheet. Revenues associated with the servicing of loans are recognized over the expected life of the loan through the consolidated income statement, and the servicing asset is reduced as this revenue is recognized. For three and nine months ended September 30, 2018, loan servicing revenue increased \$1.0 million, or 15.7%, and \$2.8 million, or 15.0%, respectively, as compared to the three and nine months ended September 30, 2017, as a result of an increase in the average outstanding balance of guaranteed loans sold. At September 30, 2018, the outstanding balance of government guaranteed loans sold in the secondary market was \$3.10 billion compared to \$2.58 billion at September 30, 2017.

**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 September 30, 2018, there was a net negative loan servicing revaluation adjustment of \$9.4 million compared to a net negative adjustment of \$3.7 million for the three months ended September 30, 2017. For the nine months ended September 30, 2018, there was a net negative loan servicing revaluation adjustment of \$18.1 million compared to a net negative adjustment of \$6.9 million for the nine months

ended September 30, 2017. The higher negative loan servicing revaluation amount for the third quarter of 2018 as compared to the third quarter of 2017 was primarily a result of the current rising rate environment and flattening yield curve which has led to increased prepayment speeds and fewer active loan purchasers relative to the growing pool of loans available for sale.

Table of Contents

Net Gains on Sale of Loans: For the three and nine months ended September 30, 2018, net gains on sales of loans increased \$3.9 million, or 21.2%, and \$14.2 million, or 25.7%, respectively, compared to the three and nine months ended September 30, 2017. For the three months ended September 30, 2018, the volume of guaranteed loans sold increased \$134.2 million, or 81.9%, to \$298.1 million from \$163.8 million for the three months ended September 30, 2017. For the nine months ended September 30, 2018, the volume of guaranteed loans sold increased \$264.3 million, or 45.9%, to \$840.5 million from \$576.3 million for the nine months ended September 30, 2017. The volume-driven increases in the year-to-date net gain on loan sale comparisons were partially offset by lower average premiums paid in the secondary market primarily due to changes driving the higher negative loan servicing valuation discussed above. The average net gain on sale of loans for the three and nine months ended September 30, 2018 was lower at \$72 thousand and \$84 thousand of revenue for each \$1 million in loans sold, respectively, compared to \$111 thousand and \$97 thousand for the three and nine months ended September 30, 2017, respectively.

## Noninterest Expense

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

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

|   | Three Months                   |          | Increase (Decrease) |         |   |
|---|--------------------------------|----------|---------------------|---------|---|
|   | Ended<br>September 30,<br>2018 | 2017     | Amount              | Percent |   |
| Noninterest expense                                       |                                |          |                     |         |   |
| Salaries and employee benefits                            | \$20,553                       | \$19,037 | \$1,516             | 7.96    | % |
| Non-staff expenses:                                       |                                |          |                     |         |   |
| Travel expense  | 2,003                          | 2,289    | (286)               | (12.49) | ) |
| Professional services expense                             | 1,228                          | 1,068    | 160                 | 14.98   |   |
| Advertising and marketing expense                         | 1,462                          | 1,516    | (54)                | (3.56)  | ) |
| Occupancy expense   | 1,588                          | 1,473    | 115                 | 7.81    |   |
| Data processing expense                                   | 3,661                          | 1,982    | 1,679               | 84.71   |   |
| Equipment expense   | 3,649                          | 2,228    | 1,421               | 63.78   |   |
| Other loan origination and maintenance expense            | 1,742                          | 1,601    | 141                 | 8.81    |   |
| FDIC insurance  | 1,105                          | 858      | 247                 | 28.79   |   |
| Title insurance closing services expense                  | 114                            | 687      | (573)               | (83.41) | ) |
| Impairment expense on goodwill and other intangibles, net | 2,680                          | —        | 2,680               | 100.00  |   |
| Other expense   | 1,459                          | 3,117    | (1,658)             | (53.19) | ) |
| Total non-staff expenses                                  | 20,691                         | 16,819   | 3,872               | 23.02   |   |
| Total noninterest expense                                 | \$41,244                       | \$35,856 | \$5,388             | 15.03   | % |



Table of Contents

|   | Nine Months Ended     |           | Increase (Decrease) |          |
|---|-----------------------|-----------|---------------------|----------|
|   | September 30,<br>2018 | 2017      | Amount              | Percent  |
| Noninterest expense                                       |                       |           |                     |          |
| Salaries and employee benefits                            | \$62,908              | \$55,687  | \$7,221             | 12.97 %  |
| Non-staff expenses:                                       |                       |           |                     |          |
| Travel expense  | 5,887                 | 6,035     | (148 )              | (2.45 )  |
| Professional services expense                             | 3,645                 | 4,228     | (583 )              | (13.79 ) |
| Advertising and marketing expense                         | 4,992                 | 4,977     | 15                  | 0.30     |
| Occupancy expense   | 5,327                 | 4,018     | 1,309               | 32.58    |
| Data processing expense                                   | 9,404                 | 5,536     | 3,868               | 69.87    |
| Equipment expense   | 10,094                | 5,005     | 5,089               | 101.68   |
| Other loan origination and maintenance expense            | 4,485                 | 3,587     | 898                 | 25.03    |
| FDIC insurance  | 2,687                 | 2,308     | 379                 | 16.42    |
| Title insurance closing services expense                  | 912                   | 1,877     | (965 )              | (51.41 ) |
| Impairment expense on goodwill and other intangibles, net | 2,680                 | —         | 2,680               | 100.00   |
| Other expense   | 7,125                 | 8,883     | (1,758 )            | (19.79 ) |
| Total non-staff expenses                                  | 57,238                | 46,454    | 10,784              | 23.21    |
| Total noninterest expense                                 | \$120,146             | \$102,141 | \$18,005            | 17.63 %  |

Total noninterest expense for the three and nine months ended September 30, 2018 increased \$5.4 million, or 15.0%, and \$18.0 million, or 17.6%, respectively, compared to the same periods in 2017. The increase in noninterest expense was principally comprised of increased personnel, occupancy, data processing and equipment expense driven by the significant growth of the Company's core business. Also contributing significantly to the increase in noninterest expense was a one-time \$2.7 million net impairment expense associated with the sale of the title insurance business. Changes in various components of noninterest expense are discussed below.

Salaries and employee benefits: Total personnel expense for the three and nine months ended September 30, 2018 increased by \$1.5 million, or 8.0%, and \$7.2 million, or 13.0%, respectively, compared to the same periods in 2017. The primary drivers for this increase was the continued investment in human capital to support the growing loan and lease production from new and existing verticals partially offset by transferring the recognition of costs associated with software development to data processing expense with the formation of Apiture. Total full-time equivalent employees decreased from 530 at September 30, 2017 to 504 at September 30, 2018. Another limiting factor was the sale of the title insurance business on August 1, 2018 which reduced the full-time equivalent count by 33 for the last two months of the quarter. Salaries and employee benefits expense included \$2.5 million and \$2.0 million of stock-based compensation in the three months ended September 30, 2018 and 2017, respectively, and \$7.1 million and \$6.2 million for the nine months ended September 30, 2018 and 2017, respectively. Expenses related to the employee stock purchase program, stock grants, stock option compensation and restricted stock expense are all considered stock-based compensation.

Of the total stock-based compensation included in salaries and employee benefits, \$360 thousand for the third quarter and \$1.1 million for the first nine months of 2018 and \$286 thousand for the third quarter and \$1.0 million for the first nine months of 2017, respectively, were related to restricted stock unit ("RSU") awards for key employee retention with an effective grant date of May 24, 2016.

Occupancy expense: For the three and nine months ended September 30, 2018, total occupancy expense increased \$115 thousand, or 7.8%, and \$1.3 million, or 32.6%, respectively, compared to the same periods in 2017. This increase was driven by continued investment in facilities and infrastructure to support the Company's growth initiatives.

Data processing expense: For the three and nine months ended September 30, 2018, total data processing expense increased \$1.7 million, or 84.7%, and \$3.9 million, or 69.9%, respectively, compared to the same periods in 2017. Largely influencing this increase was the contribution of software development resources to Apiture which transferred

the recognition of costs associated with the Company's technology development from salaries and employee benefits to data processing.

Equipment expense: For the three and nine months ended September 30, 2018, the total costs associated with equipment increased \$1.4 million, or 63.8%, and \$5.1 million, or 101.7%, respectively, compared to the same periods in 2017. A major factor behind this increase was the depreciation of solar panels arising from operating lease activities that began during the second quarter of 2017.

Table of Contents

Impairment expense on goodwill and other intangible assets, net: This \$2.7 million in expense is related to the seller financed exit of the title insurance business in the third quarter of 2018. See Note 1 under the subheading Sale of Title Insurance for more information.

Income Tax Benefit

The effective tax rates for the three and nine months ended September 30, 2018 was (28.9)% and (6.2)%, respectively, compared to the effective rates of (64.8)% and (15.5)% for the three and nine months ended September 30, 2017, respectively. The negative tax rates principally reflect the anticipated generation of investment tax credits by the solar panel leasing activity under the Company's strategic initiatives in the renewable energy sector. Additionally, the tax rate for the three months ended September 30, 2018 was reduced due to an updated income forecast for the year that in turn impacted the expected effective tax rate. The actual effective tax rate for 2018 may differ from the estimated annualized amount because the actual amount will be dependent upon the nature and amount of future income and expenses as well as investments generating investment tax credits and transactions with discrete tax effects.

Discussion and Analysis of Financial Condition

September 30, 2018 vs. December 31, 2017

Total assets at September 30, 2018 were \$3.44 billion, an increase of \$686.3 million, or 24.9%, compared to total assets of \$2.76 billion at December 31, 2017. The growth in total assets was principally driven by the following:

- Increased cash and due from banks largely due to the significant growth from deposit gathering campaigns that generated \$664.0 million in new deposits and were designed to strengthen the liquidity profile;
- Increased investment securities available-for-sale of \$280.9 million which was driven by the Company's strategic plan to enhance contingency funding sources;
- Growth in loans and leases held for investment of \$287.4 million due to newly originated loans and leases; and
- Increased premises and equipment of \$85.1 million related primarily to expansion of facilities and infrastructure to accommodate Company growth and the addition of solar panels to meet leasing commitments.

Cash and cash equivalents were \$368.6 million at September 30, 2018, an increase of \$73.3 million, or 24.8%, compared to \$295.3 million at December 31, 2017. This increase primarily reflected the results of successful deposit gathering campaigns and the sale of loans.

Total investment securities increased \$280.9 million during the first nine months of 2018, from \$93.4 million at December 31, 2017, to \$374.3 million at September 30, 2018, an increase of 300.9%. The Company increased its investment securities position during the first and second quarter of 2018 as part of the aforementioned strategic liquidity initiative employed to enhance contingent funding sources. At September 30, 2018, the investment portfolio is comprised of U.S. treasury, U.S. government agency and residential mortgage-backed securities.

Loans held for sale decreased \$34.0 million, or 5.0%, during the first nine months of 2018, from \$680.5 million at December 31, 2017, to \$646.5 million at September 30, 2018. This decrease reflected the impact of a higher volume of loan sales combined with a slowdown in origination activity during the same period. Lower origination volume was primarily the result of increased lending competition in existing verticals.

Loans and leases held for investment increased \$287.4 million, or 21.4%, during the first nine months of 2018, from \$1.34 billion at December 31, 2017, to \$1.63 billion at September 30, 2018. The increase was primarily the result of continued growth in loan and lease origination activities during the first three quarters of 2018, partially offset by an increase in prepayments.

Premises and equipment, net, increased \$85.1 million, or 47.6%, during the first nine months of 2018 which was primarily driven by construction of new facilities and infrastructure to accommodate Company growth and the addition of solar panels to meet leasing commitments.

Servicing assets decreased \$3.0 million, or 5.8%, during the first nine months of 2018 due to the higher negative loan servicing revaluation amount in the third quarter of 2018 discussed more fully in the preceding Noninterest Income section under the subheading Loan Servicing Revaluation. This decrease was partially offset by additions to the servicing asset from loan sales.

Total deposits were \$2.92 billion at September 30, 2018, an increase of \$664.0 million, or 29.4%, from \$2.26 billion at December 31, 2017. The increase in deposits was driven by the combined success of deposit gathering campaigns

to support the growth in loan and lease originations and strategic liquidity initiatives.

56

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Table of Contents

Long term borrowings decreased \$25.1 million, or 94.3%, during the first nine months of 2018, from \$26.6 million at December 31, 2017 to \$1.5 million at September 30, 2018. The decrease was primarily the result of significant debt reductions during the first quarter of 2018, largely funded by capital raised in the third quarter of 2017.

Other liabilities increased \$7.0 million, or 20.2%, during the first nine months of 2018, from \$34.7 million at December 31, 2017 to \$41.7 million at September 30, 2018. The increase is principally related to premises and equipment accruals.

Shareholders' equity at September 30, 2018 was \$477.2 million as compared to \$436.9 million at December 31, 2017. The book value per share was \$11.89 at September 30, 2018 compared to \$10.95 at December 31, 2017. Average equity to average assets was 13.8% for the nine months ended September 30, 2018 compared to 13.5% for the full year ended December 31, 2017. The increase in shareholders' equity was principally the result of net income to common shareholders for the nine months ended September 30, 2018 of \$41.0 million combined with stock-based compensation expense of \$7.1 million, partially offset by other comprehensive losses of \$5.3 million and \$3.6 million in dividends.

**Asset Quality**

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

**Nonperforming Assets**

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

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

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

|   | September 30, December 31, |           |
|---|----------------------------|-----------|
|   | 2018                       | 2017      |
| Nonperforming assets:   |                            |           |
| Total nonperforming loans (all on nonaccrual)                               | \$ 52,709                  | \$ 23,480 |
| Total accruing loans past due 90 days or more                               | —                          | —         |
| Foreclosed assets   | 1,429                      | 1,281     |
| Total troubled debt restructurings  | 20,095                     | 10,223    |
| Less nonaccrual troubled debt restructurings                                | (6,292 )                   | (8,129 )  |
| Total performing troubled debt restructurings                               | 13,803                     | 2,094     |
| Total nonperforming assets and troubled debt restructurings                 | \$ 67,941                  | \$ 26,855 |
| Total nonperforming loans to total loans and leases held for investment     | 3.23                       | % 1.75 %  |
| Total nonperforming loans to total assets                                   | 1.53                       | % 0.85 %  |
| Total nonperforming assets and troubled debt restructurings to total assets | 1.97                       | % 0.97 %  |

Table of Contents

|   | September<br>30, 2018 | December 31,<br>2017 |   |  |
|---|-----------------------|----------------------|---|--|
| Nonperforming assets guaranteed by U.S. government:   |                       |                      |   |  |
| Total nonperforming loans guaranteed by the SBA (all on nonaccrual)                                   | \$ 39,812             | \$ 19,870            |   |  |
| Total accruing loans past due 90 days or more guaranteed by the SBA                                   | —                     | —                    |   |  |
| Foreclosed assets guaranteed by the SBA   | 1,271                 | 1,191                |   |  |
| Total troubled debt restructurings guaranteed by the SBA  | 14,841                | 7,178                |   |  |
| Less nonaccrual troubled debt restructurings guaranteed by the SBA                                    | (5,707 )              | (7,099 )             |   |  |
| Total performing troubled debt restructurings guaranteed by SBA                                       | 9,134                 | 79                   |   |  |
| Total nonperforming assets and troubled debt restructurings guaranteed by the SBA                     | \$ 50,217             | \$ 21,140            |   |  |
| Total nonperforming loans not guaranteed by the SBA to total held for investment loans and leases     | 0.79                  | % 0.27               | % |  |
| Total nonperforming loans not guaranteed by the SBA to total assets                                   | 0.37                  | % 0.13               | % |  |
| Total nonperforming assets and troubled debt restructurings not guaranteed by the SBA to total assets | 0.51                  | % 0.21               | % |  |

Total nonperforming assets and troubled debt restructurings at September 30, 2018 were \$67.9 million, which represented a \$41.1 million, or 153.0%, increase from December 31, 2017. Total nonperforming assets at September 30, 2018 were comprised of \$52.7 million in nonaccrual loans and \$1.4 million in foreclosed assets. Of the \$67.9 million of nonperforming assets and troubled debt restructurings ("TDRs"), \$50.2 million carried an SBA guarantee, leaving an unguaranteed exposure of \$17.7 million in total nonperforming assets and TDRs at September 30, 2018. This represents an increase of \$12.0 million, or 210.1%, from an unguaranteed exposure of \$5.7 million at December 31, 2017. Almost all of this increase in nonperforming assets and TDRs arose from our mature verticals. See the below discussion related to the change in potential problem and impaired loans for management's overall observations in regard to growth in this area.

As a percentage of the Bank's total capital, nonperforming loans represented 14.0% at September 30, 2018, compared to 7.8% at December 31, 2017. Adjusting the ratio to include only the unguaranteed portion of nonperforming loans to reflect management's belief that the greater magnitude of risk resides in this portion, the ratios at September 30, 2018 and December 31, 2017 were 3.4% and 1.2%, respectively.

As of September 30, 2018 and December 31, 2017, potential problem and impaired loans and leases totaled \$135.7 million and \$76.8 million, respectively. Risk Grades 5 through 8 represent the spectrum of criticized and impaired loans and leases. At September 30, 2018, the portion of criticized loans and leases guaranteed by the SBA or USDA totaled \$66.0 million resulting in unguaranteed exposure risk of \$69.7 million, or 4.9% of total held for investment unguaranteed exposure. This compares to the December 31, 2017 portion of criticized loans and leases guaranteed by the SBA or USDA which totaled \$34.7 million resulting in unguaranteed exposure risk of \$42.1 million, or 3.4% of total held for investment unguaranteed exposure. As of September 30, 2018 loans and leases in Healthcare, Veterinary, Independent Pharmacy and Agriculture industry verticals comprise the largest portion of the total potential problem and impaired loans at 29.2%, 17.1%, 15.6% and 15.1%, respectively. As of December 31, 2017 loans in the Healthcare and Veterinary industries comprised the largest portion of the total potential problem and impaired loans and leases at 30.0% and 27.3%, respectively. No systemic issues were identified in the first nine months of 2018 increase in potential problem and impaired loans and leases which were comprised of a relatively small number of borrowers largely concentrated in our more mature verticals. Furthermore, the Company believes that its underwriting and credit quality standards have improved as the business has matured.

The Bank does not classify loans and leases that experience insignificant payment delays and payment shortfalls as impaired. The Bank considers an "insignificant period of time" from payment delays to be a period of 90 days or less. The Bank would consider a modification for a customer experiencing what is expected to be a short-term event that has temporarily impacted cash flow. This could be due, among other reasons, to illness, weather, impact from a one-time expense, slower than expected start-up, construction issues or other short-term issues. In all cases, credit will review the request to determine if the customer is stressed and how the event has impacted the ability of the customer

to repay the loan or lease long term. To date, the only types of short term modifications the Bank has given are payment deferral and interest only extensions. The Bank does not typically alter the rate or lengthen the amortization of the note due to insignificant payment delays. Short term modifications are not classified as TDRs, because they do not meet the definition set by the applicable accounting standards and the Federal Deposit Insurance Corporation.

Table of Contents

Management endeavors to be proactive in its approach to identify and resolve problem loans and leases and is focused on working with the borrowers and guarantors of these loans and leases to provide loan and lease modifications when warranted. Management implements a proactive approach to identifying and classifying loans and leases as criticized, Risk Grade 5. For example, at September 30, 2018 and December 31, 2017, Risk Grade 5 loans and leases totaled \$59.0 million and \$37.0 million, respectively. The increase in Risk Grade 5 loans during the first nine months of 2018 was principally confined to three verticals; Government Contracting (\$9.4 million or 42.7% of increase), Wine and Craft Beverage (\$7.0 million or 31.7% of increase) and Agriculture (\$4.5 million or 20.6% of increase). The majority of the Government Contracting loans downgraded to Risk Grade 5 in the first half of 2018 are asset-based, collateral intensive loans. During the second quarter of 2018, management enhanced the risk grading methodology for these types of loans. The enhanced methodology includes more robust collateral centric loss given default measures. As these loans come up for renewal and reapproval, additional servicing controls can be enhanced and appropriately measured, which is expected to improve the overall risk grades for some of these loans. This continues to be an ongoing process over the next several quarters. The first nine months of 2018 increase in Risk Grade 5 loans related to Wine and Craft Beverage was due to the ongoing maturity of larger existing verticals while the increase in Agriculture was related principally to issues with a single integrator impacting one relationship. This relationship was also a primary driver in the increase of TDRs for the three months ended September 30, 2018. At September 30, 2018, approximately 97.7% of loans classified as Risk Grade 5 are performing with no current payments past due more than 30 days. While the level of nonperforming assets fluctuates in response to changing economic and market conditions, the relative size and composition of the loan and lease portfolio, and management's degree of success in resolving problem assets, management believes that a proactive approach to early identification and intervention is critical to successfully managing a small business loan portfolio.

Allowance for Loan and Lease Losses

The allowance for loan and lease losses ("ALLL"), a material estimate which could change significantly in the near-term in the event of rapidly deteriorating credit quality, is established through a provision for loan and lease losses charged to earnings to account for losses that are inherent in the loan and lease portfolio and estimated to occur, and is maintained at a level that management considers appropriate to absorb potential losses in the portfolio. Loan and lease losses are charged against the ALLL when management believes that the collectability of the principal loan and lease balance is unlikely. Subsequent recoveries, if any, are credited to the ALLL when received.

Judgment in determining the adequacy of the ALLL is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available and as situations and information change.

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

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

The ALLL of \$24.2 million at December 31, 2017 increased by \$2.6 million, or 10.8%, to \$26.8 million at September 30, 2018. The ALLL, as a percentage of loans and leases held for investment, amounted to 1.6% at September 30, 2018 and 1.8% at December 31, 2017. The increase in the allowance for loan and lease losses was largely attributable to continued growth in the loan and lease portfolio which was largely offset by the effects of updated loss factors in the third quarter 2018, as addressed more fully in the Provision for Loan and Lease Losses



section of Results of Operations. General reserves as a percentage of non-impaired loans amounted to 1.29% at September 30, 2018 and 1.62% December 31, 2017. See the aforementioned Provision for Loan and Lease Losses section for a discussion of the Company's charge-off experience.

Table of Contents

Actual past due held for investment loans and leases have increased by \$27.4 million since December 31, 2017. Of this increase, \$20.3 million, or 73.9%, is 90 days or more past due with \$5.0 million of that amount being comprised of unguaranteed loans and leases. At September 30, 2018 and December 31, 2017, total held for investment unguaranteed loans and leases past due as a percentage of total held for investment unguaranteed loans and leases was 0.86% and 0.43%, respectively. The growth in past dues during the first nine months of 2018 is reflected in the earlier discussed increase in classified loans during the same period. Management continues to actively monitor and work to improve asset quality. Management believes the ALLL of \$26.8 million at September 30, 2018 is appropriate in light of the risk inherent in the loan and lease portfolio. Management's judgments are based on numerous assumptions about current events that it believes to be reasonable, but which may or may not be valid. Thus, there can be no assurance that loan and lease losses in future periods will not exceed the current ALLL or that future increases in the ALLL will not be required. No assurance can be given that management's ongoing evaluation of the loan and lease portfolio in light of changing economic conditions and other relevant circumstances will not require significant future additions to the ALLL, thus adversely affecting the Company's operating results. Additional information on the ALLL is presented in Note 5 - Loans and Leases Held for Investment and Allowance for Loan and Lease Losses of the Notes to the Unaudited Condensed Consolidated Financial Statements in this report.

**Liquidity Management**

Liquidity management refers to the ability to meet day-to-day cash flow requirements based primarily on activity in loan and deposit accounts of the Company's customers. Liquidity is immediately available from four major sources: (a) cash on hand and on deposit at other banks; (b) the outstanding balance of federal funds sold; (c) the market value of unpledged investment securities; and (d) availability under lines of credit. At September 30, 2018, the total amount of these four items was \$1.07 billion, or 31.2% of total assets, an increase of \$399.5 million from \$674.2 million, or 24.4% of total assets, at December 31, 2017.

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

At September 30, 2018, none of the investment securities portfolio was pledged to secure public deposits or pledged to retail repurchase agreements, while \$98 thousand was pledged for trust activities in the State of Ohio and \$2.5 million was pledged for uninsured trust assets, leaving \$371.7 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 September 30, 2018. The payment amounts represent those amounts contractually due to the recipient. The table excludes liabilities recorded where management cannot reasonably estimate the timing of any payments that may be required in connection with these liabilities.

|  | Payments Due by Period |                          |                          |                           |                            |
|--|------------------------|--------------------------|--------------------------|---------------------------|----------------------------|
|  | Total                  | Less than<br>One<br>Year | One to<br>Three<br>Years | Three to<br>Five<br>Years | More<br>Than Five<br>Years |
| <b>Contractual Obligations</b>           |                        |                          |                          |                           |                            |
| Deposits without stated maturity         | \$1,107,959            | \$1,107,959              | \$—                      | \$—                       | \$—                        |
| Time deposits                            | 1,816,329              | 1,154,837                | 514,305                  | 71,041                    | 76,146                     |
| Long term borrowings                     | 1,506                  | 4                        | 1,497                    | 5                         | —                          |
| Operating lease obligations <sup>1</sup> | 2,603                  | 1,219                    | 836                      | 431                       | 117                        |
| <b>Total</b>                             | <b>\$2,928,397</b>     | <b>\$2,264,019</b>       | <b>\$516,638</b>         | <b>\$71,477</b>           | <b>\$76,263</b>            |

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

As of September 30, 2018 and December 31, 2017, the Company had unfunded commitments to provide capital contributions for on-balance sheet investments in the amount of \$3.0 million and \$3.5 million, respectively.



Table of Contents**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 asset and liability repricing timing differences as of the report date and does not address earnings, market value nor growth. Therefore, management uses an earnings simulation model to prepare, on a regular basis, earnings projections based on a range of interest rate scenarios to more accurately measure interest rate risk. The balance sheet is asset-sensitive with a total cumulative gap position of 2.6% at September 30, 2018. This is relatively unchanged in asset sensitivity from the prior quarter. An asset-sensitive position means that net interest income will generally move in the same direction as interest rates. For instance, if interest rates increase, net interest income can be expected to increase, and if interest rates decrease, net interest income can be expected to decrease. The Company attempts to mitigate interest rate risk by matching funding assets and liabilities with similar 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.

**Capital**

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

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

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



Table of Contents

Capital amounts and ratios as of September 30, 2018 and December 31, 2017, are presented in the table below.

|  | Actual    |        | Minimum Capital Requirement |       | Minimum To Be Well Capitalized Under Prompt Corrective Action Provisions <sup>(1)</sup> |        |
|--|-----------|--------|-----------------------------|-------|---|--------|
|  | Amount    | Ratio  | Amount                      | Ratio | Amount  | Ratio  |
| Consolidated - September 30, 2018              |           |        |                             |       |   |        |
| Common Equity Tier 1 (to Risk-Weighted Assets) | \$428,224 | 16.95% | \$113,671                   | 4.50% | N/A   | N/A    |
| Total Capital (to Risk-Weighted Assets)        | \$455,021 | 18.01% | \$202,082                   | 8.00% | N/A   | N/A    |
| Tier 1 Capital (to Risk-Weighted Assets)       | \$428,224 | 16.95% | \$151,561                   | 6.00% | N/A   | N/A    |
| Tier 1 Capital (to Average Assets)             | \$428,224 | 12.53% | \$136,662                   | 4.00% | N/A   | N/A    |
| Bank - September 30, 2018                      |           |        |                             |       |   |        |
| Common Equity Tier 1 (to Risk-Weighted Assets) | \$348,522 | 13.97% | \$112,261                   | 4.50% | \$162,155   | 6.50%  |
| Total Capital (to Risk-Weighted Assets)        | \$375,490 | 15.05% | \$199,576                   | 8.00% | \$249,470   | 10.00% |
| Tier 1 Capital (to Risk-Weighted Assets)       | \$348,522 | 13.97% | \$149,682                   | 6.00% | \$199,576   | 8.00%  |
| Tier 1 Capital (to Average Assets)             | \$348,522 | 10.35% | \$134,636                   | 4.00% | \$168,295   | 5.00%  |
| Consolidated - December 31, 2017               |           |        |                             |       |   |        |
| Common Equity Tier 1 (to Risk-Weighted Assets) | \$390,816 | 17.81% | \$98,764                    | 4.50% | N/A   | N/A    |
| Total Capital (to Risk-Weighted Assets)        | \$415,006 | 18.91% | \$175,580                   | 8.00% | N/A   | N/A    |
| Tier 1 Capital (to Risk-Weighted Assets)       | \$390,816 | 17.81% | \$131,685                   | 6.00% | N/A   | N/A    |
| Tier 1 Capital (to Average Assets)             | \$390,816 | 15.50% | \$100,828                   | 4.00% | N/A   | N/A    |
| Bank - December 31, 2017                       |           |        |                             |       |   |        |
| Common Equity Tier 1 (to Risk-Weighted Assets) | \$277,943 | 12.89% | \$97,060                    | 4.50% | \$140,197   | 6.50%  |
| Total Capital (to Risk-Weighted Assets)        | \$302,385 | 14.02% | \$172,551                   | 8.00% | \$215,688   | 10.00% |
| Tier 1 Capital (to Risk-Weighted Assets)       | \$277,943 | 12.89% | \$129,413                   | 6.00% | \$172,551   | 8.00%  |
| Tier 1 Capital (to Average Assets)             | \$277,943 | 11.36% | \$97,864                    | 4.00% | \$122,330   | 5.00%  |

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

#### Critical Accounting Policies and Estimates

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

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

• Determination of the allowance for loan and lease losses;

• Valuation of servicing assets;

• Income taxes;

• Restricted stock unit awards with market price conditions;

• Valuation of foreclosed assets;

• Business combination and goodwill; and



Table of Contents

Unconsolidated joint ventures.

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

Item 3. Quantitative and Qualitative Disclosures About Market Risk

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

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

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

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

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

An evaluation of the Company's disclosure controls and procedures (as defined in Rules 13(a)-15(e) and 15(d)-15(e) of the Securities Exchange Act of 1934, as amended (the "Exchange Act")), was carried out under the supervision and with the participation of the Company's Chief Executive Officer and Chief Financial Officer as of September 30, 2018, the last day of the period covered by this Quarterly Report. The Company's Chief Executive Officer and Chief Financial Officer concluded that the disclosure controls and procedures were effective as of September 30, 2018 in ensuring that the information required to be disclosed in the reports the Company files or submits under the Exchange Act is (i) accumulated and communicated to management (including the Company's Chief Executive Officer and Chief Financial Officer) as appropriate to allow timely decisions regarding required disclosures, and (ii) recorded, processed, summarized, and reported within the time periods specified in the SEC's rules and forms.

Changes in Internal Control Over Financial Reporting

There were no changes in the Company's internal control over financial reporting during the three months ended September 30, 2018 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.



Table of Contents

**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 and nine months ended September 30, 2018, any pending legal proceedings other than nonmaterial proceedings occurring in the ordinary course of business.

**Item 1A. Risk Factors**

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

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

None.

**Item 3. Defaults Upon Senior Securities**

None.

**Item 4. Mine Safety Disclosures**

Not applicable.

**Item 5. Other Information**

None.

**Item 6. Exhibits**

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

Table of Contents

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

Table of Contents

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 amended registration statement on Form S-1, filed on July 13, 2015)
- 4.1 Form of Common Stock Certificate (incorporated by reference to Exhibit 4.1 of the registration statement on Form S-1, filed on June 19, 2015)
- 4.2 Registration and Other Rights Agreement between Live Oak Bancshares, Inc. and Wellington purchasers (incorporated by reference to Exhibit 4.2 of the registration statement on Form S-1, filed on June 19, 2015)
- 31.1 Certification of Principal Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002\*
- 31.2 Certification of Principal Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002\*
- 32 Certification Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002\*\*  
Interactive data files pursuant to Rule 405 of Regulation S-T: (i) Condensed Consolidated Balance Sheets as of September 30, 2018 and December 31, 2017; (ii) Condensed Consolidated Statements of Income for the Three and Nine Months Ended September 30, 2018 and 2017; (iii) Condensed Consolidated Statements of Comprehensive Income for the Three and Nine Months Ended September 30, 2018 and 2017; (iv) Condensed Consolidated Statements of Changes in Shareholders' Equity for the Nine Months Ended September 30, 2018 and 2017; (v) Condensed Consolidated Statements of Cash Flows for the Nine Months Ended September 30, 2018 and 2017; and (vi) Notes to Unaudited Condensed Consolidated Financial Statements\*

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

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

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