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

Table of Contents

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	26-4596286
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
1741 Tiburon Drive Wilmington, North Carolina	28403
(Address of principal executive offices)	(Zip Code)

(910) 790-5867
(Registrant’s telephone number, including area code)
Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES ý NO ¨
Indicate by check mark whether the registrant has submitted electronically 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	x

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. ¨
Indicate by check mark whether registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). YES ¨ NO ý
APPLICABLE ONLY TO CORPORATE ISSUERS:
Indicate the number of shares outstanding of each of the issuer’s classes of common stock, as of the latest practicable date.

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.

Table of Contents

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

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 30, 2018	December 31, 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 Ended September 30,		Nine Months Ended 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

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 Ended September 30,		Nine Months Ended 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 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

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 Shares Class A	Class B	Amount	Retained earnings	Accumulated other comprehensive loss	Total equity
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 Ended 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 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.

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.

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 September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
Basic earnings per share:				
Net income available to common shareholders	$14,252	$ 12,862	$40,958	$ 28,769
Weighted-average basic shares outstanding	40,119,561	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	40,119,561	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	1,244,683
Total weighted-average diluted shares outstanding	41,688,430	38,644,677	41,586,987	36,730,054
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 Cost	Unrealized Gains	Unrealized Losses	Fair 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 [(1)]	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.

September 30, 2018	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
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	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
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.

Live Oak Bancshares, Inc.
Notes to Unaudited Condensed Consolidated Financial Statements

Loans and leases consist of the following:

	September 30, 2018	December 31, 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[1]	1,639,178	1,346,850
Net Deferred Costs	7,336	8,545
Discount on SBA 7(a) and USDA Unguaranteed[2]	(15,177)	(11,422)
Loans and Leases, Net of Unearned	$1,631,337	$1,343,973

1 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.

2 The Company measures the carrying value of the retained portion of loans sold at fair value under ASC Subtopic 825-10. 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 1 - 4	Risk Grade 5	Risk Grades 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[1]	$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 1 - 4	Risk Grade 5	Risk Grades 6 - 8	Total
December 31, 2017				
Commercial & Industrial				
Agriculture	$ 3,052	$ 222	$ —	$ 3,274
Death Care Management	13,371	117	7	13,495
Healthcare	36,530	2,246	4,525	43,301
Independent Pharmacies	86,152	5,541	8,227	99,920
Registered Investment Advisors	90,911	2,134	725	93,770
Veterinary Industry	42,313	1,704	2,370	46,387
Other Industries	184,540	363	—	184,903
Total	456,869	12,327	15,854	485,050
Construction & Development				
Agriculture	31,738	2,450	—	34,188
Death Care Management	6,119	—	—	6,119
Healthcare	47,813	699	1,258	49,770
Independent Pharmacies	1,496	—	—	1,496
Registered Investment Advisors	376	—	—	376
Veterinary Industry	13,184	—	—	13,184
Other Industries	58,120	—	—	58,120
Total	158,846	3,149	1,258	163,253
Commercial Real Estate				
Agriculture	46,717	—	—	46,717
Death Care Management	60,671	3,881	2,829	67,381
Healthcare	112,321	9,992	4,318	126,631
Independent Pharmacies	15,641	1,825	1,562	19,028
Registered Investment Advisors	11,649	140	—	11,789
Veterinary Industry	97,065	2,948	13,919	113,932
Other Industries	133,493	679	—	134,172
Total	477,557	19,465	22,628	519,650
Commercial Land				
Agriculture	176,811	2,086	—	178,897
Total	176,811	2,086	—	178,897
Total[1]	$ 1,270,083	$ 37,027	$ 39,740	$ 1,346,850

1 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 Days Past Due & Not Accruing	30-89 Days Past Due & Accruing	30-89 Days Past Due & Not Accruing	90 Days or More Past Due	Total Not Accruing & Past Due	Current	Total Loans and Leases	90 Days or More Past Due & 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 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 & 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 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 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	—

Total[1]	$ 8,400	$ 10,765	$ 7,607	$36,702	$ 63,474	$1,575,704	$1,639,178	$ —

20

Table of Contents

Live Oak Bancshares, Inc.
Notes to Unaudited Condensed Consolidated Financial Statements

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

1 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

$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:

September 30, 2018	Loan and Lease Balance	Guaranteed Balance	Unguaranteed Exposure
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	Loan and Lease Balance	Guaranteed Balance	Unguaranteed Exposure
Commercial & Industrial			
Healthcare	$3,806	$ 3,235	$ 571
Independent Pharmacies	4,961	3,906	1,055
Veterinary Industry	1,517	1,478	39
Total	10,284	8,619	1,665
Commercial Real Estate			
Death Care Management	1,559	1,237	322
Healthcare	3,506	2,719	787
Independent Pharmacies	1,562	1,562	—
Veterinary Industry	6,569	5,733	836
Total	13,196	11,251	1,945

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

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

Nine months ended	Construction & Development	Commercial Real Estate	Commercial & Industrial	Commercial Land	Total
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[2]	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[1]:					
Loans and leases individually evaluated for impairment	$ 2,172	$ 34,842	$ 12,520		