

TREATY OAK BANCORP INC
Form 10KSB
December 29, 2006

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, DC 20549

FORM 10-KSB

**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934**

For the fiscal year ended September 30, 2006

Commission File Number: 333-112325

Treaty Oak Bancorp, Inc.

(Exact name of registrant as specified in its charter)

Texas

(State or other jurisdiction of corporation or
organization)

20-0413144

(I.R.S. Employer Identification Number)

101 Westlake Drive, Austin, Texas

(Address of Principal Executive Offices)

78746

(Zip Code)

(512) 617-3600

(Registrant's telephone number, including area code)

Securities registered under Section 12(b) of the Exchange Act: None.

Securities registered under Section 12(g) of the Exchange Act: None.

Indicate by check mark whether the issuer (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 x No o

Check if there is no disclosure of delinquent filers in response to Item 405 of Regulation S-B contained in this form, and no disclosure will be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-KSB or any amendment to this Form 10-KSB.

Yes x No o

The issuer's revenues for its most recent fiscal year were approximately \$5,227,000.

Edgar Filing: TREATY OAK BANCORP INC - Form 10KSB

The aggregate market value of the common stock held by non-affiliates, based upon the last reported sales price at which the common stock was sold as of December 1, 2006, was \$17,069,512.

The number of shares outstanding of common stock, par value \$0.01 per share, as of the close of business on December 1, 2006 was 2,730,187.

Transitional Small Business Disclosure Format (Check One): Yes ; No

ANNUAL REPORT ON FORM 10-KSB
FOR THE FISCAL YEAR ENDED SEPTEMBER 30, 2006

TABLE OF CONTENTS

	Page
Part I.	
Item 1. <u>Description of Business</u>	1
Item 2. <u>Description of Property</u>	14
Item 3. <u>Legal Proceedings</u>	14
Item 4. <u>Submission of Matters to a Vote of Security Holder</u>	15
Part II.	
Item 5. <u>Market for Common Equity Holders</u>	15
Item 6. <u>Management's Discussion and Analysis</u>	17
Item 7. <u>Financial Statements</u>	40
Item 8. <u>Changes in and Disagreements with Accountants on Accounting and Financial Disclosure</u>	40
Item 8A. <u>Controls and Procedures</u>	40
Item 8B. <u>Other Information</u>	40
Part III.	
Item 9. <u>Directors, Executive Officers, Promoters and Control Persons; Compliance with Section 16(a) of the Exchange Act</u>	41
Item 10. <u>Executive Compensation</u>	45
Item 11. <u>Security Ownership of Certain Beneficial Owners And Management and Related Stockholder Matters</u>	48
Item 12. <u>Certain Relationships and Related Transactions</u>	51
Item 13. <u>Exhibits</u>	55
Item 14. <u>Principal Accountant Fees and Services</u>	56
<u>Signatures</u>	

This Form 10-KSB contains forward-looking statements consisting of estimates with respect to the financial condition, results of operations and other business of Treaty Oak Bancorp, Inc., that are subject to various factors, which could cause actual results to differ materially from those estimates. Factors that could influence the estimates include changes in the national, regional and local market conditions, legislative and regulatory conditions, and an adverse interest rate environment.

Part I

Item 1. Description of Business

Overview

Holding Company

Treaty Oak Bancorp, Inc. (the Company, we, us, or our hereafter) was incorporated under the laws of the State of Texas on November 18, 2003. Our primary business is to own and manage our wholly-owned banking subsidiary, Treaty Oak Bank, which is a Texas state-chartered banking association (the Bank). Subsequent to our fiscal year end, on November 15, 2006, we acquired Treaty Oak Holdings, Inc., one of our original organizing shareholders by merging Treaty Oak Holdings, Inc. with and into the Company. As a result of the merger transaction, we now control all of the property where our offices and the headquarters of the Bank are located.

We chose a holding company structure because we believe this structure provides flexibility in accommodating our business objectives. For example, we may assist the Bank in maintaining its required capital ratios, or increasing its legal lending limits, by borrowing money and contributing the proceeds to the Bank as primary capital. Additionally, under provisions of the Gramm-Leach-Bliley Act, if we elect to be a financial holding company, we may engage in activities that are financial in nature or incidental or complementary to a financial activity, including merchant banking activities, in which the Bank would be prohibited from engaging. Although we do not presently intend to engage in these financial activities, we would be able to do so without notice to or a filing with the Federal Reserve if we believed that there is a need for these services in our market area, that we can be successful in these activities, and that these activities would be profitable.

Bank

The primary focus of our Austin branch is on medium and small commercial businesses (including professionals such as doctors, dentists and lawyers) and real estate lending (including interim construction and commercial real estate loans), while our Texline branch has continued to focus primarily on agricultural lending. As of September 30, 2006, the Bank had total assets of approximately \$91,352,000 and total deposits of approximately \$81,546,000.

When we opened the Austin offices of the Bank, our goal was to return a high level of personal service and personal contact to our banking relationships. Our management has accomplished this by:

- demonstrating that banking can be built on interpersonal relationships and still be profitable, by capitalizing on our relationships in the community to build our loan and deposit base;
- creating a bank driven by client needs and expectations by training our staff and establishing policies and reward systems that are driven by client feedback;
- using technology to enhance the relationship between the Bank and its clients instead of replacing that relationship with technology solutions to banking, as well as maintaining a strong commitment to personal service and a personal banking relationship with our private bankers;
- empowering clients through education by providing both programs and printed information designed to increase our clients' awareness both of banking opportunities and of general financial matters; and
- facilitating an open dialogue between clients and our staff by creating both a physical and emotional atmosphere conducive to communication between staff and clients.

We attempt to differentiate ourselves from other banks in our market area by delivering a high degree of personal service combined with a suite of products and capabilities comparable to that offered by much larger banks, all

within a neighborhood community bank. We empower our employees with both the authority and the responsibility to ensure that each client's needs are addressed in a timely and satisfactory manner. We measure our success in the relationships we have developed with our clients by their referrals to us and by their feedback about their experiences with us and with our staff.

On June 28, 2005, the Bank acquired a 50% ownership interest in Treaty Oak Mortgage, LLC (Treaty Oak Mortgage), which offices in the same building as the Company and the Bank. Treaty Oak Mortgage is a mortgage broker focused primarily on a wide range of residential lending products that compliment our own products and provide a greater degree of residential mortgage flexibility. We do not have a controlling financial interest in Treaty Oak Mortgage, and it is, therefore, not included in our consolidated results of operations.

On June 29, 2006, the Bank acquired a 50% ownership interest in Treaty Oak Commercial Group, LLC (TOCG). TOCG is a commercial real estate mortgage brokerage firm providing medium and long term mortgages on commercial real estate. TOCG works with life insurance and pension companies to fund these mortgages. TOCG offices in the same building as the Company and the Bank, and also maintains an office in Houston, Texas. Aside from its initial investment, the Company has no risk associated with operating expenditures or other liabilities of TOCG. The transaction was approved by the Texas Department of Banking on June 19, 2006.

Regulatory Matters

From its initial acquisition of Texline State Bank, the Company's banking operations had been subject to a Memorandum of Understanding (MOU) with the FDIC. The MOU ensured that bank management appropriately and adequately addressed certain deficiencies identified by the FDIC and the Texas Department of Banking (TDB) during previous regulatory examinations prior to the Company's acquisition of Texline State Bank on March 9, 2004. Following the FDIC examination of the Bank in November, 2004, the FDIC terminated the MOU and proposed a new MOU that was more limited in scope. In February 2005, the Bank agreed to the new MOU, which was executed effective March 3, 2005 by the FDIC. The Bank addressed all of the issues identified in the new MOU by March 31, 2005. At the follow-up review of the Bank, conducted jointly by the FDIC and the TDB, the on-site examiners deemed the Bank's actions to date with regard to the new MOU to be satisfactory. The Bank was later advised to discontinue the submission of quarterly responses to the MOU based upon noted progress in addressing the issues cited.

The TDB and the FDIC conducted a joint safety and soundness examination of the Bank during December, 2005 and reported their findings to the board of directors on January 10, 2006. The final written report was received by management in March, 2006, at which time the Bank was advised of the official termination of the MOU.

Primary Clients and Markets

In the Austin area, the Bank concentrates on small and middle market businesses and individual clients with net worth in excess of \$1,000,000. The Bank's Texline branch in the Texas panhandle continues to concentrate its efforts primarily in agricultural lending. We believe that the diverse nature of customers in the target markets provides a varied client base and allows the Bank to spread lending risk over different industries. We plan to open additional branches through internal growth and capital expansion, but do not compete on a retail basis with the large national banks that have branches located in and around Austin.

Banking Operations

Our core services include traditional banking activities, such as personal and commercial deposit accounts and loans, as well as finance, consulting, and treasury services. Ancillary services include notary services, safe deposit boxes, cashiers' checks and money orders, traveler's checks, wire transfers, and other services.

The Bank is an active business lender, with approximately 32% of its total loans as commercial loans, 52% as residential, commercial and construction real estate loans, and the balance in agricultural and personal lending. The Bank's primary targeted businesses are those requiring aggregate loans in the \$100,000 to \$10,000,000 range. The Bank offers business-oriented banking products and services, including the following:

- commercial loans for businesses to finance internal growth, acquisitions, and working capital needs;
- real estate and construction loans;
- cash management services, including on-line banking; and
- remote deposit opportunities and other business services.

The Bank also offers consumer-oriented banking services, which include consumer loans, checking accounts with debit cards and overdraft protection available, credit card services, traditional savings accounts and certificates of deposit, and 24-hour telephone and Internet banking.

Business Strategies

Our primary objective is to take advantage of expansion opportunities while maintaining efficiency and individualized client service, supplemented with technological advances and strategic branch expansion in key market areas, using the following strategies:

- *Developing Middle Market Commercial and Private Client Banking.*
- *Developing Mutual Referral Relationships with Organizations Offering Complimentary Services.*
- *Increasing Loan Volume and Diversifying Loan Portfolio.*
- *Expanding Operations.*

We continue to develop systems and train personnel to deliver the level of banking experience that is the cornerstone of our business. We market through a series of established relationships, including current clients, investors, friends, and business partners of our advisors and directors. By working with community and business leaders, we are developing a bank that is an integral part of the community. We endeavor to create professional relationships with individuals and businesses that complement our client base.

We are forecasting the opening of new offices as part of our growth; the first new branch in the Marble Falls/Horseshoe Bay area in the Texas Hill Country 45 miles northwest of Austin is expected to open in the spring of 2007, while our Barton Creek branch in West Austin is expected to open in the fall of 2007. Given the number of banks and bank branches in the Austin, Texas market, the success of electronic banking services, courier services and other remote banking alternatives that we provide our clients, and our desire to maintain our levels of service, we carefully review both the location of proposed branches and the timing of their opening when planning for expansion.

Services

Deposit Services

The Bank offers a traditional mix of deposit accounts. Rates and terms are set by the Bank's senior management team with input and guidance from our Asset/Liability Committee (ALCO), and are continually updated based on market conditions. The team strives to create a stable, low-cost base of deposits through personalized offerings and high levels of client service.

The Bank also offers a variety of other types of accounts, including:

- goal-oriented savings accounts;
- accumulation certificates of deposit (CDs);

- standard CDs;
- children's savings accounts;
- medical savings accounts;
- IRA accounts; and
- educational accounts.

In order to maximize our ability to serve our clients in a cost-effective manner, we provide automated and electronic account management tools free of charge to all clients.

Lending Services

Our lending practices are structured to meet the credit needs of medium and small-sized businesses. These loans include lines of credit, term loans, home equity products, construction loans and commercial real estate loans for owner-occupants. Our loan portfolio relies on the commercial and consumer credit experience of the loan committee and primary servicing officers.

The Bank's credit standards include consideration of the following:

- historical and projected financial information;
- strength of management, including the experience and character of the principals;
- acceptable collateral and associated advance rates;
- market conditions; and
- trends in the borrower's industry.

As a state chartered bank, total loans and extensions of credit to a person or entity at one time may not exceed an amount equal to 25% of the lesser of the Bank's capital and certified surplus or the Bank's total equity capital according to Texas law.

The Bank is primarily a secured lender with 90% or more of all loans collateralized. Further, a maximum loan to value ratio of 80% is generally targeted for purchase money loans or loans based upon an acceptable appraisal.

We analyze prospective loans based on industry concentrations in the Bank's loan portfolio to prevent an unacceptable concentration of loans in any particular industry. The Bank strives to diversify its loan portfolio by spreading loans over multiple industries and reviewing concentration of loans to related industries. The Bank focuses on middle market commercial and high net worth individual clients. The Bank endeavors to ensure loans that are appropriately collateralized according to its credit standards. We strive to tailor credit policies and underwriting guidelines to address the unique risks of each industry in the portfolio. We seek a reasonable mix of industries and loan types with up to 40% of the Bank's portfolio over time comprised of commercial loans to businesses, and up to 55% of the portfolio concentrated in real estate loans, including interim construction loans secured by real estate owned by owner/operators.

Interest rates of the Bank's variable rate loans fluctuate with a predetermined indicator, such as the United States prime rate or the London Inter-Bank Offered Rate. Variable rates help to protect the Bank from risks associated with interest rate fluctuations since the rates of interest earned by the Bank automatically reflect those fluctuations. Our expectation is to retain a loan portfolio consisting of at least 90% variable rate loans.

Internet Services

Our service strategy is enhanced through the Internet. We believe the Bank's Internet client demographics parallel those of the general Internet population. Our website, TreatyOakBank.com, provides a complete line of deposit services. Customers are able to view multiple accounts, transfer funds between related accounts, view statements, send and receive messages, pay bills and other traditional online services.

Additionally, we now offer remote deposit services via internet integrated devices that reside at our commercial clients' offices, thereby reducing the need for customers to drive to a branch location for deposit services.

We have contracted with third party vendors to provide both basic computer systems and advanced security measures. All banking transactions are encrypted and routed behind the security system. Clients are able to access the Bank's services through any Internet service provider by means of a secure Web browser.

Mortgage Services

In June 2006, following authorization from the TDB, the Bank acquired a 50% interest in TOCG, a commercial mortgage brokerage sourcing various long-term fixed rate commercial mortgage loans. In June, 2005, the Bank acquired a 50% interest in Treaty Oak Mortgage. Treaty Oak Mortgage is a full service mortgage brokerage offering an array of residential mortgage products. Under the conditions to acquire granted by the TDB, Treaty Oak Mortgage and TOCG are managed on a day-to-day basis by its officers, but all decisions are ultimately under the control of the Bank to ensure that the mortgage operation does not inadvertently engage in a service or activity inconsistent with state banking regulations.

Other Services

We provide other incentives and benefits to our customers, including the following:

- Rebates of ATM fees paid at most ATM machines throughout the United States;
- Correspondent relationships, which allow customers to use the correspondent's locations to make deposits;
- The ability to link multiple accounts of different but related Bank clients for the calculation of overall relationship profitability; and
- Extended banking hours.

Market Analysis

Competition

The banking business in our primary market area of Austin and Central Texas has become increasingly competitive over the past several years, and we expect the level of competition to continue to increase. We compete with some of the largest banking organizations in the state and the country. In addition, we face competition from other financial institutions, such as federally and state-chartered savings and loan institutions, and other lenders engaged in the business of extending credit or taking investment monies, such as consumer finance companies and mutual funds. Our competitors also include well-capitalized local banks, branches of large regional or national banks, and state-regulated entities offering bank-like services and products. In addition, there are also quasi-banking institutions, such as credit unions and brokerage houses that may compete with us. These types of competitors have the ability to make loans, issue credit cards, cash checks, conduct wire transfers, and mimic most other banking functions.

Many of our larger competitors have broader geographic markets and higher lending limits than us and have greater access to capital and other resources. They are also able to provide more services and make greater use of media advertising. Although we will compete directly with these larger institutions from time to time, we will likely compete

more directly with regional and mid-sized banks that have offices in our target markets. These community banks and others in surrounding areas have a direct competitive advantage as borrowers tend to shop the terms of their loans and deposits. In addition, the quasi-banking institutions and non-bank competitors do not fall under the tight regulatory environment applicable to banks. This lack of regulatory oversight gives these competitors advantages over us in providing some services and may enable them to offer more favorable financing alternatives.

Despite the competition in our target markets, we believe that we have certain competitive advantages that distinguish us from our competition. We believe the Bank competes effectively with other financial institutions by emphasizing client service, technology, and responsive decision-making, and by building long-term client relationships based on products and services designed to address clients' specific needs. We offer customers modern banking services without forsaking community values such as prompt, personal service and friendliness. We offer personalized services and attract customers by being responsive and sensitive to their individualized needs. One of our principal competitive advantages is our local decision-making process as opposed to electronic, remote, or out-of-market decisions. We believe our approach to business builds goodwill among our customers, shareholders, and the communities we serve that will result in referrals from shareholders and satisfied customers.

Marketing

The majority of our new business opportunity is derived from referrals from our shareholders, existing customers, officers and directors, and others close to the Bank. In addition to the referral activity, we market in our primary markets through sponsorships and the active involvement and leadership of our employees in community and civic events. By using our limited marketing budget in this manner, we have developed an image as the community bank in our primary markets.

Employees

We have a total of 29 full time employees. Of those, 23 are employed at the Austin headquarters, and six are employed in Texline, Texas.

Supervision and Regulation

The following is a summary description of the relevant laws, rules and regulations governing banks and bank holding companies. The descriptions of, and references to, the statutes and regulations below are brief summaries and do not purport to be complete. The descriptions are qualified in their entirety by reference to the specific statutes and regulations discussed.

Banking is a complex, highly regulated industry. Consequently, our growth and earnings performance and those of the Bank can be affected not only by management decisions and general and local economic conditions, but also by the statutes administered by, and the regulations and policies of, various governmental regulatory authorities. These authorities include, but are not limited to, the Board of Governors of the Federal Reserve System, the FDIC, the Texas Department of Banking, the Internal Revenue Service, and state taxing authorities. The effect of these statutes, regulations, and policies and any changes to any of them can be significant and cannot be predicted.

The primary goals of the banking regulatory design are to maintain a safe and sound banking system and to facilitate the conduct of sound monetary policy. In furtherance of these goals, Congress has created several largely autonomous regulatory agencies and enacted numerous laws that govern banks, bank holding companies, and the banking industry. The system of supervision and regulation applicable to us and our banking subsidiary establishes a comprehensive framework for their respective operations and is intended primarily for the protection of the FDIC's deposit insurance funds, the bank's depositors, and the public, rather than the shareholders and creditors. The following is an attempt to summarize some of the relevant laws, rules, and regulations governing banks and bank holding companies, but does not purport to be a complete summary of all applicable laws, rules, and regulations governing banks and bank holding companies. The descriptions are qualified in their entirety by reference to the specific statutes and regulations discussed.

Treaty Oak Bancorp, Inc.

We are a bank holding company registered with, and subject to regulation by, the Federal Reserve under the Bank Holding Company Act of 1956 (the Bank Holding Company Act). The Bank Holding Company Act and other federal laws subject bank holding companies to particular restrictions on the types of activities in which they may engage, and to a range of supervisory requirements and activities, including regulatory enforcement actions for violations of laws and regulations.

In accordance with Federal Reserve policy, we are expected to act as a source of financial strength to the Bank and commit resources to support the Bank. This support may be required under circumstances when we might not be inclined to do so absent this Federal Reserve policy. As discussed below, we could be required to guarantee the capital plan of the Bank if it becomes undercapitalized for purposes of banking regulations.

Certain acquisitions. The Bank Holding Company Act requires every bank holding company to obtain the prior approval of the Federal Reserve Board before (1) acquiring more than 5% of the voting stock of any bank or other bank holding company, (2) acquiring all or substantially all of the assets of any bank or bank holding company, or (3) merging or consolidating with any other bank holding company.

Additionally, the Bank Holding Company Act provides that the Federal Reserve may not approve any of these transactions if it would result in or tend to create a monopoly or substantially lessen competition or otherwise function as a restraint of trade, unless the anti-competitive effects of the proposed transaction are clearly outweighed by the public interest in meeting the convenience and needs of the community to be served. The Federal Reserve is also required to consider the financial and managerial resources and future prospects of the bank holding companies and banks concerned and the convenience and needs of the community to be served. The Federal Reserve's consideration of financial resources generally focuses on capital adequacy, which is discussed below. As a result of the USA PATRIOT Act, which is discussed below, the Federal Reserve is also required to consider the record of a bank holding company and its subsidiary bank(s) in combating money laundering activities in its evaluation of bank holding company merger or acquisition transactions.

Under the Bank Holding Company Act, any bank holding company located in Texas, if adequately capitalized and adequately managed, may purchase a bank located outside of Texas. Conversely, an adequately capitalized and adequately managed bank holding company located outside of Texas may purchase a bank located inside Texas. In each case, however, restrictions currently exist on the acquisition of a bank that has only been in existence for a limited amount of time or will result in specified concentrations of deposits.

Change in Bank control. Subject to various exceptions, the Bank Holding Company Act and the Change in Bank Control Act of 1978, together with related regulations, require Federal Reserve approval prior to any person or company acquiring control of a bank holding company. Control is conclusively presumed to exist if an individual or company acquires 25% or more of any class of voting securities of the bank holding company. With respect to our Company, control is presumed to exist if a person or company acquires 10% or more, but less than 25%, of any class of voting securities.

Permitted activities. Generally, bank holding companies are prohibited under the Bank Holding Company Act from engaging in or acquiring direct or indirect control of more than 5% of the voting shares of any company engaged in any activity other than (1) banking or managing or controlling banks or (2) an activity that the Federal Reserve determines to be so closely related to banking as to be a proper incident to the business of banking.

Activities that the Federal Reserve has found to be so closely related to banking as to be a proper incident to the business of banking include:

- factoring accounts receivable;
- making, acquiring, brokering, or servicing loans and usual related activities;

- leasing personal or real property;
- operating a non-bank depository institution, such as a savings association;
- trust company functions;
- financial and investment advisory activities;
- conducting discount securities brokerage activities;
- underwriting and dealing in government obligations and money market instruments;
- providing specified management consulting and counseling activities;
- performing selected data processing services and support services;
- acting as agent or broker in selling credit life insurance and other types of insurance in connection with credit transactions; and
- performing selected insurance underwriting activities.

Despite prior approval, the Federal Reserve has the authority to require a bank holding company to terminate an activity or terminate control of or liquidate or divest certain subsidiaries or affiliates when the Federal Reserve Board believes the activity or the control of the subsidiary or affiliate constitutes a significant risk to the financial safety, soundness, or stability of any of its banking subsidiaries. A bank holding company that qualifies and elects to become a financial holding company is permitted to engage in additional activities that are financial in nature or incidental or complementary to financial activity. The Bank Holding Company Act expressly lists the following activities as financial in nature:

- lending, exchanging, transferring, investing for others, or safeguarding money or securities;
- insuring, guaranteeing, or indemnifying against loss or harm, or providing and issuing annuities, and acting as principal, agent, or broker for these purposes, in any state;
- providing financial, investment, or advisory services;
- issuing or selling instruments representing interests in pools of assets permissible for a bank to hold directly;
- underwriting, dealing in, or making a market in securities;