

Oak Valley Bancorp  
Form 10-Q  
November 13, 2017

---

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**Form 10-Q**

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

**For the quarterly period ended September 30, 2017**

**OR**

**TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**Commission file number 001-34142**

**OAK VALLEY BANCORP**

(Exact name of registrant as specified in its charter)

<b>California</b>	<b>26-2326676</b>
State or other jurisdiction of incorporation or organization	I.R.S. Employer Identification No.

**125 N. Third Ave., Oakdale, CA 95361**

(Address of principal executive offices)

**(209) 848-2265**

Issuer's telephone number

**Not applicable**

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the issuer (1) has filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 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 No

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a 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. (Check one):

Large accelerated filer	Accelerated filer
Non-accelerated filer	Smaller reporting company
(Do not check if a smaller reporting company)	Emerging growth company

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

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

**APPLICABLE ONLY TO CORPORATE ISSUERS**

State the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: 8,098,605 shares of common stock outstanding as of November 3, 2017.

---

---

Table of Contents

**Oak Valley Bancorp**

**September 30, 2017**

**Table of Contents**

	<b>Page</b>
<b><u>PART I – FINANCIAL INFORMATION</u></b>	
<b><u>Item 1. Financial Statements</u></b>	3
<u>Condensed Consolidated Balance Sheets at September 30, 2017 (Unaudited) and December 31, 2016 (Unaudited)</u>	4
<u>Condensed Consolidated Statements of Income for the Three and Nine month period Ended September 30, 2017 and September 30, 2016 (Unaudited)</u>	5
<u>Condensed Consolidated Statements of Comprehensive Income for the Three and Nine month period Ended September 30, 2017 and September 30, 2016 (Unaudited)</u>	6
<u>Condensed Consolidated Statements of Changes of Shareholders’ Equity for the Year Ended December 31, 2016 and the Nine-month period Ended September 30, 2017 (Unaudited)</u>	7
<u>Condensed Consolidated Statements of Cash Flows for the Nine-month periods Ended September 30, 2017 and September 30, 2016 (Unaudited)</u>	8
<u>Notes to Condensed Consolidated Financial Statements</u>	9
<b><u>Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations</u></b>	31
<b><u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u></b>	46
<b><u>Item 4. Controls and Procedures</u></b>	46
<b><u>PART II – OTHER INFORMATION</u></b>	47
<b><u>Item 1. Legal Proceedings</u></b>	47
<b><u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u></b>	47
<b><u>Item 3. Defaults Upon Senior Securities</u></b>	47
<b><u>Item 4. Mine Safety Disclosures</u></b>	47
<b><u>Item 5. Other Information</u></b>	47
<b><u>Item 6. Exhibits</u></b>	48



Table of Contents

**PART I – FINANCIAL STATEMENTS**

3

---

Table of Contents**OAK VALLEY BANCORP****CONDENSED CONSOLIDATED BALANCE SHEETS (UNAUDITED)**

	September 30, 2017	December 31, 2016
<b>ASSETS</b>		
Cash and due from banks	\$ 129,633	\$ 179,025
Federal funds sold	9,995	11,785
Cash and cash equivalents	139,628	190,810
Securities available for sale	180,857	160,333
Loans, net of allowance for loan loss of \$7,917 and \$7,832 at September 30, 2017 and December 31, 2016, respectively	626,911	601,104
Bank premises and equipment, net	13,048	13,688
Other real estate owned	253	1,210
Interest receivable and other assets	36,024	34,965
	\$ 996,721	\$ 1,002,110
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Deposits	\$ 901,716	\$ 914,093
Interest payable and other liabilities	5,329	5,567
Total liabilities	907,045	919,660
Commitments and contingencies		
Shareholders' equity		
Common stock, no par value; 50,000,000 shares authorized, 8,098,605 and 8,088,455 shares issued and outstanding at September 30, 2017 and December 31, 2016, respectively	24,773	24,682
Additional paid-in capital	3,551	3,473
Retained earnings	60,003	54,520
Accumulated other comprehensive income (loss), net of tax	1,349	(225 )
Total shareholders' equity	89,676	82,450
	\$ 996,721	\$ 1,002,110

*The accompanying notes are an integral part of these condensed consolidated financial statements.*





Table of Contents**OAK VALLEY BANCORP****CONDENSED CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)**

(dollars in thousands, except per share amounts)	THREE		NINE MONTHS	
	MONTHS		MONTHS	
	ENDED		ENDED	
	SEPTEMBER		SEPTEMBER 30,	
	30,			
	2017	2016	2017	2016
<b>INTEREST INCOME</b>				
Interest and fees on loans	\$7,300	\$6,807	\$21,451	\$20,484
Interest on securities available for sale	1,138	1,045	3,314	3,038
Interest on federal funds sold	28	4	65	18
Interest on deposits with banks	428	169	1,100	492
Total interest income	8,894	8,025	25,930	24,032
<b>INTEREST EXPENSE</b>				
Deposits	274	196	773	555
Total interest expense	274	196	773	555
Net interest income	8,620	7,829	25,157	23,477
Provision for loan losses	70	90	105	415
Net interest income after provision for loan losses	8,550	7,739	25,052	23,062
<b>OTHER INCOME</b>				
Service charges on deposits	365	341	1,051	1,011
Earnings on cash surrender value of life insurance	130	102	386	305
Mortgage commissions	28	49	127	144
Gains on called securities	4	10	394	28
Other	749	575	2,824	1,682
Total non-interest income	1,276	1,077	4,782	3,170
<b>OTHER EXPENSES</b>				
Salaries and employee benefits	3,534	3,225	10,603	9,950
Occupancy expenses	823	819	2,496	2,470
Data processing fees	399	435	1,154	1,346
Regulatory assessments (FDIC & DBO)	102	178	381	505
Other operating expenses	1,202	1,267	3,708	4,027
Total non-interest expense	6,060	5,924	18,342	18,298
Net income before provision for income taxes	3,766	2,892	11,492	7,934
PROVISION FOR INCOME TAXES	1,298	962	3,987	2,591
NET INCOME	\$2,468	\$1,930	\$7,505	\$5,343

Edgar Filing: Oak Valley Bancorp - Form 10-Q

NET INCOME PER COMMON SHARE	\$0.31	\$0.24	\$0.93	\$0.67
NET INCOME PER DILUTED COMMON SHARE	\$0.31	\$0.24	\$0.93	\$0.66

*The accompanying notes are an integral part of these condensed consolidated financial statements.*

Table of Contents**OAK VALLEY BANCORP****CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (UNAUDITED)**

	THREE MONTHS ENDED		NINE MONTHS ENDED SEPTEMBER	
	SEPTEMBER		30,	
(in thousands)	2017	2016	2017	2016
Net income	\$2,468	\$1,930	\$7,505	\$5,343
Other comprehensive income:				
Unrealized gains on securities:				
Unrealized holdings gains (losses) arising during the period	39	(262 )	3,069	1,723
Less: reclassification for net gains included in net income	(4 )	(10 )	(394 )	(29 )
Other comprehensive income (loss), before tax	35	(272 )	2,675	1,694
Tax expense (benefit) related to items of other comprehensive income	(14 )	112	(1,101)	(697 )
Total other comprehensive income (loss)	21	(160 )	1,574	997
Comprehensive income	\$2,489	\$1,770	\$9,079	\$6,340

*The accompanying notes are an integral part of these condensed consolidated financial statements.*

Table of Contents**OAK VALLEY BANCORP****CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY  
(UNAUDITED)**YEAR ENDED DECEMBER 31, 2016 AND NINE MONTHS ENDED  
SEPTEMBER 30, 2017

(dollars in thousands)	Common Stock		Additional	Retained	Accumulated	Total
	Shares	Amount	Paid-in Capital	Earnings	Other Comprehensive Income (Loss)	Shareholders' Equity
Balances, January 1, 2016	8,078,155	\$24,682	\$ 3,217	\$48,795	\$ 1,569	\$ 78,263
Restricted stock issued	17,000					0
Restricted stock forfeited	(6,700 )					0
Cash dividends declared				(1,940 )		(1,940 )
Stock based compensation			256			256
Other comprehensive loss					(1,794 )	(1,794 )
Net income				7,665		7,665
Balances, December 31, 2016	8,088,455	\$24,682	\$ 3,473	\$54,520	\$ (225 )	\$ 82,450
Stock options exercised	9,000	91				91
Restricted stock issued	8,000					0
Restricted stock forfeited	(6,850 )					0
Cash dividends declared				(2,022 )		(2,022 )
Stock based compensation			78			78
Other comprehensive income					1,574	1,574
Net income				7,505		7,505
Balances, September 30, 2017	8,098,605	\$24,773	\$ 3,551	\$60,003	\$ 1,349	\$ 89,676

*The accompanying notes are an integral part of these condensed consolidated financial statements*

Table of Contents**OAK VALLEY BANCORP****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)**

(dollars in thousands)	NINE MONTHS ENDED SEPTEMBER 30, 2017      2016	
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income	\$7,505	\$5,343
Adjustments to reconcile net earnings to net cash from operating activities:		
Provision for loan losses	105	415
Increase (decrease) in deferred fees/costs, net	40	(29 )
Depreciation	847	948
Amortization of investment securities, net	624	270
Stock based compensation	78	195
Gain on sale of premises and equipment	0	(4 )
OREO (gain) loss on sales and write downs	(211 )	88
Gain on sales and calls of available for sale securities	(394 )	(29 )
Earnings on cash surrender value of life insurance	(386 )	(305 )
Gain on BOLI death benefit	0	(2 )
(Decrease) increase in interest payable and other liabilities	(238 )	320
Decrease in interest receivable	101	52
Increase in other assets	(1,535 )	(227 )
Net cash from operating activities	6,536	7,035
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Purchases of available for sale securities	(41,542 )	(47,182 )
Proceeds from maturities, calls, and principal paydowns of securities available for sale	23,463	20,103
Net increase in loans	(25,952 )	(62,895 )
Purchase of FHLB Stock	(340 )	(79 )
Purchase of BOLI policies	0	(4,000 )
Proceeds from sale of OREO	1,168	746
Proceeds from redemption of BOLI policies	0	186
Proceeds from sales of premises and equipment	0	4
Net purchases of premises and equipment	(207 )	(383 )
Net cash used in investing activities	(43,410 )	(93,500 )
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Shareholder cash dividends paid	(2,022 )	(1,940 )
Net (decrease) increase in demand deposits and savings accounts	(8,381 )	40,612
Net (decrease) increase in time deposits	(3,996 )	4,453
Proceeds from sale of common stock and exercise of stock options	91	0
Net cash (used in) from financing activities	(14,308 )	43,125

Edgar Filing: Oak Valley Bancorp - Form 10-Q

NET DECREASE IN CASH AND CASH EQUIVALENTS	(51,182 )	(43,340 )
CASH AND CASH EQUIVALENTS, beginning of period	190,810	190,603
CASH AND CASH EQUIVALENTS, end of period	\$139,628	\$147,263
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:		
Cash paid during the period for:		
Interest	\$785	\$558
Income taxes	\$4,437	\$1,434
NON-CASH INVESTING ACTIVITIES:		
Real estate acquired through foreclosure	\$0	\$253
Change in unrealized gain on available-for-sale securities	\$2,675	\$1,694

*The accompanying notes are an integral part of these condensed consolidated financial statements.*

Table of Contents

**OAK VALLEY BANCORP**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**NOTE 1 – BASIS OF PRESENTATION**

On July 3, 2008 (the “Effective Date”), a bank holding company reorganization was completed whereby Oak Valley Bancorp (“the Company”) became the parent holding company for Oak Valley Community Bank ( the “Bank”). On the Effective Date, a tax-free exchange was completed whereby each outstanding share of the Bank was converted into one share of the Company and the Company became the sole wholly-owned subsidiary of the holding company.

The consolidated financial statements include the accounts of the parent company and its wholly-owned bank subsidiary. Unless otherwise stated, the “Company” refers to the consolidated entity, Oak Valley Bancorp, while the “Bank” refers to Oak Valley Community Bank. All material intercompany transactions have been eliminated. In the opinion of Management, the consolidated financial statements contain all adjustments necessary to present fairly the financial position, results of operations, changes in shareholders’ equity and cash flows. All adjustments are of a normal, recurring nature. The interim consolidated financial statements included in this report are unaudited but reflect all adjustments which, in the opinion of management, are necessary for a fair presentation of the financial position and results of operations for the interim periods presented. All such adjustments are of a normal recurring nature. The results of operations for the three and nine month periods ended September 30, 2017 are not necessarily indicative of the results of a full year’s operations. Certain prior year amounts have been reclassified to conform to the current year presentation. There was no effect on net income or shareholders’ equity as a result of reclassifications. For further information, refer to the audited consolidated financial statements and footnotes included in the Company’s Form 10-K for the year ended December 31, 2016.

Oak Valley Community Bank is a California state-chartered bank. The Company was incorporated under the laws of the State of California on May 31, 1990, and began operations in Oakdale on May 28, 1991. The Company operates branches in Oakdale, Sonora, Bridgeport, Bishop, Mammoth Lakes, Modesto, Manteca, Patterson, Turlock, Ripon, Stockton, and Escalon, California. The Bridgeport, Mammoth Lakes, and Bishop branches operate as a separate division, Eastern Sierra Community Bank. The Company’s primary source of revenue is providing loans to customers who are predominantly middle-market businesses.

On December 23, 2015, the Company completed its acquisition of Mother Lode Bank (“MLB”), a California state-chartered bank headquartered in Sonora, California, in a transaction in which Mother Lode Bank was merged with and into the Bank, with the Bank as the surviving company in the transaction. The purchase price for Mother Lode Bank was approximately \$7.3 million.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions. These estimates and assumptions affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Significant accounting estimates reflected in the Company's consolidated financial statements include the allowance for loan losses, accounting for income taxes, fair value measurements, and the determination, recognition and measurement of impaired loans. Actual results could differ from these estimates.

## **NOTE 2 – RECENT ACCOUNTING PRONOUNCEMENTS**

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2014-09, Revenue from Contracts with Customers (Topic 606). This ASU is a converged standard involving FASB and International Financial Reporting Standards that provides a single comprehensive revenue recognition model for all contracts with customers across transactions and industries. The core principal of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount and at a time that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. Subsequent updates related to Revenue from Contracts with Customers (Topic 606) are as follows:

August 2015 ASU No. 2015-14 - Deferral of the Effective Date, institutes a one-year deferral of the effective date of this amendment to annual reporting periods beginning after December 15, 2017. Early application is permitted only as of annual periods beginning after December 15, 2016, including interim reporting periods within that reporting period.

March 2016 ASU No. 2016-08 - Principal versus Agent Considerations (Reporting Revenue Gross versus Net), clarifies the implementation guidance on principal versus agent considerations and on the use of indicators that assist an entity in determining whether it controls a specified good or service before it is transferred to the customer.

April 2016 ASU No. 2016-10 - Identifying Performance Obligations and Licensing, provides guidance in determining performance obligations in a contract with a customer and clarifies whether a promise to grant a license provides a right to access or the right to use intellectual property.

May 2016 ASU No. 2016-12 - Narrow Scope Improvements and Practical Expedients, gives further guidance on assessing collectability, presentation of sales taxes, noncash consideration, and completed contracts and contract modifications at transition.



Table of Contents

The adoption of this update is not expected to have a material impact on the Company's consolidated financial statements.

In September, 2015, the FASB issued ASU No. 2015-16, *Simplifying the Accounting for Measurement Period Adjustments (Topic 805)*. This ASU eliminates the requirement to restate prior period financial statements for measurement period adjustments to assets acquired and liabilities assumed in a business combination. The new guidance under this update requires the cumulative impact of measurement period adjustments be recognized in the period the adjustment is determined. This update does not change what constitutes a measurement period adjustment, nor does it change the length of the measurement period. The new standard is effective for interim annual periods beginning after December 15, 2015 and should be applied prospectively to measurement period adjustments that occur after the effective date. The adoption of this update did not have a material impact on the Company's consolidated financial statements.

In January 2016, the FASB issued ASU No. 2016-01, *Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*. The amendments in this ASU make improvements to GAAP related to financial instruments that include the following as applicable to us:

Equity investments, except for those accounted for under the equity method of accounting or those that result in consolidation of the investee, are required to be measured at fair value with changes in fair value recognized in net income. However, an entity may choose to measure equity investments that do not have readily determinable fair values at cost minus impairment, if any, plus or minus changes resulting from observable price changes in orderly transactions for the identical or a similar investment of the same issuer.

Simplifies the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment - if impairment exists, this requires measuring the investment at fair value.

Eliminates the requirement for public companies to disclose the method(s) and significant assumptions used to estimate the fair value that is currently required to be disclosed for financial instruments measured at amortized cost on the balance sheet.

Public companies will be required to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes.

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.

The reporting entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities in combination with the entity's other deferred tax assets.

ASU 2016-01 is effective for public business entities for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. This ASU will impact our financial statement disclosures, however, we do not expect this ASU to have a material impact on our financial condition or results of operations.

In February 2016, the FASB issued ASU No. 2016-02, *Leases (Topic 842)*. This ASU was issued to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities, including leases classified as operating leases under previous GAAP, on the balance sheet and requiring additional disclosures of key information about leasing arrangements. ASU 2016-02 is effective for annual periods, including interim periods within those annual periods beginning after December 15, 2018 and requires a modified retrospective approach to adoption. Early application of the amendments is permitted. While the Company has not quantified the impact to its balance sheet, it does expect the adoption of this ASU will result in a gross-up in its balance sheet as a result of recording a right-of-use asset and a lease liability for each lease, which is expected to decrease our leverage ratio by less than one percent.

In March 2016, FASB issued ASU 2016-09, *Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting*. The amendments in ASU 2016-09 simplify several aspects of the accounting for share-based payment award transactions, including: (a) income tax consequences; (b) classification of awards as either equity or liabilities; and (c) classification on the statement of cash flows. The amendments are effective for public companies for annual periods beginning after December 15, 2016, and interim periods within those annual periods. Early adoption is permitted for any interim or annual period. The Company adopted this ASU for the full fiscal year of 2016 and it did not have a significant impact on its consolidated financial statements.

Table of Contents

In June 2016, the FASB issued ASU No. 2016-13, *Financial Instruments – Credit Losses (Topic 326)*. This update changes the methodology used by financial institutions under current U.S. GAAP to recognize credit losses in the financial statements. Currently, U.S. GAAP requires the use of the incurred loss model, whereby financial institutions recognize in current period earnings, incurred credit losses and those inherent in the financial statements, as of the date of the balance sheet. This guidance results in a new model for estimating the allowance for loan and lease losses, commonly referred to as the Current Expected Credit Loss (“CECL”) model. Under the CECL model, financial institutions are required to estimate future credit losses and recognize those losses in current period earnings. The amendments within the update are effective for fiscal years and all interim periods beginning after December 15, 2019, with early adoption permitted. Upon adoption of the amendments within this update, the Company will be required to make a cumulative-effect adjustment to the opening balance of retained earnings in the year of adoption. The Company is currently in the process of evaluating the impact the adoption of this update will have on its financial statements. While the Company has not quantified the impact of this ASU, it does expect changing from the current incurred loss model to an expected loss model will result in an earlier recognition of losses, and an increase to our allowance for loan losses.

In August 2016, the FASB issued ASU No. 2016-15, *Statement of Cash Flows – Classification of Certain Cash Receipts and Cash Payments (Topic 230)*. This update clarifies how entities should classify certain cash receipts and cash payments on the statement of cash flows with the objective of reducing the existing diversity in practice related to eight specific cash flow issues. The amendments in this update are effective for annual periods beginning after December 15, 2017, and interim periods within those fiscal years. Early adoption is permitted. The Company does not expect the adoption of the amendments within this update will have a material impact on the Company’s financial statements.

In January 2017, FASB issued ASU 2017-03, *Accounting Changes and Error Corrections (Topic 250) and Investments - Equity Method and Joint Ventures (Topic 323): Amendments to SEC Paragraphs Pursuant to Staff Announcements at the September 22, 2016 and November 17, 2016 EITF Meetings*. These amendments apply to ASU 2014-9 (Revenue from Contracts with Customers), ASU 2016-02 (Leases), and ASU 2016-13 (Financial Instruments - Credit Losses). The Company does not expect these amendments to have a significant impact on its consolidated financial statements.

**NOTE 3 – SECURITIES**

The amortized cost and estimated fair values of debt securities as of September 30, 2017 are as follows:

(dollars in thousands)	<b>Amortized Gross</b>	<b>Gross</b>	<b>Fair Value</b>
------------------------	------------------------	--------------	-------------------

Edgar Filing: Oak Valley Bancorp - Form 10-Q

	<b>Cost</b>	<b>Unrealized</b>	<b>Unrealized</b>	
		<b>Gains</b>	<b>Losses</b>	
Available-for-sale securities:				
U.S. agencies	\$ 26,780	\$ 513	\$ (84 )	\$ 27,209
Collateralized mortgage obligations	3,963	6	(29 )	3,940
Municipalities	88,026	2,677	(103 )	90,600
SBA pools	12,389	33	(15 )	12,407
Corporate debt	19,356	98	(722 )	18,732
Asset backed securities	24,727	137	(11 )	24,853
Mutual fund	3,324	0	(208 )	3,116
	\$ 178,565	\$ 3,464	\$ (1,172 )	\$ 180,857

Table of Contents

The following tables detail the gross unrealized losses and fair values aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at September 30, 2017.

(dollars in thousands)	<b>Less than 12 months</b>		<b>12 months or more</b>		<b>Total</b>	
	<b>Fair</b>	<b>Unrealized</b>	<b>Fair</b>	<b>Unrealized</b>	<b>Fair</b>	<b>Unrealized</b>
<b>Description of Securities</b>	<b>Value</b>	<b>Loss</b>	<b>Value</b>	<b>Loss</b>	<b>Value</b>	<b>Loss</b>
U.S. agencies	\$6,464	(72 )	\$1,841	\$ (12 )	\$8,305	\$ (84 )
Collateralized mortgage obligations	1,122	(10 )	968	(19 )	2,090	(29 )
Municipalities	10,158	(58 )	2,879	(45 )	13,037	(103 )
SBA pools	3,812	(8 )	716	(7 )	4,528	(15 )
Corporate debt	1,984	(16 )	13,785	(706 )	15,769	(722 )
Asset backed securities	6,219	(9 )	347	(2 )	6,566	(11 )
Mutual fund	0	0	3,116	(208 )	3,116	(208 )
Total temporarily impaired securities	\$29,759	\$ (173 )	\$23,652	\$ (999 )	\$53,411	\$ (1,172 )

At September 30, 2017, there were ten corporate debts, four municipalities, two SBA pools, one U.S. agency, one collateralized mortgage obligation, one asset backed securities and one mutual fund that comprised the total securities in an unrealized loss position for greater than 12 months and twelve municipalities, five U.S. agencies, four asset backed securities, two SBA pools, one collateralized mortgage obligation, and one corporate debt that make up the total securities in a loss position for less than 12 months. Management periodically evaluates each available-for-sale investment security in an unrealized loss position to determine if the impairment is temporary or other than temporary. This evaluation encompasses various factors including, the nature of the investment, the cause of the impairment, the severity and duration of the impairment, credit ratings and other credit related factors such as third party guarantees and volatility of the security's fair value. Management has determined that no investment security is other than temporarily impaired. The unrealized losses are due primarily to interest rate changes and the Company does not intend to sell the securities and it is not likely that we will be required to sell the securities before the earlier of the forecasted recovery or the maturity of the underlying investment security.

The amortized cost and estimated fair value of investment securities at September 30, 2017, by contractual maturity or call date, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

(dollars in thousands)	<b>Amortized Cost</b>	<b>Fair Value</b>
Available-for-sale securities:		
Due in one year or less	\$ 12,724	\$ 12,981
Due after one year through five years	57,326	57,740
Due after five years through ten years	56,841	58,143

Edgar Filing: Oak Valley Bancorp - Form 10-Q

Due after ten years	51,674	51,993
	\$ 178,565	\$ 180,857

12

---

Table of Contents

The amortized cost and estimated fair values of debt securities as of December 31, 2016, are as follows:

(dollars in thousands)	<b>Amortized Cost</b>	<b>Gross Unrealized Gains</b>	<b>Gross Unrealized Losses</b>	<b>Fair Value</b>
Available-for-sale securities:				
U.S. agencies	\$ 27,879	\$ 616	\$ (209 )	\$ 28,286
Collateralized mortgage obligations	4,159	7	(57 )	4,109
Municipalities	77,957	1,318	(946 )	78,329
SBA pools	7,219	0	(51 )	7,168
Corporate debt	21,349	81	(867 )	20,563
Asset backed securities	18,888	32	(101 )	18,819
Mutual fund	3,264	0	(205 )	3,059
	\$ 160,715	\$ 2,054	\$ (2,436 )	\$ 160,333

The following tables detail the gross unrealized losses and fair values aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at December 31, 2016.

(dollars in thousands)	<b>Less than 12 months</b>		<b>12 months or more</b>		<b>Total</b>	
<b>Description of Securities</b>	<b>Fair</b>	<b>Unrealized</b>	<b>Fair</b>	<b>Unrealized</b>	<b>Fair</b>	<b>Unrealized</b>
	<b>Value</b>	<b>Loss</b>	<b>Value</b>	<b>Loss</b>	<b>Value</b>	<b>Loss</b>
U.S. agencies	\$ 8,769	\$ (208 )	\$ 718	\$ (1 )	\$ 9,487	\$ (209 )
Collateralized mortgage obligations	3,166	(57 )	0	0	3,166	(57 )
Municipalities	45,137	(917 )	402	(29 )	45,539	(946 )
SBA pools	6,415	(46 )	753	(5 )	7,168	(51 )
Corporate debt	12,776	(757 )	2,884	(110 )	15,660	(867 )
Asset backed securities	2,576	(15 )	8,272	(86 )	10,848	(101 )
Mutual fund	0	0	3,059	(205 )	3,059	(205 )
Total temporarily impaired securities	\$ 78,839	\$ (2,000 )	\$ 16,088	\$ (436 )	\$ 94,927	\$ (2,436 )

We recognized gross gains of \$4,000 and \$394,000 for the three and nine month periods ended September 30, 2017, respectively, on certain available-for-sale securities that were called, which compares to \$10,000 and \$29,000 in the same periods of 2016. There were no securities sold during the first nine months of 2017 or 2016.

Securities carried at \$93,594,000 and \$89,362,000 at September 30, 2017 and December 31, 2016, respectively, were pledged to secure deposits of public funds.



Table of Contents**NOTE 4 – LOANS**

Our customers are primarily located in Stanislaus, San Joaquin, Tuolumne, Inyo, and Mono Counties. As of September 30, 2017, approximately 79% of the Company's loans are commercial real estate loans which include construction loans. Approximately 10% of the Company's loans are for general commercial uses including professional, retail, and small business. Additionally, 6% of the Company's loans are for residential real estate and other consumer loans. The remaining 5% are agriculture loans. Loan totals were as follows:

	September 30, 2017	December 31, 2016
Commercial real estate:		
Commercial real estate- construction	\$ 20,254	\$ 23,378
Commercial real estate- mortgages	417,253	389,495
Land	8,496	9,823
Farmland	56,670	56,159
Commercial and industrial	65,444	64,201
Consumer	607	767
Consumer residential	37,836	38,672
Agriculture	30,049	28,454
	636,609	610,949
Deferred loan fees and costs, net	(1,781 )	(2,013 )
Allowance for loan losses	(7,917 )	(7,832 )
	\$ 626,911	\$ 601,104

*Loan Origination/Risk Management.* The Company has certain lending policies and procedures in place that are designed to maximize loan income within an acceptable level of risk. Management reviews and approves these policies and procedures on a regular basis. A reporting system supplements the review process by providing management with frequent reports related to loan production, loan quality, concentration of credit, loan delinquencies and non-performing and potential problem loans. Diversification in the loan portfolio is a means of managing risk associated with fluctuations in economic conditions.

Commercial and industrial loans are underwritten after evaluating and understanding the borrower's ability to operate profitably and prudently expand its business. Underwriting standards are designed to promote relationship banking rather than transactional banking. Once it is determined that the borrower's management possesses sound ethics and solid business acumen, our management examines current and projected cash flows to determine the ability of the

borrower to repay their obligations as agreed. Commercial and industrial loans are primarily made based on the identified cash flows of the borrower and secondarily on the underlying collateral provided by the borrower. The cash flows of borrowers, however, may not be as expected and the collateral securing these loans may fluctuate in value. Most commercial and industrial loans are secured by the assets being financed or other business assets such as accounts receivable or inventory and may incorporate a personal guarantee; however, some short-term loans may be made on an unsecured basis. In the case of loans secured by accounts receivable, the availability of funds for the repayment of these loans may be substantially dependent on the ability of the borrower to collect amounts due from its customers.

Commercial real estate loans are subject to underwriting standards and processes similar to commercial and industrial loans, in addition to those of real estate loans. These loans are viewed primarily as cash flow loans and secondarily as loans secured by real estate. Commercial real estate lending typically involves higher loan principal amounts and the repayment of these loans is generally largely dependent on the successful operation of the property securing the loan or the business conducted on the property securing the loan. Commercial real estate loans may be more adversely affected by conditions in the real estate markets or in the general economy. The properties securing the Company's commercial real estate portfolio are diverse in terms of type and geographic location. This diversity helps reduce the Company's exposure to adverse economic events that affect any single market or industry. Management monitors and evaluates commercial real estate loans based on collateral, geography and risk grade criteria. As a general rule, the Company avoids financing single-purpose projects unless other underwriting factors are present to help mitigate risk. The Company also utilizes third-party experts to provide insight and guidance about economic conditions and trends affecting market areas it serves. In addition, management tracks the level of owner-occupied commercial real estate loans versus non-owner occupied loans. At September 30, 2017 and December 31, 2016, commercial real estate loans equal to approximately 42.3% and 40.9%, respectively, of the outstanding principal balance of our commercial real estate loans were secured by owner-occupied properties.

Table of Contents

With respect to loans to developers and builders that are secured by non-owner occupied properties that the Company may originate from time to time, the Company generally requires the borrower to have had an existing relationship with the Company and have a proven record of success. Construction loans are underwritten utilizing feasibility studies, independent appraisal reviews, sensitivity analysis of absorption and lease rates and financial analysis of the developers and property owners. Construction loans are generally based upon estimates of costs and value associated with the complete project. These estimates may be inaccurate. Construction loans often involve the disbursement of substantial funds with repayment substantially dependent on the success of the ultimate project. Sources of repayment for these types of loans may be pre-committed permanent loans from approved long-term lenders, sales of developed property or an interim loan commitment from the Company until permanent financing is obtained. These loans are closely monitored by on-site inspections and are considered to have higher risks than other real estate loans due to their ultimate repayment being sensitive to interest rate changes, governmental regulation of real property, general economic conditions and the availability of long-term financing.

Agricultural production, real estate and development lending is susceptible to credit risks including adverse weather conditions, pest and disease, as well as market price fluctuations and foreign competition. Agricultural loan underwriting standards are maintained by following Company policies and procedures in place to minimize risk in this lending segment. These standards consist of limiting credit to experienced farmers who have demonstrated farm management capabilities, requiring cash flow projections displaying margins sufficient for repayment from normal farm operations along with equity injected as required by policy, as well as providing adequate secondary repayment and sponsorship including satisfactory collateral support. Credit enhancement obtained through government guarantee programs may also be used to provide further support as available.

The Company originates consumer loans utilizing common underwriting criteria specified in policy. To monitor and manage consumer loan risk, policies and procedures are developed and modified, as needed, jointly by line and staff personnel. This activity, coupled with relatively small loan amounts that are spread across many individual borrowers, minimizes risk. Additionally, trend and outlook reports are reviewed by management on a regular basis. Underwriting standards for 1-4 family, home equity lines and loans follow bank policy, which include, but are not limited to, a maximum loan-to-value percentage of 80%, a maximum housing and total debt ratio of 36% and 42%, respectively and other specified credit and documentation requirements.

The Company maintains an independent loan review department that reviews and validates the credit risk program on a periodic basis. Results of these reviews are presented to management. The loan review process complements and reinforces the risk identification and assessment decisions made by lenders and credit personnel, as well as the Bank's policies and procedures.

*Non-Accrual and Past Due Loans.* Loans are considered past due if the required principal and interest payments have not been received as of the date such payments were due. Loans are placed on non-accrual status when, in management's opinion, the borrower may be unable to meet payment obligations as they become due, as well as when required by regulatory provisions. Loans may be placed on non-accrual status regardless of whether or not such loans are considered past due. When interest accrual is discontinued, all unpaid accrued interest is reversed. Interest income

is subsequently recognized only to the extent cash payments are received in excess of principal due. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

Non-accrual loans, segregated by class of loans, were as follows:

(in thousands)	September 30, 2017	December 31, 2016
Commercial real estate:		
Commercial real estate- construction	\$ 0	\$ 0
Commercial real estate- mortgages	0	0
Land	993	2,715
Farmland	0	0
Commercial and industrial	302	306
Consumer	0	0
Consumer residential	16	16
Agriculture	0	0
Total non-accrual loans	\$ 1,311	\$ 3,037

Table of Contents

Excluded from the above non-accrual loan table is the \$33,000 carrying value of one Purchased Credit Impaired loan acquired in the MLB Acquisition.

Had non-accrual loans performed in accordance with their original contract terms, we would have recognized additional interest income of approximately \$27,000 and \$95,000 in the three and nine month periods ended September 30, 2017, respectively, as compared to \$38,000 and \$118,000 in the same periods of 2016.

The following table analyzes past due loans including the non-accrual loans in the above table, segregated by class of loans, as of September 30, 2017 (in thousands):

<u>September 30, 2017</u>	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days Past Due		Total Past Due	Current	Purchased Credit Impaired Loans	Total	Greater Than 90 Days Past Due and Still Accruing
			Than 90 Days Past Due	Total					
Commercial real estate:									
Commercial R.E. - construction	\$ 0	\$ 0	\$0	\$0	\$0	\$20,254	\$ 0	\$20,254	\$ 0
Commercial R.E. - mortgages	25	0	0	25	417,228	0	417,253	0	
Land	0	0	993	993	7,470	33	8,496	0	
Farmland	0	0	0	0	56,670	0	56,670	0	
Commercial and industrial	0	0	302	302	65,142	0	65,444	0	
Consumer	0	0	0	0	607	0	607	0	
Consumer residential	0	0	0	0	37,836	0	37,836	0	
Agriculture	0	0	0	0	30,049	0	30,049	0	
Total	\$ 25	\$ 0	\$ 1,295	\$ 1,320	\$ 635,256	\$ 33	\$ 636,609	\$ 0	

The following table analyzes past due loans including the non-accrual loans in the above table, segregated by class of loans, as of December 31, 2016 (in thousands):

<u>December 31, 2016</u>	30-59	60-89	Greater	Total	Current	Purchased	Total	Greater
--------------------------	-------	-------	---------	-------	---------	-----------	-------	---------

Edgar Filing: Oak Valley Bancorp - Form 10-Q

	Days Past Due	Days Past Due	Than 90 Days Past Due	Past Due		Credit Impaired Loans		Than 90 Days Past Due and Still Accruing
Commercial real estate:								
Commercial R.E. - construction	\$ 0	\$ 0	\$0	\$0	\$23,378	\$ 0	23,378	\$ 0
Commercial R.E. - mortgages	0	0	0	0	389,495	0	389,495	0
Land	0	0	2,715	2,715	7,075	33	9,823	0
Farmland	0	0	0	0	56,159	0	56,159	0
Commercial and industrial	0	0	302	302	63,899	0	64,201	0
Consumer	0	0	0	0	767	0	767	0
Consumer residential	0	0	16	16	38,656	0	38,672	0
Agriculture	0	0	0	0	28,454	0	28,454	0
Total	\$ 0	\$ 0	\$3,033	\$3,033	\$607,883	\$ 33	610,949	\$ 0

*Impaired Loans.* Loans are considered impaired when, based on current information and events, it is probable the Company will be unable to collect all amounts due in accordance with the original contractual terms of the loan agreement, including scheduled principal and interest payments. Impairment is evaluated in total for smaller-balance loans of a similar nature and on an individual loan basis for other loans. If a loan is impaired, a specific valuation allowance is allocated, if necessary, so that the loan is reported net, at the present value of estimated future cash flows using the loan's existing rate or at the fair value of collateral if repayment is expected solely from the collateral. Interest payments on impaired loans are typically applied to principal unless collectability of the principal amount is reasonably assured, in which case interest is recognized on a cash basis. There was no interest income realized on impaired loans for the three and nine months ended September 30, 2017 and 2016.

Table of Contents

Impaired loans as of September 30, 2017 and December 31, 2016 are set forth in the following tables. PCI loans are excluded from the tables below, as they have not experienced post acquisition declines in cash flows expected to be collected.

(in thousands)	Unpaid Contractual Principal Balance	Recorded Investment With No Allowance	Recorded Investment With Allowance	Total Recorded Investment	Related Allowance
<b><u>September 30, 2017</u></b>					
Commercial real estate:					
Commercial R.E. - construction	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0
Commercial R.E. - mortgages	0	0	0	0	0
Land	1,309	0	993	993	680
Farmland	0	0	0	0	0
Commercial and Industrial	351	302	0	302	0
Consumer	0	0	0	0	0
Consumer residential	16	16	0	16	0
Agriculture	0	0	0	0	0
Total	\$ 1,676	\$ 318	\$ 993	\$ 1,311	\$ 680

(in thousands)	Unpaid Contractual Principal Balance	Recorded Investment With No Allowance	Recorded Investment With Allowance	Total Recorded Investment	Related Allowance
<b><u>December 31, 2016</u></b>					
Commercial real estate:					
Commercial R.E. - construction	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0
Commercial R.E. - mortgages	0	0	0	0	0
Land	3,131	0	2,715	2,715	680
Farmland	0	0	0	0	0
Commercial and Industrial	353	306	0	306	0
Consumer	0	0	0	0	0
Consumer residential	16	16	0	16	0
Agriculture	0	0	0	0	0
Total	\$ 3,500	\$ 322	\$ 2,715	\$ 3,037	\$ 680





Table of Contents

Average recorded investment in impaired loans outstanding as of September 30, 2017 and 2016 is set forth in the following table.

(in thousands)	Average Recorded Investment for the			
	Three	Three	Nine	Nine
	Months	Months	Months	Months
	Ended	Ended	Ended	Ended
	September	September	September	September
	30,	30,	30,	30,
	2017	2016	2017	2016
Commercial real estate:				
Commercial R.E. - construction	\$0	\$ 0	\$ 0	\$ 0
Commercial R.E. - mortgages	0	0	0	0
Land	1,518	2,324	2,018	2,439
Farmland	0	0	0	0
Commercial and Industrial	302	312	304	316
Consumer	0	0	0	0
Consumer residential	75	0	96	0
Agriculture	0	0	0	0
Total	\$1,895	\$ 2,636	\$ 2,418	\$ 2,755

*Troubled Debt Restructurings* – In order to determine whether a borrower is experiencing financial difficulty, an evaluation is performed of the probability that the borrower will be in payment default on any of its debt in the foreseeable future without the modification. This evaluation is performed under the Company’s internal underwriting policy.

At September 30, 2017, there were 5 loans that were considered to be troubled debt restructurings, all of which are considered non-accrual totaling \$1,311,000. At December 31, 2016, there were 6 loans that were considered to be troubled debt restructurings, all of which are considered non-accrual totaling \$3,037,000. At September 30, 2017 and December 31, 2016 there were no unfunded commitments on loans classified as a troubled debt restructures. We have allocated \$680,000 of specific reserves to loans whose terms have been modified in troubled debt restructurings as of September 30, 2017 and December 31, 2016.

The modification of the terms of such loans typically includes one or a combination of the following: a reduction of the stated interest rate of the loan; an extension of the maturity date; or a temporary payment modification in which the payment amount allocated towards principal was reduced. In some cases, a permanent reduction of the accrued interest on the loan is conceded.

During the three and nine months ended September 30, 2017, no loans were modified as troubled debt restructurings, compared to one loan with a recorded investment of \$292,000 that was modified as a troubled debt restructuring by extending the maturity date during the nine month period ended September 30, 2016. This troubled debt restructuring did not increase the allowance for loan losses as a result of loan modifications. There were no charge-offs as a result of the loan modification, as the contractual balances outstanding were determined to be collectible.

There were no loans modified as troubled debt restructurings within the previous twelve months and for which there was a payment default during the three and nine month periods ended September 30, 2017 and 2016. A loan is considered to be in payment default once it is ninety days contractually past due under the modified terms.

*Loan Risk Grades*— Quality ratings (Risk Grades) are assigned to all commitments and stand-alone notes. Risk grades define the basic characteristics of commitments or stand-alone note in relation to their risk. All loans are graded using a system that maximizes the loan quality information contained in loan review grades, while ensuring that the system is compatible with the grades used by bank examiners.

We grade loans using the following letter system:

- 1 Exceptional Loan
- 2 Quality Loan
- 3 A Better Than Acceptable Loan
- 3 B Acceptable Loan
- 3 C Marginally Acceptable Loan
- 4 (W) Watch Acceptable Loan
- 5 Other Loans Especially Mentioned
- 6 Substandard Loan
- 7 Doubtful Loan
- 8 Loss

Table of Contents

1. Exceptional Loan - Loans with A+ credits that contain very little, if any, risk. Grade 1 loans are considered Pass. To qualify for this rating, the following characteristics must be present:

- A high level of liquidity and whose debt-servicing capacity exceeds expected obligations by a substantial margin.
- Where leverage is below average for the industry and earnings are consistent or growing without severe vulnerability to economic cycles.
- Also included in this rating (but not mandatory unless one or more of the preceding characteristics are missing) are loans that are fully secured and properly margined by our own time instruments or U.S. blue chip securities. To be properly margined cash collateral must be equal to, or greater than, 110% of the loan amount.

2. Quality Loan - Loans with excellent sources of repayment that conform in all respects to bank policy and regulatory requirements. These are also loans for which little repayment risk has been identified. No credit or collateral exceptions. Grade 2 loans are considered Pass. Other factors include:

- Unquestionable debt-servicing capacity to cover all obligations in the ordinary course of business from well-defined primary and secondary sources.
- Consistent strong earnings.
- A solid equity base.

3A. Better than Acceptable Loan - In the interest of better delineating the loan portfolio's true credit risk for reserve allocation, further granularity has been sought by splitting the grade 3 category into three classifications. The distinction between the three are bank-defined guidelines and represent a further refinement of the regulatory definition of a pass, or grade 3 loan. Grade 3A is the stronger third of the pass category, but is not strong enough to be a grade 2 and is characterized by:

- Strong earnings with no loss in last three years and ample cash flow to service all debt well above policy guidelines.
- Long term experienced management with depth and defined management succession.
- The loan has no exceptions to policy.
- Loan-to-value on real estate secured transactions is 10% to 20% less than policy guidelines.
- Very liquid balance sheet that may have cash available to pay off our loan completely.
- Little to no debt on balance sheet.

3B. Acceptable Loan - 3B loans are simply defined as all loans that are less qualified than 3A loans and are stronger than 3C loans. These loans are characterized by acceptable sources of repayment that conform to bank policy and regulatory requirements. Repayment risks are acceptable for these loans. Credit or collateral exceptions are minimal, are in the process of correction, and do not represent repayment risk. These loans:

-Are those where the borrower has average financial strengths, a history of profitable operations and experienced management.

-Are those where the borrower can be expected to handle normal credit needs in a satisfactory manner.

3C. Marginally Acceptable - 3C loans have similar characteristics as that of 3Bs with the following additional characteristics:

Requires collateral. A credit facility where the borrower has average financial strengths, but usually lacks reliable secondary sources of repayment other than the subject collateral. Other common characteristics can include some or all of the following: minimal background experience of management, lacking continuity of management, a start-up operation, erratic historical profitability (acceptable reasons-well identified), lack of or marginal sponsorship of guarantor, and government guaranteed loans.

4W Watch Acceptable - Watch grade will be assigned to any credit that is adequately secured and performing but monitored for a number of indicators. These characteristics may include any unexpected short-term adverse financial performance from budgeted projections or prior period's results (i.e., declining profits, sales, margins, cash flow, or increased reliance on leverage, including adverse balance sheet ratios, trade debt issues, etc.). Additionally, any managerial or personal problems of company management, decline in the entire industry or local economic conditions, or failure to provide financial information or other documentation as requested; issues regarding delinquency, overdrafts, or renewals; and any other issues that cause concern for the company. Loans to individuals or loans supported by guarantors with marginal net worth and/or marginal collateral. Weakness identified in a Watch credit is short-term in nature. Loans in this category are usually accounts the Bank would want to retain providing a positive turnaround can be expected within a reasonable time frame. Grade 4 loans are considered Pass.

5 Other Loans Especially Mentioned (Special Mention) - A special mention extension of credit is defined as having potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may, at some future date result in the deterioration of the repayment prospects for the credit or the institution's credit position. Extensions of credit that might be detailed in this category include the following:

-The lending officer may be unable to properly supervise the credit because of an inadequate loan or credit agreement.

-Questions exist regarding the condition of and/or control over collateral.

-Economic or market conditions may unfavorably affect the obligor in the future.

-A declining trend in the obligor's operations or an imbalanced position in the balance sheet exists, but not to the point that repayment is jeopardized.



Table of Contents

6 Substandard Loan - A “substandard” extension of credit is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Extensions of credit so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected. Loss potential, while existing in the aggregate amount of substandard credits, does not have to exist in individual extensions of credit classified substandard.

7 Doubtful Loan - An extension of credit classified “doubtful” has all the weaknesses inherent in one classified substandard, with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable. The possibility of loss is extremely high but because of certain important and reasonably specific pending factors that may work to the advantage of and strengthen the credit, its classification as an estimated loss is deferred until its more exact status may be determined. Pending factors may include a proposed merger or acquisition, liquidation proceedings, capital injection, perfecting liens on additional collateral or refinancing plans. The entire loan need not be classified doubtful when collection of a specific portion appears highly probable. An example of proper use of the doubtful category is the case of a company being liquidated, with the trustee-in-bankruptcy indicating a minimum disbursement of 40 percent and a maximum of 65 percent to unsecured creditors, including the Bank. In this situation, estimates are based on liquidation value appraisals with actual values yet to be realized. By definition, the only portion of the credit that is doubtful is the 25 percent difference between 40 and 65 percent.

A proper classification of such a credit would show 40 percent substandard, 25 percent doubtful, and 35 percent loss. A credit classified as doubtful should be resolved within a ‘reasonable’ period of time. Reasonable is generally defined as the period between examinations. In other words, a credit classified doubtful at an examination should be cleared up before the next exam. However, there may be situations that warrant continuation of the doubtful classification a while longer.

8 Loss - Extensions of credit classified “loss” are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the credit has absolutely no recovery or salvage value, but rather that it is not practical or desirable to defer writing off, even though partial recovery may be affected in the future. It should not be the Company’s practice to attempt long-term recoveries while the credit remains on the books. Losses should be taken in the period in which they surface as uncollectible.

As of September 30, 2017 and December 31, 2016, there are no loans that are classified with a risk grade of 8- Loss.

The following table presents weighted average risk grades of our loan portfolio:

	September 30, 2017 Weighted Average	December 31, 2016 Weighted Average
	Risk Grade	Risk Grade
Commercial real estate:		
Commercial real estate - construction	3.00	3.07
Commercial real estate - mortgages	3.07	3.08
Land	3.98	4.39
Farmland	3.22	3.09
Commercial and industrial	3.59	2.70
Consumer	2.15	2.28
Consumer residential	3.01	3.03
Agriculture	3.20	3.08
Total gross loans	3.15	3.06

Table of Contents

The following table presents risk grade totals by class of loans as of September 30, 2017 and December 31, 2016. Risk grades 1 through 4 have been aggregated in the “Pass” line.

(in thousands)	Commercial R.E. Construction	Commercial R.E. Mortgages	Land (1)	Farmland	Commercial and Industrial	Consumer	Consumer Residential	Agriculture	Total
<u>September 30, 2017</u>									
Pass	\$ 20,254	\$ 416,289	\$ 7,041	\$ 56,670	\$ 60,335	\$ 579	\$ 37,773	\$ 30,049	\$ 628,990
Special mention	-	258	-	-	3,920	-	-	-	4,178
Substandard	-	706	1,175	-	1,189	28	63	-	3,161
Doubtful	-	-	280	-	-	-	-	-	280
Total loans	\$ 20,254	\$ 417,253	\$ 8,496	\$ 56,670	\$ 65,444	\$ 607	\$ 37,836	\$ 30,049	\$ 636,609

December 31, 2016

Pass	\$ 22,560	\$ 388,365	\$ 6,637	\$ 56,159	\$ 62,770	\$ 738	\$ 38,300	\$ 28,454	\$ 603,983
Special mention	818	1,063	-	-	189	-	-	-	2,070
Substandard	-	67	2,906	-	1,242	29	372	-	4,616
Doubtful	-	-	280	-	-	-	-	-	280
Total loans	\$ 23,378	\$ 389,495	\$ 9,823	\$ 56,159	\$ 64,201	\$ 767	\$ 38,672	\$ 28,454	\$ 610,949

Included in the above table is Purchased Credit Impaired loans recorded at their fair value of \$33,000 as of (1) September 30, 2017 and December 31, 2016, which were acquired in the MLB Acquisition.

Allowance for Loan Losses. The allowance for loan losses is a reserve established by the Company through a provision for loan losses charged to expense, which represents management’s best estimate of probable losses that have been incurred within the existing portfolio of loans. The allowance, in the judgment of management, is necessary to reserve for estimated loan losses and risks inherent in the loan portfolio. The allowance for loan loss methodology includes allowance allocations calculated in accordance with ASC Topic 310, “Receivables” and allowance allocations calculated in accordance with ASC Topic 450, “Contingencies.” Accordingly, the methodology is based on historical loss experience by type of credit and internal risk grade, specific homogeneous risk pools and specific loss allocations, with adjustments for current events and conditions. The process for determining the appropriate level of the allowance for loan losses is designed to account for credit deterioration as it occurs. The provision for loan losses reflects loan quality trends, including the levels of and trends related to non-accrual loans, past due loans, potential problem loans, criticized loans and net charge-offs or recoveries, among other factors. The provision for loan losses also reflects the totality of actions taken on all loans for a particular period. In other words, the amount of the provision reflects not only the necessary increases in the allowance for loan losses related to newly identified criticized loans, but it also reflects actions taken related to other loans including, among other things, any necessary increases or decreases in required allowances for specific loans or loan pools.



The level of the allowance reflects management's continuing evaluation of industry concentrations, specific credit risks, loan loss experience, current loan portfolio quality, present economic, political and regulatory conditions and unidentified losses inherent in the current loan portfolio. Portions of the allowance may be allocated for specific credits; however, the entire allowance is available for any credit that, in management's judgment, should be charged off. While management utilizes its best judgment and information available, the ultimate adequacy of the allowance is dependent upon a variety of factors beyond the Company's control, including, among other things, the performance of the Company's loan portfolio, the economy, changes in interest rates and the view of the regulatory authorities toward loan classifications.

The Company's allowance for loan losses consists of three elements: (i) specific valuation allowances determined in accordance with ASC Topic 310 based on probable losses on specific loans; (ii) historical valuation allowances determined in accordance with ASC Topic 450 based on historical loan loss experience for similar loans with similar characteristics and trends, adjusted, as necessary, to reflect the impact of current conditions; (iii) general valuation allowances determined in accordance with ASC Topic 450 based on general economic conditions and other qualitative risk factors both internal and external to the Bank and the Company; and (iv) unallocated allowance which represents the excess allowance not allocated to specific loans pools.

The allowances established for probable losses on specific loans are based on a regular analysis and evaluation of problem loans. Loans are classified based on an internal credit risk grading process that evaluates, among other things: (i) the obligor's ability to repay; (ii) the underlying collateral, if any; and (iii) the economic environment and industry in which the borrower operates. This analysis is performed at the relationship manager level for all commercial loans. When a loan has a calculated grade of 5 or higher, a special assets officer analyzes the loan to determine whether the loan is impaired and, if impaired, the need to specifically allocate a portion of the allowance for loan losses to the loan. Specific valuation allowances are determined by analyzing the borrower's ability to repay amounts owed, collateral deficiencies, the relative risk grade of the loan and economic conditions affecting the borrower's industry, among other things.

Table of Contents

Historical valuation allowances are calculated based on the historical loss experience of specific types of loans and the internal risk grade of such loans at the time they were charged-off. The Company calculates historical loss ratios for pools of similar loans with similar characteristics based on the proportion of actual charge-offs experienced to the total population of loans in the pool. The historical loss ratios are periodically updated based on actual charge-off experience. A historical valuation allowance is established for each pool of similar loans based upon the product of the historical loss ratio and the total dollar amount of the loans in the pool. The Company's pools of similar loans include similarly risk-graded groups of commercial and industrial loans, commercial real estate loans, consumer real estate loans and consumer and other loans.

General valuation allowances are based on general economic conditions and other qualitative risk factors both internal and external to the Bank and the Company. In general, such valuation allowances are determined by evaluating, among other things: (i) the experience, ability and effectiveness of the Bank's lending management and staff; (ii) the effectiveness of the Bank's loan policies, procedures and internal controls; (iii) changes in asset quality; (iv) changes in loan portfolio volume; (v) the composition and concentrations of credit; (vi) the impact of competition on loan structuring and pricing; (vii) the effectiveness of the internal loan review function; (viii) the impact of environmental risks on portfolio risks; and (ix) the impact of rising interest rates on portfolio risk. Management evaluates the degree of risk that each one of these components has on the quality of the loan portfolio on a quarterly basis. Each component is determined to have either a high, moderate or low degree of risk. The results are then input into a "general allocation matrix" to determine an appropriate general valuation allowance.

Included in the general valuation allowances are allocations for groups of similar loans with risk characteristics that exceed certain concentration limits established by management. Concentration risk limits have been established, among other things, for certain industry concentrations, large balance and highly leveraged credit relationships that exceed specified risk grades, and loans originated with policy exceptions that exceed specified risk grades.

Loans identified as losses by management, internal loan review and/or bank examiners are charged-off. Furthermore, consumer loan accounts are charged-off automatically based on regulatory requirements.

Table of Contents

The following table details activity in the allowance for loan losses by portfolio segment for the three and nine months ended September 30, 2017 and 2016. Allocation of a portion of the allowance to one category of loans does not preclude its availability to absorb losses in other categories.

(in thousands)	Commercial	Commercial	Consumer				Total
<b><u>Three Months Ended September 30, 2017</u></b>	Real Estate	and Industrial	Consumer	Residential	Agriculture	Unallocated	
Beginning balance	\$ 6,247	\$ 746	\$ 30	\$ 321	\$ 453	\$ 57	\$7,854
Charge-offs	0	0	(9 )	0	0	0	(9 )
Recoveries	0	0	2	0	0	0	2
(Reversal of) provision for loan losses	3	15	0	(7 )	100	(41 )	70
Ending balance	\$ 6,250	\$ 761	\$ 23	\$ 314	\$ 553	\$ 16	\$7,917

**Nine Months Ended September 30, 2017**

Beginning balance	\$ 6,185	\$ 697	\$ 51	\$ 325	\$ 504	\$ 70	\$7,832
Charge-offs	0	0	(26 )	0	0	0	(26 )
Recoveries	0	0	5	1	0	0	6
(Reversal of) provision for loan losses	65	64	(7 )	(12 )	49	(54 )	105
Ending balance	\$ 6,250	\$ 761	\$ 23	\$ 314	\$ 553	\$ 16	\$7,917

(in thousands)	Commercial	Commercial	Consumer				Total
<b><u>Three Months Ended September 30, 2016</u></b>	Real Estate	and Industrial	Consumer	Residential	Agriculture	Unallocated	
Beginning balance	\$ 6,133	\$ 671	\$ 55	\$ 387	\$ 431	\$ 3	\$7,680
Charge-offs	0	0	(5 )	0	0	0	(5 )
Recoveries	0	0	2	0	0	0	2
(Reversal of) provision for loan losses	(62 )	60	(4 )	(8 )	63	41	90
Ending balance	\$ 6,071	\$ 731	\$ 48	\$ 379	\$ 494	\$ 44	\$7,767

**Nine Months Ended September 30, 2016**

Beginning balance	\$ 5,920	\$ 627	\$ 38	\$ 426	\$ 309	\$ 36	\$7,356
Charge-offs	-	-	(12 )	-	-	-	(12 )
Recoveries	3	-	5	-	-	-	8
(Reversal of) provision for loan losses	148	104	17	(47 )	185	8	415
Ending balance	\$ 6,071	\$ 731	\$ 48	\$ 379	\$ 494	\$ 44	\$7,767

Table of Contents

The following table details the allowance for loan losses and ending gross loan balances as of September 30, 2017, December 31, 2016 and September 30, 2016 summarized by collective and individual evaluation methods of impairment.

(in thousands)	Commercial Real Estate	Commercial and Industrial	Consumer Consumer	Residential	Agriculture	Unallocated	Total
<u>September 30, 2017</u>							
Allowance for loan losses for loans:							
Individually evaluated for impairment	\$ 680	\$ 0	\$ 0	\$ 0	\$ 0		\$ 680
Collectively evaluated for impairment	5,570	761	23	314	553	16	7,237
	\$ 6,250	\$ 761	\$ 23	\$ 314	\$ 553	\$ 16	\$ 7,917
Ending gross loan balances:							
Individually evaluated for impairment	\$ 993	\$ 303	\$ 0	\$ 15	\$ 0	\$ 0	\$ 1,311
Individually evaluated purchased credit impaired loans	33	0	0	0	0	0	33
Collectively evaluated for impairment	501,647	65,141	607	37,821	30,049	0	635,265
	\$ 502,673	\$ 65,444	\$ 607	\$ 37,836	\$ 30,049	\$ 0	\$ 636,609
<u>December 31, 2016</u>							
Allowance for loan losses for loans:							
Individually evaluated for impairment	\$ 680	\$ 0	\$ 0	\$ 0	\$ 0		\$ 680
Collectively evaluated for impairment	5,505	697	51	325	504	70	7,152
	\$ 6,185	\$ 697	\$ 51	\$ 325	\$ 504	\$ 70	\$ 7,832
Ending gross loans balances:							
Individually evaluated for impairment	\$ 2,715	\$ 306	\$ 0	\$ 16	\$ 0	\$ 0	\$ 3,037
Individually evaluated purchased credit impaired loans	33	0	0	0	0	0	33
Collectively evaluated for impairment	476,107	63,895	767	38,656	28,454	0	607,879
	\$ 478,855	\$ 64,201	\$ 767	\$ 38,672	\$ 28,454	\$ 0	\$ 610,949
<u>September 30, 2016</u>							
Allowance for loan losses for loans:							
	\$ 680	\$ 0	\$ 0	\$ 0	\$ 0		\$ 680

Edgar Filing: Oak Valley Bancorp - Form 10-Q

Individually evaluated for impairment							
Collectively evaluated for impairment	5,391	731	48	379	494	44	7,087
	\$ 6,071	\$ 731	\$ 48	\$ 379	\$ 494	\$ 44	\$ 7,767
Ending gross loans balances:							
Individually evaluated for impairment	\$ 2,305	\$ 309	\$ 0	\$ 0	\$ 0	\$ 0	\$ 2,614
Individually evaluated purchased credit impaired loans	33	499	0	0	0	0	532
Collectively evaluated for impairment	466,899	67,265	736	36,756	27,767	0	599,423
	\$ 469,237	\$ 68,073	\$ 736	\$ 36,756	\$ 27,767	\$ 0	\$ 602,569

Changes in the reserve for off-balance-sheet commitments were as follows:

	<b>THREE MONTHS ENDED SEPTEMBER 30,</b>		<b>NINE MONTHS ENDED SEPTEMBER 30,</b>	
	<b>2017</b>	<b>2016</b>	<b>2017</b>	<b>2016</b>
Balance, beginning of period	\$ 302	\$ 257	\$ 284	\$ 238
Provision (Recovery) to Operations for Off Balance Sheet Commitments	(4 )	6	14	(25 )
Balance, end of period	\$ 298	\$ 263	\$ 298	\$ 263

The method for calculating the reserve for off-balance-sheet loan commitments is based on a reserve percentage which is less than other outstanding loan types because they are at a lower risk level. This reserve percentage, based on many factors including historical losses and existing economic conditions, is evaluated by management periodically and is applied to the total undisbursed loan commitment balance to calculate the reserve for off-balance-sheet commitments. Reserves for off-balance-sheet commitments are recorded in interest payable and other liabilities on the condensed consolidated balance sheets.

At September 30, 2017 and December 31, 2016, loans carried at \$636,609,000 and \$610,949,000, respectively, were pledged as collateral on advances from the Federal Home Loan Bank.



Table of Contents

**NOTE 5 – OTHER REAL ESTATE OWNED**

As of September 30, 2017, the Company owned two properties classified as other real estate totaling \$253,000, as compared to three properties totaling \$1,210,000 as of December 31, 2016. One of the properties owned at September 30, 2017 and December 31, 2016, was a residential land property that was written down to a zero balance because the public utilities have not been obtainable rendering these land lots unmarketable at this time. Each of the OREO properties were acquired through loan foreclosures. During the nine months ended September 30, 2017, there was one sale of an OREO property resulting in a gain on sale of \$211,000, and there were no OREO property acquisitions. The Company acquired one property through a loan foreclosure during the three and nine months ended September 30, 2016 with a balance of \$253,000. There was one sale during the nine months ended September 30, 2016 that accounted for the disposition of two OREO properties resulting in a loss of \$88,000.

Real estate properties acquired through, or in lieu of, loan foreclosure are to be sold and are initially recorded at the lower of carrying amount of the loan or fair value of the property at the date of foreclosure less selling costs.

Subsequent to foreclosure, valuations are periodically performed and any subject revisions in the estimate of fair value are reported as adjustment to the carrying value of the real estate, provided the adjusted carrying amount does not exceed the original amount at foreclosure. Revenues and expenses from operations and changes in the valuation allowance are included in other operating expenses.

**NOTE 6– OTHER POST-RETIREMENT BENEFIT PLANS**

During January 2008, the Bank awarded certain officers a salary continuation plan (the “Plan”). Under the Plan, the participants will be provided with a fixed annual retirement benefit for ten to twenty years after retirement. The Bank is also responsible for certain pre-retirement death benefits under the Plan. In connection with the implementation of the Plan, the Bank purchased single premium life insurance policies on the life of each of the officers covered under the Plan. The Bank is the owner and partial beneficiary of these life insurance policies. The assets of the Plan, under Internal Revenue Service regulations, are owned by the Bank and are available to satisfy the Company’s general creditors.

In August 2001, the Board of Directors of the Bank authorized Director Retirement Plans (“DRP”) with each director. The Bank awarded a director retirement plan to two of its directors in January 2008, to three of its directors in March 2014, and to its newest director in 2016. Under the DRP, the participants will be provided with a fixed annual retirement benefit for ten years after retirement. The Bank is also responsible for certain pre-retirement death benefits under the DRP. In connection with the implementation of the DRP, the Bank purchased single premium life insurance policies on the life of each director covered under the DRP. The Bank is the owner and partial beneficiary of these life insurance policies. The assets of the DRP, under Internal Revenue Service regulations, are the property of the Bank

and are available to satisfy the Bank's general creditors.

Future compensation under both plans is earned for services rendered through retirement. The Bank accrues for the salary continuation liability based on anticipated years of service and vesting schedules provided under the plans. The Bank's current benefit liability is determined based on vesting and the present value of the benefits at a corresponding discount rate. The discount rate used is an equivalent rate for investment-grade bonds with lives matching those of the service periods remaining for the salary continuation contracts, which average approximately 10 years. The salary continuation liability as of September 30, 2017 and December 31, 2016 was \$2,960,000 and \$2,762,000, respectively, and is reported in interest payable and other liabilities on the condensed consolidated balance sheets.

During January 2008, the Bank purchased \$4.7 million in bank owned life insurance policies and entered into split-dollar life insurance agreements with certain officers and directors. During March 2014, the Bank purchased an additional \$1.0 million in bank owned life insurance policies and entered into split-dollar life insurance agreements with its three newest directors. During September 2016, the Bank purchased an additional \$4.0 million in bank owned life insurance policies and entered into split-dollar life insurance agreements with certain officers and directors. In connection with the implementation of the split-dollar agreements, the Bank purchased single premium life insurance policies on the life of each of the officers and directors covered by the split-dollar life insurance agreements. The Bank is the owner of the policies and the partial beneficiary in an amount equal to the cash surrender value of the policies.

The combined cash surrender value of all Bank-owned life insurance policies recorded in interest receivable and other assets on the condensed consolidated balance sheets were \$18,389,000 and \$18,004,000 at September 30, 2017 and December 31, 2016, respectively.

#### **NOTE 7 — FINANCIAL INSTRUMENTS AND FAIR VALUE MEASUREMENTS**

**Fair values of financial instruments** — The consolidated financial statements include various estimated fair value information as of September 30, 2017 and December 31, 2016. Such information, which pertains to the Company's financial instruments, does not purport to represent the aggregate net fair value of the Company. Further, the fair value estimates are based on various assumptions, methodologies, and subjective considerations, which vary widely among different financial institutions and which are subject to change.



## Table of Contents

Fair value measurements defines fair value, establishes a framework for measuring fair value, establishes a three-level valuation hierarchy for disclosure of fair value measurement and enhances disclosure requirements for fair value measurements. The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. The three levels are defined as follow:

Level 1: Inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets.

Level 2: Inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.

Level 3: Inputs to the valuation methodology are unobservable and significant to the fair value measurement.

In certain cases, the inputs used to measure fair value may fall into different levels of the fair value hierarchy. In such cases, the level in the fair value hierarchy within which the fair value measurement in its entirety falls has been determined based on the lowest level input that is significant to the fair value measurement in its entirety. The Company's assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment, and considers factors specific to the asset or liability. Transfers between levels of the fair value hierarchy are recognized on the actual date of the event or circumstance that caused the transfer, which generally corresponds with the Company's quarterly valuation process. There were no transfers between levels during the nine month periods ended September 30, 2017 or 2016.

Following is a description of valuation methodologies used for assets and liabilities in the tables below:

Cash and cash equivalents – The carrying amounts of cash and cash equivalents approximate their fair value and are considered a level 1 valuation.

Restricted Equity Securities- The carrying amounts of the stock the Company's owns in FRB and FHLB approximate their fair value and are considered a level 2 valuation.

Loans receivable — For variable-rate loans that reprice frequently and have no significant change in credit risk, fair values are based on carrying values. The fair values for other loans (e.g., real estate construction and mortgage, commercial, and installment loans) are estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. The allowance for loan losses is considered to be a reasonable estimate of loan discount due to credit risks. The Company's fair value model takes into

account many inputs including current market rates on new loans, the U.S. treasury yield curve, LIBOR yield curve, rate floors, rate ceilings, remaining maturity, and average life based on specific loan type. Loans are considered to be a level 3 valuation.

Deposit liabilities — The fair values estimated for demand deposits (interest and non-interest checking, savings, and certain types of money market accounts) are, by definition, equal to the amount payable on demand at the reporting date (i.e. their carrying amounts). The carrying amounts for variable-rate, fixed-term money market accounts and certificates of deposit approximate their fair values at the reporting date. Fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered on certificates to a schedule of the aggregate expected monthly maturities on time deposits. The fair value of deposits is determined by the Company's internal assets and liabilities modeling system that accounts for various inputs such as decay rates, rate floors, FHLB yield curve, maturities and current rates offered on new accounts. Fair value on deposits is considered a level 3 valuation.

Interest receivable and payable - The carrying amounts of accrued interest approximate their fair value and are considered to be a level 2 valuation.

Off-balance-sheet instruments — Fair values for the Bank's off-balance-sheet lending commitments are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the credit standing of the counterparties. The Company considers the Bank's off balance sheet instruments to be a level 3 valuation.

Table of Contents

The estimated fair values of the Company's financial instruments not measured at fair value at September 30, 2017 were as follows:

(in thousands)	Carrying Amount	Fair Value	Hierarchy Valuation Level
<b>Financial assets:</b>			
Cash and cash equivalents	\$139,628	\$139,628	1
Restricted equity securities	4,135	4,135	2
Loans, net	626,911	633,841	3
Interest receivable	2,730	2,730	2
<b>Financial liabilities:</b>			
Deposits	(901,716)	(802,610)	3
Interest payable	(33 )	(33 )	2
<b>Off-balance-sheet assets (liabilities):</b>			
Commitments and standby letters of credit		(1,165 )	3

The estimated fair values of the Company's financial instruments not measured at fair value at December 31, 2016 were as follows:

(in thousands)	Carrying Amount	Fair Value	Hierarchy Valuation Level
<b>Financial assets:</b>			
Cash and cash equivalents	\$190,810	\$190,810	1
Restricted equity securities	3,795	3,795	2
Loans, net	601,104	611,553	3
Interest receivable	2,831	2,831	2
<b>Financial liabilities:</b>			
Deposits	(914,093)	(811,519)	3
Interest payable	(45 )	(45 )	2
<b>Off-balance-sheet assets (liabilities):</b>			
Commitments and standby letters of credit		(1,107 )	3

Table of Contents

The following table presents the carrying value of recurring and nonrecurring financial instruments that were measured at fair value and that were still held in the condensed consolidated balance sheets at each respective period end, by level within the fair value hierarchy as of September 30, 2017 and December 31, 2016.

(in thousands)	<b>Fair Value Measurements at September 30, 2017</b>			
	<b>Using</b>	<b>Quoted Prices in Active Markets for Identical Assets (Level 1)</b>	<b>Significant Other Observable Inputs (Level 2)</b>	<b>Significant Unobservable Inputs (Level 3)</b>
Assets and liabilities measured on a recurring basis:				
Available-for-sale securities:				
U.S. agencies	\$27,209	\$ 0	\$ 27,209	\$ 0
Collateralized mortgage obligations	3,940	0	3,940	0
Municipalities	90,600	0	90,600	0
SBA pools	12,407	0	12,407	0
Corporate debt	18,732	0	18,732	0
Asset backed securities	24,853	0	24,853	0
Mutual fund	3,116	3,116	0	0
Assets and liabilities measured on a non-recurring basis:				
Impaired loans:				
Land	\$313	\$ 0	\$ 0	\$ 313
Commercial and industrial	302	0	0	302
Other real estate owned	253	0	0	253

(in thousands)	<b>Fair Value Measurements at December 31, 2016</b>			
	<b>Using</b>	<b>Quoted Prices in Active Markets for Identical Assets (Level 1)</b>	<b>Significant Other Observable Inputs (Level 2)</b>	<b>Significant Unobservable Inputs (Level 3)</b>
Assets and liabilities measured on a recurring basis:				
Available-for-sale securities				
U.S. agencies	\$28,286	\$ 0	\$ 28,286	\$ 0

Edgar Filing: Oak Valley Bancorp - Form 10-Q

Collateralized mortgage obligations	4,109	0	4,109	0
Municipalities	78,329	0	78,329	0
SBA pools	7,168	0	7,168	0
Corporate debt	20,563	0	20,563	0
Asset backed securities	18,819	0	18,819	0
Mutual fund	3,059	3,059	0	0

Assets and liabilities measured on a non-recurring basis:

Impaired loans:

Land	\$1,746	\$ 0	\$ 0	\$ 1,746
Commercial and industrial	302	0	0	302
Other real estate owned	\$1,210	\$ 0	\$ 0	\$ 1,210

## Table of Contents

Following is a description of valuation methodologies used for assets and liabilities recorded at fair value.

Available-for-sale securities - Investment securities available-for-sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted market prices, if available. If quoted market prices are not available, fair values are measured using independent pricing models or other model-based valuation techniques such as the present value of future cash flows, adjusted for the security's credit rating, prepayment assumptions, and other factors such as credit loss assumptions. Level 1 securities include those traded on an active exchange, such as the New York Stock Exchange, U.S. Treasury securities that are traded by dealers or brokers in active over-the-counter markets and money market funds. Level 2 securities include mortgage-backed securities issued by government sponsored entities, municipal bonds and corporate debt securities. Securities classified as Level 3 include asset-backed securities in less liquid markets where significant inputs are unobservable.

Impaired loans - ASC Topic 820 applies to loans measured for impairment using the practical expedients permitted by ASC Topic 310, *Accounting by Creditors for Impairment of a Loan*. The Company does not record loans at fair value on a recurring basis. However, from time to time, a loan is considered impaired and an allowance for loan losses is established. Loans for which it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan agreement are considered impaired. Impaired loans where an allowance is established based on the fair value of collateral less the cost related to liquidation of the collateral require classification in the fair value hierarchy. When the fair value of the collateral is based on an observable market price or a current appraised value, the Company records the impaired loan as non-recurring Level 3. Likewise, when an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Company records the impaired loan as non-recurring Level 3.

Other Real Estate Owned - Other real estate assets ("OREO") acquired through, or in lieu of, foreclosure are held-for-sale and are initially recorded at the lower of cost or fair value, less selling costs. Any write-downs to fair value at the time of transfer to OREO are charged to the allowance for loan losses, subsequent to foreclosure. Appraisals or evaluations are then done periodically thereafter charging any additional write-downs or valuation allowances to the appropriate expense accounts. Values are derived from appraisals of underlying collateral and discounted cash flow analysis. OREO is classified within Level 3 of the hierarchy.

Net realizable value of the underlying collateral is the fair value of the collateral less estimated selling costs and any prior liens. Appraisals, recent comparable sales, offers and listing prices are factored in when valuing the collateral. We review and verify the qualifications and licenses of the certified general appraisers used for appraising commercial properties or certified residential appraisers for residential properties. Real estate appraisals may utilize a combination of approaches including replacement cost, sales comparison and the income approach. Comparable sales and income data are analyzed by the appraisers and adjusted to reflect differences between them and the subject property such as type, leasing status and physical condition. When the appraisals are received, Management reviews the assumptions and methodology utilized in the appraisal, as well as the overall resulting value in conjunction with independent data sources such as recent market data and industry-wide statistics. We generally use a 6% discount for selling costs which is applied to all properties, regardless of size. Appraised values may be adjusted to reflect changes in market

conditions that have occurred subsequent to the appraisal date, or for revised estimates regarding the timing or cost of the property sale. These adjustments are based on qualitative judgments made by management on a case-by-case basis. No fair value adjustments were made to OREO properties during the three months ended September 30, 2017.

There have been no significant changes in the valuation techniques during the period ended September 30, 2017.

#### **NOTE 8 – EARNINGS PER SHARE**

Earnings per share (“EPS”) are based upon the weighted average number of common shares outstanding during each year. The following table shows: (1) weighted average basic shares, (2) effect of dilutive securities related to stock options and non-vested restricted stock, and (3) weighted average shares of common stock and common stock equivalents. Net income available to common stockholders is calculated as net income reduced by dividends accumulated on preferred stock, if any. Basic EPS are calculated by dividing net income available to common stockholders by the weighted average number of common shares outstanding during each period, excluding unvested restricted stock awards. Diluted EPS are calculated using the weighted average diluted shares, which reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock. The dilutive shares included in year-to-date diluted EPS is a weighted average of the dilutive shares included in each quarterly diluted EPS computation under the treasury stock method. We have two forms of outstanding common stock: common stock and unvested restricted stock awards. Holders of restricted stock awards receive non-forfeitable dividends at the same rate as common stockholders and they both share equally in undistributed earnings. Therefore, under the two class method the difference in EPS is not significant for these participating securities.

Table of Contents

The Company's calculation of basic and diluted earnings per share ("EPS") for the three and nine month periods ended September 30, 2017 and 2016 are reflected in the table below.

(In thousands)	<b>THREE MONTHS ENDED SEPTEMBER 30, 2017    2016</b>	
<b>BASIC EARNINGS PER SHARE</b>		
Net income	\$2,468	\$1,930
Weighted average shares outstanding	8,065	8,031
Net income per common share	\$0.31	\$0.24
<b>DILUTED EARNINGS PER SHARE</b>		
Net income	\$2,468	\$1,930
Weighted average shares outstanding	8,065	8,031
Effect of dilutive stock options	5	1
Effect of dilutive non-vested restricted shares	13	31
Weighted average shares of common stock and common stock equivalents	8,083	8,063
Net income per diluted common share	\$0.31	\$0.24
	<b>NINE MONTHS ENDED SEPTEMBER 30, 2017    2016</b>	
(In thousands)		
<b>BASIC EARNINGS PER SHARE</b>		
Net income	\$7,505	\$5,343
Weighted average shares outstanding	8,056	8,023
Net income per common share	\$0.93	\$0.67
<b>DILUTED EARNINGS PER SHARE</b>		
Net income	\$7,505	\$5,343
Weighted average shares outstanding	8,056	8,023
Effect of dilutive stock options	18	35
Effect of dilutive non-vested restricted shares	4	1
Weighted average shares of common stock and common stock equivalents	8,078	8,059



Edgar Filing: Oak Valley Bancorp - Form 10-Q

Net income per diluted common share	\$0.93	\$0.66
-------------------------------------	--------	--------

During the three and nine month periods ended September 30, 2017, there were no anti-dilutive options to purchase shares of common stock, as compared to anti-dilutive weighted average stock options of 12,261 and 22,446 outstanding during the three and nine month periods of 2016, respectively, with prices ranging from \$9.95 to \$15.00. These options were not included in the computation of diluted EPS because the options' exercise price was greater than the average market price of the common shares.

There were no anti-dilutive non-vested restricted stock grants for the three and nine months ended September 30, 2017 and 2016.

Table of Contents

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

The following discussion explains the significant factors affecting our operations and financial position for the periods presented. The discussion should be read in conjunction with our financial statements and the notes related thereto which appear or that are referenced to elsewhere in this report, and with the audited consolidated financial statements and accompanying notes included in our 2016 Annual Report on Form 10-K. Average balances, including balances used in calculating certain financial ratios, are generally comprised of average daily balances.

The discussion and analysis of our financial condition and results of operations is based upon our financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires management to make estimates and judgments that affect the reported amounts of assets and liabilities, revenues and expenses, and related disclosures of contingent assets and liabilities at the date of our financial statements. Actual results may differ from these estimates under different assumptions or conditions. This discussion and analysis includes executive management’s (“Management”) insight of the Company’s financial condition and results of operations of Oak Valley Bancorp and its subsidiary. Unless otherwise stated, the “Company” refers to the consolidated entity, Oak Valley Bancorp, while the “Bank” refers to Oak Valley Community Bank.

***Forward-Looking Statements***

*Some matters discussed in this Form 10-Q may be “forward-looking statements” within the meaning of the Private Securities Litigation Reform Act of 1995 and therefore may involve risks, uncertainties and other factors which may cause our actual results to be materially different from the results expressed or implied by our forward-looking statements. These statements generally appear with words such as “anticipate,” “believe,” “estimate,” “may,” “intend,” and “expect.” Although management believes that the assumptions and expectations reflected in such forward-looking statements are reasonable, it can give no assurance that such expectations will prove to be correct. Factors that could cause actual results to differ from results discussed in forward-looking statements include, but are not limited to: economic conditions (both generally and in the markets where the Company operates); competition from other providers of financial services offered by the Company; changes in government regulation and legislation; changes in interest rates; material unforeseen changes in the financial stability and liquidity of the Company’s credit customers; risks associated with concentrations in real estate related loans; changes in accounting standards and interpretations; and other risks as may be detailed from time to time in the Company’s filings with the Securities and Exchange Commission, all of which are difficult to predict and which may be beyond the control of the Company. The Company undertakes no obligation to revise forward-looking statements to reflect events or changes after the date of this discussion or to reflect the occurrence of unanticipated events.*

*Forward-looking statements speak only as of the date they are made, and the Company does not undertake to update forward-looking statements to reflect circumstances or events that occur after the date the forward-looking statements*

are made, whether as a result of new information, future developments or otherwise, except as may be required by law.

## **Critical Accounting Estimates**

*Management has determined the following five accounting policies to be critical:*

### *Allowance for Loan Losses*

Accounting for allowance for loan losses involves significant judgment and assumptions by management and is based on historical data and management's view of the current economic environment. At least on a quarterly basis, our management reviews the methodology and adequacy of allowance for loan losses and reports its assessment to the Board of Directors for its review and approval.

We base our allowance for loan losses on an estimation of probable losses inherent in our loan portfolio. Our methodology for assessing loan loss allowances are intended to reduce the differences between estimated and actual losses and involves a detailed analysis of our loan portfolio in three phases:

the specific review of individual loans,

the segmenting and review of loan pools with similar characteristics, and

our judgmental estimate based on various subjective factors.

Table of Contents

The first phase of our methodology involves the specific review of individual loans to identify and measure impairment. We evaluate each loan by use of a risk rating system, except for homogeneous loans, such as automobile loans and home mortgages. Specific risk rated loans are deemed impaired if all amounts, including principal and interest, will likely not be collected in accordance with the contractual terms of the related loan agreement. Impairment for commercial and real estate loans is measured either based on the present value of the loan's expected future cash flows or, if collection on the loan is collateral dependent, the estimated fair value of the collateral, less selling and holding costs.

The second phase involves the segmenting of the remainder of the risk rated loan portfolio into groups or pools of loans, together with loans with similar characteristics, for evaluation. We determine the calculated loss ratio to each loan pool based on its historical net losses and benchmark it against the levels of other peer banks.

In the third phase, we consider relevant internal and external factors that may affect the collectability of loan portfolio and each group of loan pool. The factors considered are, but are not limited to:

concentration of credits,

nature and volume of the loan portfolio,

delinquency trends,

non-accrual loan trend,

problem loan trend,

loss and recovery trend,

quality of loan review,

lending and management staff,

lending policies and procedures,

economic and business conditions, and

other external factors, including regulatory review.

Our management estimates the probable effect of such conditions based on our judgment, experience and known or anticipated trends. Such estimation may be reflected as an additional allowance to each group of loans, if necessary. Management reviews these conditions with our senior credit officers. To the extent that any of these conditions is evidenced by a specifically identifiable problem credit or portfolio segment as of the evaluation date, management's estimate of the effect of such condition may be reflected as a specific allowance applicable to such credit or portfolio segment. Where any of these conditions is not evidenced by a specific, identifiable problem credit or portfolio segment as of the evaluation date, management's evaluation of the inherent loss related to such condition is reflected in the unallocated allowance.

Central to our credit risk management and our assessment of appropriate loss allowance is our loan risk rating system. Under this system, the originating credit officer assigns borrowers an initial risk rating based on a thorough analysis of each borrower's financial capacity in conjunction with industry and economic trends. Approvals are made based upon the amount of inherent credit risk specific to the transaction and are reviewed for appropriateness by senior line and credit administration personnel. Credits are monitored by line and credit administration personnel for deterioration in a borrower's financial condition which may impact the ability of the borrower to perform under the contract. Although management has allocated a portion of the allowance to specific loans, specific loan pools, and off-balance sheet credit exposures (which are reported separately as part of other liabilities), the adequacy of the allowance is considered in its entirety.

#### *Non-Accrual Loan Policy*

Interest on loans is credited to income as earned and is accrued only if deemed collectible. Accrual of interest is discontinued when a loan is over 90 days delinquent or if management believes that collection is highly uncertain. Generally, payments received on non-accrual loans are recorded as principal reductions. Interest income is recognized after all principal has been repaid or an improvement in the condition of the loan has occurred that would warrant resumption of interest accruals. Loans are considered past due if the required principal and interest payments have not been received as of the date such payments were due.

Table of Contents

*Asset Impairment Judgments*

Certain of our assets are carried in our consolidated balance sheets at fair value or at the lower of cost or fair value. Valuation allowances are established when necessary to recognize impairment of such assets. We periodically perform analyses to test for impairment of various assets. In addition to our impairment analyses related to loans, another significant impairment analysis relates to other than temporary declines in the value of our securities.

Loans for which it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan agreement are considered impaired and are carried at fair value or below. Appraisals are done periodically on impaired loans and if required an allowance is established based on the fair value of collateral less the cost related to liquidation of the collateral. In some circumstances, an impaired loan may be charged off to bring the carrying value to fair value.

Other real estate assets (“OREO”) acquired through, or in lieu of, foreclosure are held-for-sale and are initially recorded at the lower of cost or fair value, less selling costs. Any write-downs to fair value at the time of transfer to OREO are charged to the allowance for loan losses, subsequent to foreclosure. Appraisals or evaluations are then done periodically and any subsequent declines in the fair value of the OREO property after the date of transfer are recorded through a write-down of the asset. Any subsequent operating expenses or income, reduction in estimated fair values, and gains or losses on disposition of such properties are charged or credited to current operations.

Net realizable value of the underlying collateral is the fair value of the collateral less estimated selling costs and any prior liens. Appraisals, recent comparable sales, offers and listing prices are factored in when valuing the collateral. We review and verify the qualifications and licenses of the certified general appraisers used for appraising commercial properties or certified residential appraisers for residential properties. Real estate appraisals may utilize a combination of approaches including replacement cost, sales comparison and the income approach. Comparable sales and income data are analyzed by the appraisers and adjusted to reflect differences between them and the subject property such as type, leasing status and physical condition. When the appraisals are received, Management reviews the assumptions and methodology utilized in the appraisal, as well as the overall resulting value in conjunction with independent data sources such as recent market data and industry-wide statistics. We generally use a 6% discount for selling costs which is applied to all properties, regardless of size. Appraised values may be adjusted to reflect changes in market conditions that have occurred subsequent to the appraisal date, or for revised estimates regarding the timing or cost of the property sale. These adjustments are based on qualitative judgments made by management on a case-by-case basis.

Our available for sale portfolio is carried at estimated fair value, with any unrealized gains and losses, net of taxes, reported as accumulated other comprehensive income in shareholders’ equity. We conduct a periodic review and evaluation of the securities portfolio to determine if the value of any security has declined below its carrying value and whether such decline is other than temporary. If such decline is deemed other than temporary, we would adjust the

carrying amount of the security by writing down the security to fair market value through a charge to current period income. The market values of our securities are significantly affected by changes in interest rates.

In general, as interest rates rise, the market value of fixed-rate securities will decrease; as interest rates fall, the market value of fixed-rate securities will increase. With significant changes in interest rates, we evaluate our intent and ability to hold the security for a sufficient time to recover the recorded principal balance. Estimated fair values for securities are based on published or securities dealers' market values. Market volatility is unpredictable and may impact such values.

#### *Fair Value Measurements*

We use fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. We base our fair values on the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Securities available for sale, derivatives, and loans held for sale, if any, are recorded at fair value on a recurring basis. Additionally, from time to time, we may be required to record certain assets at fair value on a non-recurring basis, such as certain impaired loans held for investment and securities held to maturity that are other-than-temporarily impaired. These non-recurring fair value adjustments typically involve write-downs of individual assets due to application of lower-of-cost or market accounting.

We have established and documented a process for determining fair value. We maximize the use of observable inputs and minimize the use of unobservable inputs when developing fair value measurements. Whenever there is no readily available market data, management uses its best estimate and assumptions in determining fair value, but these estimates involve inherent uncertainties and the application of management's judgment. As a result, if other assumptions had been used, our recorded earnings or disclosures could have been materially different from those reflected in these financial statements.

Table of Contents

*Income Taxes*

Deferred income taxes are provided for the temporary differences between the financial reporting basis and the tax basis of the Company's assets and liabilities. Deferred tax assets and liabilities are reflected at currently enacted income tax rates applicable to the period in which the deferred tax assets or liabilities are expected to be realized or settled using the liability method. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes.

The Company files income tax returns in the U.S. federal jurisdiction, and the state of California. With few exceptions, the Company is no longer subject to U.S. federal or state/local income tax examinations by tax authorities for years before 2012.

**Introduction**

Effective July 3, 2008, Oak Valley Community Bank became a subsidiary of Oak Valley Bancorp, a newly established bank holding company. Oak Valley Bancorp operates Oak Valley Community Bank as a community bank in the general commercial banking business, with our primary market encompassing the California Central Valley around Oakdale and Modesto, and the Eastern Sierras. As such, unless otherwise noted, all references are about Oak Valley Bancorp.

Oak Valley Community Bank commenced operations in May 1991. We are an insured bank under the Federal Deposit Insurance Act and are a member of the Federal Reserve. Since its formation, the Bank has provided basic banking services to individuals and business enterprises in Oakdale, California and the surrounding areas. The focus of the Bank is to offer a range of commercial banking services designed for both individuals and small to medium-sized businesses in the two main areas of service of the Company: the Central Valley and the Eastern Sierras.

The Bank offers a complement of business checking and savings accounts for its business customers. The Bank also offers commercial and real estate loans, as well as lines of credit. Real estate loans are generally of a short-term nature for both residential and commercial purposes. Longer-term real estate loans are generally made with adjustable interest rates and contain normal provisions for acceleration. In addition, the Bank offers traditional residential mortgages through a third party.



The Bank also offers other services for both individuals and businesses including online banking, remote deposit capture, merchant services, night depository, extended hours, traveler's checks, wire transfer of funds, note collection, and automated teller machines in a national network. The Bank does not currently offer international banking or trust services although the Bank may make such services available to the Bank's customers through financial institutions with which the Bank has correspondent banking relationships. The Bank does not offer stock transfer services nor does it directly issue credit cards.

## **Overview of Results of Operations and Financial Condition**

The purpose of this summary is to provide an overview of the items management focuses on when evaluating the condition of the Company and its success in implementing its business and shareholder value strategies. The Company's business strategy is to operate the Bank as a well-capitalized, profitable and independent community-oriented bank. The Company's shareholder value strategy has three major objectives: (1) enhancing shareholder value; (2) making its retail banking franchise more valuable; and (3) efficiently utilizing its capital.

Management believes the following were important factors in the Company's performance during the three and nine month periods ended September 30, 2017:

The Company recognized net income of \$2,468,000 and \$7,505,000 for the three and nine month periods ended September 30, 2017, respectively, as compared to \$1,930,000 and \$5,343,000 for the same periods in 2016. The factors contributing to these results will be discussed below.

The Company recognized loan loss provisions of \$70,000 and \$105,000 for the three and nine month periods ended September 30, 2017, respectively, as compared to \$90,000 and \$415,000 during the same periods of 2016. This variance corresponds to a lower volume of gross loan growth during the first nine months of 2017 as compared to 2016, and an improvement in credit quality during 2017.

Net interest income increased \$791,000 or 10.1% and \$1,680,000 or 7.2% for the three and nine month periods ended September 30, 2017, respectively, compared to the same periods in 2016. The increase was primarily due to the growth of our loan and investment security portfolios.

Non-interest income increased by \$199,000 or 18.5% and \$1,612,000 or 50.9% for the three and nine months ended September 30, 2017, respectively, as compared to the same periods in 2016, primarily due to professional service provider settlement payments and an increase in gains on called securities.

Non-interest expense increased by \$136,000 or 2.3% and \$44,000 or 0.2% for the three and nine month periods ended September 30, 2017, respectively, as compared to the same periods in 2016. The increase was partially due to staffing increases necessary for providing service on our growing loan and deposit portfolios.

Total assets decreased \$5,389,000 or 0.5% from December 31, 2016. Total net loans increased by \$25,807,000 or 4.3% and investment securities increased by \$20,524,000 or 12.8% from December 31, 2016 to September 30, 2017, while deposits decreased by \$12,377,000 or 1.4% for the same period. Consequently, liquid assets declined due to the decline in deposits and the funding of new loans and investment purchases, which was offset by the growth in equity due to earnings and securities valuation.

Table of Contents**Income Summary**

For the three and nine month periods ended September 30, 2017, the Company recorded net income of \$2,468,000 and \$7,505,000, respectively, representing increases of \$538,000 and \$2,162,000, as compared to \$1,930,000 and \$5,343,000 recorded during the same periods in 2016. Return on average assets (annualized) was 0.98% and 1.01% for the three and nine months ended September 30, 2017, respectively, as compared to 0.82% and 0.78% for the same periods in 2016. Annualized return on average common equity was 11.04% and 11.64% for the three and nine months ended September 30, 2017, respectively, as compared to 9.28% and 8.83% for the same periods of 2016.

Net income before provisions for income taxes increased \$874,000 and \$3,558,000 for the three and nine month periods ended September 30, 2017, respectively, from the comparable 2016 periods. The income statement components of these variances are as follows:

***Pre-Tax Income Variance Summary:***

	<b>Effect on Pre-Tax Income</b>	<b>Effect on Pre-Tax Income</b>
<i>(In thousands)</i>	<b><i>Increase (Decrease)</i></b>	<b><i>Increase (Decrease)</i></b>
	<b>Three Months Ended September 30, 2017</b>	<b>Nine months ended September 30, 2017</b>
Change from 2016 to 2017 in:		
Net interest income	\$ 791	\$ 1,680
Provision for loan losses	20	310
Non-interest income	199	1,612
Non-interest expense	(136 )	(44 )
Change in net income before income taxes	\$ 874	\$ 3,558

These variances will be explained in the discussion below.

## **Net Interest Income**

Net interest income is the largest source of the Company's operating income. For the three and nine month periods ended September 30, 2017, net interest income was \$8,620,000 and \$25,157,000, respectively, which represented increases of \$791,000 or 10.1% and \$1,680,000 or 7.2%, from the comparable periods in 2016. The increase is primarily due to loan and investment portfolio growth.

The net interest margin (net interest income as a percentage of average interest earning assets) was 3.78% and 3.74% for the three and nine month periods ended September 30, 2017, respectively, compared to 3.73% and 3.84% for the same periods in 2016. The year to date decrease is mainly due to a decrease in loan discount amortization on acquired loans. In general, the Company has experienced net interest margin compression since the economic downturn in 2010 for several reasons: 1) deposit interest rates have essentially reached a threshold in which they cannot reasonably be further reduced, 2) competition in the lending market has driven new loan rates down, 3) loan and investment portfolio yields continue to decrease due to contractual repricing and 4) deposit growth in recent years has resulted in high interest-bearing cash balances, which yield approximately 1.25%, has compressed our net interest margin. The quarter over quarter increase in net interest margin is primarily due to an increase in the average loan balance and yield on earning assets.

Earning asset yield increased by 7 basis points for the three month period ended September 30, 2017, but decreased by 8 basis points for the nine month period ended September 30, 2017, as compared to the same periods of 2016. The quarter over quarter increase is mainly due to an increase in loan volume, loan yield, and the yield on cash balances that have been recognized due to the recent FOMC rate hikes. Additionally, the earning asset yield is trending upward as a result of deploying low yielding cash equivalent balances into the loan and investment portfolios which recognized average balance increases of \$47 million and \$26 million, respectively, in the nine month period of 2017 as compared to 2016. The year to date earning asset decrease is mainly due to a decrease in loan discount accretion on loans acquired in the Mother Lode Bank acquisition.

Table of Contents

The cost of funds on interest-bearing liabilities increased by 5 basis points and 4 basis points for the three and nine month periods of 2017, respectively, as compared to the same periods in 2016, as deposit rates remain low and the banking industry has not reacted to the recent FOMC interest rate hikes thus far. The Company continues to recognize strong core deposit growth as evidenced by the increase in average non-interest-bearing demand deposit balances of \$48 million, for the nine month period ended September 30, 2017, as compared to the same period of 2016.

The following tables shows the relative impact of changes in average balances of interest earning assets and interest bearing liabilities, and interest rates earned and paid by the Company on those assets and liabilities for the three and nine month periods ended September 30, 2017 and 2016:

**Net Interest Analysis**

	Three Months Ended September 30, 2017			Three Months Ended September 30, 2016		
	Average Balance	Interest Income / Expense	Avg Rate/ Yield (5)	Average Balance	Interest Income / Expense	Avg Rate/ Yield (5)
<i>(in thousands)</i>						
<b>Assets:</b>						
Earning assets:						
Gross loans (1) (2)	\$627,372	\$ 7,339	4.64 %	\$586,070	\$ 6,811	4.61 %
Investment securities (2)	174,041	1,413	3.22 %	147,728	1,300	3.49 %
Federal funds sold	9,041	28	1.23 %	3,421	4	0.46 %
Interest-earning deposits	127,915	429	1.33 %	122,052	169	0.55 %
Total interest-earning assets	938,369	9,209	3.89 %	859,271	8,284	3.82 %
Total noninterest earning assets	60,522			72,760		
Total Assets	998,891			932,031		
<b>Liabilities and Shareholders' Equity:</b>						
Interest-bearing liabilities:						
Interest-earning DDA	202,094	73	0.14 %	178,291	44	0.10 %
Money market deposits	289,893	151	0.21 %	284,917	76	0.11 %
Savings deposits	66,673	8	0.05 %	74,994	31	0.16 %
Time certificates of deposit \$250,000 or more	18,822	17	0.36 %	22,118	18	0.32 %
Other time deposits	32,288	25	0.31 %	33,029	27	0.32 %
Other borrowings	0	0	0.00 %	13	0	0.00 %
Total interest-bearing liabilities	609,770	274	0.18 %	593,362	196	0.13 %
Noninterest-bearing liabilities:						
Noninterest-bearing deposits	294,854			251,759		
Other liabilities	5,591			4,433		
Total noninterest-bearing liabilities	300,445			256,192		

Edgar Filing: Oak Valley Bancorp - Form 10-Q

Shareholders' equity	88,676	82,477	
Total liabilities and shareholders' equity	\$998,891	\$932,031	
Net interest income	\$ 8,935	\$ 8,088	
Net interest spread (3)		3.72 %	3.69 %
Net interest margin (4)		3.78 %	3.73 %

(1) *Loan fees have been included in the calculation of interest income.*

(2) *Yields and interest income on municipal securities and loans have been adjusted to their fully-taxable equivalents, based on a federal marginal tax rate of 34.0%.*

(3) *Represents the average rate earned on interest-earning assets less the average rate paid on interest-bearing liabilities.*

(4) *Represents net interest income as a percentage of average interest-earning assets.*

(5) *Annual interest rates are computed by dividing the interest income/expense by the number of days in the period multiplied by 365.*

Table of Contents

<i>(in thousands)</i>	Nine months ended			Nine months ended		
	September 30, 2017			September 30, 2016		
	Average	Interest	Avg	Average	Interest	Avg
	Balance	Income	Rate/ Yield	Balance	Income	Rate/ Yield
	Expense	(5)		Expense	(5)	
<b>Assets:</b>						
Earning assets:						
Gross loans (1) (2)	\$617,408	\$21,512	4.66 %	\$570,861	\$20,495	4.78 %
Investment securities (2)	168,912	4,117	3.26 %	142,776	3,800	3.55 %
Federal funds sold	8,333	65	1.04 %	5,134	19	0.49 %
Interest-earning deposits	137,004	1,100	1.07 %	122,194	492	0.54 %
Total interest-earning assets	931,657	26,794	3.85 %	840,965	24,806	3.93 %
Total noninterest earning assets	62,731			71,398		
Total assets	994,388			912,363		
<b>Liabilities and Shareholders' Equity:</b>						
Interest-bearing liabilities:						
Interest-earning DDA	196,199	202	0.14 %	167,597	108	0.09 %
Money market deposits	290,133	398	0.18 %	288,026	236	0.11 %
Savings deposits	69,290	43	0.08 %	73,799	5	0.15 %
Time certificates of deposit \$250,000 or more	20,596	57	0.37 %	22,077	44	0.27 %
Other time deposits	32,221	73	0.30 %	30,107	82	0.36 %
Other borrowings	0	0	0.00 %	17	0	0.00 %
Total interest-bearing liabilities	608,439	773	0.17 %	581,623	555	0.13 %
Noninterest-bearing liabilities:						
Noninterest-bearing deposits	294,193			245,903		
Other liabilities	5,564			4,205		
Total noninterest-bearing liabilities	299,757			250,108		
Shareholders' equity	86,192			80,632		
Total liabilities and shareholders' equity	\$994,388			\$912,363		
Net interest income		\$26,021			\$24,251	
Net interest spread (3)			3.68 %			3.80 %
Net interest margin (4)			3.73 %			3.84 %

(1) Loan fees have been included in the calculation of interest income.

(2) Yields and interest income on municipal securities and loans have been adjusted to their fully-taxable equivalents, based on a federal marginal tax rate of 34.0%.

(3) Represents the average rate earned on interest-earning assets less the average rate paid on interest-bearing liabilities.

*(4) Represents net interest income as a percentage of average interest-earning assets.*

*(5) Annual interest rates are computed by dividing the interest income/expense by the number of days in the period multiplied by 365.*



Table of Contents

Shown in the following tables are the relative impacts on net interest income of changes in the average outstanding balances (volume) of earning assets and interest bearing liabilities and the rates earned and paid by the Company on those assets and liabilities for the three and nine month periods ended September 30, 2017 and 2016. Changes in interest income and expense that are not attributable specifically to either rate or volume are allocated to the rate column below.

**Rate / Volume Variance Analysis***(In thousands)*

(in thousands)	<b>For the Three Months Ended September 30, 2017 vs 2016</b>		
	<b>Increase (Decrease) in interest income and expense due to changes in:</b>		
	<b>Volume</b>	<b>Rate</b>	<b>Total</b>
<b>Interest income:</b>			
Gross loans (1) (2)	\$480	\$48	\$528
Investment securities (2)	232	(119)	113
Federal funds sold	7	17	24
Interest-earning deposits	8	252	260
<b>Total interest income</b>	<b>\$727</b>	<b>\$198</b>	<b>\$925</b>
<b>Interest expense:</b>			
Interest-earning DDA	6	23	29
Money market deposits	1	74	75
Savings deposits	(3 )	(20 )	(23 )
Time CD \$250K or more	(3 )	2	(1 )
Other time deposits	(1 )	(1 )	(2 )
Other borrowings	0	0	0
<b>Total interest expense</b>	<b>\$0</b>	<b>\$78</b>	<b>\$78</b>
<b>Change in net interest income</b>	<b>\$727</b>	<b>\$120</b>	<b>\$847</b>

(1) Loan fees have been included in the calculation of interest income.

(2) Interest income on municipal securities and loans has been adjusted to their fully-taxable equivalents, based on a federal marginal tax rate of 34.0%.

The table above reflects an increase of \$120,000 in net interest income due to rate changes for the third quarter of 2017 as compared to the same period of 2016. This increase is the result of the positive impact of recent FOMC rate hikes on interest-earning cash balance accounts, but was partially offset by the current flat yield curve's negative impact on investment security yields. The increase in earning asset balances combined with the overall change in mix of balances resulted in an increase of \$727,000 to net interest income over the same period.

Table of Contents

(in thousands)	<b>For the Nine Months Ended September 30, 2017 vs 2016</b>		
	<b>Increase (Decrease) in interest income and expense due to changes in:</b>		
	<b>Volume</b>	<b>Rate</b>	<b>Total</b>
<b>Interest income:</b>			
Gross loans (1) (2)	\$1,671	\$(654)	\$1,017
Investment securities (2)	696	(379)	317
Federal funds sold	12	34	46
Interest-earning deposits	61	547	608
<b>Total interest income</b>	<b>\$2,440</b>	<b>\$(452)</b>	<b>\$1,988</b>
<b>Interest expense:</b>			
Interest-earning DDA	\$18	\$76	\$94
Money market deposits	2	160	162
Savings deposits	(5 )	(37 )	(42 )
Time CD \$250K or more	(3 )	16	13
Other time deposits	6	(15 )	(9 )
Other borrowings	0	0	0
<b>Total interest expense</b>	<b>\$18</b>	<b>\$200</b>	<b>\$218</b>
<b>Change in net interest income</b>	<b>\$2,422</b>	<b>\$(652)</b>	<b>\$1,770</b>

(1) Loan fees have been included in the calculation of interest income.

(2) Interest income on municipal securities and loans has been adjusted to their fully-taxable equivalents, based on a federal marginal tax rate of 34.0%.

The table above reflects a decrease of \$652,000 in net interest income due to rate changes for the nine month period of 2017 as compared to the same period of 2016. This decrease is primarily the result of a \$542,000 decline in loan discount accretion on loans acquired at fair value, and is compounded by the adverse impact the current low interest rate environment has had on security yields, but was partially offset by the recent interest rate hike's positive impact on interest-earning deposits. The increase in earning asset balances combined with the overall change in mix of balances resulted in an increase of \$2,422,000 to net interest income over the same period.

**Non-Interest Income**

Non-interest income represents service charges on deposit accounts and other non-interest related charges and fees, including fees from mortgage commissions and investment service fee income. For the three and nine month periods ended September 30, 2017, non-interest income was \$2,036,000 and \$3,507,000, respectively, representing increases of \$980,000 or 92.8% and \$1,414,000 or 67.6%, compared to the same periods in 2016.

The following tables show the major components of non-interest income:

(in thousands)	For the Three Months Ended September 30,				
	2017	2016	\$ change	% change	
Service charges on deposits	\$365	\$341	\$ 24	7.0	%
Earnings on cash surrender value of life insurance	130	102	28	27.5	%
Mortgage commissions	28	49	(21 )	(42.9%)	
Gains on calls and sales of securities	4	10	(6 )	(60.0%)	
Other income	749	575	174	30.3	%
Total non-interest income	\$1,276	\$1,077	\$ 199	18.5	%

Table of Contents

(in thousands)	For the Nine Months Ended September 30,			
	2017	2016	\$ change	% change
Service charges on deposits	\$1,051	\$1,011	\$40	4.0 %
Earnings on cash surrender value of life insurance	386	305	81	26.6 %
Mortgage commissions	127	144	(17 )	(11.8%)
Net gain on sales and calls of securities	394	28	366	1307.1 %
Other income	2,824	1,682	1,142	67.9 %
Total non-interest income	\$4,782	\$3,170	\$1,612	50.9 %

Service charges on deposits increased by \$24,000 and \$40,000 for the three and nine months ended September 30, 2017, respectively, compared to the same periods in 2016, due to an increase in the number of deposit accounts.

Earnings on cash surrender value of life insurance increased by \$28,000 and \$81,000 for the three and nine months ended September 30, 2017, respectively, compared to the same periods in 2016, due to the five most recently issued policies that began accruing earnings during the fourth quarter of 2016.

Mortgage commissions decreased by \$21,000 and \$17,000 for the three and nine months ended September 30, 2017, respectively, as compared to the same periods of 2016, as the demand for home purchases and refinancing has retracted.

Net gain on sales and calls of securities decreased by \$6,000 for the three months ended September 30, 2017, and increased by \$366,000 for the nine months ended September 30, 2017, as compared to the same periods in 2016, due to two large gains on called securities recorded during the first quarter of 2017.

Other income increased by \$174,000 and \$1,142,000 for the three and nine month periods ended September 30, 2017, respectively, as compared to the same periods of 2016. The quarter-over-quarter increase is due to a gain of \$211,000 recorded on the sale of an OREO property during the third quarter of 2017. The year-to-date increase was due to settlement payments, recorded during the second quarter of 2017, totaling \$938,000 from professional service providers related to the acquisition of Mother Lode Bank.

**Non-Interest Expense**

Non-interest expense represents salaries and benefits, occupancy expenses, professional expenses, outside services, and other miscellaneous expenses necessary to conduct business.

The following tables show the major components of non-interest expenses:

(in thousands)	<b>For the Three Months Ended September 30,</b>				
	<b>2017</b>	<b>2016</b>	<b>\$ change</b>	<b>% change</b>	
Salaries and employee benefits	\$3,534	\$3,225	\$ 309	9.6	%
Occupancy	823	819	4	0.5	%
Data processing fees	399	435	(36 )	(8.3%)	
Regulatory assessments (FDIC & DBO)	102	178	(76 )	(42.7%)	
Other	1,202	1,267	(65 )	(5.1%)	
Total non-interest expense	\$6,060	\$5,924	\$ 136	2.3	%

(in thousands)	<b>For the Nine Months Ended September 30,</b>				
	<b>2017</b>	<b>2016</b>	<b>\$ change</b>	<b>% change</b>	
Salaries and employee benefits	\$10,603	\$9,950	\$ 653	6.6	%
Occupancy	2,496	2,470	26	1.1	%
Data processing fees	1,154	1,346	(192 )	(14.3%)	
Regulatory assessments (FDIC & DBO)	381	505	(124 )	(24.6%)	
Other	3,708	4,027	(319 )	(7.9%)	
Total non-interest expense	\$18,342	\$18,298	\$ 44	0.2	%

Table of Contents

Non-interest expenses increased by \$136,000 or 2.3% and \$44,000 or 0.2% for the three and nine months ended September 30, 2017, respectively, as compared to the same periods of 2016. Salaries and employee benefits increased \$309,000 and \$653,000 for the three and nine months ended September 30, 2017, respectively, as compared to the same periods of 2016, primarily due to additional staffing required to support the continued loan and deposit growth.

Occupancy expenses increased by \$4,000 and \$26,000 for the three and nine months ended September 30, 2017, respectively, as compared to the same periods of 2016, which is primarily due to rent and general overhead associated with the branches. Data processing fees decreased by \$36,000 and \$192,000 for the three and nine month periods ended September 30, 2017, respectively, as a result of cost efficiencies gained from the conversion of the Mother Lode Bank core data system completed in April 2016.

FDIC and DBO (California Department of Business Oversight) regulatory assessments decreased by \$76,000 and \$124,000 for the three and nine months ended September 30, 2017, respectively, as compared to the same periods in 2016. The initial base assessment rate for financial institutions varies based on the overall risk profile of the institution as defined by the FDIC and our risk profile has remained stable during 2016 and 2017. In April of 2016 the FDIC changed the methodology for determining the assessment rate, which first appeared on the December 31, 2016 invoice. The result was a reduction in our assessment rate and resulting calculated expense, as the FDIC assessment rates are applied to average quarterly total liabilities as the primary basis.

Other expense decreased by \$65,000 and \$319,000 for the three and nine months ended September 30, 2017, respectively, compared to the same periods in 2016, partially as a result of a \$204,000 decrease in merger related expenses on a year-to-date basis. Additionally, the Company recorded an \$85,000 legal settlement payment received related to an OREO that was recorded as an offset to OREO expenses during the second quarter of 2017.

Management anticipates that non-interest expense will continue to increase as we continue to grow. However, management remains committed to cost-control and efficiency, and we expect to keep these increases to a minimum relative to growth.

**Income Taxes**

We reported provisions for income taxes of \$1,298,000 and \$3,987,000 for the three and nine month periods ended September 30, 2017, respectively, representing increases of \$336,000 and \$1,396,000 as compared to the provisions reported in the comparable periods of 2016. The effective income tax rates on income from continuing operations was 34.5% and 34.7% for the three and nine months ended September 30, 2017, respectively, compared to 33.3% and

32.7% for the comparable periods of 2016. These provisions reflect accruals for taxes at the applicable rates for federal income tax and California franchise tax based upon reported pre-tax income, and adjusted for the effects of all permanent differences between income for tax and financial reporting purposes (such as earnings on qualified municipal securities, BOLI and certain tax-exempt loans). The disparity between the effective tax rates for 2017 as compared to 2016 is primarily due to tax credits from California Enterprise Zones and low income housing projects as well as tax free-income on municipal securities and loans that comprise a larger proportion of pre-tax income in 2016 as compared to 2017.

## Asset Quality

Non-performing assets consist of loans on non-accrual status, including loans restructured on non-accrual status, where the terms of repayment have been renegotiated resulting in a reduction or deferral of interest or principal, loans 90 days or more past due and still accruing interest and other real estate owned (“OREO”).

Loans are generally placed on non-accrual status when they become 90 days past due, unless management believes the loan is adequately collateralized and in the process of collection. The past due loans may or may not be adequately collateralized, but collection efforts are continuously pursued. Loans may be restructured by management when a borrower has experienced some changes in financial status, causing an inability to meet the original repayment terms, and where we believe the borrower will eventually overcome those circumstances and repay the loan in full. OREO consists of properties acquired by foreclosure or similar means and which management intends to offer for sale.

Non-accrual loans totaled \$1,311,000 at September 30, 2017, as compared to \$3,037,000 at December 31, 2016. The non-accrual loans as of September 30, 2017 are loans made to three borrowers primarily for residential real estate development and general commercial purposes. As of September 30, 2017, we had five loans considered troubled debt restructurings totaling \$1,311,000 million, all of which are included in non-accrual loans.

OREO as of September 30, 2017 consisted of two properties, one of which was a residential land acquired through foreclosure that was written down to a zero balance because the public utilities have not been obtainable rendering these land lots unmarketable at this time. The other OREO asset was a residential property with a carrying value of \$253,000 that was acquired through foreclosure.



Table of Contents

The following table presents information about the Bank's non-performing assets, including asset quality ratios as of September 30, 2017 and December 31, 2016:

***Non-Performing Assets***

<i>(in thousands)</i>	<b>September 30, 2017</b>		<b>December 31, 2016</b>	
Loans in non-accrual status	\$ 1,311		\$ 3,037	
Loans past due 90 days or more and accruing	0		0	
Total non-performing loans	1,311		3,037	
Other real estate owned	253		1,210	
Total non-performing assets	\$ 1,564		\$ 4,247	
Allowance for loan losses	\$ 7,917		\$ 7,832	
Asset quality ratios:				
Non-performing assets to total assets	0.16	%	0.42	%
Non-performing loans to total loans	0.21	%	0.50	%
Allowance for loan losses to total loans	1.24	%	1.28	%
Allowance for loan losses to total non-performing loans	603.9	%	257.9	%

Non-performing assets decreased by \$1,005,000 as of September 30, 2017, as compared to December 31, 2016, as a result of principal payments of \$854,000 and one loan totaling \$289,000 that was returned to accrual status, which was offset by a loan totaling \$138,000 that was placed on non-accrual status during the first six months of 2017. The Company did not acquire or sell any OREO properties during the first nine months of 2017, and there were no fair value adjustments to OREO properties during the first nine months of 2017.

***Allowance for Loan and Lease Losses (“ALLL”)***

Due to credit risk inherent in our lending business, we routinely set aside allowances through charges to earnings. Such charges are not only made for the outstanding loan portfolio, but also for off-balance sheet items, such as commitments to extend credits or letters of credit. Charges made for the outstanding loan portfolio have been credited to the allowance for loan losses, whereas charges for off-balance sheet items have been credited to the reserve for off-balance sheet items, which is presented as a component of other liabilities. The Company recorded loan loss

provisions of \$70,000 and \$105,000 during the three and nine months ended September 30, 2017, respectively, compared to provisions of \$90,000 and \$415,000 during the comparable periods of 2016.

The allowance for loan losses increased by \$85,000 or 1.1%, to \$7,917,000 at September 30, 2017, as compared to \$7,832,000 at December 31, 2016, due to the \$105,000 loan loss provision which was offset by net loan charge-off of \$20,000 recorded during the nine month period of 2017. Improved credit quality combined with loan growth resulted in a decrease to the allowance for loan losses as a percentage of total loans to 1.24% at September 30, 2017 as compared to 1.28% at December 31, 2016.

The Company will continue to monitor the adequacy of the allowance for loan losses and make additions to the allowance in accordance with the analysis referred to above. Because of uncertainties inherent in estimating the appropriate level of the allowance for loan losses, actual results may differ from management's estimate of credit losses and the related allowance.

The Company makes provisions for loan losses when required to bring the total allowance for loan and lease losses to a level deemed appropriate for the level of risk in the loan portfolio. At least quarterly, management conducts an assessment of the overall quality of the loan portfolio and general economic trends in the local market. The determination of the appropriate level for the allowance is based on that review, considering such factors as historical experience, the volume and type of lending conducted, the amount of and identified potential loss associated with specific non-performing loans, regulatory policies, general economic conditions, and other factors related to the collectability of loans in the portfolio.

Although management believes the allowance at September 30, 2017 was adequate to absorb probable losses from any known and inherent risks in the portfolio, no assurance can be given that the adverse effect of current and future economic conditions on our service areas, or other variables, will not result in increased losses in the loan portfolio in the future.

Table of Contents

**Investment Activities**

Investments are a key source of interest income. Management of our investment portfolio is set in accordance with strategies developed and overseen by our Investment Committee. Investment balances, including cash equivalents and interest-bearing deposits in other financial institutions, are subject to change over time based on our asset/liability funding needs and interest rate risk management objectives. Our liquidity levels take into consideration anticipated future cash flows and all available sources of credits, and are maintained at levels management believes are appropriate to assure future flexibility in meeting anticipated funding needs.

*Cash Equivalents*

The Company holds federal funds sold, unpledged available-for-sale securities and salable government guaranteed loans to help meet liquidity requirements and provide temporary holdings until the funds can be otherwise deployed or invested. As of September 30, 2017, and December 31, 2016, we had \$139,628,000 and \$190,810,000, respectively, in cash and cash equivalents.

*Investment Securities*

Management of our investment securities portfolio focuses on providing an adequate level of liquidity and establishing an interest rate-sensitive position, while earning an adequate level of investment income without taking undue risk. Investment securities that we intend to hold until maturity are classified as held-to-maturity securities, and all other investment securities are classified as available-for-sale. Currently, all of our investment securities are classified as available-for-sale. The carrying values of available-for-sale investment securities are adjusted for unrealized gains or losses as a valuation allowance and any gain or loss is reported on an after-tax basis as a component of other comprehensive income.

Management has evaluated the investment securities portfolio to determine if the impairment of any security in an unrealized loss position is temporary or other than temporary. We conduct a periodic review and evaluation of the securities portfolio to determine if the value of any security has declined below its carrying value. If such decline is deemed other than temporary, we would adjust the carrying amount of the security by writing down the security to fair value through a charge to current period income or a charge to accumulated other comprehensive income depending on the nature of the impairment and managements intent or requirement to sell the security. Management has determined that no investment security is other than temporarily impaired. The unrealized losses are due primarily to interest rate changes.

## Goodwill

Goodwill arises when the Company's purchase price exceeds the fair value of the net assets of an acquired business. Goodwill represents the value attributable to intangible elements acquired. The value of goodwill is supported ultimately by profit from the acquired business. A decline in earnings could lead to impairment, which would be recorded as a write-down in the Company's consolidated statements of earnings. Events that may indicate goodwill impairment include significant or adverse changes in results of operations of the acquired business or asset, economic or political climate; an adverse action or assessment by a regulator; unanticipated competition; and a more-likely-than-not expectation that a reporting unit will be sold or disposed of at a loss. While goodwill is not amortized, the Company does conduct periodic impairment analysis on goodwill at least annually or more often as conditions require.

At September 30, 2017, the Company had goodwill in the amount of \$3,312,000 in connection with the acquisition of Mother Lode Bank in December of 2015.

## Deposits

Total deposits at September 30, 2017 were \$901,716,000, a \$12,377,000 or 1.4% decrease from the deposit total of \$914,093,000 at December 31, 2016. Average deposits increased \$75,123,000 to \$902,632,000 for the nine month period ended September 30, 2017 as compared to the same period in 2016. We believe we attracted deposits due to the safety and soundness of the Bank and our focus on customer service.

### *Deposits Outstanding*

	<b>September 30, 2017</b>	<b>December 31, 2016</b>	<b>Nine Month Change</b>	
<i>(in thousands)</i>			<b>\$</b>	<b>%</b>
Demand	\$ 495,454	\$ 500,930	\$(5,476 )	(1.1% )
MMDA	288,217	283,643	4,574	1.6 %
Savings	67,643	75,122	(7,479 )	(10.0%)
Time < \$250K	31,854	33,428	(1,574 )	(4.7% )
Time > \$250K	18,548	20,970	(2,422 )	(11.6%)
	<b>\$ 901,716</b>	<b>\$ 914,093</b>	<b>\$(12,377)</b>	<b>(1.4% )</b>



## Table of Contents

Because our client base is comprised primarily of commercial and industrial accounts, individual account balances are generally higher than those of consumer-oriented banks. Five of our clients carry deposit balances of more than 1% of our total deposits, one of which had a deposit balance of more than 3% of total deposits at September 30, 2017. We believe that our funding concentration risk is not significant, and is mitigated by the ample sources of funds the Bank has access to.

Since our deposit growth strategy emphasizes core deposit growth we have avoided relying on brokered deposits as a consistent source of funds. The Company had \$50,000 in brokered deposits as of September 30, 2017 and December 31, 2016. The only brokered deposits the Bank holds are from CDARS and ICS, a certificate of deposit and money market account program, respectively, that exchanges funds with other network banks to offer full FDIC insurance coverage to the customer.

## **Borrowings**

Although deposits are the primary source of funds for our lending and investment activities and for general business purposes, we may obtain advances from the Federal Home Loan Bank of San Francisco (“FHLB”) as an alternative to retail deposit funds. Our outstanding FHLB advances remained a zero balance at December 31, 2016 and September 30, 2017, as we continue to rely on deposit growth as our primary source of funding. See “Liquidity Management” below for the details on the FHLB borrowings program.

## **Capital Ratios**

The Company is regulated by the Board of Governors of the Federal Reserve Board (FRB) and is subject to the securities registration and public reporting regulations of the Securities and Exchange Commission. As a California state-chartered bank, our banking subsidiary is subject to primary supervision, examination and regulation by the California Department of Business Oversight (DBO) and the Federal Reserve Board. The Federal Reserve Board is the primary federal regulator of state member banks. The Bank is also subject to regulation by the FDIC, which insures the Bank’s deposits as permitted by law. We are not aware of any recommendations of regulatory authorities or otherwise which, if they were to be implemented, would have a material effect on our liquidity, capital resources, or operations.

The Company must comply with regulatory capital requirements established by the FRB. Failure to meet minimum capital requirements can initiate certain mandatory, and possibly additional discretionary, actions by regulators that, if undertaken, could have a direct material effect on our financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, we must meet specific capital guidelines that involve quantitative measures of our assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. Our capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors. These capital standards require us to maintain minimum ratios of “Tier 1” capital to total risk-weighted assets and total capital to risk-weighted assets of 6.00% and 8.00%, respectively. Tier 1 capital is comprised of total shareholders’ equity calculated in accordance with generally accepted accounting principles, excluding accumulated other comprehensive income (loss), less intangible assets, and total capital is comprised of Tier 1 capital plus certain adjustments, the largest of which is our allowance for loan losses. Risk-weighted assets refer to our on- and off-balance sheet exposures, adjusted for their related risk levels using formulas set forth in FRB and FDIC regulations.

In addition to the risk-based capital requirements described above, we are subject to a leverage capital requirement, which calls for a minimum ratio of Tier 1 capital (as defined above) to quarterly average total assets of 4.00%.

In July 2013, the U.S. banking agencies approved the U.S. version of Basel III. The federal bank regulatory agencies adopted version of Basel III revises the risk-based and leverage capital requirements and the method for calculating risk-weighted assets to make them consistent with Basel III and to meet the requirements of the Dodd-Frank Act. Although many of the rules contained in these final regulations are applicable only to large, internationally active banks, some of them will apply on a phased in basis to all banking organizations, including the Company and the Bank. Among other things, the rules establish a new minimum common equity Tier 1 ratio (4.5% of risk-weighted assets), a higher minimum Tier 1 risk-based capital requirement (6.0% of risk-weighted assets) and a minimum non-risk-based leverage ratio (4.00% eliminating a 3.00% exception for higher rated banks). The new additional capital conservation buffer of 2.5% of risk weighted assets over each of the required capital ratios will be phased in from 2016 to 2019 and must be met to avoid limitations on the ability of the Bank to pay dividends, repurchase shares or pay discretionary bonuses. The additional “countercyclical capital buffer” is also required for larger and more complex institutions. The new rules assign higher risk weighting to exposures that are more than 90 days past due or are on nonaccrual status and certain commercial real estate facilities that finance the acquisition, development or construction of real property. The rules also change the permitted composition of Tier 1 capital to exclude trust preferred securities, mortgage servicing rights and certain deferred tax assets and include unrealized gains and losses on available for sale debt and equity securities (with a one-time opt out option for Standardized Banks (banks with less than \$250 billion of total consolidated assets and less than \$10 billion of foreign exposures)). The rules, including alternative requirements for smaller community financial institutions like the Company, would be phased in through 2019. The implementation of the Basel III framework for the Company and the Bank commenced on January 1, 2015.

Table of Contents

Failure to meet minimum capital requirements can trigger regulatory actions that could have a material adverse effect on our financial statements and operations. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, we must meet specific capital guidelines that rely on quantitative measures of our assets, liabilities and certain off-balance-sheet items as calculated under regulatory accounting practices. Our capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

The following table shows our capital ratios, as calculated under regulatory guidelines, compared to the regulatory minimum capital ratios and the regulatory minimum capital ratios needed to qualify as a “well-capitalized” institution at September 30, 2017 and December 31, 2016:

<i>(in thousands)</i>	<b>Actual</b>		<b>For capital adequacy purposes</b>		<b>To be well capitalized under prompt corrective action provisions</b>	
	<b>Amount</b>	<b>Ratio</b>	<b>Amount</b>	<b>Ratio</b>	<b>Amount</b>	<b>Ratio</b>
<b><u>Capital ratios for Bank:</u></b>						
As of September 30, 2017						
Total capital (to Risk- Weighted Assets)	\$92,289	11.5%	\$73,996	≥9.25%	\$79,996	≥10.0%
Tier I capital (to Risk- Weighted Assets)	\$84,074	10.5%	\$57,997	≥7.25%	\$63,996	≥8.0%
Common Equity Tier 1 Capital (to Risk Weighted Assets)	\$84,074	10.5%	\$45,997	≥5.75%	\$51,997	≥6.5%
Tier I capital (to Average Assets)	\$84,074	8.5%	\$39,806	≥4.0%	\$49,757	≥5.0%
As of December 31, 2016						
Total capital (to Risk- Weighted Assets)	\$86,603	11.3%	\$66,358	≥8.625%	\$76,937	≥10.0%
Tier I capital (to Risk- Weighted Assets)	\$78,487	10.2%	\$50,970	≥6.625%	\$61,549	≥8.0%
Common Equity Tier 1 Capital (to Risk Weighted Assets)	\$78,487	10.2%	\$39,430	≥5.125%	\$50,009	≥6.5%
Tier I capital (to Average Assets)	\$78,487	8.1%	\$38,726	≥4.0%	\$48,408	≥5.0%
<b><u>Capital ratios for the Company:</u></b>						
As of September 30, 2017						
Total capital (to Risk- Weighted Assets)	\$92,655	11.6%	\$74,000	≥9.25%	N/A	N/A
Tier I capital (to Risk- Weighted Assets)	\$84,440	10.6%	\$58,000	≥7.25%	N/A	N/A
Common Equity Tier 1 Capital (to Risk Weighted Assets)	\$84,440	10.6%	\$58,000	≥5.75%	N/A	N/A
Tier I capital (to Average Assets)	\$84,440	8.5%	\$39,809	≥4.0%	N/A	N/A
As of December 31, 2016						
Total capital (to Risk- Weighted Assets)	\$86,966	11.3%	\$66,365	≥8.625%	N/A	N/A
Tier I capital (to Risk- Weighted Assets)	\$78,850	10.3%	\$50,976	≥6.625%	N/A	N/A
Common Equity Tier 1 Capital (to Risk Weighted Assets)	\$78,850	10.3%	\$39,435	≥5.125%	N/A	N/A
Tier I capital (to Average Assets)	\$78,850	8.1%	\$38,731	≥4.0%	N/A	N/A



The Bank is also subject to capital requirements similar to those discussed above. The Bank's capital ratios do not vary materially from our capital ratios presented above. At September 30, 2017, the Bank exceeded the minimum ratios established by the FRB.

### **Liquidity Management**

Since the Company is a holding company and does not conduct regular banking operations, its primary sources of liquidity are dividends from the Bank. Under the California Financial Code, payment of a dividend from the Bank to the Company is restricted to the lesser of the Bank's retained earnings or the amount of the Bank's undistributed net profits from the previous three fiscal years. The primary uses of funds for the Company are stockholder dividends, investment in the Bank and ordinary operating expenses. Management anticipates that there will be sufficient earnings at the Bank level to provide dividends to the Company to meet its funding requirements for the next twelve months.

## Table of Contents

Maintenance of adequate liquidity requires that sufficient resources be available at all times to meet our cash flow requirements. Liquidity in a banking institution is required primarily to provide for deposit withdrawals and the credit needs of its customers and to take advantage of investment opportunities as they arise. Liquidity management involves our ability to convert assets into cash or cash equivalents without incurring significant loss, and to raise cash or maintain funds without incurring excessive additional cost. For this purpose, we maintain a portion of our funds in cash and cash equivalents, salable government guaranteed loans and securities available for sale. We obtain funds from the repayment and maturity of loans as well as deposit inflows, investment security maturities and paydowns, Federal funds purchased, FHLB advances, and other borrowings. Our primary uses of funds are the origination of loans, the purchase of investment securities, withdrawals of deposits, maturity of certificate of deposits, repayment of borrowings and dividends to common and preferred stockholders. Our liquid assets at September 30, 2017 were \$251.5 million compared to \$269.7 million at December 31, 2016. Our liquidity level measured as the percentage of liquid assets to total assets was 25.2% at September 30, 2017 and December 31, 2016. We anticipate that cash and cash equivalents on hand and other sources of funds will provide adequate liquidity for our operating, investing and financing needs and our regulatory liquidity requirements for the next twelve months. Management monitors our liquidity position daily, balancing loan funding/payments with changes in deposit activity and overnight investments.

As a secondary source of liquidity, we rely on advances from the FHLB to supplement our supply of lendable funds and to meet deposit withdrawal requirements. Advances from the FHLB are typically secured by a portion of our loan portfolio. The FHLB determines limitations on the amount of advances by assigning a percentage to each eligible loan category that will count towards the borrowing capacity. As of September 30, 2017, our borrowing capacity from the FHLB was approximately \$255.1 million and there were no outstanding advances. We also maintain 2 lines of credit with correspondent banks to purchase up to \$30 million in federal funds, for which there were no advances as of September 30, 2017.

## **Off-Balance-Sheet Arrangements**

During the ordinary course of business, we provide various forms of credit lines to meet the financing needs of our customers. These commitments, which represent a credit risk to us, are not represented in any form on our balance sheets.

As of September 30, 2017 and December 31, 2016, we had commitments to extend credit of \$116.6 million and \$110.8 million, respectively, which includes obligations under letters of credit of \$1.4 million and \$1.3 million.

The effect on our revenues, expenses, cash flows and liquidity from the unused portion of the commitments to provide credit cannot be reasonably predicted because there is no guarantee that the lines of credit will be used.

**Item 3.**

**Quantitative and Qualitative Disclosures About Market Risk**

Not applicable.

**Item 4.**

**Controls and Procedures**

The Company's Chief Executive Officer and its Chief Financial Officer, after evaluating the effectiveness of the Company's disclosure controls and procedures, as defined in Exchange Act Rules 13a-15(e) and 15(d)-15(e) promulgated under the Exchange Act, as of the end of the period covered by this report (the "Evaluation Date") have concluded that as of the Evaluation Date, the Company's disclosure controls and procedures were effective to ensure that material information relating to the Company would be made known to them by others within the Company, particularly during the period in which this report was being prepared. Disclosure controls and procedures are designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by us in the reports that we file under the Exchange Act is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

There were no significant changes in our internal control over financial reporting during the quarter ended September 30, 2017 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting subsequent to the Evaluation Date.

Table of Contents

**PART II - OTHER INFORMATION**

**Item 1. Legal Proceedings**

There are no pending, or to management's knowledge, any threatened, material legal proceedings to which we are a defendant, or to which any of our properties are subject. There are no material legal proceedings to which any director, any nominee for election as a director, any executive officer, or any associate of any such director, nominee or officer is a party adverse to us.

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

None.

**Item 3. Defaults Upon Senior Securities**

None.

**Item 4. Mine Safety Disclosures**

None.

**Item 5. Other Information**

None.



Table of Contents

**Item 6. Exhibits**

The following exhibits are filed as part of this report:

<b>Exhibit No.</b>	<b>Exhibit Description</b>
31.01	<u>Certification of Principal Executive Officer pursuant to Rule 13a-14(a)/15d-14(a) as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.</u>
31.02	<u>Certification of Principal Financial Officer pursuant to Rule 13a-14(a)/15d-14(a) as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.</u>
32.01	<u>Certification pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.</u>
101.INS*	XBRL Instance Document
101.SCH*	XBRL Taxonomy Extension Schema Document
101.CAL*	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF*	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB*	XBRL Taxonomy Extension Label Linkbase Document
101.PRE*	XBRL Taxonomy Extension Presentation Linkbase Document

\*In accordance with Rule 406T of Regulation S-T, the information in these exhibits is “furnished” and shall not be deemed to be “filed” for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, or otherwise subject to liability under that section, and shall not be incorporated by reference into any registration statement or other document filed under the Securities Act of 1933, as amended, except as expressly set forth by specific reference in such filing.

Table of Contents

**SIGNATURES**

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

**Oak Valley Bancorp**

Date: November 7, 2017 By: /s/ JEFFREY A. GALL

**Jeffrey A. Gall**  
**Senior Vice President and Chief Financial Officer**  
**(Principal Financial Officer and duly authorized**  
**signatory)**