Independent Bank Group, Inc.
Form 10-Q
November 04, 2014

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q
(Mark One)
ý Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.
For the quarterly period ended September 30, 2014.
or
¨ Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.
For the transition period from to .
Commission file number 001-35854

Independent Bank Group, Inc.
(Exact name of registrant as specified in its charter)

Texas	13-4219346
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
1600 Redbud Boulevard, Suite 400 McKinney, Texas	75069-3257
(Address of principal executive offices)	(Zip Code)

(972) 562-9004
(Registrant’s telephone number, including area code)
Not applicable
(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or such shorter periods that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ý No ¨
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ý No ¨
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See definitions of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act. Check One:

Large accelerated filer	¨	Accelerated filer	¨
Non-accelerated filer	ý	Smaller reporting company	¨

Indicate by a check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
Yes ¨ No ý
Applicable Only to Corporate Issuers
Indicate the number of shares outstanding of each of the issuer’s classes of common stock, as of the latest practical date.

Common Stock, Par Value $0.01 Per Share – 17,017,169 shares as of November 3, 2014.

INDEPENDENT BANK GROUP, INC. AND SUBSIDIARIES
Form 10-Q
September 30, 2014

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Independent Bank Group, Inc. and Subsidiaries

Consolidated Balance Sheets
September 30, 2014 and December 31, 2013 (unaudited)
(Dollars in thousands, except share information)

Assets	September 30, 2014	December 31, 2013
Cash and due from banks	$121,983	$27,408
Federal Reserve Excess Balance Account (EBA)	127,786	65,646
Cash and cash equivalents	249,769	93,054
Securities available for sale (amortized cost of $233,501 and $196,689, respectively)	235,844	194,038
Loans held for sale	1,811	3,383
Loans, net of allowance for loan losses of $16,840 and $13,960, respectively	2,874,084	1,709,200
Premises and equipment, net	81,791	72,735
Other real estate owned	4,084	3,322
Federal Home Loan Bank (FHLB) of Dallas stock and other restricted stock	15,715	9,494
Bank-owned life insurance (BOLI)	39,503	21,272
Deferred tax asset	2,983	4,834
Goodwill	207,607	34,704
Core deposit intangible, net	10,418	3,148
Other assets	23,073	14,800
Total assets	$3,746,682	$2,163,984
Liabilities and Stockholders' Equity		
Deposits:		
Noninterest-bearing	$715,843	$302,756
Interest-bearing	2,097,817	1,407,563
Total deposits	2,813,660	1,710,319
FHLB advances	324,424	187,484
Repurchase agreements	5,235	—
Other borrowings	69,410	4,460
Other borrowings, related parties	3,320	3,270
Junior subordinated debentures	18,147	18,147
Other liabilities	12,175	6,532
Total liabilities	3,246,371	1,930,212
Commitments and contingencies		
Stockholders' equity:		
Series A preferred stock (23,938.35 and 0 shares issued and outsanding, respectively)	23,938	—
Common stock (16,370,313 and 12,330,158 shares outstanding, respectively)	164	123
Additional paid-in capital	445,379	222,116
Retained earnings	28,714	12,663
Accumulated other comprehensive income (loss)	2,116	(1,130)
Total stockholders' equity	500,311	233,772
Total liabilities and stockholders' equity	$3,746,682	$2,163,984

See Notes to Consolidated Financial Statements

1

Independent Bank Group, Inc. and Subsidiaries

Consolidated Statements of Income
Three and Nine Months Ended September 30, 2014 and 2013 (unaudited)
(Dollars in thousands, except per share information)

	Three months ended September 30,		Nine months ended September 30,	
	2014	2013	2014	2013
Interest income:				
Interest and fees on loans	$35,633	$21,140	$93,637	$62,347
Interest on taxable securities	711	358	2,187	999
Interest on nontaxable securities	404	258	1,028	765
Interest on federal funds sold and other	192	85	328	256
Total interest income	36,940	21,841	97,180	64,367
Interest expense:				
Interest on deposits	2,530	1,717	6,874	5,178
Interest on FHLB advances	975	819	2,792	2,475
Interest on repurchase agreements, notes payable and other borrowings	871	253	1,142	1,326
Interest on junior subordinated debentures	133	137	402	408
Total interest expense	4,509	2,926	11,210	9,387
Net interest income	32,431	18,915	85,970	54,980
Provision for loan losses	976	830	3,608	2,939
Net interest income after provision for loan losses	31,455	18,085	82,362	52,041
Noninterest income:				
Service charges on deposit accounts	1,541	1,248	4,205	3,597
Mortgage fee income	1,080	957	2,777	3,120
Gain on sale of loans	1,078	—	1,078	—
Gain on sale of other real estate	20	—	59	173
(Loss) gain on sale of premises and equipment	(22)	5	(22)	4
Increase in cash surrender value of BOLI	281	80	690	240
Other	232	161	876	475
Total noninterest income	4,210	2,451	9,663	7,609
Noninterest expense:				
Salaries and employee benefits	12,551	7,976	37,797	23,688
Occupancy	3,435	2,117	9,200	6,562
Data processing	472	357	1,420	969
FDIC assessment	426	253	1,246	241
Advertising and public relations	204	216	618	620
Communications	498	412	1,220	1,090
Net other real estate owned expenses (including taxes)	122	111	258	368
Operations of IBG Adriatica, net	—	228	23	600
Other real estate impairment	22	12	22	475
Core deposit intangible amortization	361	175	859	527
Professional fees	828	353	1,792	918
Acquisition expense, including legal	629	474	2,628	602
Other	2,614	1,966	6,498	5,297
Total noninterest expense	22,162	14,650	63,581	41,957

Income before taxes	13,503	5,886	28,444	17,693
Income tax expense	4,543	1,927	9,564	2,172
Net income	$8,960	$3,959	$18,880	$15,521
Basic earnings per share	$0.54	$0.33	$1.26	$1.44
Diluted earnings per share	$0.54	$0.33	$1.25	$1.43
Pro Forma:				
Income tax expense	n/a	n/a	n/a	5,798
Net income	n/a	n/a	n/a	$11,895
Basic earnings per share	n/a	n/a	n/a	$1.10
Diluted earnings per share	n/a	n/a	n/a	$1.10

See Notes to Consolidated Financial Statements

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Independent Bank Group, Inc. and Subsidiaries

Consolidated Statements of Comprehensive Income
Three and Nine Months Ended September 30, 2014 and 2013 (unaudited)
(Dollars in thousands)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Net income	$8,960	$3,959	$18,880	$15,521
Other comprehensive income (loss) before tax:				
Change in net unrealized gains (losses) on available for sale securities during the year	408	1,002	4,994	(4,348)
Reclassification adjustment for loss on sale of securities available for sale included in net income	—	—	—	—
Other comprehensive income (loss) before tax	408	1,002	4,994	(4,348)
Income tax expense (benefit)	143	351	1,748	(1,212)
Other comprehensive income (loss), net of tax	265	651	3,246	(3,136)
Comprehensive income	$9,225	$4,610	$22,126	$12,385

See Notes to Consolidated Financial Statements

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Independent Bank Group, Inc. and Subsidiaries

Consolidated Statements of Changes in Stockholders' Equity
Nine Months Ended September 30, 2014 and 2013 (unaudited)
(Dollars in thousands, except for par value, share and per share information)

	Series A Preferred Stock $.01 Par Value 10 million shares authorized	Common Stock $.01 Par Value 100 million shares authorized		Additional Paid in Capital	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Income (Loss)	Total
		Shares	Amount					
Balance, December 31, 2013	$—	12,330,158	$123	$222,116	$12,663	$—	$ (1,130)	$233,772
Net income	—	—	—	—	18,880	—	—	18,880
Other comprehensive income, net of tax	—	—	—	—	—	—	3,246	3,246
Series A preferred stock issued	23,938	—	—	—	—	—	—	23,938
Stock issued for acquisition of banks, net of offering costs of $550	—	3,851,480	39	219,928	—	—	—	219,967
Restricted stock forfeited	—	(394)	—	—	—	—	—	—
Restricted stock granted	—	189,069	2	(2)	—	—	—	—
Stock based compensation expense	—	—	—	2,011	—	—	—	2,011
Excess tax benefit on restricted stock vested	—	—	—	1,326	—	—	—	1,326
Preferred stock dividends	—	—	—	—	(109)	—	—	(109)
Cash dividends ($0.18 per share)	—	—	—	—	(2,720)	—	—	(2,720)
Balance, September 30, 2014	$23,938	16,370,313	$164	$445,379	$28,714	$—	$ 2,116	$500,311
Balance, December 31, 2012	$—	8,278,354	$83	$88,791	$33,290	$(232)	$ 2,578	$124,510
Net income	—	—	—	—	15,521	—	—	15,521
Other comprehensive (loss), net of tax	—	—	—	—	—	—	(3,136)	(3,136)
Treasury stock retired	—	(8,647)	—	(232)	—	232	—	—
Common stock issued, net of offering costs	—	3,680,000	37	86,600	—	—	—	86,637
Reclassification adjustment for change in taxable status	—	—	—	33,624	(33,624)	—	—	—
Restricted stock granted	—	127,220	1	(1)	—	—	—	—
	—	—	—	9	—	—	—	9

Excess tax benefit on restricted stock vested								
Stock based compensation expense	—	—	—	1,049	—	—	—	1,049
Cash dividends ($0.71 per share)	—	—	—	—	(6,079)	—	—	(6,079)
Balance, September 30, 2013	$—	12,076,927	$121	$209,840	$9,108	$—	$ (558)	$218,511

See Notes to Consolidated Financial Statements

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Independent Bank Group, Inc. and Subsidiaries

Consolidated Statements of Cash Flows
Nine Months Ended September 30, 2014 and 2013 (unaudited)
(Dollars in thousands)

	Nine Months Ended September 30,	
	2014	2013
Cash flows from operating activities:		
Net income	$18,880	$15,521
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation expense	3,787	3,171
Amortization of core deposit intangibles	859	527
Amortization of premium on securities, net	1,506	51
Stock based compensation expense	2,011	1,049
FHLB stock dividends	(33)	(20)
Net loss (gain) on sale of premises and equipment	22	(4)
Gain on sale of loans	(1,078)	—
Gain recognized on other real estate transactions	(59)	(173)
Impairment of other real estate	22	475
Deferred tax expense (benefit)	128	(1,727)
Provision for loan losses	3,608	2,939
Increase in cash surrender value of life insurance	(690)	(240)
Loans originated for sale	(103,165)	(132,897)
Proceeds from sale of loans	104,737	137,805
Net change in other assets	(4,981)	317
Net change in other liabilities	(1,587)	1,575
Net cash provided by operating activities	23,967	28,369
Cash flows from investing activities:		
Proceeds from maturities, calls and pay downs of securities available for sale	67,927	142,887
Purchases of securities available for sale	(28,364)	(163,918)
Proceeds from maturities of certificates held in other banks	—	7,372
Proceeds from sale of loans	12,147	—
Net purchases of FHLB stock	625	(139)
Net loans originated	(324,030)	(190,128)
Additions to premises and equipment	(3,423)	(6,165)
Proceeds from sale of premises and equipment	13	66
Proceeds from sale of other real estate owned	1,923	1,047
Capitalized additions to other real estate	(28)	(85)
Cash received from acquired banks	167,771	—
Cash paid in connection with acquisitions	(44,010)	—
Net cash used in investing activities	(149,449)	(209,063)
Cash flows from financing activities:		
Net increase in demand deposits, NOW and savings accounts	85,935	109,341
Net increase in time deposits	91,139	40,667
Net change in FHLB advances	41,940	(3,094)
Net change in repurchase agreements	1,502	—
Repayments of notes payable and other borrowings	—	(28,787)
Proceeds from other borrowings	65,000	—

Proceeds from sale of common stock	—	86,637
Offering costs paid in connection with acquired banks	(550)	—
Dividends paid	(2,769)	(6,079)
Net cash provided by financing activities	282,197	198,685
Net change in cash and cash equivalents	156,715	17,991
Cash and cash equivalents at beginning of year	93,054	102,290
Cash and cash equivalents at end of period	$249,769	$120,281

See Notes to Consolidated Financial Statements

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Independent Bank Group, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (unaudited)
(Dollars in thousands, except for share and per share information)

Note 1. Summary of Significant Accounting Policies
Nature of Operations: Independent Bank Group, Inc. (IBG) through its subsidiary, Independent Bank, a Texas state banking corporation (Bank) (collectively known as the Company), provides a full range of banking services to individual and corporate customers in the North Texas, Central Texas and Houston areas through its various branch locations in those areas. The Company is engaged in traditional community banking activities, which include commercial and retail lending, deposit gathering, investment and liquidity management activities. The Company's primary deposit products are demand deposits, money market accounts and certificates of deposit, and its primary lending products are commercial business and real estate, real estate mortgage and consumer loans.
Basis of Presentation: The accompanying consolidated financial statements include the accounts of IBG, its wholly-owned subsidiaries, the Bank and IBG Adriatica Holdings, Inc. (Adriatica) and the Bank's wholly-owned subsidiaries, IBG Real Estate Holdings, Inc. and IBG Aircraft Acquisition, Inc. Adriatica was formed in 2011 to acquire a mixed use residential and retail real estate development in McKinney, Texas. Adriatica was dissolved during the first quarter of 2014. All material intercompany transactions and balances have been eliminated in consolidation. In addition, the Company wholly-owns IB Trust I (Trust I), IB Trust II (Trust II), IB Trust III (Trust III), IB Centex Trust I (Centex Trust I) and Community Group Statutory Trust I (CGI Trust I). The Trusts were formed to issue trust preferred securities and do not meet the criteria for consolidation.
The consolidated interim financial statements are unaudited, but include all adjustments, which, in the opinion of management, are necessary for a fair presentation of the results of the periods presented. All such adjustments were of a normal and recurring nature. These financial statements should be read in conjunction with the financial statements and the notes thereto in the Company's Annual Report of Form10-K for the year ended December 31, 2013. The consolidated statement of condition at December 31, 2013 had been derived from the audited financial statements as of that date, but does not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements.
Segment Reporting: The Company has one reportable segment. The Company's chief operating decision-maker uses consolidated results to make operating and strategic decisions.
Pro forma statements: Because the Company was not a taxable entity prior to April 1, 2013, pro forma amounts for income tax expense and basic and diluted earnings per share have been presented assuming the Company's effective tax rate of 32.8% for the nine months ended September 30, 2013, as if it had been a C Corporation during that period. The difference in the statutory rate of 35% and the Company's effective rate is primarily due to nontaxable income earned on municipal securities and bank owned life insurance.

Subsequent events: Companies are required to evaluate events and transactions that occur after the balance sheet date but before the date the financial statements are issued. They must recognize in the financial statements the effect of all events or transactions that provide additional evidence of conditions that existed at the balance sheet date, including the estimates inherent in the financial statement preparation process. Entities shall not recognize the impact of events or transactions that provide evidence about conditions that did not exist at the balance sheet date but arose after that date. The Company has evaluated subsequent events through the date of filing these financial statements with the SEC and noted no subsequent events requiring financial statement recognition or disclosure, except as disclosed in Note 13.
Earnings per share: Basic earnings per common share are net income available to common shareholders divided by the weighted average number of common shares outstanding during the period. The unvested share-based payment awards that contain rights to non forfeitable dividends are considered participating securities for this calculation. Diluted earnings per common share include the dilutive effect of additional potential common shares issuable under stock warrants. The dilutive effect of participating non vested common stock was not included as it was anti-dilutive. Proceeds from the assumed exercise of dilutive stock warrants are assumed to be used to repurchase common stock at

the average market price.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Basic earnings per share:				
Net income	$8,960	$3,959	$18,880	$15,521
Less: Preferred stock dividends	(60)	—	(109)	—
Net income after preferred stock dividends	8,900	3,959	18,771	15,521
Less:				
Undistributed earnings allocated to participating securities	157	68	291	184
Dividends paid on participating securities	19	15	49	119
Net income available to common shareholders	$8,724	$3,876	$18,431	$15,218
Weighted-average basic shares outstanding	16,046,935	11,823,655	14,657,873	10,588,554
Basic earnings per share	$0.54	$0.33	$1.26	$1.44
Diluted earnings per share:				
Net income available to common shareholders	$8,724	$3,876	$18,431	$15,218
Total weighted-average basic shares outstanding	16,046,935	11,823,655	14,657,873	10,588,554
Add dilutive stock warrants	98,725	74,229	100,595	58,874
Total weighted-average diluted shares outstanding	16,145,660	11,897,884	14,758,468	10,647,428
Diluted earnings per share	$0.54	$0.33	$1.25	$1.43
Pro forma earnings per share:				
Pro forma net income	n/a	n/a	n/a	$11,895
Less undistributed earnings allocated to participating securities	n/a	n/a	n/a	113
Less dividends paid on participating securities	n/a	n/a	n/a	119
Pro forma net income available to common shareholders after tax	n/a	n/a	n/a	$11,663
Pro forma basic earnings per share	n/a	n/a	n/a	$1.10
Pro forma diluted earnings per share	n/a	n/a	n/a	$1.10
Anti-dilutive participating securities	73,120	151,674	122,209	139,416

Note 2. Statement of Cash Flows

As allowed by the accounting standards, the Company has chosen to report on a net basis its cash receipts and cash payments for time deposits accepted and repayments of those deposits, and loans made to customers and principal collections on those loans. The Company uses the indirect method to present cash flows from operating activities. Other supplemental cash flow information is presented below:

	Nine Months Ended September 30,	
	2014	2013
Cash transactions:		
Interest expense paid	$10,222	$9,270
Income taxes paid	$7,730	$3,100
Noncash transactions:		
Accrued preferred stock dividends	$60	$—
Transfers of loans to other real estate owned	$1,088	$2,885
Loans to facilitate the sale of other real estate owned	$48	$113
Writeoff of debt origination costs related to warrants	$—	$223
Securities purchased, not yet settled	$—	$1,000
Excess tax benefit on restricted stock vested	$1,326	$9
Transfer of bank premises to other real estate	$356	$—

Supplemental schedule of noncash investing activities from the Live Oak Financial Corp. and BOH Holdings acquisitions are as follows:

	Nine Months Ended September 30,	
	2014	2013
Noncash assets acquired		
Cash and cash equivalents	$167,771	$—
Securities available for sale	75,881	—
Loans	856,899	—
Premises and equipment	9,811	—
Other real estate owned	1,224	—
Goodwill	172,151	—
Core deposit intangibles	8,147	—
Other assets	27,804	—
Total assets	$1,319,688	$—
Noncash liabilities assumed:		
Deposits	$925,762	$—
Repurchase agreements	3,733	—
FHLB advances	95,000	—
Other liabilities	6,728	—
Total liabilities	$1,031,223	$—
Cash paid to shareholders of acquired banks	$44,010	$—
Series A preferred stock exchanged in connection with acquired banks	$23,938	$—
Fair value of common stock issued to shareholders of acquired banks	$220,517	$—

In addition, the following measurement-period adjustments were made during the period relating the November 30, 2013 acquisition of Collin Bank:

	Nine Months Ended September 30,	
	2014	2013
Noncash assets acquired:		
Loans	$(328)	$—
Goodwill	752	—
Core deposit intangibles	(18)	—
Deferred tax asset	109	—
Other assets	10	—
Total assets	$525	$—
Noncash liabilities assumed:		
Deposits	$505	$—
Other liabilities	20	—
Total liabilities	$525	$—

Note 3. Securities Available for Sale

Securities available for sale have been classified in the consolidated balance sheets according to management's intent. The amortized cost of securities and their approximate fair values at September 30, 2014 and December 31, 2013, are as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Securities Available for Sale				
September 30, 2014:				
U.S. treasuries	$999	$9	$—	$1,008
Government agency securities	67,666	171	(430)	67,407
Obligations of state and municipal subdivisions	73,447	1,735	(545)	74,637
Corporate bonds	1,071	—	(2)	1,069
Residential pass-through securities guaranteed by FNMA, GNMA, FHLMC and FHR	90,318	1,406	(1)	91,723
	$233,501	$3,321	$(978)	$235,844
December 31, 2013:				
U.S. treasuries	$3,498	$15	$—	$3,513
Government agency securities	95,407	84	(1,076)	94,415
Obligations of state and municipal subdivisions	37,861	541	(1,787)	36,615
Corporate bonds	2,079	—	(27)	2,052
Residential pass-through securities guaranteed by FNMA, GNMA, FHLMC and FHR	57,844	67	(468)	57,443
	$196,689	$707	$(3,358)	$194,038

Securities with a carrying amount of approximately $177,754 and $111,673 at September 30, 2014 and December 31, 2013, respectively, were pledged to secure public fund deposits and repurchase agreements.

There were no sales of securities during the three and nine months ended September 30, 2014 and 2013.

The amortized cost and estimated fair value of securities available for sale at September 30, 2014, by contractual maturity, are shown below. Maturities of pass-through certificates will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	September 30, 2014	
	Securities Available for Sale	
	Amortized Cost	Fair Value
Due in one year or less	$3,983	$3,990
Due from one year to five years	57,240	56,927
Due from five to ten years	42,682	42,911
Thereafter	39,278	40,293
	143,183	144,121
Residential pass-through securities guaranteed by FNMA, GNMA, FHLMC and FHR	90,318	91,723
	$233,501	$235,844

The number of securities, unrealized losses and fair value, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, as of September 30, 2014 and December 31, 2013, are summarized as follows:

	Less Than 12 Months			Greater Than 12 Months			Total	
Description of Securities	Number of Securities	Estimated Fair Value	Unrealized Losses	Number of Securities	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses
Securities Available for Sale								
September 30, 2014								
Government agency securities	9	$13,036	$(58)	16	$24,624	$(372)	$37,660	$(430)
Obligations of state and municipal subdivisions	37	14,109	(156)	15	10,040	(389)	24,149	(545)
Corporate bonds	1	1,069	(2)	—	—	—	1,069	(2)
Residential pass-through securities guaranteed by FNMA, GNMA, FHLMC and FHR	1	94	(1)	—	—	—	94	(1)
	48	$28,308	$(217)	31	$34,664	$(761)	$62,972	$(978)
December 31, 2013								
Government agency securities	46	$74,331	$(1,076)	—	$—	$—	$74,331	$(1,076)
Obligations of state and municipal subdivisions	21	11,888	(1,139)	6	4,047	(648)	15,935	(1,787)
Corporate bonds	2	2,052	(27)	—	—	—	2,052	(27)
Residential pass-through securities guaranteed by FNMA, GNMA, FHLMC and FHR	14	49,126	(468)	—	—	—	49,126	(468)

	83	$137,397	$(2,710)	6	$4,047	$(648)	$141,444	$(3,358)

Unrealized losses are generally due to changes in interest rates. The Company has the intent to hold these securities until maturity or a forecasted recovery, and it is more likely than not that the Company will not have to sell the securities before the recovery of their cost basis. As such, the losses are deemed to be temporary.

Note 4. Loans, Net and Allowance for Loan Losses
Loans, net at September 30, 2014 and December 31, 2013, consisted of the following:

	September 30, 2014	December 31, 2013
Commercial	$587,488	$241,178
Real estate:		
Commercial	1,336,416	843,436
Commercial construction, land and land development	290,086	130,320
Residential	479,714	338,654
Single family interim construction	116,785	83,144
Agricultural	43,575	40,558
Consumer	36,967	45,762
Other	161	108
	2,891,192	1,723,160
Deferred loan fees	(268)	—
Allowance for loan losses	(16,840)	(13,960)
	$2,874,084	$1,709,200

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, concentrations of credit, loan delinquencies and non-performing and potential problem loans.
Commercial loans are underwritten after evaluating and understanding the borrower’s ability to operate profitably and prudently expand its business. The Company’s management examines current and projected cash flows to determine the ability of the borrower to repay their obligations as agreed. Commercial loans are primarily made based on the identified cash flows of the borrower and secondarily on the underlying collateral provided by the borrower. These cash flows, however, may not be as expected and the value of collateral securing the loans may fluctuate. Most commercial 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. Additionally, our commercial loan portfolio includes loans made to customers in the energy industry, which is a complex, technical and cyclical industry. Experienced bankers with specialized energy lending experience originate our energy loans. Companies in this industry produce, extract, develop, exploit and explore for oil and natural gas. Loans are primarily collateralized with proven producing oil and gas reserves based on a technical evaluation of these reserves.
Commercial real estate loans are subject to underwriting standards and processes similar to commercial 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 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. Management monitors the diversification of the portfolio on a quarterly basis by type and geographic location. Management also tracks the level of owner occupied property versus non owner occupied property.
Land and commercial land development loans are underwritten using feasibility studies, independent appraisal reviews and financial analysis of the developers or property owners. Generally, borrowers must have a proven track record of success. Commercial construction loans are generally based upon estimates of cost and value of the completed project. These estimates may not be accurate. Commercial construction loans often involve the disbursement of substantial funds with the repayment dependent on the success of the ultimate project. Sources of

repayment for these loans may be pre-committed permanent financing or sale of the developed property. The loans in this portfolio are geographically diverse and due to the increased risk are monitored closely by management and the board of directors on a quarterly basis.

Residential real estate and single family interim construction loans are underwritten primarily based on borrowers' credit scores, documented income and minimum collateral values. Relatively small loan amounts are spread across many individual

borrowers, which minimizes risk in the residential portfolio. In addition, management evaluates trends in past dues and current economic factors on a regular basis.
Agricultural loans are collateralized by real estate and/or agricultural-related assets. Agricultural real estate loans are primarily comprised of loans for the purchase of farmland. Loan-to-value ratios on loans secured by farmland generally do not exceed 80% and have amortization periods limited to twenty years. Agricultural non-real estate loans are generally comprised of term loans to fund the purchase of equipment, livestock and seasonal operating lines to grain farmers to plant and harvest corn and soybeans. Specific underwriting standards have been established for agricultural-related loans, including the establishment of projections for each operating year based on industry developed estimates of farm input costs and expected commodity yields and prices. Operating lines are typically written for one year and secured by the crop and other farm assets as considered necessary.
Agricultural loans carry significant credit risks as they involve larger balances concentrated with single borrowers or groups of related borrowers. In addition, repayment of such loans depends on the successful operation or management of the farm property securing the loan or for which an operating loan is utilized. Farming operations may be affected by adverse weather conditions such as drought, hail or floods that can severely limit crop yields.
Consumer loans represent less than 3% of the outstanding total loan portfolio. Collateral consists primarily of automobiles and other personal assets. Credit score analysis is used to supplement the underwriting process.
Most of the Company’s lending activity occurs within the State of Texas, primarily in the north, central and southeast Texas regions. A large percentage of the Company’s portfolio consists of commercial and residential real estate loans. As of September 30, 2014 and December 31, 2013, there were no concentrations of loans related to a single industry in excess of 10% of total loans.
The allowance for loan losses is an amount that management believes will be adequate to absorb estimated losses relating to specifically identified loans, as well as probable credit losses inherent in the balance of the loan portfolio. The allowance is derived from the following two components: 1) allowances established on individual impaired loans, which are based on a review of the individual characteristics of each loan, including the customer’s ability to repay the loan, the underlying collateral values, and the industry in which the customer operates, and 2) allowances based on actual historical loss experience for the last three years for similar types of loans in the Company’s loan portfolio adjusted for primarily changes in the lending policies and procedures; collection, charge-off and recovery practices; nature and volume of the loan portfolio; volume and severity of nonperforming loans; existence and effect of any concentrations of credit and the level of such concentrations and current, national and local economic and business conditions. This second component also includes an unallocated allowance to cover uncertainties that could affect management’s estimate of probable losses. The unallocated allowance reflects the imprecision inherent in the underlying assumptions used in the methodologies for estimating this component.
The Company’s management continually evaluates the allowance for loan losses determined from the allowances established on individual loans and the amounts determined from historical loss percentages adjusted for the qualitative factors above. Should any of the factors considered by management change, the Company’s estimate of loan losses could also change and would affect the level of future provision expense. While the calculation of the allowance for loan losses utilizes management’s best judgment and all the information available, the adequacy of the allowance for loan losses is dependent on a variety of factors beyond the Company’s control, including, among other things, the performance of the entire loan portfolio, the economy, changes in interest rates and the view of regulatory authorities towards loan classifications.
In addition, regulatory agencies, as an integral part of their examination process, periodically review the Bank’s allowance for loan losses, and may require the Bank to make additions to the allowance based on their judgment about information available to them at the time of their examinations.
Loans requiring an allocated loan loss provision are generally identified at the servicing officer level based on review of weekly past due reports and/or the loan officer’s communication with borrowers. In addition, past due loans are discussed at weekly officer loan committee meetings to determine if classification is warranted. The Company’s credit department has implemented an internal risk based loan review process to identity potential internally classified loans that supplements the annual independent external loan review. The external review generally covers all loans greater than $1.5 million. These reviews include analysis of borrower’s financial condition, payment histories and collateral

values to determine if a loan should be internally classified. Generally, once classified, an impaired loan analysis is completed by the credit department to determine if the loan is impaired and the amount of allocated allowance required.

The Texas economy, specifically the Company’s lending area of north, central and southeast Texas, has generally performed better and appears to be recovering faster than certain other parts of the country. However, Texas is not completely immune to the problems associated with the U.S. economy. The risk of loss associated with all segments of the loan portfolio continues to be impacted by the prolonged economic recovery. The economy and other risk factors are minimized by the Company’s underwriting standards, which include the following principles: 1) financial strength of the borrower including strong earnings, high net worth, significant liquidity and acceptable debt to worth ratio, 2) managerial business competence, 3) ability to repay, 4) loan to value, 5) projected cash flow and 6) guarantor financial statements as applicable. The following is a summary of the activity in the allowance for loan losses by loan class for the three and nine months ended September 30, 2014 and 2013:

	Commercial	Commercial Real Estate, Land and Land Development	Residential Real Estate	Single-Family Interim Construction	Agricultural	Consumer	Other	Unallocated	Total
Three months ended September 30, 2014									
Balance at the beginning of period	$ 3,676	$ 9,100	$ 2,291	$ 584	$ 272	$ 349	$ —	$ (53)	$ 16,219
Provision for loan losses	427	706	4	(26)	21	(109)	—	(47)	976
Charge-offs	—	(318)	—	—	—	(76)	—	—	(394)
Recoveries	6	23	3	—	—	7	—	—	39
Balance at end of period	$ 4,109	$ 9,511	$ 2,298	$ 558	$ 293	$ 171	$ —	$ (100)	$ 16,840
Nine months ended September 30, 2014									
Balance at the beginning of period	$ 2,401	$ 7,872	$ 2,440	$ 577	$ 238	$ 363	$ —	$ 69	$ 13,960
Provision for loan losses	2,061	1,907	(117)	(30)	55	(99)		(169)	3,608
Charge-offs	(368)	(339)	(32)	—	—	(118)	—	—	(857)
Recoveries	15	71	7	11	—	25	—	—	129
Balance at end of period	$ 4,109	$ 9,511	$ 2,298	$ 558	$ 293	$ 171	$ —	$ (100)	$ 16,840
Three months ended September 30, 2013									
Balance at the beginning of period	$ 1,970	$ 7,044	$ 2,567	$ 540	$ 210	$ 350	$ —	$ 81	$ 12,762
Provision for loan losses	264	401	(67)	46	(17)	(3)	—	206	830
Charge-offs	(350)	(78)	(21)	—	—	(26)	—	—	(475)
Recoveries	5	13	2	—	—	8	—	—	28
Balance at end of period	$ 1,889	$ 7,380	$ 2,481	$ 586	$ 193	$ 329	$ —	$ 287	$ 13,145
Nine months ended September 30, 2013									

Balance at the beginning of period	$ 2,377	$ 4,924	$ 2,965	$ 523	$ 159	$ 278	$—	$ 252	$ 11,478
Provision for loan losses	79	3,068	(405)	63	34	65	—	35	2,939
Charge-offs	(581)	(634)	(87)	—	—	(50)	—	—	(1,352)
Recoveries	14	22	8	—	—	36	—	—	80
Balance at end of period	$ 1,889	$ 7,380	$ 2,481	$ 586	$ 193	$ 329	$—	$ 287	$ 13,145

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The following table details the amount of the allowance for loan losses and recorded investment in loans by class as of September 30, 2014 and December 31, 2013:

	Commercial	Commercial Real Estate, Land and Land Development	Residential Real Estate	Single-Family Interim Construction	Agricultural	Consumer	Other	Unallocated	Total
September 30, 2014									
Allowance for losses:									
Individually evaluated for impairment	$ 49	$ 223	$ 7	$ —	$ —	$ 15	$—	$ —	$ 294
Collectively evaluated for impairment	4,060	9,288	2,291	558	293	156	—	(100)	16,546
Loans acquired with deteriorated credit quality	—	—	—	—	—	—	—	—	—
Ending balance	$ 4,109	$ 9,511	$ 2,298	$ 558	$ 293	$ 171	$—	$ (100)	$ 16,840
Loans:									
Individually evaluated for impairment	$ 135	$ 6,967	$ 3,276	$ —	$ —	$ 95	$—	$ —	$ 10,473
Collectively evaluated for impairment	582,508	1,573,165	474,978	116,785	43,575	36,867	161	—	2,828,039
Acquired with deteriorated credit quality	4,845	46,370	1,460	—	—	5	—	—	52,680
Ending balance	$ 587,488	$ 1,626,502	$ 479,714	$ 116,785	$ 43,575	$ 36,967	$ 161	$ —	$ 2,891,192
December 31, 2013									
Allowance for losses:									
Individually evaluated for impairment	$ 313	$ 504	$ 14	$ —	$ —	$ 24	$—	$ —	$ 855
Collectively evaluated for impairment	2,088	7,368	2,426	577	238	339	—	69	13,105
Loans acquired with deteriorated credit quality	—	—	—	—	—	—	—	—	—
Ending balance	$ 2,401	$ 7,872	$ 2,440	$ 577	$ 238	$ 363	$—	$ 69	$ 13,960
Loans:									
	$ 501	$ 8,013	$ 3,182	$ 170	$ —	$ 68	$—	$ —	$ 11,934

Individually evaluated for impairment									
Collectively evaluated for impairment	234,103	959,254	334,770	82,974	40,558	45,682	108	—	1,697,449
Acquired with deteriorated credit quality	6,574	6,489	702	—	—	12	—	—	13,777
Ending balance	$ 241,178	$ 973,756	$ 338,654	$ 83,144	$ 40,558	$ 45,762	$ 108	$ —	$ 1,723,160

Nonperforming loans by loan class at September 30, 2014 and December 31, 2013, are summarized as follows:

	Commercial	Commercial Real Estate, Land and Land Development	Residential Real Estate	Single-Family Interim Construction	Agricultural	Consumer	Other	Total
September 30, 2014								
Nonaccrual loans	$ 54	$ 208	$ 1,998	$ —	$ —	$ 66	$—	$ 2,326
Loans past due 90 days and still accruing	—	—	—	—	—	6	—	6
Troubled debt restructurings (not included in nonaccrual or loans past due and still accruing)	80	4,702	1,262	—	—	9	—	6,053
	$ 134	$ 4,910	$ 3,260	$ —	$ —	$ 81	$—	$ 8,385
December 31, 2013								
Nonaccrual loans	$ 357	$ 253	$ 1,852	$ 170	$ —	$ 43	$—	$ 2,675
Loans past due 90 days and still accruing	—	—	—	—	—	—	—	—
Troubled debt restructurings (not included in nonaccrual or loans past due and still accruing)	107	5,090	1,288	—	—	1	—	6,486
	$ 464	$ 5,343	$ 3,140	$ 170	$ —	$ 44	$—	$ 9,161

The accrual of interest is discontinued on a loan when management believes after considering collection efforts and other factors that the borrower's financial condition is such that collection of interest is doubtful. All interest accrued but not collected for loans that are placed on nonaccrual status or charged-off is reversed against interest income. Cash collections on nonaccrual loans are generally credited to the loan receivable balance, and no interest income is recognized on those loans until the principal balance has been collected. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.
Impaired loans are those loans where it is probable that all amounts due according to contractual terms of the loan agreement will not be collected. The Company has identified these loans through its normal loan review procedures. Impaired loans are measured based on 1) the present value of expected future cash flows discounted at the loans effective interest rate; 2) the loan's observable market price; or 3) the fair value of collateral if the loan is collateral dependent. Substantially all of the Company’s impaired loans are measured at the fair value of the collateral. In limited cases, the Company may use the other methods to determine the level of impairment of a loan if such loan is not collateral dependent.
All commercial, real estate, agricultural loans and troubled debt restructurings are considered for individual impairment analysis. Smaller balance consumer loans are collectively evaluated for impairment.

Impaired loans by loan class at September 30, 2014 and December 31, 2013, are summarized as follows:

	Commercial	Commercial Real Estate, Land and Land Development	Residential Real Estate	Single-Family Interim Construction	Agricultural	Consumer	Other	Total
September 30, 2014								
Recorded investment in impaired loans:								
Impaired loans with an allowance for loan losses	$ 83	$ 2,131	$ 14	$ —	$ —	$ 23	$—	$2,251
Impaired loans with no allowance for loan losses	52	4,836	3,262	—	—	72	—	8,222
Total	$ 135	$ 6,967	$ 3,276	$ —	$ —	$ 95	$—	$10,473
Unpaid principal balance of impaired loans	$ 137	$ 7,473	$ 3,385	$ —	$ —	$ 111	$—	$11,106
Allowance for loan losses on impaired loans	$ 49	$ 223	$ 7	$ —	$ —	$ 15	$—	$294
December 31, 2013								
Recorded investment in impaired loans:								
Impaired loans with an allowance for loan losses	$ 401	$ 3,866	$ 1,135	$ —	$ —	$ 40	$—	$5,442
Impaired loans with no allowance for loan losses	100	4,147	2,047	170	—	28	—	6,492
Total	$ 501	$ 8,013	$ 3,182	$ 170	$ —	$ 68	$—	$11,934
Unpaid principal balance of impaired loans	$ 501	$ 8,408	$ 3,216	$ 170	$ —	$ 75	$—	$12,370
Allowance for loan losses on impaired loans	$ 313	$ 504	$ 14	$ —	$ —	$ 24	$—	$855
For the three months ended September 30, 2014								
Average recorded investment in impaired loans	$ 139	$ 7,538	$ 3,232	$ —	$ —	$ 73	$—	$10,982
Interest income recognized on impaired loans	$ 2	$ 101	$ 44	$ —	$ —	$ 1	$—	$148
For the nine months ended September 30, 2014								
Average recorded investment in impaired loans	$ 257	$ 7,663	$ 3,219	$ 43	$ —	$ 68	$—	$11,250
Interest income recognized on impaired loans	$ 7	$ 302	$ 126	$ —	$ —	$ 2	$—	$437
For the three months ended September 30, 2013								
Average recorded investment in impaired loans	$ 599	$ 8,095	$ 3,394	$ —	$ —	$ 73	$—	$12,161
Interest income recognized on impaired loans	$ 4	$ 112	$ 34	$ —	$ —	$ 1	$—	$151

For the nine months ended September 30, 2013								
Average recorded investment in impaired loans	$ 687	$ 8,833	$ 3,435	$ —	$ —	$ 83	$—	$13,038
Interest income recognized on impaired loans	$ 26	$ 347	$ 120	$ —	$ —	$ 4	$—	$497

Certain impaired loans have adequate collateral and do not require a related allowance for loan loss.

The Company will charge off that portion of any loan which management considers a loss. Commercial and real estate loans are generally considered for charge-off when exposure beyond collateral coverage is apparent and when no further collection of the loss portion is anticipated based on the borrower's financial condition.

The restructuring of a loan is considered a "troubled debt restructuring" if both 1) the borrower is experiencing financial difficulties and 2) the creditor has granted a concession. Concessions may include interest rate reductions or below market interest rates, principal forgiveness, extending amortization and other actions intended to minimize potential losses.

A “troubled debt restructured” loan is identified as impaired and measured for credit impairment as of each reporting period in accordance with the guidance in Accounting Standards Codification (ASC) 310-10-35. The recorded investment in troubled debt restructurings, including those on nonaccrual, was $7,443 and $7,938 as of September 30, 2014 and December 31, 2013.

Following is a summary of loans modified under troubled debt restructurings during the three months and nine months ended September 30, 2014 and 2013:

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	Commercial	Commercial Real Estate, Land and Land Development	Residential Real Estate	Single-Family Interim Construction	Agricultural	Consumer	Other	Total
Troubled debt restructurings during the three months ended September 30, 2014								
Number of contracts	—	—	—	—	—	1	—	1
Pre-restructuring outstanding recorded investment	$—	$—	$—	$ —	$—	$ 9	$—	$9
Post-restructuring outstanding recorded investment	$—	$—	$—	$ —	$—	$ 9	$—	$9
Troubled debt restructurings during the nine months ended September 30, 2014								
Number of contracts	—	2	—	—	—	1	—	3
Pre-restructuring outstanding recorded investment	$—	$ 1,108	$—	$ —	$—	$ 9	$—	$ 1,117
Post-restructuring outstanding recorded investment	$—	$ 1,108	$—	$ —	$—	$ 9	$—	$ 1,117
Troubled debt restructurings during the three months ended September 30, 2013								
Number of contracts	—	1	—	—	—	—	—	1
Pre-restructuring outstanding recorded investment	$—	$ 640	$—	$ —	$—	$—	$—	$ 640
Post-restructuring outstanding recorded investment	$—	$ 640	$—	$ —	$—	$—	$—	$ 640

Troubled debt restructurings during the nine months ended September 30, 2013								
Number of contracts	—	2	—	—	—	—	—	2
Pre-restructuring outstanding recorded investment	$—	$1,460	$—	$ —	$—	$—	$—	$1,460
Post-restructuring outstanding recorded investment	$—	$1,460	$—	$ —	$—	$—	$—	$1,460

At September 30, 2014 and 2013, there were no loans modified under troubled debt restructurings during the previous twelve month period that subsequently defaulted during the three and nine months ended September 30, 2014 and, 2013, respectively. At September 30, 2014 and 2013, the Company had no commitments to lend additional funds to any borrowers with loans whose terms have been modified under troubled debt restructurings.

Modifications primarily relate to extending the amortization periods of the loans and interest rate concessions. The majority of these loans were identified as impaired prior to restructuring; therefore, the modifications did not materially impact the Company's determination of the allowance for loan losses.

Loans are considered past due if the required principal and interest payments have not been received as of the date such payments were due. The following table presents information regarding the aging of past due loans by loan class as of September 30, 2014 and December 31, 2013:

	Loans 30-89 Days Past Due	Loans 90 or More Past Due	Total Past Due Loans	Current Loans	Total Loans
September 30, 2014					
Commercial	$505	$8	$513	$586,975	$587,488
Commercial real estate, land and land development	295	124	419	1,626,083	1,626,502
Residential real estate	1,787	388	2,175	477,539	479,714
Single-family interim construction	—	—	—	116,785	116,785
Agricultural	17	—	17	43,558	43,575
Consumer	168	49	217	36,750	36,967
Other	—	—	—	161	161
	$2,772	$569	$3,341	$2,887,851	$2,891,192
December 31, 2013					
Commercial	$257	$357	$614	$240,564	$241,178
Commercial real estate, land and land development	2,076	73	2,149	971,607	973,756
Residential real estate	1,322	1,603	2,925	335,729	338,654
Single-family interim construction	—	170	170	82,974	83,144
Agricultural	3	—	3	40,555	40,558
Consumer	97	1	98	45,664	45,762
Other	—	—	—	108	108
	$3,755	$2,204	$5,959	$1,717,201	$1,723,160

The Company’s internal classified report is segregated into the following categories: 1) Pass/Watch, 2) Other Assets Especially Mentioned (OAEM), 3) Substandard and 4) Doubtful. The loans placed in the Pass/Watch category reflect the Company’s opinion that the loans reflect potential weakness that requires monitoring on a more frequent basis. The loans in the OAEM category reflect the Company’s opinion that the credit contains weaknesses which represent a greater degree of risk and warrant extra attention. These loans are reviewed monthly by officers and senior management to determine if a change in category is warranted. The loans placed in the Substandard category are considered to be potentially inadequately protected by the current debt service capacity of the borrower and/or the pledged collateral. These credits, even if apparently protected by collateral value, have shown weakness related to adverse financial, managerial, economic, market or political conditions, which may jeopardize repayment of principal and interest. There is possibility that some future loss could be sustained by the Company if such weakness is not corrected. The Doubtful category includes loans that are in default or principal exposure is probable. Substandard and Doubtful loans are individually evaluated to determine if they should be classified as impaired and an allowance is allocated if deemed necessary under ASC 310-10.

The loans that are not impaired are included with the remaining “pass” credits in determining the portion of the allowance for loan loss based on historical loss experience and other qualitative factors. The portfolio is segmented into categories including: commercial loans, consumer loans, commercial real estate loans, residential real estate loans and agricultural loans. The adjusted historical loss percentage is applied to each category. Each category is then added together to determine the allowance allocated under ASC 450-20.

A summary of loans by credit quality indicator by class as of September 30, 2014 and December 31, 2013, is as follows:

	Pass	Pass/ Watch	OAEM	Substandard	Doubtful	Total
September 30, 2014						
Commercial	$576,180	$9,355	$1,496	$457	$—	$587,488
Commercial real estate, construction, land and land development	1,599,245	9,381	6,384	11,492	—	1,626,502
Residential real estate	471,541	2,680	195	5,298	—	479,714
Single-family interim construction	116,785	—	—	—	—	116,785
Agricultural	43,510	58	—	7	—	43,575
Consumer	36,818	44	8	97	—	36,967
Other	161	—	—	—	—	161
	$2,844,240	$21,518	$8,083	$17,351	$—	$2,891,192
December 31, 2013						
Commercial	$231,080	$7,199	$1,311	$1,453	$135	$241,178
Commercial real estate, construction, land and land development	952,863	10,697	2,982	7,214	—	973,756
Residential real estate	328,918	5,379	454	3,903	—	338,654
Single-family interim construction	83,144	—	—	—	—	83,144
Agricultural	40,328	210	—	20	—	40,558
Consumer	45,556	82	39	85	—	45,762
Other	108	—	—	—	—	108
	$1,681,997	$23,567	$4,786	$12,675	$135	$1,723,160

The Company has acquired certain loans which experienced credit deterioration since origination (purchased credit impaired (PCI) loans). Accretion on PCI loans is based on estimated future cash flows, regardless of contractual maturity. There are no PCI loans outstanding for acquisitions prior to 2012.

The following table summarizes the outstanding balance and related carrying amount of purchased credit impaired loans by acquired bank as of the respective acquisition date for the acquisitions occurring in 2014 and 2013:

	Acquisition Date		
	April 15, 2014	January 1, 2014	November 30, 2013
	Bank of Houston	Live Oak	Collin Bank
Outstanding balance	$55,718	$3,583	$11,897
Nonaccretable difference	(5,798)	(519)	(1,810)
Accretable yield	(2,579)	(182)	(408)
Carrying amount	$47,341	$2,882	$9,679

The carrying amount of all acquired PCI loans included in the consolidated balance sheet and the related outstanding balance at September 30, 2014 and December 31, 2013, were as follows:

	September 30, 2014	December 31, 2013
Outstanding balance	$61,690	$15,768
Carrying amount	52,680	13,777

At September 30, 2014 and December 31, 2013, there was no allocation established in the allowance for loan losses related to purchased credit impaired loans.

Note 5. Commitments and Contingencies

Financial Instruments with Off-Balance Sheet Risk
The Company is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. The commitments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the balance sheet.
The Company’s exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit is represented by the contractual amount of this instrument. The Company uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments.
At September 30, 2014 and December 31, 2013, the approximate amounts of these financial instruments were as follows:

	September 30, 2014	December 31, 2013
Commitments to extend credit	$559,620	$365,575
Standby letters of credit	7,147	2,120
	$566,767	$367,695

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Company evaluates each customer’s credit worthiness on a case-by-case basis. The amount of collateral obtained if deemed necessary by the Company upon extension of credit is based on management’s credit evaluation of the counterparty. Collateral held varies but may include accounts receivable, inventory, farm crops, property, plant and equipment and income-producing commercial properties.
Letters of credit are written conditional commitments used by the Company to guarantee the performance of a customer to a third party. The Company’s policies generally require that letter of credit arrangements contain security and debt covenants similar to those contained in loan arrangements. In the event the customer does not perform in accordance with the terms of the agreement with the third party, the Company would be required to fund the commitment. The maximum potential amount of future payments the Company could be required to make is represented by the contractual amount shown in the table above. If the commitment is funded, the Company would be entitled to seek recovery from the customer. As of September 30, 2014 and December 31, 2013, no amounts have been recorded as liabilities for the Company’s potential obligations under these guarantees.

Litigation
The Company is involved in certain legal actions arising from normal business activities. Management believes that the outcome of such proceedings will not materially affect the financial position, results of operations or cash flows of the Company.

Lease Commitments
The Company leases certain branch facilities and other facilities. Rent expense related to these leases amounted to $391 and $907 for the three and nine months ended September 30, 2014, respectively, and $168 and $538 for the three and nine months ended September 30, 2013, respectively.

Note 6. Repurchase Agreements and Other Borrowings

The Company assumed repurchase agreement accounts in the Live Oak acquisition on January 1, 2014. At September 30, 2014 and December 31, 2013, repurchase accounts totaled $5,235 and $0, respectively. Securities held in safekeeping totaling $5,890 are pledged as security on these repurchase agreement accounts.

In June 2014, the Company entered into a $35 million unsecured revolving line of credit with an unrelated bank. The line bears interest at LIBOR plus 2.50% and matures May 3, 2015. As of September 30, 2014 there is no outstanding balance on the line.

In July 2014, the Company issued $65 million of 5.875% subordinated notes (Notes) which are due August 1, 2024. Interest on the Notes will be payable semiannually beginning February 1, 2015. The notes may not be redeemed prior to maturity and meet the criteria to be recognized as Tier 2 capital for regulatory purposes.

Other borrowings, including those borrowings due to related parties totaled $72,730 and $7,730 at September 30, 2014 and December 31, 2013, respectively.

Note 7. Income Taxes

In connection with the initial public offering, the Company terminated its S-Corporation status and became a taxable entity (C Corporation) on April 1, 2013. As such, any periods prior to March 31, 2013 do not reflect income tax expense.

Income tax expense for the three and nine months ended September 30, 2014 and 2013 was as follows:

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2014	2013	2014	2013
Current income tax expense	$4,543	$1,927	$9,564	$3,932
Initial recording of deferred tax benefit	—	—	—	(1,760)
Income tax expense for the period	$4,543	$1,927	$9,564	$2,172
Effective tax rate	33.6%	32.7%	33.6%	12.3%

The reported income tax expense for the nine months ended September 30, 2013 reflects the initial recording of the deferred tax net asset of $1,760, which is the result of timing differences in the recognition of income/deductions for generally accepted accounting principles (GAAP) and tax purposes. Without the initial recording of the deferred tax benefit, the effective tax rate would have been 32.8%. The effective tax rates differ from the statutory federal tax rate of 35% largely due to tax exempt interest income earned on certain investment securities and loans and the nontaxable earnings on bank owned life insurance.

Note 8. Fair Value Measurements

The fair value of an asset or liability is the price that would be received to sell that asset or paid to transfer that liability in an orderly transaction occurring in the principal market (or most advantageous market in the absence of a principal market) for such asset or liability. In estimating fair value, the Company utilizes valuation techniques that are consistent with the market approach, the income approach and/or the cost approach. Such valuation techniques are consistently applied. Inputs to valuation techniques include the assumptions that market participants would use in pricing an asset or liability. ASC Topic 820, Fair Value Measurements and Disclosures, establishes a fair value hierarchy for valuation inputs that gives the highest priority to quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. The fair value hierarchy is as follows:

Level 1 Inputs – Unadjusted quoted prices in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date.

Level 2 Inputs – Inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. These might include quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, inputs other than quoted prices that are observable for the asset or liability (such as interest rates, volatilities, prepayment speeds, credit risks, etc.) or inputs that are derived principally from or corroborated by market data by correlation or other means.

Level 3 Inputs – Unobservable inputs for determining the fair values of assets or liabilities that reflect an entity's own assumptions about the assumptions that market participants would use in pricing the assets or liabilities.

The following table represents assets reported on the consolidated balance sheets at their fair value on a recurring basis as of September 30, 2014 and December 31, 2013 by level within the ASC Topic 820 fair value measurement hierarchy:

		Fair Value Measurements at Reporting Date Using		
	Assets/ Liabilities Measured at Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
September 30, 2014				
Measured on a recurring basis:				
Assets:				
Investment securities available for sale:				
U.S. treasuries	$1,008	$—	$1,008	$—
Government agency securities	67,407	—	67,407	—
Obligations of state and municipal subdivisions	74,637	—	74,637	—
Corporate bonds	1,069	—	1,069	—
Residential pass-through securities guaranteed by FNMA, GNMA, FHLMC and FHR	91,723	—	91,723	—
December 31, 2013				
Measured on a recurring basis:				
Assets:				
Investment securities available for sale:				
U.S. treasuries	$3,513	$—	$3,513	$—
Government agency securities	94,415	—	94,415	—
Obligations of state and municipal subdivisions	36,615	—	36,615	—
Corporate bonds	2,052	—	2,052	—
Residential pass-through securities guaranteed by FNMA, GNMA, FHLMC and FHR	57,443	—	57,443	—

There were no transfers between level categorizations for the periods presented.

A description of the valuation methodologies used for instruments measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy, is set forth below.

Securities classified as available for sale are reported at fair value utilizing Level 2 inputs. For these securities, the Company obtains fair value measurements from an independent pricing service. The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury and other yield curves, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the security's terms and conditions, among other things.

Contingent consideration, related to the acquisition of Town Center Bank in 2010, was reported at fair value using Level 3 inputs. The contingent consideration was remeasured on a recurring basis based on the expected present value of cash flows to be paid to the shareholders of the acquired institution using a market discount rate. In August 2013, the Company paid the final contingent payment. The following table presents the activity in the contingent consideration for the nine months ended September 30, 2013:

	Nine months ended September 30, 2013
Balance, beginning of period	$290

Settlements	(287)
Change in estimated payments to be made	(3)
Balance, end of period	$—

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In accordance with ASC Topic 820, certain assets and liabilities are measured at fair value on a nonrecurring basis; that is, the assets and liabilities are not measured at fair value on an ongoing basis but are subject to fair value adjustments in certain circumstances (for example, when there is evidence of impairment). The following table presents the assets carried on the consolidated balance sheet by caption and by level in the fair value hierarchy at September 30, 2014 and December 31, 2013, for which a nonrecurring change in fair value has been recorded:

		Fair Value Measurements at Reporting Date Using			
	Assets Measured at Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Period Ended Total (Gains) Losses
September 30, 2014					
Measured on a nonrecurring basis:					
Assets:					
Impaired loans	$2,453	$—	$—	$2,453	$(3)
Other real estate	138	—	—	138	$22
December 31, 2013					
Measured on a nonrecurring basis:					
Assets:					
Impaired loans	$1,514	$—	$—	$1,514	$497
Other real estate	2,449	—	—	2,449	537

Impaired loans (loans which are not expected to repay all principal and interest amounts due in accordance with the original contractual terms) are measured at an observable market price (if available) or at the fair value of the loan's collateral (if collateral dependent). Fair value of the loan's collateral is determined by appraisals or independent valuation, which is then adjusted for the estimated costs related to liquidation of the collateral. Management's ongoing review of appraisal information may result in additional discounts or adjustments to valuation based upon more recent market sales activity or more current appraisal information derived from properties of similar type and/or locale. Therefore, the Company has categorized its impaired loans as Level 3.

The Company has no nonfinancial assets or nonfinancial liabilities measured at fair value on a recurring basis. Other real estate is measured at fair value on a nonrecurring basis (upon initial recognition or subsequent impairment). Other real estate is classified within Level 3 of the valuation hierarchy. When transferred from the loan portfolio, other real estate is adjusted to fair value less estimated selling costs and is subsequently carried at the lower of carrying value or fair value less estimated selling costs. The fair value is determined using an external appraisal process, discounted based on internal criteria.

In addition, mortgage loans held for sale are required to be measured at the lower of cost or fair value. The fair value of mortgage loans held for sale is based upon binding quotes or bids from third party investors. As of September 30, 2014 and December 31, 2013, all mortgage loans held for sale were recorded at cost.

The methods and assumptions used by the Company in estimating fair values of financial instruments as disclosed herein in accordance with ASC Topic 825, Financial Instruments, other than for those measured at fair value on a recurring and nonrecurring basis discussed above, are as follows:

Cash and cash equivalents: The carrying amounts of cash and cash equivalents approximate their fair value.

Loans and loans held for sale: For variable-rate loans that reprice frequently and have no significant changes in credit risk, fair values are based on carrying values. Fair values for certain mortgage loans (for example, one-to-four family residential), commercial real estate and commercial 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.

Federal Home Loan Bank of Dallas and other restricted stock: The carrying value of restricted securities such as stock in the Federal Home Loan Bank of Dallas and Independent Bankers Financial Corporation approximates fair value.

Deposits: The fair values disclosed for demand deposits are, by definition, equal to the amount payable on demand at the reporting date (that is their carrying amounts). The carrying amounts of variable-rate certificates of deposit (CDs) approximate their fair values at the reporting date. Fair values for fixed-rate CDs are estimated using a discounted cash flow calculation that applies interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturities on time deposits.

Federal Home Loan Bank advances, line of credit and federal funds purchased: The fair value of advances maturing within 90 days approximates carrying value. Fair value of other advances is based on the Company's current borrowing rate for similar arrangements.

Repurchase agreements and other borrowings: The carrying value of repurchase agreements approximates fair value due to the short term nature. The fair values of private subordinated debentures are based upon prevailing rates on similar debt in the market place. The subordinated notes that are publicly traded are valued based on indicative bid prices based upon market pricing observations in the current market.

Junior subordinated debentures: The fair value of junior subordinated debentures is estimated using discounted cash flow analyses based on the Company's current incremental borrowing rates for similar types of borrowing arrangements.

Accrued interest: The carrying amounts of accrued interest approximate their fair values.

Off-balance sheet instruments: Commitments to extend credit and standby letters of credit have short maturities and therefore have no significant fair value.

The carrying amount, estimated fair value and the level of the fair value hierarchy of the Company’s financial instruments were as follows at September 30, 2014 and December 31, 2013:

			Fair Value Measurements at Reporting Date Using		
	Carrying Amount	Estimated Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
September 30, 2014					
Financial assets:					
Cash and cash equivalents	$249,769	$249,769	$249,769	$—	$—
Securities available for sale	235,844	235,844	—	235,844	—
Loans held for sale	1,811	1,811	—	1,811	—
Loans, net	2,874,084	2,895,276	—	2,893,319	1,957
FHLB of Dallas stock and other restricted stock	15,715	15,715	—	15,715	—
Accrued interest receivable	8,025	8,025	—	8,025	—
Financial liabilities:					
Deposits	2,813,660	2,816,258	—	2,816,258	—
Accrued interest payable	1,936	1,936	—	1,936	—
FHLB advances	324,424	323,936	—	323,936	—
Repurchase agreements	5,235	5,235	—	5,235	—
Other borrowings	72,730	74,884	—	74,884	—
Junior subordinated debentures	18,147	18,127	—	18,127	—
Off-balance sheet assets (liabilities):					
Commitments to extend credit	—	—	—	—	—
Standby letters of credit	—	—	—	—	—
December 31, 2013					
Financial assets:					
Cash and cash equivalents	$93,054	$93,054	$93,054	$—	$—
Securities available for sale	194,038	194,038	—	194,038	—
Loans held for sale	3,383	3,383	—	3,383	—
Loans, net	1,709,200	1,714,815	—	1,710,228	4,587
FHLB of Dallas stock and other restricted stock	9,494	9,494	—	9,494	—
Accrued interest receivable	4,713	4,713	—	4,713	—
Financial liabilities:					
Deposits	1,710,319	1,712,654	—	1,712,654	—
Accrued interest payable	948	948	—	948	—
FHLB advances	187,484	189,092	—	189,092	—
Other borrowings	7,730	8,061	—	8,061	—
Junior subordinated debentures	18,147	18,099	—	18,099	—
Off-balance sheet assets (liabilities):					
Commitments to extend credit	—	—	—	—	—
Standby letters of credit	—	—	—	—	—

Note 9. Stock Awards and Stock Warrants
The Company grants common stock awards to certain employees of the Company. The common stock issued prior to 2013 vests five years from the date the award is granted and the related compensation expense is recognized over the vesting period. In connection with the initial public offering in April 2013, the Board of Directors adopted a new 2013 Equity Incentive Plan. Under this plan, the Compensation Committee may grant awards in the form of restricted stock, restricted stock rights, restricted stock units, qualified and nonqualified stock options, performance-based share awards and other equity-based awards. The Plan reserved 800,000 shares of common stock to be awarded by the Company’s compensation committee. The shares currently issued under the 2013 Plan are restricted and will vest evenly over the required employment period, ranging from three to five years. Shares granted under a previous plan prior to 2012 and those in and subsequent to 2013 under the 2013 Equity Incentive Plan were issued at the date of grant and receive dividends. Shares issued under a revised plan in 2012 are not outstanding shares of the Company until they vest and do not receive dividends.
The following table summarizes the activity in nonvested shares for the nine months ended September 30, 2014 and 2013:

	Number of Shares	Weighted Average Grant Date Fair Value
Nonvested shares, December 31, 2013	306,524	$22.75
Granted during the period	189,069	56.70
Vested during the period	(121,364)	19.93
Forfeited during the period	(1,194)	30.37
Nonvested shares, September 30, 2014	373,035	$40.85
Nonvested shares, December 31, 2012	208,608	$17.07
Granted during the period	119,540	28.68
Vested during the period	(22,716)	14.30
Nonvested shares, September 30, 2013	305,432	$22.16

Compensation expense related to these awards is recorded based on the fair value of the award at the date of grant and totaled $841 and $2,011 for the three and nine months ended September 30, 2014, respectively and $455 and $1,049 for the three and nine months ended September 30, 2013, respectively. Compensation expense is recorded in salaries and employee benefits in the accompanying consolidated statements of income. At September 30, 2014, future compensation expense is estimated to be $12,662 and will be recognized over a remaining weighted average period of 3.69 years.
The fair value of common stock awards that vested during the nine months ended September 30, 2014 and 2013 was $6,288 and $641, respectively. The Company has recorded $1,326 and $9 to additional paid in capital, which represents the excess tax benefit recognized on the vested shares for the nine months ended September 30, 2014 and 2013, respectively.
At September 30, 2014, the future vesting schedule of the nonvested shares is as follows:

First year	84,041
Second year	83,920
Third year	97,110
Fourth year	75,364
Fifth year	32,600
Total nonvested shares	373,035

The Company has issued warrants representing the right to purchase 150,544 shares of Company stock at $17.19 per share to certain Company directors and shareholders. The warrants were issued in return for the shareholders' agreement to repurchase the subordinated debt outstanding to an unaffiliated bank in the event of Company default. The warrants expire in December 2018 and were recorded as equity at a fair value of $475 as of the date of the warrants issuance. The Company recorded this amount as debt origination costs and was amortizing it over the term of the debt. In April 2013, the Company paid off the subordinated debt and wrote off the remaining balance of $223 of the debt origination costs to interest expense.

Note 10. Regulatory Matters

Under banking law, there are legal restrictions limiting the amount of dividends the Bank can declare. Approval of the regulatory authorities is required if the effect of dividends declared would cause the regulatory capital of the Bank to fall below specified minimum levels. For state banks, subject to regulatory capital requirements, payment of dividends is generally allowed to the extent of net profits.

The Company (on a consolidated basis) and the Bank are subject to various regulatory capital requirements administered by federal and state banking agencies. 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 the Company’s consolidated financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and the Bank must meet specific capital guidelines that involve quantitative measures of assets, liabilities and certain off-balance sheet items as calculated under regulatory accounting practices. The capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios (set forth in the table below) of total and Tier I capital (as defined in the regulations) to risk weighted assets (as defined), and of Tier I capital (as defined) to average assets (as defined). Management believes, as of September 30, 2014 and December 31, 2013, the Company and the Bank meet all capital adequacy requirements to which they are subject.

As of September 30, 2014 and December 31, 2013, the Bank’s capital ratios exceeded those levels necessary to be categorized as “well capitalized” under the regulatory framework for prompt corrective action. To be categorized as “well capitalized," the Bank must maintain minimum total risk based, Tier I risk based and Tier I leverage ratios as set forth in the table. There are no conditions or events since that notification that management believes have changed the Bank’s category.

The actual capital amounts and ratios of the Company and Bank as of September 30, 2014 and December 31, 2013, are presented in the following table:

	Actual			Minimum for Capital Adequacy Purposes			To Be Well Capitalized Under Prompt Corrective Action Provisions		
	Amount	Ratio		Amount	Ratio		Amount	Ratio	
September 30, 2014									
Total capital to risk weighted assets:									
Consolidated	$384,794	13.36	%	$230,356	8.00	%	N/A	N/A	
Bank	361,351	12.57		229,997	8.00		$287,496	10.00	%
Tier I capital to risk weighted assets:									
Consolidated	297,770	10.34		115,178	4.00		N/A	N/A	
Bank	344,511	11.98		114,998	4.00		172,498	6.00	%
Tier I capital to average assets:									
Consolidated	297,770	8.50		140,132	4.00		N/A	N/A	
Bank	344,511	9.98		138,090	4.00		172,613	5.00	%

December 31, 2013										
Total capital to risk weighted assets:										
Consolidated	$234,794	13.83	%	$135,801	8.00	%	N/A	N/A		
Bank	212,656	12.54		135,648	8.00		$169,560	10.00	%	
Tier I capital to risk weighted assets:										
Consolidated	214,650	12.64		67,901	4.00		N/A	N/A		
Bank	198,696	11.72		67,824	4.00		101,736	6.00	%	
Tier I capital to average assets:										
Consolidated	214,650	10.71		80,204	4.00		N/A	N/A		
Bank	198,696	9.97		79,710	4.00		99,637	5.00	%	

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Note 11. Small Business Lending Fund Preferred Stock

In connection with the acquisition of BOH Holdings on April 15, 2014, the Company entered into an Assignment and Assumption Agreement with BOH Holdings to acquire all assets and assume all liabilities of BOH Holdings. BOH Holdings participated in the US Treasury's Small Business Lending Fund (SBLF) program. The SBLF is a U.S. Department of the Treasury lending program that encourages qualified community banks to partner with small businesses and entrepreneurs to create jobs and promote economic development in local communities. As a result of continued participation in the program, the Company issued 23,938.35 shares of Senior Non-Cumulative Perpetual SBLF Preferred Stock, Series A at $1,000 par value to the US Treasury Department in exchange for the 23,938.35 shares of BOH Series C SBLF Preferred Stock.

The SBLF Preferred Stock qualifies as Tier 1 capital. The holders of SBLF Preferred Stock are entitled to receive non-cumulative dividends, payable quarterly. The dividend rate was determined based on the level of Qualified Small Business Lending at BOH Holdings and was set at 1.00% at time of acquisition. The Company qualified for the 1.00% rate continuing through January 2016, at which time the dividend rate will increase to 9.00%. During the three and nine months ended September 30, 2014, the Company recorded preferred stock dividends of $60 and $109, respectively.

The Series A Preferred Stock is non-voting, except in limited circumstances. The Company may redeem the shares of Series A Preferred Stock, in whole or in part, at any time at a redemption price equal to the sum of the Liquidation Amount of $1,000 per share and the per share amount of any unpaid dividends for the then-current period, subject to any required prior approval by the Company’s primary federal banking regulator.

Note 12. Business Combinations

Collin Bank

During the nine months ended September 30, 2014, the Company made certain measurement-period adjustments to previous purchase accounting estimates for the November 30, 2013 acquisition of Collin Bank. The differences from estimated values resulted from completion of the valuations. The following table summarizes the previously reported estimates and the measurement-period adjustments made to asset and liability accounts to derive at the final purchase accounting allocations for Collin Bank.

	As Reported at December 31, 2013	Measurement Period Adjustments	Final Recorded Value
Assets of acquired bank:			
Cash and cash equivalents	$22,792	$—	$22,792
Securities available for sale	62,373	—	62,373
Loans	72,611	(328)	72,283
Premises and equipment	141	—	141
Investment in FHLB stock	1,156	—	1,156
Goodwill	5,962	752	6,714
Core deposit intangible	600	(18)	582
Deferred tax asset	1,385	109	1,494
Other assets	775	10	785
Total assets	$167,795	$525	$168,320

Liabilities of acquired bank:			
Deposits	$111,164	$505	$111,669
FHLB advances	26,000	—	26,000
Other liabilities	358	20	378
Total liabilities	$137,522	$525	$138,047
Common stock issued in the Collin Bank transaction	$11,861	$—	$11,861
Cash paid in the Collin Bank transaction	$18,412	$—	$18,412

Live Oak Financial Corp.
On January 1, 2014, the Company acquired 100% of the outstanding stock of Live Oak Financial Corp. and its wholly owned subsidiary, Live Oak State Bank, Dallas, TX (Live Oak) with one branch located east of downtown Dallas. The Company issued 235,594 shares of Company stock and paid $10.0 million in cash for the outstanding shares of Live Oak common stock.

The Company recognized goodwill of $6,988, which is calculated as the excess of both the consideration exchanged and liabilities assumed compared to the fair market value of identifiable assets acquired. The goodwill in this acquisition resulted from a combination of expected synergies and a desirable branch location. None of the goodwill recognized is expected to be deductible for income tax purposes.

During the nine months ended September 30, 2014, the Company made measurement-period adjustments to increase goodwill by $32, other assets by $18 and deposits by $50. The Company has incurred expenses related to the acquisition of approximately $354 and $357 during the nine months ended September 30, 2014 and year ended December 31, 2013, respectively, which is included in acquisition expenses in the consolidated statements of income. The acquisition is not considered significant to the Company's financial statements and therefore, pro forma financial data is not included.

Non-credit impaired loans had a fair value of $68,256 at the date of acquisition and contractual balances of $68,351. The difference of $95 will be recognized into interest income as an adjustment to yield over the life of the loans.

Fair values of the assets acquired and liabilities assumed in this transaction as of the closing date are as follows:

Assets of acquired bank:	
Cash and cash equivalents	$32,246
Securities available for sale	16,740
Loans	71,304
Premises and equipment	2,600
Goodwill	6,988
Core deposit intangible	882
Other assets	248
Total assets	$131,008
Liabilities of acquired bank:	
Deposits	$105,010
Repurchase agreements	3,733
Other liabilities	565
Total liabilities	$109,308
Common stock issued in the Live Oak transaction	$11,700
Cash paid in the Live Oak transaction	$10,000

BOH Holdings

On April 15, 2014, the Company acquired 100% of the outstanding stock of BOH Holdings, Inc. and its subsidiary, Bank of Houston (BOH), Houston, Texas. This transaction gives the Company six branches in the greater Houston area. The Company issued 3,615,886 shares of Company stock and paid $34,010 in cash for the outstanding shares of BOH common stock. In addition, the Company issued 23,938.35 shares of Senior Non-Cumulative Perpetual Preferred Stock, Series A to the US Treasury Department in exchange for the 23,938.35 shares of BOH Series C Preferred Stock. The preferred stock is senior to the Company's common stock with respect to dividend rights and liquidation.

The Company has recognized a provisional amount of goodwill of approximately $165.2 million which is calculated as the excess of both the consideration exchanged and liabilities assumed compared to the fair market value of identifiable assets acquired. The goodwill in this acquisition resulted from a combination of expected synergies and entrance into a desirable Texas market. None of the goodwill recognized is expected to be deductible for income tax purposes.

The Company has incurred expenses related to the acquisition of approximately $1,715 for the nine months ended September 30, 2014, which is included in acquisition expenses in the consolidated statements of income. The Company incurred expenses of $592 during the year ended December 31, 2013. In addition, for the nine months ended September 30, 2014, the Company paid offering costs totaling $550 which were recorded as a reduction to stock issuance proceeds through additional paid in capital. Provisional estimates have been recorded for the acquisition as independent valuations have not been finalized. The Company does not not expect any significant differences from estimated values upon completion of the valuations.

Estimated fair values of the assets acquired and liabilities assumed in this transaction as of the closing date are as follows:

	Initially recorded at Acquisition Date	Measurement Period Adjustments	Adjusted Values
Assets of acquired bank:			
Cash and cash equivalents	$135,525	$—	$135,525
Securities available for sale	59,141	—	59,141
Loans	786,761	(1,166)	785,595
Premises and equipment	7,211	—	7,211
Other real estate	1,191	33	1,224
Goodwill	164,766	397	165,163
Core deposit intangible	7,265	—	7,265
Other assets	27,394	162	27,556
Total assets acquired	$1,189,254	$(574)	$1,188,680
Liabilities of acquired bank:			
Deposits	$820,752	$—	$820,752
FHLB Advances	95,000	—	95,000
Other liabilities	6,737	(574)	6,163
Total liabilities assumed	$922,489	$(574)	$921,915
Common stock issued at $57.75 per share	$208,817	$—	$208,817
Series A Preferred Stock Exchanged in connection with acquired bank	$23,938	$—	$23,938
Cash paid	$34,010	$—	$34,010

Pro forma net income for the nine months ended September 30, 2014 and 2013 was $19,519 and $23,710, respectively and pro forma revenue was $119,310 and $102,424, respectively had the transaction occurred as of January 1, 2014. Pro forma after tax net income for the year ended December 31, 2013 was $26,959 and pro forma revenue was $139,164 had the transaction occurred on January 1, 2013.

Note 13. Subsequent Events

Business Combination - Houston City Bancshares

On October 1, 2014, the Company acquired 100% of the outstanding stock of Houston City Bancshares, Inc. and its wholly owned subsidiary, Houston Community Bank, Houston, TX (HCB) with six branches located in the Houston area. The Company issued 637,856 shares of Company stock and paid approximately $16.8 million in cash for the outstanding shares of HCB common stock.

The Company recognized a provisional amount of goodwill of $19.6 million, which is calculated as the excess of both the consideration exchanged and liabilities assumed compared to the fair market value of identifiable assets acquired. The goodwill in this acquisition resulted from a combination of expected synergies and the intent to expand our presence in the Houston market. None of the goodwill recognized is expected to be deductible for income tax purposes.

Management is still evaluating the loan portfolio but does not anticipate a significant amount of credit-impaired loans.

The Company has incurred expenses related to the acquisition of approximately $180 and $337 during the three and nine months ended September 30, 2014, which is included in acquisition expenses in the consolidated statements of income. The acquisition is not considered significant to the Company's financial statements and therefore, pro forma financial data is not included.

Provisional estimates have been recorded for the acquisition as independent valuations have not been finalized. The Company does not not expect any significant differences from estimated values upon completion of the valuations.

Estimated fair values of the assets acquired and liabilities assumed in this transaction as of the closing date are as follows:

Assets of acquired bank:	
Cash and cash equivalents	$118,825
Securities available for sale	3,549
Loans	196,791
Premises and equipment	8,678
Goodwill	19,602
Core deposit intangible	1,801
Other assets	1,498
Total assets	$350,744
Liabilities of acquired bank:	
Deposits	$303,092
Other liabilities	582
Total liabilities	$303,674
Common stock issued in the HCB transaction	$30,266
Cash paid for the HCB transaction	$16,804

Declaration of Dividends

On November 4, 2014, the Company declared a quarterly cash dividend in the amount of $0.06 per share of common stock to the stockholders of record on November 14, 2014. The dividend will be paid on November 26, 2014.

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ITEM 2. MANAGEMENT’S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Cautionary Note Regarding Forward Looking Statements

This Quarterly Report on Form 10-Q, our other filings with the SEC, and other press releases, documents, reports and announcements that we make, issue or publish may contain statements that we believe are “forward-looking statements” within the meaning of the Private Securities Litigation Reform Act of 1995. These forward-looking statements are statements or projections with respect to matters such as our future results of operations, including our future revenues, income, expenses, provision for taxes, effective tax rate, earnings per share and cash flows, our future capital expenditures and dividends, our future financial condition and changes therein, including changes in our loan portfolio and allowance for loan losses, our future capital structure or changes therein, the plan and objectives of management for future operations, our future or proposed acquisitions, the future or expected effect of acquisitions on our operations, results of operations and financial condition, our future economic performance and the statements of the assumptions underlying any such statement. Such statements are typically identified by the use in the statements of words or phrases such as “aim,” “anticipate,” “estimate,” “expect,” “goal,” “guidance,” “intend,” “is anticipated,” “is estimated expected,” “is intended,” “objective,” “plan,” “projected,” “projection,” “will affect,” “will be,” “will continue,” “will decrease “will impact,” “will increase,” “will incur,” “will reduce,” “will remain,” “will result,” “would be,” variations of such words or phrases (including where the word “could”, “may” or “would” is used rather than the word “will” in a phrase) and similar words and phrases indicating that the statement addresses some future result, occurrence, plan or objective. The forward-looking statements that we make are based on the Company’s current expectations and assumptions regarding its business, the economy, and other future conditions. Because forward-looking statements relate to future results and occurrences, they are subject to inherent uncertainties, risks and changes in circumstances that are difficult to predict. The Company’s actual results may differ materially from those contemplated by the forward-looking statements, which are neither statements of historical fact nor guarantees or assurances of future performance. Many possible events or factors could affect the future financial results and performance of the Company and could cause such results or performance to differ materially from those expressed in forward-looking statements. These factors include, but are not limited to, the following:

- worsening business and economic conditions nationally, regionally and in our target markets, particularly in Texas and the geographic areas in which we operate;
- our dependence on our management team and our ability to attract, motivate and retain qualified personnel;
- the concentration of our business within our geographic areas of operation in Texas;
- deteriorating asset quality and higher loan charge-offs;
- concentration of our loan portfolio in commercial and residential real estate loans and changes in the prices, values and sales volumes of commercial and residential real estate;
- inaccuracy of the assumptions and estimates we make in establishing reserves for probable loan losses and other estimates;
- lack of liquidity, including as a result of a reduction in the amount of sources of liquidity we currently have;
- material decreases in the amount of deposits we hold;
- regulatory requirements to maintain minimum capital levels;
- changes in market interest rates that affect the pricing of our loans and deposits and our net interest income;
- fluctuations in the market value and liquidity of the securities we hold for sale;
- effects of competition from a wide variety of local, regional, national and other providers of financial, investment and insurance services;
- changes in economic and market conditions that affect the amount of assets we have under administration;
- the institution and outcome of litigation and other legal proceeding against us or to which we become subject;
- the occurrence of market conditions adversely affecting the financial industry generally;
- the impact of recent and future legislative and regulatory changes, including changes in banking, securities and tax laws and regulations and their application by our regulators, such as the Dodd-Frank Wall Street Reform and Consumer Protection Act, or the Dodd-Frank Act;

- changes in accounting policies and practices, as may be adopted by the bank regulatory agencies, the Financial Accounting Standards Board, the SEC and Public Company Accounting Oversight Board:
- governmental monetary and fiscal policies;
- changes in the scope and cost of FDIC insurance and other coverage;
- the effects of war or other conflicts, acts of terrorism (including cyber attacks) or other catastrophic events, including storms, droughts, tornadoes and flooding, that may affect general economic conditions;

- our actual cost savings resulting from the acquisitions of BOH Holdings, Houston City Bancshares, Live Oak Financial Corp. and Collin Bank are less than expected, we are unable to realize those cost savings as soon as expected or we incur additional or unexpected costs;
- our revenues after the BOH Holdings, Inc., Houston City Bancshares, Live Oak Financial Corp. and Collin Bank acquisitions are less than expected;
- deposit attrition, operating costs, customer loss and business disruption before and after our completed acquisitions, including, without limitation, difficulties in maintaining relationships with employees, may be greater than we expected;
- the risk that the businesses of the Company, and financial institutions that it has or will acquire, will not be integrated successfully, or such integrations may be more difficult, time-consuming or costly than expected;
- the quality of the assets acquired from other organizations being lower than determined in our due diligence investigation and related exposure to unrecoverable losses on loans acquired;
- general business and economic conditions in our markets change or are less favorable than expected;
- changes occur in business conditions and inflation;
- personal or commercial customers’ bankruptcies increase;
- technology-related changes are harder to make or are more expensive than expected; and
- the other factors that are described or referenced in Part II, Item 1A. of this Quarterly Report on Form 10-Q under the caption “Risk Factors.”

We urge you to consider all of these risks, uncertainties and other factors carefully in evaluating all such forward-looking statements we may make. As a result of these and other matters, including changes in facts, assumptions not being realized or other factors, the actual results relating to the subject matter of any forward-looking statement may differ materially from the anticipated results expressed or implied in that forward-looking statement. Any forward-looking statement made by the Company in any report, filing, press release, document, report or announcement speaks only as of the date on which it is made. The Company undertakes no obligation to update any forward-looking statement, whether as a result of new information, future developments or otherwise, except as may be required by law.

A forward looking-statement may include a statement of the assumptions or bases underlying the forward-looking statement. The Company believes it has chosen these assumptions or bases in good faith and they are reasonable. However, the Company cautions you that assumptions or bases almost always vary from actual results, and the differences between assumptions or bases and actual results can be material. The Company undertakes no obligation to publicly update or otherwise revise any forward-looking statements, whether as a result of new information, future events or otherwise.

Overview

This Management’s Discussion and Analysis of Financial Condition and Results of Operations analyzes the major elements of the Company’s financial condition and results of operation as reflected in the interim consolidated financial statements and accompanying notes appearing in this Quarterly Report on Form 10-Q. This section should be read in conjunction with the Company’s interim consolidated financial statements and accompanying notes included elsewhere in this report and with the consolidated financial statements included in the Annual Report on Form 10-K for the year ended December 31, 2013.

The Company was organized as a bank holding company in 2002. On January 1, 2009, we merged with Independent Bank Group Central Texas, Inc., and, since that time, we have pursued a strategy to create long-term shareholder value through organic growth of our community banking franchise in our market areas and through selective acquisitions of complementary banking institutions with operations in our market areas. On April 8, 2013, the Company consummated the initial public offering, or IPO, of its common stock which began trading on the NASDAQ Global Market on April 3, 2013. Effective January 1, 2014, the Company’s common stock began trading on the NASDAQ Global Select Market.

At September 30, 2014, the Company operated 35 full service banking locations, with 22 located in the Dallas/North Texas region, 7 located in the Austin/Central Texas region and 6 in the Houston region. The Company’s headquarters are located at 1600 Redbud, Suite 400, McKinney, Texas 75069, and its telephone number is (972) 562-9004. The Company’s website address is www.ibtx.com. Information contained on the Company’s website is not incorporated by reference into this Quarterly Report on Form 10-Q and is not part of this or any other report.
Our principal business is lending to and accepting deposits from businesses, professionals and individuals. We conduct all of our banking operations through Independent Bank, which is a Texas state banking corporation and our principal subsidiary (the Bank). We derive our income principally from interest earned on loans and, to a lesser extent, income from securities available for sale. We also derive income from non-interest sources, such as fees received in connection with various deposit services and

mortgage brokerage operations. From time to time, we also realize gains on the sale of assets and, in some instances, gains on acquisitions. Our principal expenses include interest expense on interest-bearing customer deposits, advances from the Federal Home Loan Bank of Dallas, or the FHLB, and other borrowings, operating expenses, such as salaries, employee benefits, occupancy costs, data processing and communication costs, expenses associated with other real estate owned, other administrative expenses, provisions for loan losses and our assessment for FDIC deposit insurance.

Certain Events Affect Year-over-Year Comparability

Acquisitions. During 2013 and the first nine months of 2014, the Company completed three acquisitions. These acquisitions increased total assets, gross loans and deposits on the respective acquisition dates as detailed below.

	Acquisition Date	Total Assets	Gross Loans	Deposits
Collin Bank	November 29, 2013	$168.3 million	$72.3 million	$111.7 million
Live Oak Financial Corp.	January 1, 2014	131.0 million	71.3 million	105.0 million
BOH Holdings	April 15, 2014	1.2 billion	785.6 million	820.8 million

The comparability of the Company's consolidated financial condition as of December 31, 2013 and September 30, 2014 and results of operations for the three and nine months ended September 30, 2014 and 2013 are affected by these acquisitions.

In addition, as of September 30, 2014, the Company had one acquisition pending, Houston City Bancshares, which closed October 1, 2014.

S Corporation Status

From its formation in 2002 through March 31, 2013, the Company elected to be taxed for federal income tax purposes as an S corporation under the provisions of Section 1361 through 1379 of the Internal Revenue Code. As a result, the Company’s net income was not subject to, and the Company did not pay, U.S. federal income taxes, and the Company was not required to make any provision or recognize any liability for federal income tax in its financial statements for the periods ended on or prior to March 31, 2013. The Company terminated its status as an S corporation in connection with its initial public offering. Starting April 1, 2013, the Company became subject to corporate federal income tax and the Company’s net income for each subsequent fiscal year and each subsequent interim period will reflect a provision for federal income taxes. As a result of that change in the Company’s status under the federal income tax laws, the net income and earnings per share data presented in the Company’s historical financial statements set forth elsewhere in this report, which do not include any provision for federal income taxes, are not be comparable with the Company’s net income and earnings per share in periods in which the Company is taxed as a C corporation.

Deferred tax assets and liabilities are, and in future periods will be, recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of any change in tax rates will be recognized in income in the quarter such change takes place. On April 1, 2013, the Company recorded an initial net deferred tax asset of $1.8 million to recognize the difference between the financial statement carrying amounts of assets and liabilities and their respective tax bases as of the date that the Company became a taxable corporate entity.

Discussion and Analysis of Results of Operations for the Three and Nine Months Ended September 30, 2014 and 2013

The following discussion and analysis of our results of operations compares our results of operations for the three and nine months ended September 30, 2014 with the three and nine months ended September 30, 2013. The results of operations for the three and nine months ended September 30, 2014 are not necessarily indicative of the results of operations that may be expected for all of the year ending December 31, 2014.

Results of Operations

For the three months ended September 30, 2014, net income was $9.0 million ($0.54 per common share on a diluted basis) compared with $4.0 million ($0.33 per common share on a diluted basis) for the three months ended September 30, 2013. The Company posted annualized returns on average common equity of 7.60% and 7.30%, returns on average assets of 0.95% and 0.81% and efficiency ratios of 60.5% and 68.6% for the three months ended September 30, 2014 and 2013, respectively. The efficiency ratio is calculated by dividing total noninterest expense (which does not include the provision for loan losses) by net interest income plus noninterest income.

For the nine months ended September 30, 2014, net income was $18.9 million ($1.25 per common share on a diluted basis) compared to $15.5 million ($1.43 per common share on a diluted basis) for the nine months ended September 30, 2013. The nine months ended September 30, 2013 includes the initial recording of the deferred tax benefit of $1.8 million due to the Company's change in taxable status effective April 1, 2013. Pro forma net income after excluding the Company's initial deferred tax benefit was $11.9 million ($1.10 per common share on a diluted basis) for the nine months ended September 30, 2013. The Company posted annualized returns on average common equity of 6.54% and 10.85%, returns on average assets of 0.81% and 1.12% and efficiency ratios of 66.5% and 67.0% for the nine months ended September 30, 2014 and 2013, respectively.

Net Interest Income

The Company’s net interest income is its interest income, net of interest expenses. Changes in the balances of the Company’s earning assets and its deposits, FHLB advances and other borrowings, as well as changes in the market interest rates, affect the Company’s net interest income. The difference between the Company’s average yield on earning assets and its average rate paid for interest-bearing liabilities is its net interest spread. Noninterest-bearing sources of funds, such as demand deposits and stockholders’ equity, also support the Company’s earning assets. The impact of the noninterest-bearing sources of funds is reflected in the Company’s net interest margin, which is calculated as annualized net interest income divided by average earning assets.

Net interest income was $32.4 million for the three months ended September 30, 2014, an increase of $13.5 million, or 75.3%, from $18.9 million at September 30, 2013. This increase is due primarily to a $1.4 billion increase, or 78.3%, in average interest earning assets to $3.2 billion for the three months ended September 30, 2014 compared to $1.8 billion for the three months ended September 30, 2013. The greatest part of the increases in interest-earning assets and interest-bearing deposits occurred as a result of the acquisitions the Company completed in November 2013, January 2014 and April 2014 but was also due in part to organic loan and deposit growth. The net interest margin for the three months ended September 30, 2014 decreased 16 basis points to 4.04% compared to 4.20% for the three months ended September 30, 2013. The decrease from the prior year is due to interest expense on subordinated debt issued in July 2014 (9 basis point effect on net interest margin for the quarter) and a decrease in loan yields of 55 basis points from the prior year. The average yield on interest earning assets decreased 25 basis points from 4.85% to 4.60%. The effect of this decrease was partially offset by a decrease in the average rate paid on interest bearing liabilities of 7 basis points from 0.80% to 0.73%. This change was due to a decrease in the cost of deposits and the repayment of notes payable and subordinated indebtedness during 2013 partially offset by the increase in other borrowings due to the new issuance of the subordinated debt.

Net interest income was $86.0 million for the nine months ended September 30, 2014, an increase of $30.1 million, or 56.4%, from $55.0 million for the same period in 2013. The increase is due primarily to a $1.1 billion increase, or 62.8%, in average interest earning assets to $2.8 billion for the nine months ended September 30, 2014 compared to $1.7 billion for the nine months ended September 30, 2013. The greatest part of the increases in interest-earning assets and interest-bearing deposits occurred as a result of the acquisitions the Company completed in November 2013, January 2014 and April 2014 but was also due in part to organic loan and deposit growth. The net interest margin for the nine months ended September 30, 2014 decreased 17 basis points to 4.16% compared to 4.33% for the nine months ended September 30, 2013. The average yield on interest earning assets decreased 37 basis points from 5.07% to 4.70%. The effect of this decrease was partially offset by a decrease in the average rate paid on interest bearing liabilities of 19 basis points from 0.89% to 0.70%.

Average Balance Sheet Amounts, Interest Earned and Yield Analysis. The following table presents average balance sheet information, interest income, interest expense and the corresponding average yields earned and rates paid for the three and nine months ended September 30, 2014 and 2013. The average balances are principally daily averages and, for loans, include both performing and nonperforming balances.

	For The Three Months Ended September 30,							
	2014				2013			
	Average Outstanding Balance	Interest	Yield/ Rate [3]		Average Outstanding Balance	Interest	Yield/ Rate [3]	
(dollars in thousands)								
Interest-earning assets:								
Loans [1]	$2,878,566	$35,633	4.91	%	$1,535,460	$21,140	5.46	%
Taxable securities	170,804	711	1.65		91,075	358	1.56	
Nontaxable securities	69,784	404	2.30		29,926	258	3.42	
Federal funds sold and other	67,908	192	1.12		131,422	85	0.26	
Total interest-earning assets	3,187,062	$36,940	4.60		1,787,883	$21,841	4.85	
Noninterest-earning assets	534,261				154,981			
Total assets	$3,721,323				$1,942,864			
Interest-bearing liabilities:								
Checking accounts	$1,126,424	$1,288	0.45		$754,835	$952	0.50	
Savings accounts	125,027	92	0.29		113,321	94	0.33	
Money market accounts	111,675	94	0.33		56,161	39	0.28	
Certificates of deposit	696,272	1,056	0.60		332,405	632	0.75	
Total deposits	2,059,398	2,530	0.49		1,256,722	1,717	0.54	
FHLB advances	303,458	975	1.27		162,009	819	2.01	
Notes payable, repurchase agreements and other borrowings	56,413	871	6.13		13,819	253	7.26	
Junior subordinated debentures	18,147	133	2.91		18,147	137	3.00	
Total interest-bearing liabilities	2,437,416	4,509	0.73		1,450,697	2,926	0.80	
Noninterest-bearing checking accounts	785,054				266,334			
Noninterest-bearing liabilities	10,647				10,652			
Stockholders' equity	488,206				215,181			
Total liabilities and equity	$3,721,323				$1,942,864			
Net interest income		$32,431				$18,915		
Interest rate spread			3.87	%			4.05	%
Net interest margin [2]			4.04				4.20	
Average interest earning assets to interest bearing liabilities			130.76				123.24	

(1) Average loan balances include nonaccrual loans.

(2) Net interest margins for the periods presented represent: (i) the difference between interest income on interest-earning assets and the interest expense on interest-bearing liabilities, divided by (ii) average interest-earning assets for the period.

(3) Yield and rates for the three-month periods are annualized.

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For The Nine Months Ended September 30,		
2014		2013
Average Outstanding Balance	Interest	